

THE INTERNATIONAL  
CAPITAL MARKETS  
REVIEW

NINTH EDITION

Editor  
Jeffrey Golden

THE LAWREVIEWS

# THE INTERNATIONAL CAPITAL MARKETS REVIEW

NINTH EDITION

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# CONTENTS

|   |     |
|---|-----|
| PREFACE.....  | v   |
| <i>Jeffrey Golden</i>   |     |
| Chapter 1      AUSTRALIA.....   | 1   |
| <i>Ian Paterson</i>   |     |
| Chapter 2      BRAZIL.....  | 27  |
| <i>Ricardo Simões Russo, Marcello Mammocchi Pompilio and Felipe Moraes Assunção</i> |     |
| Chapter 3      CHINA.....   | 34  |
| <i>Lei (Raymond) Shi</i>  |     |
| Chapter 4      COLOMBIA.....  | 47  |
| <i>Camilo Martínez Beltrán and Sebastian Celis Rodríguez</i>                        |     |
| Chapter 5      DENMARK.....   | 59  |
| <i>Rikke Schiøtt Petersen, Morten Nybom Bethe and Knuth Larsen</i>                  |     |
| Chapter 6      FRANCE.....  | 69  |
| <i>Olivier Hubert and Arnaud Pince</i>  |     |
| Chapter 7      GERMANY.....   | 89  |
| <i>Stefan Henkelmann and Lennart Dahmen</i>   |     |
| Chapter 8      JAPAN.....   | 97  |
| <i>Akihiro Wani and Reiko Omachi</i>  |     |
| Chapter 9      KUWAIT.....  | 114 |
| <i>Abdullah Alharoun</i>  |     |
| Chapter 10      LUXEMBOURG.....   | 126 |
| <i>Frank Mausen, Henri Wagner and Paul Péporté</i>                                  |     |

|            |   |     |
|------------|---|-----|
| Chapter 11 | MEXICO .....  | 153 |
|            | <i>Julián Garza, Gunter A Schwandt and Jenny Ferrón C</i>                           |     |
| Chapter 12 | NETHERLANDS.....  | 162 |
|            | <i>Marieke Driessen and Niek Groenendijk</i>  |     |
| Chapter 13 | NEW ZEALAND.....  | 181 |
|            | <i>Deemle Budhia and Ling Yan Pang</i>  |     |
| Chapter 14 | NIGERIA.....  | 191 |
|            | <i>Fred Onuobia and Ayodele Ashiata Kadiri</i>                                      |     |
| Chapter 15 | PORTUGAL.....   | 201 |
|            | <i>José Pedro Fazenda Martins, Orlando Vogler Guiné and Soraia Ussene</i>           |     |
| Chapter 16 | RUSSIA .....  | 213 |
|            | <i>Vladimir Khrenov</i>   |     |
| Chapter 17 | SPAIN.....  | 229 |
|            | <i>David García-Ochoa Mayor and Carlos Montoro Esteve</i>                           |     |
| Chapter 18 | SWITZERLAND .....   | 240 |
|            | <i>François M Bianchi, Daniel Bono, Andrea Giger and Till Spillmann</i>             |     |
| Chapter 19 | THAILAND .....  | 248 |
|            | <i>Patcharaporn Pootranon, Veerakorn Samranweth and Natcharee Apichotsuratsamee</i> |     |
| Chapter 20 | TURKEY.....   | 262 |
|            | <i>Ömer Çollak, Ökkeş Şaban and Nazlı Tönük Çapan</i>                               |     |
| Chapter 21 | UNITED ARAB EMIRATES .....  | 277 |
|            | <i>Gregory J Mayew and Silvia A Pretorius</i>                                       |     |
| Chapter 22 | UNITED KINGDOM .....  | 292 |
|            | <i>Anna Delgado, Tim Morris, Thomas Picton, Paul Miller and Jonathan Walsh</i>      |     |
| Chapter 23 | UNITED STATES .....   | 303 |
|            | <i>Mark Walsh and Michael Hyatte</i>  |     |
| Appendix 1 | ABOUT THE AUTHORS.....  | 323 |
| Appendix 2 | CONTRIBUTORS' CONTACT DETAILS.....  | 341 |

# PREFACE

This book serves two purposes – one obvious, but the other possibly less so.

Quite obviously, and one reason for its continuing popularity, *The International Capital Markets Review* addresses the comparative law aspect of our readers' international capital markets (ICM) workload and equips them with a reference source. Globalisation and technological change mean that the transactional practice of a capital markets lawyer, wherever based, no longer enjoys the luxury – if ever it did – of focusing solely at home within the confines of a single jurisdiction. Globalisation means that fewer and fewer opportunities or challenges are truly local, and technology more and more permits a practitioner to tackle international issues.

Moreover, clients certainly may have multi-jurisdictional ambitions or, even if unintended, their activities often may risk multi-jurisdictional impact. In such cases, it would be a brave but possibly foolish counsel who assumed: 'The only law, regulation and jurisdiction that matter are my own!'

Ironically, the second purpose this book aims to serve is to equip its readers to do a better job as practitioners at home. In other words, reading the summaries of foreign lawyers, who can describe relevant foreign laws and practices, is perfectly consistent with and helpful when interpreting and giving advice about one's own law and practice.

As well as giving guidance for navigating a particular local but, from the standpoint of the reader, foreign scene, the comparative perspectives presented by our authors present an agenda for thought, analysis and response about home jurisdiction laws and regulatory frameworks, thereby also giving lawyers, in-house compliance officers, regulators, law students and law teachers an opportunity to create a checklist of relevant considerations both in light of what is or may currently be required in their own jurisdiction but also as to where things there could, or should, best be headed (based on best practices of another jurisdiction) for the future.

Thus, an unfamiliar and still-changing legal jurisdiction abroad may raise awareness and stimulate discussion, which in turn may assist practitioners to revise concepts, practices and advice in both our domestic and international work. Why is this so important? The simple answer is that it cannot be avoided in today's ICM practice. Just as importantly, an ICM practitioner's clients would not wish us to have a more blinkered perspective.

Not long ago, I had the honour of sharing the platform with a United Kingdom Supreme Court Justice, a distinguished Queen's Counsel and three American academics. Our topic was 'Comparative Law as an Appropriate Topic for Courts'. The others concentrated their remarks, as might have been expected, on the context of matters of constitutional law, and that gave rise to a spirited debate. I attempted to take some of the more theoretical

aspects of our discussion and ground them in the specific example of capital markets, and particularly the over-the-counter derivatives market.

Activity in that market, I said, could be characterised as truly global. More to the point, I posited, that, whereas you might get varied answers if you asked a country's citizens whether they considered it appropriate for a court to take account of the experiences of other jurisdictions when considering issues of constitutional law, in my view derivatives market participants would uniformly wish courts to at least be aware of and consider relevant financial market practice beyond their jurisdictional borders and comparative jurisprudence (especially from English and New York courts, which are most often called upon to adjudicate disputes about derivatives), even when traditional approaches to contract construction as between courts in different jurisdictions may have differed.

In such cases, with so much at stake given the volumes of financial market trading on standard terms, and given the complexity and technicality of many of the products and the way in which they are traded and valued, there appears to me to be a growing interest in comparative law analysis and an almost insatiable appetite among judges to know at least how experienced courts have answered similar questions.

There is no reason to think that ICM practitioners are any differently situated in this regard, or less in need of or less benefited by a comparative view when facing up to the often technical and complex problems confronting them, than are judges. After all, it is only human nature to wish not to be embarrassed or disadvantaged by what you do not know.

Of course, it must be recognised that there is no substitute for actual and direct exchanges of information between lawyers from different jurisdictions. Ours should be an interdependent professional world. A world of shared issues and challenges, such as those posed by market regulation. A world of instant communication. A world of legal practices less constrained by jurisdictional borders. In that sense and to that end, the directory of experts and their law firms in the appendices to this book may help to identify local counterparts in potentially relevant jurisdictions. And, in that case, I hope that reading the content of this book may facilitate discussions with a relevant author.

In conclusion, let me add that our authors are indeed the heroes of the stories told in the pages that follow. My admiration for our contributing experts, as I wrote in the preface to the last edition, continues. It remains, too, a distinct privilege to serve as their editor, and once again I shall be glad if their collective effort proves helpful to our readers when facing the challenges of their ICM practices amid the growing interdependence of our professional world.

**Jeffrey Golden**

Joint Head of Chambers

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London

October 2019



# AUSTRALIA

*Ian Paterson*<sup>1</sup>

## I INTRODUCTION

Australia has vibrant, professional and well-regulated capital markets that are increasingly open to foreign issuers.<sup>2</sup> Australia ranked fifth in the world's leading financial systems and capital markets in the 2012 Financial Development Report published by the World Economic Forum.<sup>3</sup>

The recent 'Why Australia: Benchmark Report 2019' from the Australian Trade Commission indicates that Australia's capital markets comprise, inter alia:

- a* the third-largest stock market, by market capitalisation of freely floating stocks, in the Asian region, and the ninth-largest globally;
- b* the third-largest debt capital market in the Asian region; and
- c* the fourth-largest superannuation (retirement savings) industry in the world.<sup>4</sup>

### i Structure and regulation

Australia is a federation with three different levels of government: commonwealth (or federal), state and territory, and local (or municipal). As a general rule, commonwealth legislation governs access to, and the operation and supervision of, Australia's capital markets. Under the Constitution, the commonwealth has power to legislate in relation to, among other matters, corporations, interstate and international trade and commerce, taxation, banking and insurance. Australia has an independent judicial system that reflects the constitutional division of powers between the commonwealth government and the state and territory governments.

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1 Ian Paterson is a senior partner at King & Wood Mallesons. This chapter has been updated with the help of Louise Yun, an associate at King & Wood Mallesons.

2 By way of example, the amount of long-term non-government debt securities issued in Australia by non-residents, which include foreign governments and their agencies, international and supranational organisations, and a range of foreign financial institutions and companies (the 'kangaroo' bond market), increased from A\$8.9 billion to just under A\$200 billion in bonds outstanding during the 13 years to September 2016. In 2017, just under A\$35 billion worth of kangaroo bonds were issued. As of late 2018, Austraclear held approximately A\$200 billion in kangaroo bonds. In February 2019, McDonald's and General Motors issued their first ever Australian dollar bonds.

3 The report defines financial development as the factors, policies and institutions that lead to effective financial intermediation and markets, as well as deep and broad access to capital and financial services. Seven measures of financial development are identified in the report, available at [www.weforum.org](http://www.weforum.org).

4 See 'Why Australia: Benchmark Report 2019', Australian Trade Commission (April 2019), available at [www.austrade.gov.au](http://www.austrade.gov.au).

The broad framework for the regulation of the financial sector, including capital markets, is determined by the commonwealth government. The issuance and trading of debt and equity securities, derivatives, securitisation and other financial products is primarily governed by Chapters 6D and 7 of the Corporations Act 2001 of Australia (Corporations Act) (which applies throughout the country), as well as by the common law and principles of equity.<sup>5</sup>

Under the Corporations Act, the term financial product is defined in general terms, and there are specific inclusions and exclusions. Broadly, a financial product is any facility through which a person makes a financial investment, manages financial risk or makes non-cash payments, even if the facility is used for some other purpose. The specific inclusions illustrate the wide scope of the concept, and include equity and debt securities, interests in managed investment schemes (i.e., unit trusts and other collective investments), derivatives, foreign exchange contracts, most insurance contracts, most superannuation (retirement savings) products, most deposit-taking facilities provided by Australian banks and other authorised deposit-taking institutions (ADIs), and government debenture and bond issues. The specific exclusions are generally products that are more suitably regulated under some other regime (such as credit facilities and payment systems).

Australia's framework for the regulation of the financial sector and the issuance of financial products is based on three separate agencies operating on functional lines. These regulatory bodies have primary responsibility for maintaining the safety and soundness of markets and regulated institutions, protecting consumers and promoting systemic stability through implementing and administering the applicable regulatory regimes. Specifically:

- a* the Australian Securities and Investments Commission (ASIC) is the corporate, markets and financial services regulator responsible for market conduct and investor protection;
- b* the Australian Prudential Regulation Authority (APRA) is responsible for the prudential regulation and supervision of banks and other ADIs, life and general insurance companies, and most participants in the superannuation industry; and
- c* the Reserve Bank of Australia (RBA) is responsible for monetary policy, overseeing financial system stability and the payments system.

The Council of Financial Regulators (CFR) is the coordinating body for Australia's main financial regulatory agencies. It is a non-statutory body whose role is to contribute to the efficiency and effectiveness of financial regulation, to promote the stability of the Australian financial system and to advise the commonwealth government on the adequacy of Australia's financial regulatory arrangements. Its membership comprises the RBA (which chairs the CFR), APRA, ASIC and the Commonwealth Treasury.

In addition, the Australian Competition and Consumer Commission (ACCC) is responsible for competition policy, with a mandate that extends across the entire economy, including the financial services sector.

The vibrancy of Australia's capital markets is underpinned by:

- a* a history, since the mid 1980s, of legislative reform promoting growth and investment;
- b* a relatively low level of issuance of traditional government and semi-government fixed-interest securities (owing to budget surpluses), although the volume of issuance has increased in recent years;

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5 Takeovers are separately regulated under Chapter 6 of the Corporations Act, industry-specific regulation (in some cases), the Foreign Acquisitions and Takeovers Act 1975 of Australia and the commonwealth government's foreign investment policy, and are not considered in this chapter.

- c* an increasing demand by investors for a wide range of financial products (because of, in part, increased savings as a result of Australia's compulsory superannuation system);
- d* a highly educated, skilled, multilingual and computer-literate labour market, particularly in the financial sector;
- e* a strategic location in the Asia-Pacific region; and
- f* increasing integration with global capital markets.

In addition to participating in the domestic capital markets, the commonwealth, state and territory governments, semi-government authorities and companies have regularly issued securities and other financial products in international capital markets and the domestic capital markets of a number of foreign countries (most commonly, the United Kingdom, the United States and Japan).

## **ii Prudential regulation and supervision**

APRA's core mission is to establish and enforce prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by the institutions APRA supervises are met within a stable, efficient and competitive financial system. The framework for prudential regulation includes requirements regarding capital adequacy, credit risk, market risk, covered bonds, securitisation, liquidity, credit quality, large exposures, associations with related entities, outsourcing, business continuity management, risk management of credit card activities, audit and related arrangements for prudential reporting, governance, and fit and proper management.<sup>6</sup>

In the prudential standards for ADIs, APRA formally introduced the Basel III definition of regulatory capital, the minimum requirements for the different tiers of capital and stricter eligibility criteria for capital instruments with effect from 1 January 2013. In some instances, similar requirements have been introduced for life and general insurance companies.

There are three main elements in APRA's approach to the Basel III capital reforms, as follows:

- a* the Basel III definition of regulatory capital, the Basel III minimum requirements and eligibility criteria for regulatory capital instruments, and the Basel III regulatory adjustments to capital each specify minimum requirements, with only minor exceptions;
- b* for in-principle reasons, APRA did not adopt the concessional treatment available for certain items in calculating regulatory capital, a discretion that was available under the Basel III reforms. These items are deferred tax assets relating to temporary (timing) differences, significant investments in the common shares of non-consolidated financial institutions and mortgage servicing rights. APRA has never recognised these items in calculating regulatory capital, and in APRA's view, to do so would not be consistent with the objective of raising the quality and quantity of regulatory capital in Australia; and
- c* APRA has adopted an accelerated Basel III timetable in some areas.

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<sup>6</sup> The prudential standards of the Australian Prudential Regulation Authority are available at [www.apra.gov.au](http://www.apra.gov.au).

The chair of APRA has commented that APRA's approach to the Basel III capital reforms 'reflects its firmly held view that conservatism has served Australia well before and during the crisis, that the milestones are not demanding, and that the impact of higher capital requirements on the overall funding costs of ADIs is likely to be small'.<sup>7</sup>

On 1 January 2015, a liquidity coverage ratio (LCR) regime commenced, consistent with the Basel III liquidity framework. ADIs subject to the LCR<sup>8</sup> must at all times be able to demonstrate their ability to withstand a minimum of 30 days of severe liquidity stress. ADIs subject to the LCR are able to apply for a committed liquidity facility (CLF) made available by the RBA. The CLF is sufficient in size to cover any shortfall between ADIs' holdings of high-quality liquid assets (presently limited to commonwealth and state government securities) and the requirement to hold such assets under the LCR.

Capital conservation and countercyclical buffers for ADIs were introduced on 1 January 2016. ADIs are now required to meet a minimum common equity capital requirement of 7 per cent of risk-weighted assets, including the capital conservation buffer. Dividends and other discretionary payments will be constrained if levels of common equity capital fall below that percentage. The countercyclical buffer will be deployed by APRA in periods when excess aggregate credit growth is adjudged to be associated with a build-up of system-wide risk to ensure the banking system has a buffer of capital to protect it against future potential losses. As at January 2019, the countercyclical buffer has remained unchanged at zero per cent since its introduction.<sup>9</sup> However, it may be varied over time between zero and 2.5 per cent depending on market conditions.

APRA has also developed a framework for dealing with domestic systemically important banks, which came into effect on 1 January 2016. Its work on capital strength, liquidity management, securitisation, resolution planning, conglomerate groups and shadow banking is ongoing.

### **iii Access, authorisation and licensing**

An Australian entity is not required to obtain any general government authorisations or consents prior to issuing securities in Australia. In most cases, the only authorisations and consents required are those prescribed by the issuer's constitutional documents or governing statute.

Foreign companies are also not subject to any direct government controls in issuing securities in Australia<sup>10</sup> and, since April 1991, foreign governments, their agencies and

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7 APRA Annual Report 2012, Chapter 1, page 11, available at <https://www.apra.gov.au/file/10371>.

8 Authorised deposit-taking institutions with larger or more complex operations, which are required by APRA's prudential standards to conduct scenario analyses of their liquidity needs under different operating circumstances.

9 See APRA's annual Information Paper (29 January 2019) on the countercyclical capital buffer at <https://www.apra.gov.au>.

10 The Corporations Act requires that foreign companies that carry on business in Australia must apply for registration as a foreign company. The phrase carrying on business imports notions of system, repetition and continuity, and is to be assessed by reference to the activities of the foreign company as a whole.

Registration involves reserving a name, appointing a local agent, establishing a registered office, lodging certain documents with ASIC and the payment of a fee. However, as long as a foreign issuer of securities is not involved in other business in Australia, occasional issues into the debt markets limited to professional investors should not, of themselves, constitute carrying on business in Australia. If a foreign company issuer issues debt securities in circumstances that require a prospectus (broadly, an issue not limited to

international organisations have also been permitted to raise funds in the Australian domestic debt capital markets, subject to some limited restrictions (e.g., the debt securities must be in registered, not bearer, form). However, the issuance of other types of financial products, and the trading of both securities and other financial products, may require the issuer or trader to hold an Australian financial services licence (AFSL) from ASIC under Chapter 7 of the Corporations Act (or be exempt from the requirement to do so).

A person who carries on a financial services business in Australia (including a person who engages in conduct that is intended, or likely, to induce people in Australia to use his or her financial services)<sup>11</sup> is required to hold an AFSL (or be exempt from the requirement to do so). A person provides a financial service if he or she engages in certain activities, in particular:

- a* providing financial product advice;
- b* issuing or otherwise dealing in a financial product;
- c* making a market for a financial product;
- d* operating a registered managed investment scheme; or
- e* providing a custodial or depository service (i.e., holding financial products on behalf of others).<sup>12</sup>

Although numerous exemptions are available for particular financial services or financial products (e.g., an entity issuing its own securities, or the acquisition and disposal of a financial product if a party is dealing on its own behalf provided that it is not the issuer of that financial product),<sup>13</sup> there are few exemptions of general application. ASIC currently provides a number of limited class order exemptions for certain regulated foreign financial institutions that operate in foreign jurisdictions that have a similar level of investor protection to Australia.<sup>14</sup> However, this relief is due to expire on 31 March 2020, and ASIC is consulting on a new licensing framework for foreign financial service providers with wholesale clients in Australia and a proposal to replace its limited connection exemption with a new funds management exemption for a limited range of funds management or portfolio management services.<sup>15</sup>

APRA has clarified its policy expectations with respect to business conducted in Australia, or with Australian customers, by foreign banks that are not authorised to carry on banking business in Australia as a foreign ADI (i.e., through a local branch).<sup>16</sup> APRA

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professional investors), it is taken to carry on business in Australia and must register as a foreign company. Registration or exemption may also be required under other legislation in certain circumstances including, without limitation, the Banking Act 1959 of Australia or the Financial Sector (Collection of Data) Act 2001 of Australia.

11 Section 911D of the Corporations Act provides for an extended jurisdictional reach in relation to the requirement to hold an Australian financial services licence from ASIC.

12 See Section I.i for a discussion of the general definition of a financial product and specific inclusions within, and specific exclusions from, that definition.

13 In the case of derivatives that are not entered into or acquired on a financial market, each party to the derivative is regarded as the issuer.

14 See 'Foreign financial services providers – practical guidance', available at <https://asic.gov.au>.

15 See ASIC consultation papers 'CP 301 Foreign financial services providers' and 'CP 268 Licensing relief for foreign financial services providers with a limited connection to Australia'.

16 Letters of 14 April 2011 and 23 September 2013 entitled 'Operation of Foreign Banks in Australia' to all ADIs, available at <https://www.apra.gov.au>.

generally takes the position that foreign banks soliciting and operating an active business in Australia should be subject to Australian prudential regulation and supervision, regardless of where the business is booked. However, APRA does not object to a foreign bank conducting limited business with Australian counterparties from its offshore offices, provided certain conditions are satisfied.

There is no requirement that financial products issued in Australia be governed by Australian law, although investors are generally more familiar with Australian law, and there may be investment restrictions precluding a particular investor from purchasing financial products governed by foreign law. In certain cases, there is an expectation that financial products will be governed by Australian law – for example, issues of many financial products to retail clients (see below) and the issue of debt securities in the kangaroo bond market.<sup>17</sup>

Securities issued by Australian financial institutions that are intended to qualify as regulatory capital are required to have provisions relevant to loss absorption governed by Australian law.<sup>18</sup>

A person who undertakes the business of providing financial product advice (e.g., recommending the purchase of securities) requires a licence.<sup>19</sup> Since 1 July 2013, advisers have been subject to a duty for financial advisers to act in the best interests of their clients (subject to a reasonable steps qualification) and place the best interests of their clients ahead of their own when providing personal advice to retail clients; and a ban on conflicted remuneration structures (including commissions and volume-based payments) in relation to the distribution of, and advice about, a range of retail investment products.<sup>20</sup>

An institution that wishes to conduct banking business must be granted an ADI licence by APRA prior to conducting business as an ADI. As at 31 March 2019, there were 145 ADIs operating in Australia.<sup>21</sup> Australian ADIs are major issuers in the domestic and international capital markets, with APRA's July 2019 statistics showing nearly A\$1 trillion in combined total short-term and long-term borrowings for selected ADIs.<sup>22</sup> In May 2018, APRA announced a new restricted ADI framework. The framework allows eligible entities to seek a restricted ADI licence to conduct a limited range of business activities for two years while they build their capabilities. It establishes the eligibility criteria, minimum initial and continuing requirements, and the application of the prudential and reporting standards during the restricted phase of operation.<sup>23</sup>

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17 The terms and conditions of debt securities issued by foreign issuers need to be governed by an Australian law for the following purposes: acceptance in the Austraclear clearing system; inclusion in the domestic bond indices; eligibility for repurchase transactions with the Reserve Bank of Australia (if available); and qualification as regulatory assets for certain general insurance companies in Australia.

18 APRA Prudential Standard APS 111, Attachment E Paragraph 14 and Attachment H Paragraph 13.

19 Sections 766A(1)(b), 766B and 911A of the Corporations Act.

20 The reforms are contained in two separate but related acts: the Corporations Amendment (Future of Financial Advice) Act 2012 of Australia and the Corporations Amendment (Further Future of Financial Advice Measures) Act 2012 of Australia. Further amendments were made in the Corporations Amendment (Financial Advice Measures) Act 2016 of Australia.

21 For more information see APRA's paper 'Statistics: Quarterly authorised deposit-taking institution performance statistics' (released 19 June 2019), available at <https://www.apra.gov.au>.

22 See APRA's 'Monthly Authorised Deposit-taking Institution Statistics' (July 2019), available at <https://www.apra.gov.au>.

23 For more information see 'Phased licensing for authorised deposit-taking institutions' at <https://www.apra.gov.au/phased-licensing-authorised-deposit-taking-institutions>; see also <https://www.apra.gov.au/licensing-guidelines-adis>.

In March 2018, the Treasury Laws Amendment (Banking Measures No. 1) Bill 2017 was passed into law to further regulate non-ADI lenders, including non-ADI mortgage originators.<sup>24</sup> The new law extends APRA's powers to allow APRA to make rules and issue directions relating to the lending activities of non-ADI lenders where it has identified material risks of instability in the Australian financial system. Directions, powers and penalties will also be introduced for non-ADI lenders who contravene a direction from APRA. This will give APRA further control over entities that provide finance in Australia but that are not considered to be conducting banking business under the Banking Act 1959 as they do not take deposits. However, these powers do not extend to the continuing prudential regulation and supervision of non-ADI lenders that APRA currently has over ADIs. The new law also requires certain non-ADI lenders to register under the Financial Sector (Collection of Data) Act 2001 to allow APRA to gain access to their lending data.

#### **iv Offers of securities and other financial products**

Offers for the issue and (in certain cases) the sale or purchase of equity and debt securities<sup>25</sup> in Australia are regulated by Part 6D.2 of the Corporations Act, whereas the issue of other financial products is regulated by Part 7.9 of the Corporations Act. The provisions of the Corporations Act relating to offers of securities, and other financial products for issue or sale, do not apply to offers received outside Australia.<sup>26</sup>

As a general matter, a person must not offer or invite applications for the issue, sale or purchase of securities in Australia (including an offer or invitation that is received by a person in Australia) unless a prospectus or other disclosure document that complies with the form and content requirements of the Corporations Act has been lodged with ASIC. A similar requirement in relation to the lodgement with ASIC of a product disclosure statement (PDS) is set out in Part 7.9 of the Corporations Act in relation to offers for the issue and (in certain cases) the sale or purchase of other financial products.

The basic regulatory approach is based on disclosure. There is no general requirement for a prospectus, PDS or other disclosure document to be vetted or reviewed by ASIC or any other regulator before lodgement and publication. However, ASIC has signalled that there should be a shift away from overreliance on disclosure for consumer protection with the introduction of ASIC's product intervention powers to target consumer detriment for financial and credit products.<sup>27</sup>

At a high level, a prospectus or other disclosure document in relation to securities must contain all information that investors and their professional advisers would reasonably

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24 This law was previously introduced as the Treasury Laws Amendment (Non-ADI Lender Rules) Bill 2017.

25 Although most debt securities issued in the domestic capital market would be debentures and regulated by Chapter 6D.2 of the Corporations Act, some structured debt securities may not be debentures, but rather another type of financial product (e.g., a derivative) or, possibly, a combination of a debenture and another type of financial product, and regulated by Chapter 7 of the Corporations Act.

26 However, the licensing requirements of Chapter 7 can apply to foreign financial services providers (see discussion in Section I.iii in relation to the requirement to hold an AFSL or be exempt from the requirement to do so).

27 For more information, see 'Product intervention powers' in Section II.i.

require to make an informed assessment of specific matters, including the rights and liabilities attaching to the securities offered, and the assets and liabilities, financial position and performance, profits and losses, and prospects of the issuer.<sup>28</sup>

The information must be presented in a clear, concise and effective manner. Similar requirements apply to a PDS or other disclosure document in relation to other financial products, although the precise content requirements vary depending on the financial product. ASIC has published regulatory guidance concerning the main disclosure requirements of Chapter 6D of the Corporations Act, including:

- a* how to word and present a prospectus in a clear, concise and effective manner, including guidance on communication tools and the use of an investment overview to highlight key information;
- b* the content required to satisfy the general disclosure test of the Corporations Act, as well as guidance on business models, risks, financial information and management; and
- c* the specific disclosure required by the Corporations Act, including details of the offer and the interests of persons involved in the offer.<sup>29</sup>

### ***Simple corporate bonds***

The Corporations Amendment (Simple Corporate Bonds and Other Measures) Act 2014 significantly changed the legal processes, documentation and liability for simple corporate bonds offered by an Australian listed company to retail investors. This Act was a welcomed development to assist the development of the retail corporate bond market in Australia.<sup>30</sup>

Essentially, the legislation removed an anomaly in the previous law that required a full prospectus, satisfying equity disclosure standards, for a retail offer of simple corporate bonds by a listed company. Previously, an Australian listed company could issue additional equity to its shareholders with an investor presentation and a ‘cleansing statement’ released on the Australian Securities Exchange (ASX), or raise debt from the wholesale market with a simple offering memorandum and term sheet. Accordingly, the reform aimed to reduce the disparity between requirements for retail debt offers, retail rights issues of additional equity and wholesale debt offers. The key changes are as follows:

- a* defining the debt securities that qualify as simple corporate bonds;<sup>31</sup>
- b* the introduction of a streamlined two-part disclosure regime for offers of simple corporate bonds (a base prospectus with a life of up to three years and a short form offer specific prospectus). The content requirements for a prospectus for a simple corporate bond are set out in regulations;<sup>32</sup>

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28 In the event the offer is of securities (or options over such securities) that are in a class that was continuously quoted on the Australian Securities Exchange (ASX) in the 12 months prior to the issue of the prospectus or other disclosure document, the disclosure requirements are more limited.

29 ASIC, Regulatory Guide 228: Prospectuses: Effective Disclosure for Retail Investors (November 2016).

30 Previously, in 2010, ASIC had provided class order relief to promote the issue of vanilla corporate bonds to retail investors. The relief was intended to simplify the disclosure requirements for certain offers of listed vanilla bonds by allowing offers to be made with reduced disclosure under a short-form prospectus, but very few issues were undertaken pursuant to the class order relief.

31 Among the key requirements are that the securities be debentures, in Australian dollars, for a term not of more than 15 years, not subordinated and not convertible into other classes of securities. Early redemption rights are also regulated.

32 The legislation is now in Sections 713B to 713E of the Corporations Act and Regulation 6D2.04-06 of the Corporations Regulations.



- c* the removal of deemed civil liability for a director of a company making an offer under the prospectus (underwriters and others named in a prospectus, and anyone involved in a contravention, remain subject to the deemed liability); and
- d* changes to the criminal liability for misleading and deceptive statements in relation to a prospectus.

The first issue of a simple corporate bond took place in November 2015 by Australian Unity, and the second in June 2016 by Peet Limited. In April 2017, Villa World Limited became the third company to offer a listed simple corporate bond in Australia. In June 2017, Peet Limited issued another round of simple corporate bonds. In July 2018, Axsesstoday Ltd became the fourth company to successfully launch a simple corporate bond offer in Australia. However, the company was subsequently placed into administration in April 2019.

There remain many other commercial and market forces that need to align for the Australian domestic retail corporate bond market to develop significantly. These include the linking of the retail and corporate trading platforms, the comparative costs of accessing the wholesale and retail markets and further education for investors about this asset class.

### ***Exempt wholesale offers***

The requirement to issue a prospectus or other disclosure document for an offer of securities does not apply where the relevant securities are issued for a consideration of at least A\$500,000 per offeree (disregarding amounts lent by the offeror and its associates). In addition, a prospectus or other disclosure document is not required if potential subscribers and buyers are restricted to professional investors (as defined in the Corporations Act)<sup>33</sup> or the requirements of another exemption are satisfied,<sup>34</sup> allowing an issue for a lesser consideration to occur without disclosure in accordance with the Corporations Act. Similar restrictions can apply to the offering of securities for sale or purchase in the secondary market in certain cases.

Regarding other financial products, similar (but subtly different) exemptions apply: the requirement to issue a PDS or other disclosure document only applies to an offer to a retail client (defined as a person who is not a wholesale client). In summary, a person is a wholesale client if at least one of the following four tests applies (all other persons are retail clients):

- a* the consideration payable for the product is at least A\$500,000;
- b* the product is provided in connection with a business that is not a small business (this normally means at least 20 employees);
- c* the client's net assets are at least A\$2.5 million, or income for each of the past two years is at least A\$250,000; or
- d* the client is a professional investor.

The vast majority of offers of debt securities and other financial products by foreign issuers or offerors are structured so as not to require the issue of a prospectus, PDS or other disclosure document in compliance with the form and content requirements of either Part 6D.2 or 7.9 of the Corporations Act.

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<sup>33</sup> See Section 9 of the Corporations Act.

<sup>34</sup> See Section 708 of the Corporations Act. In particular, Section 708(19) allows an ADI to issue debentures (including retail bonds and notes) without issuing a prospectus or other disclosure document.

### ***Liability issues***

A person must not offer securities or other financial products under a prospectus, PDS or other disclosure document that is misleading or deceptive, or omits material required to be included by either Part 6D.2 or 7.9 of the Corporations Act. Those who may be liable include the issuer, directors of the issuer, other persons named in the disclosure document and persons otherwise involved in the contravention of the disclosure requirements. There is a range of defences to liability for a disclosure document; these are broadly based on the concepts of reasonable enquiry and reasonable reliance (i.e., due diligence defences).<sup>35</sup>

Irrespective of whether the offering of securities or other financial products requires disclosure to investors in accordance with either Part 6D.2 or 7.9 of the Corporations Act, an issuer or offeror may incur liability under various provisions that prohibit:

- a* offering financial products under a document that contains a misleading or deceptive statement, or a statement likely to mislead or deceive;
- b* creating an artificial price for trading in financial products on a financial market operated in Australia;
- c* creating a false or misleading appearance about the market or price for financial products;
- d* spreading misleading or false information;
- e* otherwise engaging in misleading or deceptive conduct, or conduct that is likely to mislead or deceive (including by omission and, in certain circumstances, by remaining silent); or
- f* conduct that is unconscionable.<sup>36</sup>

In general terms, these prohibitions are unlikely to impose any greater restrictions on an issuer or offeror than would be encountered in many segments of the international capital markets.

### ***Debentures and embedded derivatives***

As noted above, offers for the issue of debt securities (i.e., debentures) in Australia are regulated by Part 6D.2 of the Corporations Act, whereas the issue of derivatives is regulated by Part 7.9 of the Corporations Act. Where structured notes are offered, in light of two decisions of the Federal Court of Australia, consideration needs to be given as to whether the note is properly classified as a debenture or a derivative, as this may affect who is licensed to distribute or invest in the note and other duties in respect of the offer.

In the first decision,<sup>37</sup> the Court found that certain complex collateralised debt obligations were properly characterised as ‘undertaking[s] by the [issuer] to repay as a debt money deposited with or lent to the [issuer]’ (i.e., they could have been debentures (although

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35 It is important to note that these defences are not available for wholesale offers of securities and other financial products that are structured so as not to require the issue of a prospectus, product disclosure statement or other disclosure document under either Part 6D.2 or 7.9 of the Corporations Act. The liability regime has also been modified for simple corporate bonds as described above.

36 Additionally, issuers or offerors may be liable at general law in tort or contract if any disclosure to investors is false, inaccurate, misleading or deceptive (including by omission), or negligent.

37 *Wingecarribee Shire Council v. Lehman Brothers Australia Ltd (in liq)* (2012) 301 ALR.

they were not in the particular facts of the case)). In the second decision,<sup>38</sup> the Court found that certain constant proportion debt obligations (CPDOs) in the form of notes were derivatives. It is difficult to reconcile aspects of the reasoning applied in the two decisions.

### ***Liability of rating agencies***

The second Federal Court decision mentioned above is also notable for the finding that Standard and Poor's (S&P) was liable for misleading and deceptive conduct, and negligence, by assigning an AAA rating to the CPDOs. The Court held that the rating conveyed the representation that S&P had reached this opinion based on reasonable grounds and as a result of an exercise of reasonable care. In this case, the representation was misleading and there was a breach of the duty to take reasonable care.

## **v Some other features of Australia's capital markets<sup>39</sup>**

### ***Exchanges***

The ASX was created through the merger of the Australian Stock Exchange and the Sydney Futures Exchange, and is operated by ASX Limited. Previously, the ASX was in charge of supervising and enforcing all market and trading rules in respect of its markets. However, ASIC has now assumed the supervision of trading activities by market participants.

All listed entities must prepare and lodge an annual audited financial report, and an audited or audit-reviewed half-year financial report, complying with Australian accounting standards (which are based on International Financial Reporting Standards). Listed entities must also describe their corporate governance practices in detail in their annual reports. In addition, listed entities and the responsible entities of listed managed investment schemes must comply with the continuous disclosure requirements of the Corporations Act and the ASX Listing Rules,<sup>40</sup> and must immediately disclose (via announcements made to the ASX) any information concerning itself that a reasonable person would expect to have a material effect on the price or value of its securities.<sup>41</sup>

Chi-X Australia Pty Ltd (Chi-X) has, since November 2011, operated as an alternative securities exchange, boosting competition in Australia's financial markets.<sup>42</sup> Chi-X has ASIC

38 *ABN Amro Bank NV v. Bathurst Regional Council* (2014) 224 FCR 1.

39 A general description of Australia's taxation regime is beyond the scope of this chapter but can be found in 'A guide to doing in business in Australia', available at [www.kwm.com](http://www.kwm.com).

40 The interpretation of the Listing Rules is assisted by guidance notes issued by the ASX. Following a period of consultation, a revised guidance note on continuous disclosure (ASX Guidance Note 8) and consequential amendments to the ASX Listing Rules came into effect on 1 May 2013 and was updated on 17 August 2015. Further information on the revised Guidance Note and ASX Listing Rules is available at [www.asx.com.au](http://www.asx.com.au).

41 ASX Listing Rule 3.1. Under ASX Listing Rule 3.1A, there are limited exceptions to this obligation where a reasonable person would not expect the information to be disclosed, and the information is confidential and satisfies one of five specified conditions (including an incomplete proposal). Most listed entities and responsible entities of listed managed investment schemes adopt rigorous monitoring and reporting systems to enable price-sensitive information to be identified and disclosed in a timely fashion. ASIC has been rigorous in the enforcement of the requirement for immediate disclosure of price-sensitive information.

42 In addition to the ASX and Chi-X, there are a number of small regional securities exchanges that operate in Australia.

approval to trade in all S&P/ASX 200 component stocks and ASX-listed exchange traded funds. However, it operates only as an execution forum through which securities quoted on the ASX can be traded.

### ***Hybrid securities***

Many Australian financial institutions and corporates raise finance in capital markets by way of hybrid securities, being securities that combine elements of both debt securities and equity securities. The current market for such securities is dominated by financial institution issuers offering regulatory capital meeting APRA's prudential standards with Additional Tier 1 (AT1) capital being issued principally in the retail market and Tier 2 capital principally in the wholesale market. Australia's taxation system has made AT1 securities attractive to retail investors, as the securities are generally traded as equity for tax purposes and distributions carry an imputation credit that may be offset against other income. Some AT1 securities have distributions carrying an imputation credit while also giving rise to a deduction against the issuer's income outside Australia.

In December 2016, the Board of Taxation released a report following its review of the application of hybrid mismatch rules to regulatory capital in Australia.<sup>43</sup> The Board of Taxation recommended a change in the law to facilitate treatment of AT1 capital instruments as debt for tax purposes. This would have made the securities more attractive to wholesale investors, but it was not taken up. In August 2018, the Treasury Laws Amendment (Tax Integrity and Other Measures No. 2) Bill 2018 was passed to implement the OECD hybrid mismatch rules by preventing entities that are liable to income tax in Australia from being able to avoid paying income tax by exploiting differences between the tax treatment of entities and instruments in difference countries. The new law denies imputation benefits on franked distributions made by a corporate tax entity that give rise to a foreign income tax deduction. The measures will apply to returns on AT1 instruments paid on or after 1 January 2019. Transitional rules apply to AT1 capital instruments issued by ADIs, general insurance companies and life insurance companies before 9 May 2017.

### ***Reporting, clearing and execution of derivatives***

On 6 December 2012, the commonwealth government passed amendments to the Corporations Act under which regulations may be prescribed to designate one or more of the following as mandatory obligations: the reporting of over-the-counter (OTC) derivatives to trade repositories; the clearing of standardised OTC derivatives through central counterparties; and the execution of standardised OTC derivatives on exchanges or electronic trading platforms.

On 9 July 2013, ASIC published the Derivative Transaction Rules (Reporting) 2013 and the Derivative Trade Repository Rules 2013. These rules establish which entities are required to report, what information is required to be reported to trade repositories, when the reporting obligation commences for each class of reporting entities and type of instrument, and the conditions for electronic databases of records of derivative transactions. The rules also regulate the manner in which repositories provide their services and ASIC's approach to regulation of overseas-based repositories. ASIC has granted various forms of relief from the

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<sup>43</sup> See the report entitled 'Application of Hybrid Mismatch Rules to Regulatory Capital' at [https://cdn.tspace.gov.au/uploads/sites/70/2017/05/1216\\_Application\\_of\\_Hybrid\\_Mismatch\\_.pdf](https://cdn.tspace.gov.au/uploads/sites/70/2017/05/1216_Application_of_Hybrid_Mismatch_.pdf).

application of the rules for specified periods of time.<sup>44</sup> From September 2015, single-sided reporting is permitted for entities with low levels of OTC derivative transactions, provided that their counterparty is already required to or has agreed to report.<sup>45</sup>

Following extensive consultation, the Commonwealth Treasury implemented a mandatory central clearing obligation for OTC interest rate derivatives denominated in Australian dollars and G4 currencies (US dollars, euros, British pounds and Japanese yen), with effect from December 2015.<sup>46</sup>

To assist with reporting requirements, and following extensive market consultation, the ASX has established a domestic central clearing solution for participants in the Australian OTC market. In many cases, Australian institutions are finding they have to comply with international derivative regulatory requirements without any local market infrastructure to help. The ASX's OTC clearing service is intended to fill part of this gap, in Australia's time zone, in Australia's currency, in Australia's legal system and with collateral held in Australia. On 13 January 2014, the ASX formally lodged the final form of the Operating Rules with ASIC. The ASX launched the OTC Interest Rate Derivatives Clearing Service on 1 July 2013 for dealer activity, and the Australian Client Clearing Service was launched on 7 April 2014. In mid-2017, ASX commenced use of application programming interface technology for automation of the clearing take-up process and to facilitate pre-clearing client limit checks.

End users do not have to comply with the reporting requirements under the derivative transaction rules.<sup>47</sup> An end user is a person who is not an Australian ADI, a clearing and settlement facility licensee, an Australian financial services licensee, or a person who provides financial services relating to derivatives to wholesale clients only and whose activities relating to derivatives are regulated by an overseas regulatory authority.<sup>48</sup>

### ***Margin and collateral requirements***

With effect from 1 June 2016, the Financial System Legislation Amendment (Resilience and Collateral Protection) Act 2016 has strengthened the enforceability of certain financial collateral arrangements and removed restrictions on certain Australian institutions from providing margins to clearing systems.

### ***Non-centrally cleared derivatives: margin requirements***

Prudential Standard CPS 226: Margining and risk mitigation for non-centrally cleared derivatives commenced on 1 March 2017. Potentially, it affects certain APRA-regulated entities that transact in non-centrally cleared derivatives. Among other things, CPS 226 requires an APRA-covered entity to have appropriate margining practices in relation to non-centrally cleared derivatives, and to apply risk mitigation practices (such as trading

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44 For a list of exemptions previously and currently granted by ASIC, see <https://asic.gov.au/regulatory-resources/markets/otc-derivatives/derivative-transaction-reporting/exemption-relief-for-reporting-entities/>.

45 These reforms were implemented through the Corporations (Derivatives) Amendment Determination 2015 (No. 1) and the Corporations Amendment (Central Clearing and Single-Sided Reporting) Regulation 2015 of Australia, respectively.

46 These reforms were implemented through ASIC Derivative Transaction Rules (Clearing) 2015.

47 See Corporations Act, Section 901D(a); Corporations Regulations 2001 of Australia, Regulation 7.5A.50(2).

48 See Corporations Regulations 2001 of Australia, Regulation 7.5A.50(3).

relationship documentation, trade confirmation, valuation processes and dispute resolution processes). Margin requirements apply from differing periods from 1 March 2017 onwards, depending on an entity's qualifying level under CPS 226.

### ***Financial claims scheme and wholesale funding guarantee***

As part of its response to the global financial crisis, the commonwealth government established both the Financial Claims Scheme (FCS) and the Australian Government Guarantee Scheme for Large Deposits and Wholesale Funding.<sup>49</sup>

The FCS was amended in February 2012 and is now capped at A\$250,000 per person per institution. The FCS is designed to protect depositors by providing them with timely access to their deposits in the event that their ADI becomes insolvent, and APRA has promulgated a prudential standard that requires locally incorporated ADIs to establish a 'single customer view' for balances in accounts protected under the FCS.<sup>50</sup> This cap is estimated to protect in full the savings held in around 99 per cent of Australian deposit accounts.

A claim on the FCS would be met from commonwealth revenue. There is no compensation fund, and plans to establish one have been rejected by the commonwealth.<sup>51</sup>

### ***Corporate governance***

The Australian capital markets have high expectations of corporate governance, which continues to evolve.

Directors' duties are prescribed by legislation, in particular the Corporations Act, and an extensive body of case law (common law). Directors are fiduciaries and owe stringent duties:

- a* to act honestly;
- b* to exercise care and diligence;
- c* to act in good faith in the best interests of a company and for a proper purpose;
- d* not to improperly use their position or company information; and
- e* to disclose their material personal interests and avoid conflicts of interest.

Directors have duties regarding financial and other reporting and disclosure, and can be liable under various laws, including for breaches of fundraising, anti-money laundering, environmental, competition and consumer, privacy, and occupational health and safety laws.

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<sup>49</sup> Access to the Guarantee Scheme for new liabilities was closed in March 2010.

<sup>50</sup> Prudential Standard APS 910 Financial Claims Scheme (APS 910), which came into effect on 1 January 2012. In November 2012, APRA released a consultation package comprising a discussion paper, draft amended APS 910 and draft information paper. The package contained proposals in relation to payment, reporting and communications requirements for further implementation of the FCS. In June 2013, APRA released its response to the proposals outlined in the November 2012 package and issued its final APS 910. The final APS 910 took effect from 1 July 2013, and compliance with the new requirements has been required since 1 July 2014.

<sup>51</sup> A recommendation from the CFR to establish a fund followed recommendations (Paragraphs 51 and 52) in the Financial System Stability Assessment for Australia prepared by the International Monetary Fund in November 2012 (International Monetary Fund Country Report No. 12/308) and available at [www.imf.org](http://www.imf.org). On 1 September 2015, the commonwealth government announced that it will not implement a levy on banks to fund the Financial Stability Fund.

Some defences are available to directors, including under a limited business judgment rule in certain circumstances, for reliance on good faith after making an independent assessment and for appropriate delegation. In recent years, there has been a series of important court judgments on directors' and officers' duties, including the following:

- a *Fortescue Metals Group*: the continuous disclosure requirements of the Corporations Act and the ASX Listing Rules, and the availability of the defence for a director that all steps were undertaken that were reasonable in the circumstances to ensure that the company complied with its obligations and that the director believed on reasonable grounds that the company was complying;<sup>52</sup>
- b *Centro Properties Group and Centro Retail Group*: breaches by directors and officers of their duties in connection with deficiencies in annual financial reports, notwithstanding a finding by the Federal Court of Australia that these persons had acted honestly, had not intended to harm the company and had not benefited in any way in inadequately overseeing the financial reports;<sup>53</sup>
- c *James Hardie Industries*: directors' duties of diligence and care in approving ASX announcements;<sup>54</sup> and
- d *Cassimatis*: an argument that there can be no breach of directors' duties if the directors are the sole shareholders and the company is solvent was rejected by the Court.<sup>55</sup>

These proceedings have prompted considerable academic and public debate as to whether there is a case for law reform in relation to the extent of the duties of directors and officers, and the defences available to them, particularly where a director or officer has made a business judgement in good faith for a proper purpose. In addition to the liabilities imposed by the Corporations Act, a wide range of commonwealth, state and territory statutes impose personal criminal or civil liability, or both, on directors and officers for the actions of their companies. On 11 December 2012, the Personal Liability for Corporate Fault Reform Act 2012 of

52 Judgment in this proceeding was given in favour of the company and its directors by the High Court of Australia on 2 October 2012 in *Forrest v. Australian Securities and Investments Commission; Fortescue Metals Group Ltd v. Australian Securities and Investments Commission* (2012) 247 CLR 486, which overruled the judgment in the Federal Court of Appeal in *Australian Securities and Investments Commission v. Fortescue Metals Group Ltd* (2011) 190 FCR 364. The case of *ASIC v Vocation Ltd (in liq)* [2019] FCA 807 supports findings in *Australian Securities and Investments Commission v. Fortescue Metals Group Ltd* (2011) 190 FCR 364 that the business judgment rule is no defence to failing to comply with continuous disclosure obligations as such continuous disclosure decisions are not business judgments (see at [739]).

53 *Australian Securities and Investments Commission v. Healey* (2011) 196 FCR 291 and *Australian Securities and Investments Commission v. Healey (No. 2)* (2011) 196 FCR 430.

54 *Australian Securities and Investments Commission v. MacDonald (No. 11)* (2009) 256 ALR 199, *Morley v. Australian Securities and Investments Commission* (2010) 274 ALR 205 and *James Hardie Industries NV v. Australian Securities and Investments Commission* (2010) 274 ALR 85. Judgments in these proceedings were given by the High Court of Australia on 3 May 2012. See *Australian Securities and Investments Commission v. Hellicar* (2012) 247 CLR 345 and *Shafon v. Australian Securities and Investments Commission* (2012) 247 CLR 465.

55 *Australian Securities and Investments Commission v. Cassimatis (No. 8)* [2016] FCA 1023 at [496]–[525]. At [525] Edelman J finds that 'the content of a duty of care and diligence can be considerably affected by shareholder consent . . . but . . . the interests of the corporation are not always entirely coincident with the interest of shareholders'. In this regard, directors may still breach their directors' duties under the Corporations Act where they embark on a course of conduct that is highly likely to contravene the law, even where that conduct is authorised by shareholders.

Australia (Reform Act) commenced operation. The Reform Act is intended to harmonise the approach of all Australian jurisdictions to personal criminal liability for corporate fault, and was a direct response by the commonwealth to fulfil commitments under the Council of Australian Governments' directors' liability reform project.<sup>56</sup> The Reform Act removes certain regulatory burdens on directors and officers for corporate fault where such burdens cannot be justified on public policy grounds. For example, it removes personal criminal liability for corporate fault unless a person is dishonestly involved in the relevant contravention and removes the burden of proof on defendants to establish a defence to a charge.<sup>57</sup>

### ***Competition laws***

The Competition and Consumer Act 2010 is the primary competition and consumer protection legislation in force in Australia.<sup>58</sup> The Act is similar to North American and European competition laws, and is administered by the ACCC. The ACCC has an active enforcement policy that may affect capital markets transactions in certain circumstances.

### ***Anti-money laundering***

The Anti-Money Laundering and Counter-Terrorism Financing Act 2006 established an anti-money laundering regime that is administered by the Australian Transaction Reports and Analysis Centre. The regime covers all entities providing designated services through a permanent establishment in Australia.

Designated services include:

- a* deposit-taking;
- b* remittance services;
- c* electronic funds transfers;
- d* foreign exchange contracts;
- e* issuing and selling securities and derivatives;
- f* providing interests in managed investment schemes;
- g* lending and allowing loan transactions; and
- h* finance leasing providing custodial or depositary services, and pensions, annuities and life insurance policies.

### ***Privacy law***

The Privacy Act 1988 regulates the handling of personal information about individuals. This includes the collection, use, storage and disclosure of personal information, and access to and correction of that information.

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<sup>56</sup> Before state governments commenced to enact legislation in accordance with this reform project, there were more than 700 separate state and commonwealth laws imposing personal liability on directors and officers of a company as a result of a statutory breach by that company.

<sup>57</sup> For more information, see the Bills Digest for the Personal Liability for Corporate Fault Reform Bill 2012, available at <https://www.aph.gov.au>.

<sup>58</sup> On 1 January 2011, the Trade Practices Act 1974 of Australia was amended and renamed the Competition and Consumer Act 2010.



The Privacy Amendment (Enhancing Privacy Protection) Act 2012 became law in December 2012 and introduced a new statutory regime with mandatory privacy principles (Australian Privacy Principles) with which all relevant businesses must comply.<sup>59</sup> These principles came into force on 12 March 2014.

The Australian Privacy Principles update and consolidate the privacy principles that previously applied to government agencies (i.e., the Information Privacy Principles) and private sector entities (i.e., the National Privacy Principles), and:

- a* limit the ability of agencies and organisations to use unsolicited personal information, specifically regulate the use and disclosure of personal information held by an agency or organisation for direct marketing purposes, and introduce new responsibilities for agencies and organisations transferring data overseas;
- b* introduce a comprehensive scheme for credit reporting that regulates information disclosed to, and by, credit reporting bodies, credit providers and affected information recipients; and
- c* enhance the powers of the Information Commissioner so that he or she may, inter alia, conduct assessments regarding the Australian Privacy Principles.

Under the Australian Privacy Principles:

- a* an agency may only solicit and collect personal information that is reasonably necessary for, or directly related to, one or more of its functions or activities;
- b* an organisation may only solicit and collect personal information that is reasonably necessary for one or more of its functions or activities;
- c* an agency or organisation may only solicit and collect sensitive information if an individual consents to that information being collected (unless an exception applies); and
- d* an agency or organisation must only solicit and collect personal information by lawful and fair means, and directly from an individual (unless an exception applies).

An agency or organisation must not use or disclose information collected for a purpose other than that for which it was collected unless an individual has consented to that other use or disclosure, or an exception applies.

### ***Personal property securities reform***

The Personal Property Securities Act 2009 (PPSA) commenced operation on 30 January 2012 and introduced a national system for the registration of security interests in personal property, and rules for the creation, priority and enforcement of security interests in personal property. The PPSA partially replaced the existing commonwealth and state-based regimes, including the regime under the Corporations Act for the registration of charges. The PPSA operates with retrospective effect on security interests and security agreements arising prior to the commencement of the legislation.

The PPSA was a very significant change in Australian law that affected corporate finance, bilateral and syndicated lending, leveraged and acquisition finance and project finance more significantly than the capital markets, where issues are mostly unsecured.

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59 The enactment of the Privacy Amendment (Enhancing Privacy Protection) Act is a direct response by the commonwealth government to the Australian Law Reform Commission Report No. 108, 'For Your Information: Australian Privacy Law and Practice'.

A secured party may need to take additional steps under the PPSA to maintain the effectiveness or priority of its existing securities. Further, as a result of the broad definition of security interests under the PPSA, a secured party may need to take steps under the PPSA to maintain the effectiveness or priority of other transactions that, under the previous law, do not constitute security interests (such as retention of title arrangements, certain leases, securitisation transactions and certain subordination arrangements). The system has been substantially modelled on the personal property regimes in New Zealand, Canada and the United States.

In 2014, the commonwealth government conducted a review of the operation and effects of the PPSA. The commonwealth government considered the recommendations of the review and amended the PPSA to implement some of them.<sup>60</sup>

### ***Commonwealth bank levy***

In June 2017, the commonwealth government passed legislation to impose a major bank levy. The levy applies to a limited number of ADIs and is imposed by reference to certain liabilities of the relevant ADI, including corporate bonds, commercial paper, certificates of deposit and Tier 2 capital instruments, at a rate of 0.015 per cent per quarter.

## **II THE YEAR IN REVIEW**

The commonwealth government and regulators have continued their review of the framework for regulation of the financial sector, and for the laws governing access to, and the operation and supervision of, Australia's capital markets. This process commenced in 2010 in response to the global financial crisis. In particular, the commonwealth government remains committed to the initiatives developed through the G20, the Financial Stability Board, the International Monetary Fund and other multilateral institutions to support financial stability and to foster stronger economic growth. Some of the more important recent developments are outlined below.

### **i Developments affecting debt and equity offerings**

#### ***Product intervention powers***

On 5 April 2019, the Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2019 received Royal Assent to introduce a product intervention power available to ASIC where a risk of significant consumer detriment exists, and to introduce design and distribution obligations in relation to financial products. It is important to note that the power may be exercised notwithstanding that a product has otherwise been offered in compliance with disclosure and other applicable laws.

ASIC has sought public input on the proposed administration of its new product intervention power but has not yet released its final regulatory guide. A separate ASIC consultation on its proposed guidance on the design and distribution obligations will commence in late 2019.<sup>61</sup> ASIC has recently released a consultation paper on its proposal to

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<sup>60</sup> Personal Property Securities Amendment (Deregulatory Measures) Act 2015 of Australia.

<sup>61</sup> For more information, see media release 'ASIC consults on new product intervention power use' at <https://asic.gov.au/about-asic/news-centre/find-a-media-release/2019-releases/19-157mr-asic-consults-on-new-product-intervention-power-use/>

exercise its product intervention power to make certain market-wide product intervention orders relating to the issue and distribution of OTC binary options and contracts for difference to retail clients.<sup>62</sup>

### ***Technology and market infrastructure***

In August 2018, the World Bank mandated the Commonwealth Bank of Australia to be the sole arranger of the world's first blockchain bond, termed 'bond-i' (blockchain operated new debt instrument). In May 2019, the World Bank and CBA successfully enabled secondary market trading of this bond-i recorded on blockchain.<sup>63</sup> The bond will be created, allocated, transferred and managed through its life cycle using distributed ledger technology.<sup>64</sup>

### ***Social impact bonds***

In recent years, state governments have initiated the development of the social impact bond (SIB) as an innovative approach to financing social service programmes. SIBs are designed to raise private capital for intensive support and preventative programmes, which are suitable to being funded by state governments on an outcomes basis. Australia's first SIB was the Newpin Social Benefit Bond, initiated by the New South Wales government in collaboration with UnitingCare Burnside and SVA, which opened to investment in April 2013. There are currently around nine SIB initiatives that have been implemented by state governments, and many more are under way for implementation in Australia.<sup>65</sup>

Australian corporates have also issued green and 'gender' bonds to fund relevant social impact programmes. As of July 2018, the Australian market for investments that achieve social or environmental goals as well as financial returns was estimated to be around A\$6 billion.

## **ii Financial sector reforms**

### ***Financial system inquiry***

In October 2015, the government released its response to the financial system inquiry, which released its final report on 7 December 2014. The response sets out an agenda for improving the financial system that rests on five strategic priorities, including:

- a* resilience measures that aim to reduce the impact of potential future crises;
- b* superannuation and retirement income measures that aim to improve the efficiency and operation of the superannuation system;
- c* innovation measures that will unlock new sources of finance and support competition;
- d* consumer outcome measures designed to increase consumer confidence to participate in the financial system and their confidence that they are being treated fairly; and

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62 See ASIC consultation paper 'Product intervention: OTC binary options and CFDs' (August 2019), available at <https://asic.gov.au>.

63 For more information, see media release 'World Bank and CBA partner to enable secondary bond trading recorded on blockchain' at <https://www.commbank.com.au>.

64 For more information, see media releases at <https://www.worldbank.org/en/news/press-release/2018/08/09/world-bank-mandates-commonwealth-bank-of-australia-for-worlds-first-blockchain-bond> and <https://www.commbank.com.au/guidance/newsroom/cba-picked-by-world-bank-to-deliver-world-s-first-standalone-blo0-201808.html>.

65 For more information, see <https://www.socialventures.com.au/impact-investing/social-impact-bonds/>.

e regulatory system measures that aim to make regulators more accountable and more effective.<sup>66</sup>

As yet there is no comprehensive legislation to address all the recommendations, but the report and continued public scrutiny of financial institutions have prompted a large number of specific initiatives as well as continuing inquiries.

### ***Royal Commission into misconduct in financial services***

In November 2017, the commonwealth announced a Royal Commission into alleged misconduct by Australia's banks and other financial services entities. An interim report was published on 28 September 2018, and a final report was published on 1 February 2019, which made 76 recommendations affecting the provision of financial products to consumers.<sup>67</sup> The government has committed to taking action on all of the recommendations.<sup>68</sup> There are likely to be further regulatory measures and initiatives that stem from the findings of the Royal Commission. The Terms of Reference of the Royal Commission largely concerned an inquiry into whether conduct by financial services entities (including directors, officers and employees) falls below community standards and expectations, and methods of combating misconduct and redress for consumers. The Terms of Reference did not extend to the prudential regulation and capital structure of financial institutions,<sup>69</sup> and matters considered by the Royal Commission did not highlight instances of misconduct in capital markets.

Australian regulators, including ASIC, APRA and ACCC, have signalled greater assertiveness and willingness to pursue enforcement action against misconduct in the financial sector post the findings arising out of the Royal Commission.<sup>70</sup>

### ***ASIC v. Westpac***<sup>71</sup>

In 2016, ASIC commenced legal proceedings against three of Australia's major banks for unconscionable conduct and market manipulation in setting the Bank Bill Swap (BBSW) rate. ASIC alleged that Westpac had traded in prime bank bills to influence the setting of the BBSW with a sole or dominant purpose of influencing the setting of the BBSW to be favourable to Westpac without disclosing its practice to relevant counterparties, and that these counterparties consequently suffered loss. The Federal Court found that Westpac had

66 The response is available at [www.treasury.gov.au/fsi](http://www.treasury.gov.au/fsi).

67 For more information, including a copy of the final report, see <https://treasury.gov.au/publication/p2019-fsrc-final-report>.

68 See the government's response at <https://treasury.gov.au/publication/p2019-fsrc-response>.

69 See the Terms of Reference within the Letters Patent at <https://financialservices.royalcommission.gov.au/Documents/Signed-Letters-Patent-Financial-Services-Royal-Commission.pdf>.

70 APRA released its new Enforcement Approach in April 2019 around its future role and use of enforcement activities in achieving its prudential objectives. See media release 'APRA releases new Enforcement Approach' and APRA's page 'Enforcement', available at <https://www.apra.gov.au>. The ASIC Commissioner also recently set out ASIC's renewed enforcement priorities in his speech on 30 August 2019 at the 36th Annual Conference of the Banking and Financial Services Law Association, stating that ASIC's enforcement work will have a core focus on deterrence, public denunciation and punishment.

71 *ASIC v. Westpac* (No. 2) (2018) 357 ALR 240.

engaged in certain acts amounting to unconscionable conduct in breach of the Australian Securities and Investments Commission Act (ASIC Act),<sup>72</sup> as well as contravening its financial services licensee obligations.

### **Competition**

In May 2017, the government announced plans to enhance competition in the banking industry, which include:

- a* a new open banking regime to increase access to banking products and consumer data by consumers and third parties if consumers consent. The Open Banking Review was commissioned in July 2017 and the final report was released in February 2018. The report made 50 recommendations on the regulatory framework, the type of banking data in scope, privacy and security safeguards for banking customers, the data transfer mechanism and implementation issues;<sup>73</sup>
- b* reducing regulatory barriers to entry for new and innovative entrants; and
- c* tasking the Productivity Commissioner and the ACCC to review the state of competition in the financial system. The Productivity Commission's final report, dated 3 August 2018, has made a number of recommendations to improve consumer outcomes through increasing competition.<sup>74</sup>

In June 2018, an ACCC investigation also led to criminal cartel charges laid against three major financial institutions – ANZ, Citigroup and Deutsche Bank – relating to trading in ANZ shares held by both Citigroup and Deutsche Bank. The cartel conduct is alleged to have taken place following an ANZ institutional share placement in August 2015. Criminal charges were laid against several senior executives of these financial institutions.<sup>75</sup> In September 2018, ASIC also commenced proceedings to pursue ANZ over allegations that it failed to comply with its continuous disclosure obligations under the corporations law in relation to the same placement.<sup>76</sup> The outcome of these proceedings and any implications for capital markets may not be known for some time.

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72 The Federal Court found a breach of Section 12CC of the ASIC Act 2001 (Cth), stating that 'Westpac's conduct was against commercial conscience as informed by the normative standards and their implicit values enshrined in the text, context and purpose of the ASIC Act specifically and the Corporations Act generally' (see at [26]). The Court also found that Westpac's product disclosure statements '[fell] short of any disclosure of the vulnerability of the BBSW to manipulation' at [2160] and that Westpac 'had the capacity to trade so as to influence, or likely influence, the BBSW to its advantage' at [2190].

73 For more information, see 'Review into Open Banking in Australia – Final Report' at <https://treasury.gov.au/consultation/c2018-t247313/>.

74 For more information, see 'Competition in the Australian Financial System' at <https://www.pc.gov.au/inquiries/completed/financial-system/report>.

75 For more information, see media release 'Criminal cartel charges laid against ANZ, Citigroup and Deutsche Bank' at <https://www.accc.gov.au/media-release/criminal-cartel-charges-laid-against-anz-citigroup-and-deutsche-bank>.

76 For more information, see <https://asic.gov.au/about-asic/news-centre/find-a-media-release/2018-releases/18-268mr-asic-commences-civil-penalty-proceedings-against-anz-for-alleged-continuous-disclosure-breach-in-relation-to-2015-institutional-equity-placement/>.

### ***Bank governance***

In July 2017, the commonwealth government released a consultation paper on a new banking executive accountability regime (BEAR). The Treasury Laws Amendment (Banking Executive Accountability and Related Measures) Act received Royal Assent on 20 February 2018. The new law provides APRA with new and strengthened powers to impose penalties on ADI groups, their directors and senior executives for breaching accountability obligations.<sup>77</sup> The accountability regime commenced on 1 July 2018 for large ADIs and on 1 July 2019 for small and medium ADIs. Subordinate legislation is also now in place defining small, medium and large ADIs for the purpose of BEAR.<sup>78</sup>

The final report of the banking Royal Commission made a number of recommendations on extending BEAR to other financial sectors and all APRA regulated entities, including all entities holding an Australian financial services licence or Australian credit licence, market operators and clearing and settlement facilities. The final report also proposed having APRA and ASIC jointly administer BEAR.

### ***Crisis management of regulated entities***

On 5 March 2018, the Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Act 2017 was passed to strengthen APRA's crisis management powers following recommendations from the financial system inquiry.<sup>79</sup> The legislation includes clear powers for APRA to set resolution planning requirements and ensure banks and insurers are better prepared for times of financial crisis. The new laws also equip APRA with an expanded set of crisis resolution powers to facilitate the orderly resolution of a distressed bank or insurer. The new laws do not include a formal bail-in regime for debt capital instruments, although APRA does have powers to stop payments by regulated entities in certain circumstances.<sup>80</sup>

### ***Basel III reforms and other prudential initiatives***

On 1 January 2018, a new version of the liquidity standard (APS 210) started to introduce a net stable funding ratio (NSFR) for locally incorporated ADIs that are subject to the LCR regime introduced in 1 January 2015. The NSFR may influence the tenor and type of funding raised by ADIs to which it applies.

Since 1 July 2015, larger ADIs have been required to calculate and disclose a leverage ratio, in addition to risk-weighted capital measures. In February 2018, APRA announced the design and application of a minimum leverage ratio requirement for ADIs as a complement to the revised risk-based capital framework and consistent with the Basel Committee's final

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77 The Treasury Laws Amendment (Banking Executive Accountability and Related Measures) Act 2018 is available at <https://www.legislation.gov.au/Details/C2018A00005>.

78 The Banking Executive Accountability Regime (Size of an Authorised Deposit-taking Institution) Determination 2018 is available at <https://www.legislation.gov.au/Details/F2018L00651>.

79 See media release 'Turnbull Government to strengthen APRA's crisis management powers' at [www.treasury.gov.au](http://www.treasury.gov.au). The draft legislation is in response to the consultation on the commonwealth's September 2012 paper 'Strengthening APRA's Crisis Management Powers'.

80 Financial Sector Legislation Amendment (Crisis Resolution Powers and Other Measures) Act 2018.

leverage ratio methodology. APRA is proposing a minimum leverage ratio of 4 per cent for internal ratings-based ADIs and 3 per cent for standardised ADIs. APRA is proposing that these revisions to the capital framework will come into effect from 1 January 2022.<sup>81</sup>

In July 2017, APRA announced new capital benchmarks for the Australian banking system to ensure it has capital ratios that are ‘unquestionably strong’,<sup>82</sup> pursuant to recommendations under the 2014 financial system inquiry. These new capital benchmarks will raise the minimum capital requirements by the equivalent of around 150 basis points for ADIs using the internal ratings-based approach to credit risk and around 50 basis points for ADIs using the standardised approach to credit risk, in each case in comparison to the December 2016 levels. The target levels are well in excess of the Basel III minimum requirement for common equity capital. In June 2019, APRA released a suite of draft prudential standards for credit risk.<sup>83</sup> APRA expects to conduct one further round of consultation before finalising standards for implementation from 1 January 2021. APRA is also currently consulting on updated prudential standards on credit risk management requirements for ADIs to modernise current standards for more sophisticated analytical techniques and information systems.<sup>84</sup>

In February 2018, APRA released a discussion paper setting out proposed revisions to risk-based capital requirements for ADIs for credit, market and operational risk. The paper set out indicative risk weights and parameters used to calculate minimum capital requirements across various asset classes. In June 2019, APRA concluded its first round of consultations and released proposals on, inter alia, a standardised approach to credit risk and operational risk and adopting a simplified prudential framework for operational risk, counterparty credit risk, leverage ratio and public disclosures for smaller ADIs. The response paper was accompanied by draft prudential standards. APRA has amended its APS 112 on the standardised and internal ratings-based approaches to credit risk.<sup>85</sup> APRA has also revised its APS 115 to reflect a single standardised measurement approach for the capital treatment of operational risks.<sup>86</sup> APRA proposes aligning the implementation date of these revised capital standards with the Basel Committee timetable of 1 January 2022, with the revised APS 115 to commence for certain ADIs on 1 January 2021.<sup>87</sup> APRA will conduct further consultations on amendments to the internal ratings-based approach and interest rate risk in the banking book framework in late 2019.

In August 2018, APRA announced options to improve the transparency, comparability and flexibility of the ADI capital framework.<sup>88</sup> The focus was to amend disclosure requirements and the way in which ADIs would be required to calculate and report capital ratios, without

81 See media release ‘APRA responds to submissions on ADI leverage ratio, and extends timeline for broader capital framework reforms’ (November 2018) at <https://www.apra.gov.au>.

82 For further information, see ‘Information Paper: Strengthening banking system resilience – establishing unquestionably strong capital ratios’ (19 July 2017) at [www.apra.gov.au](http://www.apra.gov.au).

83 See APRA media release ‘APRA responds to first phase of consultation on revisions to ADI capital framework’ (June 2019), available at <https://www.apra.gov.au>.

84 See APRA Discussion Paper ‘APS 220 Credit Risk Management’ (March 2019), available at <https://www.apra.gov.au>.

85 See APS 112 Capital Adequacy: Standardised Approach to Credit Risk.

86 See APS 115 Capital Adequacy: Standardised Measurement Approach to Operational Risk.

87 See APRA’s response at [https://www.apra.gov.au/sites/default/files/response\\_to\\_submissions\\_-\\_revisions\\_to\\_the\\_capital\\_framework\\_for\\_adis.pdf](https://www.apra.gov.au/sites/default/files/response_to_submissions_-_revisions_to_the_capital_framework_for_adis.pdf).

88 See Discussion Paper ‘Improving the transparency, comparability and flexibility of the ADI capital framework’ (14 August 2018) at <https://www.apra.gov.au>.

altering the quantum and risk-sensitivity of capital requirements. Consultation on this paper closed on 2 November 2018. APRA intended to consult on draft revised prudential standards incorporating the outcome of the consultation in 2019. APRA made revisions to its APS 310, which deals with audit and related matters, in July 2019; however, the proposals in its consultation were not specifically addressed.

APRA has also revised its prudential framework for counterparty credit risk for ADIs to strengthen their frameworks. APRA will adopt an adjusted current exposure method as a simplified approach for ADIs with immaterial counterparty credit risk. Revised standards incorporating this commenced on 1 July 2019.<sup>89</sup>

In November 2018, APRA commenced consultation on proposals to change the application of the capital adequacy framework for ADIs designed to help facilitate orderly resolution in the event of failure.<sup>90</sup> In July 2019, APRA released its response to submissions, stating that domestic systematically important banks will be required to increase total capital requirements by three percentage points of risk-weighted assets by 1 January 2024, with a view to lifting this to four or five percentage points of loss-absorbing capacity over the long term. APRA is consulting on revisions to the capital framework that may result in changes to the calculation of risk-weighted assets or the measurement of capital.<sup>91</sup> It is expected that ADIs would primarily issue Tier 2 capital instruments to meet these higher requirements. APRA has not accepted submissions to allow for a new form of 'senior non-preferred' bonds.

APRA is also reviewing the levels of exposure that ADIs may have to their related entities.<sup>92</sup>

### ***Capital frameworks for mutual ADIs***

In November 2017, APRA released a response paper and revised Prudential Standard APS 111 Capital Adequacy: Measurement of Capital to allow mutually owned ADIs more flexibility in their capital management. Under the revised standard, APRA's mutual equity interest framework allows mutually owned ADIs to issue capital instruments that are eligible under Common Equity Tier 1 directly without jeopardising their mutual status. Prudential Standard APS 111 came into effect from 1 January 2018. On 5 April 2019, the Treasury Laws Amendment (Mutual Reforms) Bill 2019 received Royal Assent, providing, among other things, for a new bespoke mutual capital instrument under the Corporations Act 2001 for all eligible mutual entities to raise equity capital.<sup>93</sup> As yet, no issues have taken place under the framework.

### ***Benchmark interest rate reform***

In October 2016, the government announced it would implement measures to strengthen financial regulation to better protect Australians against the possible manipulation of

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89 See APS 180; for more information see 'Counterparty credit risk for ADIs' at <https://www.apra.gov.au/counterparty-credit-risk-adis>.

90 See Discussion Paper 'Increasing the loss-absorbing capacity of ADIs to support orderly resolution' (8 November 2018) at <https://www.apra.gov.au>.

91 For further information, see <https://www.apra.gov.au/consultation-increasing-loss-absorbing-capacity-authorised-deposit-taking-institutions-support>.

92 See Discussion Paper 'Revisions to the related entities framework for ADIs' (July 2018) at <https://www.apra.gov.au>.

93 See Treasury Laws Amendment (Mutual Reforms) Act 2019.



financial benchmarks. In April 2018, the Treasury Laws Amendment (2017 Measures No. 5) Bill 2017 and the ASIC Supervisory Cost Recovery Levy Amendment Bill 2017 were given Royal Assent to establish a framework for a financial benchmark regulatory regime.<sup>94</sup> The new laws give ASIC powers to designate significant financial benchmarks if satisfied that the designated benchmark is systemically important in Australia or there would be a material risk of financial contagion or a material impact on Australian retail or wholesale investors if there was a disruption to the operation or integrity of the benchmark. Administrators of designated significant financial benchmarks will also be required to obtain a new benchmark administrator licence from ASIC, with ASIC being able to impose conditions in granting a licence. On 1 January 2017, ASX took over the role of administrator of BBSW rates.<sup>95</sup> In June 2018, ASIC set up the ASIC Financial Benchmark (Administration) Rules 2018, which impose certain key obligations on licensed benchmark administrators and require contributors to licensed benchmarks to cooperate with ASIC.<sup>96</sup> The International Swaps and Derivatives Association's consultation on benchmark fallbacks has identified the cash rate as the fallback rate for BBSW, and while, unlike LIBOR, there is no imminent demise of BBSW, ASX encourages market participants to have robust contractual fallback provisions to address any cessation or material change to the BBSW benchmark. These proposals aim to facilitate equivalence assessments under overseas regimes, including under the European Benchmarks Regulation.

In June 2019, the South Australian Government Financing Authority issued a one-year floating rate note using an adjusted overnight cash rate, AONIA, as the reference rate.

### ***ASIC capital requirements for market participants***

ASIC is also consulting on proposed changes to the capital requirements for certain market participants that prescribe the minimum amount of capital a participant must hold to better protect investors and market integrity by strengthening the risk profile of market participants and reducing the risk of a disorderly or non-compliant wind-up. Market participants include all persons allowed to directly participate (other than principal traders or clearing participants) in any licensed financial market (i.e., ASX, ASX 24, Chi-X, SSX NSXA and FEX markets) under the operating rules of the market. The consultation period closed on 15 August 2018.<sup>97</sup> As yet, ASIC has not proposed any further changes to such capital requirements.

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94 Prior to 9 September 2017, this framework sat under the Corporations Amendment (Financial Benchmarks) Bill 2017.

95 For more information, see 'Benchmark Administration' at <https://www.asx.com.au/services/benchmark.htm>.

96 For more information, see 'Financial benchmarks' at <https://asic.gov.au/regulatory-resources/markets/financial-benchmarks/>.

97 For more information, see '18-202MR ASIC consults on proposed changes to the capital requirements for market participants' at <https://asic.gov.au/about-asic/media-centre/find-a-media-release/2018-releases/18-202mr-asic-consults-on-proposed-changes-to-the-capital-requirements-for-market-participants/>.

### **III OUTLOOK AND CONCLUSIONS**

Australia's capital markets remain accessible to both domestic and international issuers. The regulation of the market is generally sensible and well understood. There have been many reforms to the regulatory framework since the global financial crisis, and further reforms (some of which have been outlined in this chapter) will come into force in the near future.

The financial sector is currently the subject of intense public scrutiny. This is likely to generate further regulatory change, some of which may affect practices in the Australian capital market.

Overall, we expect continued growth, and that Australia will continue to be both highly regarded – and ranked – among the world's leading financial systems and capital markets.

# BRAZIL

*Ricardo Simões Russo, Marcello Mammocchi Pompilio and Felipe Moraes Assunção<sup>1</sup>*

## I INTRODUCTION

Over the past few years, Brazil has undergone a constant and significant development of its equity and debt capital markets' regulatory framework. The Brazilian capital markets regulatory framework has been subject to various amendments and updates in an attempt by the local regulators to simplify and modernise rules, promote higher standards of efficiency regarding public offerings as well as the adoption of better corporate governance requirements, and to foster access to the capital markets by Brazilian issuers and investors.

Despite the recent economic crisis and recent political developments, a significant number of public offerings have been implemented in the local markets, especially over the past four years (in which the Brazilian economy has demonstrated signs of recovery).

The number of issuances of debt and fixed income securities continue to present solid growth in 2019 due to, among other reasons, the reduction by the federal government of the Brazilian basic interest rate (SELIC rate), and it is worth highlighting the debentures offerings performed by companies such as Neoenergia, Rumo, Cosan and BRF as well as bond offerings structured for foreign investors such as those carried out by Marfrig, Natura, Petrobras and Cielo. Likewise, equity offerings have played an important role in the local capital markets, being restricted equity offerings<sup>2</sup> such as those implemented by Linx, Notre Dame, Localiza, Movida, IRB, Hapvida and Burger King, and which are key to the increase in the number of transactions. In addition, as the domestic economy shows signs of recovery, initial public offerings such as those from Banco Inter and SBF were also verified. For illustration purposes and in accordance with the Brazilian Financial and Capital Markets Association (ANBIMA) database,<sup>3</sup> from January to July 2019, local capital markets transactions involved more than 200 billion reais.

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1 Ricardo Simões Russo is a partner and Marcello Pompilio and Felipe Assunção are associates at Pinheiro Neto Advogados. Vinicius Pimenta Seixas, an associate, assisted with the tax law section.

2 Restricted public offerings are the '476 offerings', which are granted with automatic registration provided that the securities are only offered to a limited number of professional investors.

3 For further information, refer to the ANBIMA's Capital Markets Bulletin, as of July, 2019, available at [https://www.anbima.com.br/pt\\_br/informar/relatorios/mercado-de-capitais/boletim-de-mercado-de-capitais/captacoes-em-acoes-registram-o-maior-volume-semestral-da-serie-historica.htm](https://www.anbima.com.br/pt_br/informar/relatorios/mercado-de-capitais/boletim-de-mercado-de-capitais/captacoes-em-acoes-registram-o-maior-volume-semestral-da-serie-historica.htm) (last accessed on 9 September 2019).

A public policy of the recently elected federal government has seen investments in infrastructure, the privatisation of public companies and the performance of several reforms to reduce public expenses and bureaucracy, which has had a positive effect on market perceptions regarding Brazil. Specifically, it is worth mentioning that long-term infrastructure financing performed by means of capital markets transactions has been gaining prominence over the past few years, considering the consolidation of the use of instruments such as infrastructure debentures, created by Law No. 12,431, in view of the large quantity of local companies that have relied on public offerings of these types of infrastructure debt instruments to obtain the funding required for their infrastructure projects. According to information released by the federal economy department, since the enactment of this type of debt security in 2012, a total of approximately 250 public offerings were implemented until July 2019 for a total amount of approximately 65 billion reais.

### **i Current legal framework**

The Brazilian financial and capital markets system is a highly regulated sector, and is essentially composed of regulatory bodies such as the National Monetary Council (CMN) and the National Council of Private Insurance, and supervisory bodies such as the Central Bank of Brazil and the Brazilian Securities Commission (CVM), which supervise, regulate and inspect, as the case may be, publicly held corporations, financial institutions and stock exchanges, among other entities.

According to the Brazilian securities law (Law 6,385, of 7 December 1976, as amended), the CVM regulates, develops, controls and inspects the securities market. It is also responsible for regulating:

- a* the examination and inspection of publicly held companies;
- b* the trading and intermediation of the securities and derivatives markets;
- c* the organisation, functioning and operation of the stock markets, and commodities and futures markets; and
- d* the management and custody of securities.

Typically, federal laws applicable to the capital markets in Brazil contain general provisions, and their main purpose is to establish what Brazilian capital markets comprise, who may be the agents of the market, the different independent agencies that have powers of oversight and the limits of their authority. The regulations that set forth the specific rules with which each player and transaction has to comply are the CVM's instructions, Central Bank circulars and CMN resolutions. This system benefits the Brazilian capital markets, as the enactment of laws is a very bureaucratic procedure that cannot keep pace with the constant changes financial and capital markets are subject to, and the enactment of Central Bank, CMN and CVM regulations involves a more quick and effective way of regulating the markets.

Most of the relevant capital markets regulations have been issued by the CVM in an attempt to update and modernise the Brazilian market. Note the following in particular:

- a* CVM's Normative Ruling No. 358, of 3 January 2002, which contains rules on the disclosure and use of relevant information regarding publicly held corporations, and restrictions on the trading of securities;
- b* CVM's Normative Ruling No. 361, of 5 March 2002, with rules on tender offers;
- c* CVM's Normative Ruling No. 400, of 29 December 2003, which sets forth the rules applicable to public offerings of securities in the local market;

- d* CVM's Normative Ruling No. 476, of 16 January 2009, which contains rules applicable to automatic registration of public offerings to professional investors (restricted offers);
- e* CVM's Normative Ruling No. 480, of 7 December 2009, with provisions on registration as a publicly held corporation in Brazil;
- f* CVM's Normative Ruling No. 559, of 27 March 2015, with provisions on the approval of depositary receipt programmes for Brazilian securities, to be negotiated abroad; and
- g* CVM's Normative Ruling No. 560, of 27 March 2015, with provisions on the registration, requirements and disclosure of information regarding foreign investors.

The structure of the Brazilian financial and capital markets is also composed of ANBIMA, which is a self-regulatory agency that created a set of rules for increased corporate governance for its associates (inter alia, banks, underwriters, brokerage firms, investment banks) to comply with. Currently, ANBIMA has a partnership with the CVM to expedite the registration of public offerings. By means of this partnership, ANBIMA is responsible for examining and making demands as regards the documents for public offerings (ANBIMA's time limit to make demands is much shorter than the CVM's on a regular public offer), and after ANBIMA is satisfied with the documents, they are subjected to final approval of the public offering by the CVM.

Brazil currently has one registered stock exchange that allows companies to publicly trade their shares, debentures and other equity and debt securities, the B3 SA - Brasil, Bolsa, Balcão (formerly known as BM&FBOVESPA). In addition to the regulations provided by the CMN, the CVM and the Central Bank, publicly held companies that wish to trade their shares on the stock exchange must also comply with B3's regulations (which contemplate, inter alia, regulations on minimum corporate governance requirements that must be observed by listed corporations).

## II THE YEAR IN REVIEW

### i Developments affecting debt and equity offerings

#### ***Provisional Measure No. 881***

Provisional Measure No. 881, Economic Freedom Provisional Measure, was enacted on 30 April 2019, and its main goals are:

- a* to put into force a declaration of the rights of economic freedom;
- b* to embody the principles of freedom in the exercise of economic activities;
- c* to put into place a presumption of good faith; and
- d* minimal and exceptional state intervention in the economic domain.

As one of its main innovations, Provisional Measure No. 881 establishes amendments to the Brazilian Civil Code to include a specific chapter focusing on investment funds, with particular emphasis on the limitation of liability of quotaholders and fiduciary service providers of such collective investment vehicles. This long-awaited innovation seems to be compatible with the growing relevance and sophistication that investment funds in their various classes have experienced in Brazil, including within the local capital markets and in specific structured segments such as private equity, venture capital, real estate and securitisations.

Within such context, Provisional Measure No. 881 allows that funds' by-laws establish a limitation of the liability of each quotaholder in proportion to the value of their quotas; and limitations of the liability of trust service providers to perform their respective duties without any solidarity.

It is now expected that this provisional matter will be converted into a federal law over the next few months.

### ***CVM Resolution No. 809 to increase the efficiency of capital market regulation***

To increase the efficiency of capital markets regulation and to observe certain international practices, on 19 February 2019, the CVM issued Resolution No. 809 reduced certain requirements verified in registration processes for registered public offerings under CVM Normative Ruling No. 400.

As per the Resolution, issuers will now be able to request confidential treatment from the CVM when requesting the registration of public offerings of shares; or when registration as an issuer with the CVM is performed simultaneously with a public offering of shares registration request. In other words, analysis of such requests shall be kept from public scrutiny until the approval of any of the requested registrations; or until the disclosure of a notice to the market and a preliminary prospectus within the offering – whichever occurs first. It is worth pointing out that the confidential review request is voluntary. If required, issuers shall indicate the period during which the information shall remain confidential and the reason for the confidentiality request.

Another important innovation brought about by CVM Resolution No. 809 is that companies are authorised to perform public offerings within the 16-day period prior to the disclosure of their financials – the blackout period – to expand the time frame available for the performance of public offerings.

### ***Infrastructure investment funds***

After receiving suggestions and recommendations from the markets through a public hearing, on 25 March 2019, the CVM enacted Normative Ruling No. 606 to create and set the fundamental regulation of infrastructure investment funds.

Within such context, institutions authorised by the CVM to manage securities portfolios may set up investment funds that, in order to be entitled to the tax benefits and advantages provided by Law No. 12,431 (i.e., withholding income tax exemption), must invest resources of not less than 85 per cent of a fund's net equity in infrastructure debentures or other securities, or both, as indicated in Article 2 of Law No. 12,431.

Considering the relevant number of infrastructure debentures outstanding in the Brazilian capital markets, several infrastructure funds are expected to be set up in the near future.

### ***New rules applicable to the issuance of financial bills***

On 27 June 2019, the CMN published Resolution No. 4,733, which provides for new rules applicable to the issuance of financial bills.

Financial bills were developed by Provisional Measure 472 of 15 December 2009, converted into Law No. 12,249, of 11 June 2010, in response to market demand for the creation of a long-term funding instrument that could be issued by financial institutions. In 2010, the CMN issued the first regulation on the issuance of financial bills, which was later amended in 2012 by Resolution No. 4,123.

Financial bills are debt securities that can be issued by financial institutions for long-term financing and may be publicly offered on the local capital markets.

The amendments introduced by Resolution No. 4,733 aim to promote the expansion of negotiations of financial bills. The main updates are as follows:

- a* a reduction of the minimum amount of financial bills without a subordination clause from 150,000 reais to 50,000 reais;
- b* a provision for due diligence commitments to be observed by the intermediary institutions participating in the distribution, placement and trading of financial notes to ensure the provision of information regarding the investment and its suitability for the investor profile;
- c* an authorisation for the exchange of financial bills by the issuer institution considering as reference the market value of the redeemed security, less the tax obligations arising from the transaction;
- d* the admission of the issuance of financial bills with maturity of over 36 months containing repurchase option clauses; and
- e* a possibility for the Brazilian Central Bank to regulate the authorisation, in general, of the classification of the funds raised through financial bills in the formation of the reference equity of the issuing institutions (subordinated debt).

Resolution No. 4,733 became valid as of 1 October 2019.

## **ii Relevant tax law**

Recently, the Federal Revenue Offices enacted Normative Ruling No. 1,585 of the Brazilian Federal Revenue (IN 1,585) with the aim of updating and consolidating rules regarding the taxation of income and capital gains recognised by local and foreign investors in financial transactions carried out in the Brazilian markets.

Before the introduction of IN 1,585, it was common that investors contributed their equity interest in corporations to investment funds, and whenever corporations paid dividends, they were paid directly to the quotaholders of the funds, and those amounts were exempted from income tax as the legal nature of the payments would remain as dividends (which are exempted from income tax under the current tax regulations).

According to this new regulation – the lawfulness of which in respect of this specific provision is debatable – the direct on-payment of dividends by investment funds whose portfolios are focused on equity interests to their quotaholders would be treated as a legal act equated with a redemption or amortisation of quotas; therefore, withholding tax (WHT) would apply at the general 15 per cent rate.

### ***Specific rules for new types of investment***

On 5 September 2013, the CMN issued Resolution No. 4,263 regulating the issuance by Brazilian financial institutions of a new funding instrument: the structure transaction certificate (COE). A COE is a 'certificate issued against initial investment, representing a single and indivisible set of rights and obligations, with a remuneration structure presenting characteristics of derivative financial instruments' and may be issued exclusively by multiservice banks, commercial banks, investment banks and savings banks in book entry form and upon registration in the registry and settlement systems authorised by the Central Bank or the CVM.

According to IN 1,585, the profits of COEs are subject to income tax at a regressive rate from 22.5 to 15 per cent. If the settlement of a COE occurs through the delivery of assets, including shares, the acquisition cost of the asset can be deemed as the acquisition cost of the COE. Losses arising out of COE investments cannot be compensated with profits on equity transactions by a natural person; nevertheless, legal entities can deduct such losses from their taxable profits.

***Exemption from income tax on capital gains of a natural person on investments in various securities***

The former regulation exempted certain debt securities (real estate credit bills; agribusiness credit bills; agricultural receivable certificates; certificate of agricultural deposits and agricultural warrants; certificate of agribusiness credit rights; rural product notes) from income tax; nevertheless, they were not exempted from tax over capital gains. According to the provisions of IN 1,585, these investments are exempted from tax over capital gains – a positive change that had been requested by the market for a long time.

***Changes in capital gains rates***

Under Brazilian tax law, the general rule is that non-resident investors are subject to the same tax rules that are applicable to individuals who are tax residents in Brazil when it comes to income and capital gains derived from transactions carried out in Brazilian financial and capital markets.

In this scenario, capital gains derived by foreign investors on the disposition of shares in Brazilian companies have been generally subject to WHT at a 15 per cent rate. Effective since 1 January 2017, however, Brazilian law (under Law 13,259/2016, as converted from Provisional Measure 692/2015) changed that rate to a progressive regime under which the applicable rates vary as follows:

- a* 15 per cent on gains that do not exceed 5 million reais;
- b* 17.5 per cent on the portion of gain exceeding 5 million reais but that is lower than 10 million reais;
- c* 20 per cent on the portion of gain exceeding 10 million reais but that is lower than 30 million reais; and
- d* 22.5 per cent on the portion of gain that exceeds 30 million reais.

Only if an investor is based in a blacklisted tax haven jurisdiction would these rates be increased to a flat 25 per cent rate.

Capital gains accrued on the disposition of Brazilian listed stock, when carried out in the Brazilian Stock Exchange by an investor registered pursuant to the terms and conditions of Resolution No. 4,373/2014 that is not located in any blacklisted tax haven jurisdiction qualifies for a full exemption from WHT. As a result, if a 4,373 investor disposes of shares in a Brazilian listed company at a gain in the Brazilian Stock Exchange, this transaction would be exempt from any WHT in Brazil.



### ***Potential changes in taxation applicable to investment funds***

In 2018, the National Congress' lower house, the Chamber of Deputies, and the Senate proposed two new bills of law: Bill No. 10,638 on 30 July 2018 (PL 10,638/18) and Bill No. 336 on 11 November 2018 (PL 336/18), with analogous contents to the provisions originally brought about by Provisional Measure No. 806 (MP 806/17), which was not approved by the National Congress and thus was not converted into law.

The legislative bills substantially amend the rules for the deferral of taxation applicable to closed-end investment funds in an attempt by the government to eliminate the tax deferral regime for these legal entities. According to those bills of law, investment funds would be taxed according to the rules currently applicable to open-end funds.

Among the main changes brought about by the proposed legislation, one should note in particular:

- a* the automatic taxation of investment fund gains (the come-cotas regime);
- b* the retroactive taxation of all gains accrued by closed-end funds up to May 2019; and
- c* the taxation of spin-off, merger and transformation transactions of closed-end funds made as of 1 January 2019.

At this point in time, both bills of law are pending analysis before specific committees at Congress. For this reason, and taking into account that MP 806/17 was not converted into law, it is important to highlight that no tax effects are expected at this moment.

In addition, Brazil, like several other countries, has been progressively passing certain tax transparency regulations, mostly based upon concepts such as the beneficial ownership provisions as oriented by recent BEPS and OECD guidelines.

As of 1 July 2017, Brazilian regulations have imposed an obligation on certain Brazilian entities and investors holding assets in Brazil to disclose to the tax and regulatory authorities in their corresponding local CNPJs (tax ID numbers) the non-resident investors that qualify as the final beneficiaries of a given Brazilian investment (e.g., stocks of Brazilian companies, owners of fixed-income investment funds, quotas of other investment funds such as private equity funds, aeroplanes).

### **III OUTLOOK AND CONCLUSIONS**

Brazil has a comprehensive legal framework in terms of securities laws and regulations applicable to investors and issuing companies, and requirements that must be observed by each type of equity or debt security. In recent years, local regulators have enacted a number of rules completing and updating this legal framework to provide better access to the capital and financial markets by local companies, and detailed guidance and transparency to local and foreign investors who are willing to acquire securities issued in Brazil.

This effort – witnessed in recent years with the enactment of the rules described in this chapter and others enacted in previous years – is recognised by market players. In fact, its results have been verified in practical terms: in spite of the current economic and political crisis affecting Brazil, a significant number of debt and equity securities public offerings have been observed in the local market during the past few months, evidencing that both investors and issuing companies are increasingly relying on the capital markets for their (short as well as long-term) funding and capital needs.

# CHINA

*Lei (Raymond) Shi*<sup>1</sup>

## I INTRODUCTION

China's capital markets have gone through decades of development since economic normalisation. It was not initially an attractive financing option for most private Chinese enterprises. The Shanghai Stock Exchange (SSE) and Shenzhen Stock Exchange (SZSE) were established in the 1991 as arms of the central government to solve the capital shortage problems of state-owned enterprise (SOEs) and sell shares to outside investors, thereby raising the value of the government's stake in these companies. However, China's capital markets have sped past various milestones. As of December 2018, China (excluding Hong Kong) had the world's third-largest stock market with a combined aggregate market capitalisation of US\$6.3 trillion. For all of 2018, according to Refinitiv, Chinese issuers raised US\$55.65 billion in global equity capital markets, accounting for 8.7 per cent of overall issuance. In the meantime, China's US\$12.5 trillion domestic bond market is currently the world's third-largest by securities outstanding, behind only those of the United States and Japan. Having grown to be among the largest markets in the world in just over two decades, China's capital markets are usually cited as a counterexample to the significance of law for financial market development. However, a thorough examination of the development of China's capital markets will reveal that the law is actually critical to sustaining growth. Just as the experience of China suggests, law and market growth exhibit a bidirectional rather than a unidirectional causal relationship, and the course of development is more like 'growth-law-further growth'.

The legislation of the capital markets includes several fundamental laws, and most importantly the Company Law of the PRC and the judicial interpretations of that Law made by the Supreme Court of the PRC (together, the Company Law), and the Securities Law of the PRC (Securities Law), followed by a fiddly series of rules promulgated by central government (including the State Council and its delegated departments). Laws and regulations of the capital markets in China, originally borrowed largely from the legislation of developed economies, have the skeleton of a regulatory set-up supervising equity market (mainly shares), fixed income products (mainly government bonds, central bank bills, financial bonds and corporate bonds), derivatives (including futures, yuan interest rate swap and share index futures), securitisation products (mostly asset-backed securities (ABS)) and foreign exchange in a broader sense.

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The laws and regulations have many distinctly Chinese characteristics, inevitably, among which the most notable is a structurally inward-looking feature, which is evident in two ways in particular:

- a* restricted access to and unequal treatment of foreign participants (issuers, investors and intermediaries) into China's domestic capital market: for instance, foreign issuers have always been barred from offering shares in the PRC; and
- b* the regulatory regimes concern not just the domestic capital market but also share and bond issuance of 'red-chip' companies. Red-chip (which is market-created business jargon rather than a legal term) generally refers to a corporate structure in which business interests are mainly within the PRC but are owned by holding companies established overseas, which are in turn controlled by Chinese citizens or state-owned bodies. Since shares and bonds issued by red-chip companies are sold to international investors rather than within China, and the companies are only listed on overseas exchanges, if they are listed at all, the government should not have bothered about regulating this kind of operation too much, if at all. However, owing to the government's near-paranoid prejudice against foreign ownership, the red-chip structure is seen more as a way of getting round government supervision, and thus is subject to a series of complicated and less-transparent requirements.

Only the central government is involved in the legislation of the capital market. Within central government, the regulatory bodies are mainly the People's Bank of China, which is China's central bank, and two commissions: the China Securities Regulatory Commission, which regulates the securities industry, and the China Banking and Insurance Regulatory Commission (CBIRC), which regulates the banking and insurance industries. However, there are also a few departments and self-regulatory industry organisations delegated with certain administrative functions. Under the motto 'Stability conquers all', the Chinese regulators place great emphasis on maintaining the stability of the capital markets by intervening and reasserting control over both the primary and secondary markets. Inevitably, people cast doubt on the effects of this intervention. For instance, it is widely believed that policies pursued by the government in search of new sources of growth are at least partly to blame for the creation of the bubble that burst in the summer of 2015; in addition, the noisy but fruitless introduction of issuance of Chinese depository receipts in 2018 without any official admission, denial or reasons given revived the debate about whether the policy toolkits of government are able to accommodate the growth of capital markets so as to support a sustainable economy. On the other hand, since the economic open-up, China has relied to date on a reasonably successful approach involving limited experiments and pilot programmes as test cases for reform, and only expanding them after careful and deep assessment. With significant international developments occurring at an ever-faster pace, whether such a cautious and incremental approach will continue to serve China's capital markets well requires careful consideration. A broad reform agenda that encourages development of deeper, more liquid capital markets with greater choice of investment products is critical to sustaining China's growth as traditional drivers weaken, whether in terms of external trade, domestic infrastructure investment or appetite for risk on the part of global investors. At the end of the day, what is paramount is domestic capital market reform primarily for the benefit of the Chinese economy and its citizens and consumers, including minimising malfeasance, transitioning from over-reliance on retail participation to more professional investors, and proper supervision of financial market participants, including over technology firms.

## II THE YEAR IN REVIEW

In the past, China's financial model was based to a large degree on state-owned banks lending to SOEs, which in turn exported products to developed markets or financed domestic infrastructure projects. This cycle was ultimately funded by China's large base of domestic deposits, which are the result of high savings rates, a lack of alternative investment options and the relative security of bank deposits. While this financial model is undoubtedly successful in an export-driven economy in the early stages of development, in recent years rising geopolitical tensions, an easing of gross domestic product (GDP) growth and a build-up of debt have created pressure to build a financial infrastructure that is both flexible and robust. China's growth slowed in 2018 to 6.6 per cent for the full year, the lowest growth rate since 1990. A recent paper by economists at the Brookings Institution suggests growth rates were consistently overstated between 2008 and 2016, and that the actual 2018 GDP might be 10.8 trillion yuan, which lies below the official figure of 90 trillion yuan.<sup>2</sup> China's macroeconomic challenge in 2019 and beyond is meeting the combined impact of its trade dispute with the US, weakening domestic demand and high levels of off-balance sheet borrowing by local governments. The 6.4 per cent growth rate in the fourth quarter of 2018 was the lowest since the global financial crisis of 2008, and the previous two quarters also showed sharp deceleration. Nonetheless, over the next two years China is likely to use all the policy tools it has at its disposal to achieve the minimum annual growth target in order to meet its policy target to double 2010's GDP by 2020. The build up of growth pressure has also accelerated the pace of change in China's capital markets which, if trade earnings are squeezed, can serve as an alternative growth driver by mobilising domestic and foreign savings to create wealth through investment in new businesses and technologies. The worsening of China's geopolitical environment in many respects underlines the importance and urgency of continued reform in its capital markets.

In the past year, a wave of policy changes to further reform and open up the capital markets has been accelerated. The Star Market of SSE, which is meant to fund and support companies in innovative industries, has been brought from being a concept to being an open business at world-class speed. In August 2018, when the CBIRC announced the elimination of limits on foreign ownership of Chinese financial institutions, removing ownership caps that were part of the previous ruling. In January 2019, the China Securities Regulatory Commission (CSRC) published draft rules combining its two long-standing inbound investment schemes, the qualified foreign institutional investor (QFII) and the yuan-denominated renminbi (RMB) qualified foreign institutional investor (RQFII) into one, together with the removal of quantitative criteria that hampered inbound investment. In the same month, the People's Bank of China (PBOC) announced it would allow Standard & Poor's (S&P) Beijing subsidiary to conduct credit rating activities domestically and to register for bond rating services in China's interbank market. In May 2019, the CBIRC announced plans to remove limits on ownership in local insurance companies by foreign institutions and reduce size requirements for foreign banks that operate onshore. More recently, in September 2019, China's foreign exchange regulator – the State Administration of Foreign Exchange (SAFE) – announced the removal of investment quota limits for QFII and RQFII. These

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2 Wei Chen, Xiliu Chen, Chang-Tai Hsieh, and Zheng (Michael) Song, 'A forensic examination of China's national accounts', 7 March 2019, Brookings Paper on Economic Activity, Spring 2019 Edition, Brookings Institution. <https://www.brookings.edu/bpea-articles/a-forensic-examination-of-chinas-national-accounts/>.

examples hint at the potential for China's capital markets to transform themselves and adapt to the requirements of a growing economy and an ever-more sophisticated populace. In the meantime, we should point out that, since nearly all reforms and open-ups are government-led and centralised rather than market-driven, some, or perhaps many, of the top-down initiatives may have to face bumps or even failures.

## **i     Developments affecting debt and equity offerings**

### ***The debut of the Star Market***

On 22 July 2019, the new Science and Technology Innovation Board of the SSE, called the Star Market by Chinese authorities, was officially launched, with the first batch of 25 companies listed on the same day. Considering the idea for this new Board was only first unveiled by President Xi Jinping in November 2018 and the birth of the Star Market only took a few months, the implementing speed of the CSRC and the SSE is spectacular by China's standard, as is the ambition and momentum of China to bid for tech superpowers and the reform of its equity markets. At the time of writing, there were 34 companies listed on the Star Market, with more than 100 applicants waiting in the pipeline.

Often dubbed Nasdaq-style, the Star Market is intended to catch up with its United States counterpart eventually. The idea behind the Star Market is to encourage investment in domestic tech innovators, ensuring they have resources to develop and also incentives to list at home. It also will make those companies easy for mainland investors to trade in after complaints that Chinese megastars like Alibaba chose to list in the US rather than at home. Coming as the US-China trade tensions have spread to the technology sector, threatening huge homegrown stars like Huawei and others, the new market is of strategic importance to China. Beyond the ambition to rev up China's emergence as a research powerhouse while the country battles accusations of intellectual property theft and technology sanctions from the United States, the Star Market looks set to broaden companies' access to private capital. It is also a test case for capital market reforms: changes to initial public offerings (IPOs) and trading mechanisms could be rolled out to China's main boards if they succeed. Moreover, the Board could push China's industries up the value chain by channelling funds to homegrown businesses developing innovative capabilities.

### ***Broadening access to private capital***

As China pins mounting hopes on innovation to drive higher-quality growth and technological breakthroughs, the Star Market's creation is timely. It may enable not just high-tech start-ups to raise cash, but also venture capital and private equity funds to exit their investments and redeploy capital. Altogether, the Board could encourage private capital investments in the technology scene. The implications go further. A stock market that better serves China's real economy can potentially improve capital allocation in a country that has been criticised for handing out state subsidies and other forms of aid. We see the Star Market creating room for the government to reduce support, which should strengthen the economy's efficiency and longer-term resilience.

### ***Deepening capital market reforms***

China's equity markets, although massive, remain uninviting for some investors and high-quality companies looking to list. Among their concerns are strict practices that rein in market forces and impede efficiency. These include an approval-based system for IPOs,

a profitability requirement for listing candidates, an unofficial but widely observed cap on IPO valuations and daily price limits for stocks. China has pledged to reform its capital markets, and the Star Market could be a pivotal testing ground. It marks several firsts (some major breakthroughs are illustrated in the table below) in the country as it shifts to a registration-based IPO system and accepts unprofitable companies. We expect these features to give market forces greater sway and make IPOs faster and more transparent. Some of these features could also be applied to other domestic exchanges in the future.

| Select differences between major A-share exchanges and the Star Market |  |  |
|--|--|--|
|  | Major A-share exchanges  | The Star Market  |
| Listing system   | Approval-based: gives regulators the power to approve, hold back or reject listing applications based on their assessments of companies' prospects, market conditions and a host of other factors  | Registration-based: scales back regulators' scope in reviewing applications while putting greater onus on companies to disclose material information           |
| IPO valuation  | Unofficial valuation cap of 23x price-to-earnings ratio (trailing earnings): the industry widely follows this implicit rule, taking its cue from regulators' need for more disclosures if issuers price new shares at multiples that are considered aggressive | No such cap  |
| Profitability requirements   | Required for all companies   | Required only for companies with a market capitalisation of under 1.5 billion yuan   |
| Corporate structure  | Must be domestic companies; strict same share, same right  | Red-chip structure allowed; dual-class voting acceptable   |
| Investor criteria  | Open to institutional investors and retail investors   | Open to institutional investors and retail investors with at least 500,000 yuan in their trading accounts plus at least two years of equity trading experience |
| Daily price limit  | 44 per cent trading band on debut, 10 per cent trading band thereafter (with exceptions)   | No daily limits for the first five days of trading for newly listed stocks, 20 per cent trading band thereafter  |
| IPO sponsor participation  | Not applicable   | Sponsors must purchase up to 5 per cent of the shares on offer with their own capital and stay invested for at least two years                                 |

We believe this reflects China's commitment to making its capital markets more open and competitive. For Shanghai especially, the Board could aid its bid to become a global financial centre. Beyond pulling in capital, the Board is likely to inject dynamism into the financial ecosystem, whether by promoting venture capital activity or by spurring the launch of mutual funds targeting investments in technology firms. A successful Board could even entice Chinese companies listed overseas to also list onshore.

### *Promoting industry upgrade*

The Star Market could be a critical prong of China's plan to move its industries up the value chain, as tellingly shown by the first line-ups on the new market, including chipmakers, AI companies, biotech firms, electric car battery makers and suppliers for high-speed railways. China's economic rebalancing and technological survival would depend heavily on its ongoing transition from a cheap maker of low-end goods to a developer of high-tech and high-margin products. For companies with convincing strengths in innovation, the Board is a prime channel of financing that could ramp up their growth and help them, and China, compete on a global scale.

However promising the market may be, it still has its detractors. First, volatility: on the first day of trading, shares of the 25 companies all surged tremendously from their already high offering prices, ending the opening day with sizzling gains ranging from 84 per cent

to an eye-watering 400 per cent, gaining 140 per cent on average by the time the market closed. However, according to the latest trading data, of the 25 companies listed on the opening day, 21 have dropped from such closing prices, with one of them, Jingchen Holding (688099.SH), having nearly halved. Retail participation has been relatively high, leading to much speculative activity that has caused many to call China's stock markets a casino. Worries of a rapid boom and bust loom especially large. Chinese retail investors have historically shown outsized interest in new bourses and listings, driven in part by confidence in the IPO approval process and a belief that capped IPO valuations spawn easy returns later. ChiNext in Shenzhen, for example, had surged on investor exuberance shortly after its debut in 2009, only to sink when interest waned. Understandably, market excitement around the sci-tech board has stoked caution. Although a lot of measures aimed at stabilising the Star Market have been taken, whether they would work to go with the plan is anybody's guess.

Second, the policy changes introduced have been implemented more slowly or somewhat nominally than some market practitioners would like. Although it is subject to the a disclosure-based registration system rather than the approval system, the registration with the CSRC is still essentially a *de facto* approval. The CSRC has twice rejected registration applications of two companies after review and approvals by the SSE, and has been told to postpone the registrations of some companies with the intention of discouraging them from going ahead. Moreover, trading still cannot be instantly settled but is on T+1 basis, and price fluctuation beyond the 20 per cent range would still trigger automatic trading halt for a day.

Third, the Star Market has seen limited participation from foreign investors, despite their notable presence on the main board. At present, foreign investors can only access Star-listed firms through QFII and RQFII, while among the more-than 300 foreign institutions with QFII licences, only six had subscribed to the IPOs of the firms listed on the Star Market. The reasons could be the tiny size of the current Star Market, or the wait-and-see attitude of cautious and sophisticated institutional investors – namely, that high valuation usually means high volatility – of Star-listed firms may have also deterred cautious foreign investors that adopt value-investing strategies, analysts have said.

Much remains to be seen until the market expands and trading fever cools down. The fact that most applicants are not high-profile market leaders casts doubt on whether the Star Market may be another ChiNext eventually. Broadly speaking, to ease such doubts, we expect regulators to be mindful of the overall quality of companies listed, especially in the near term as they work to cement market confidence in the new board.

### ***Easing of foreign ownership restrictions on financial firms***

On 28 July 2018, the National Reform and Development Commission (NDRC) announced on its website the lifting of foreign ownership caps on brokerages, life insurers and commercial banks. This came as welcome news, although details remain that require clarification. The changes include a previously announced decision to allow 51 per cent foreign ownership of brokerages and life insurers, and the removal of the cap entirely by 2021. Rules limiting a single foreign financial institution's ownership in a Chinese commercial bank to 20 per cent were abolished, along with a rule limiting investment by multiple overseas financial institutions to 25 per cent. In addition, the NDRC cut the negative list for foreign investment from 63 industries to 48, easing or lifting ownership caps on businesses including ship and aircraft manufacturing, power grids and crop breeding (excluding wheat and corn). Foreign ownership for passenger car manufacturing will be removed by 2022, together with ownership limits on passenger rail transport and shipping, according to the announcement.

Countries around the world use ownership limits for companies and industries representing strategic or national interests. However, they tend to be overused and retained long after the original reasons have become obsolete. For all these reasons, we believe the use of ownership limits should be minimised to the extent possible. As ownership caps are eased or removed in selective industries, it will ease investing in some industries, including finance.

It has been more than a year since the regulatory authorities approved the first majority stake in a domestic financial firm by an international bank, and licences for some international rating agencies and bank card payment firms were still pending to date. UBS was the first international bank to be allowed to take a majority position in its Chinese joint venture, UBS Securities Co, in November 2018, a year after the initial announcement. In March 2019, the CSRC accepted applications for 51 per cent stakes in joint ventures for JP Morgan Securities (China) Company Limited and Nomura Orient International Securities Co Limited; in April, Credit Suisse also had its application accepted. As of April 2019, Fitch Ratings was still waiting approval despite having opened a wholly owned office in Beijing, Fitch Bohua, in November 2018 in advance of obtaining a licence. Bank card payment firms Visa and Mastercard were also awaiting approval to process renminbi payments a year after both companies submitted applications in early 2018. All the welcome policy changes to greater openness could have been implemented more rapidly than they really have been.

### ***Improvement in trading suspension***

During the past year, there has been a visible improvement in trading suspensions, which hovered for many years in the 150 to 200 range. These had dramatically dropped to single digits by the end of 2018. The seeming change of trading behaviour is by no means spontaneous: the Chinese authorities have been making significant improvements in this area over the past few years. This contrasts with 2015 when, during the height of market volatility in the summer, on some days trading in over half the stocks was suspended. This exacerbated market anxiety, which spilled into other products domestically, as well as markets globally. Suspensions cause problems for the obvious reason that a suspended stock cannot be bought or sold. For fund managers, widespread suspensions can be a major hindrance to meeting fund redemption obligations. While it can be recognised that a listed company has a right to suspend trading of its shares under specific conditions so that investors have time to digest the significance and implications of such conditions, it is particularly important to investors to know that the liquidity of the shares they hold is reliable. The rights and interests of investors and the liquidity of the market should prevail over the rights and interests of listed companies. Many have been advocating for the continued discouragement of trading suspensions except under exceptional circumstances and set out in transparently applied rules to safeguard market liquidity. On 6 November 2018, the CSRC issued the Guiding Opinions on Improving the Suspension and Resumption of Trading of Shares of Listed Companies, which was followed by the SSE and SZSE each issuing a consultation on reducing the types of events under which a listed company may request a trading suspension and the maximum period of such suspensions. Although the final SSE and SZSE Guidelines issued on 28 December 2018 keep the maximum suspension period to 10 dealing days despite requests to shorten it further to five dealing days, it is encouraging to see that the circumstances under which a listed company can suspend trading of its shares are limited. The focus of the exchanges and Chinese regulators on these concerns, as reflected by the number of trading suspensions falling to single digits by the end of 2018, is commendable.



### ***Further toughening of the delisting rules***

Clear rules and consistent implementation of a process for delisting illiquid and substandard companies – those that no longer meet the listing requirements – are crucial. From 1995 to 2016, China delisted only 0.8 per cent of total listings. Since the first of these in 2001, China's A-share market has only seen 57 firms leave the market despite the reform of the delisting rules in 2014. This is a small number compared to global rates that range as high as 10 per cent and above, and suggests that some substandard companies remain listed on Chinese exchanges that should not be. The authorities recognised the shortcomings of the delisting process, and in 2015 the CSRC introduced new rules that require a greater level of information disclosure and delisting for illegal acts and fraudulent issuance. On 21 March 2016, authorities delisted ST Boyuan from the SSE because of illegal disclosure of important information. This was encouraging, and the market widely looked forward to the continued consistent application of the new approach.

On 27 July 2018, the CSRC amended its delisting rule (Several Opinions of the China Securities Regulatory Commission on Reforming, Improving and Strictly Implementing the Delisting System for Listed Companies) after months of public consultation. The amendment states that listed companies involved in fraudulent issuance, violations of major information disclosure or other major illegal activities concerning national security, public safety, ecological safety, production safety, or public health and safety, the stock exchange shall move to suspend or terminate the listing of the company's shares. Another major revision states that the securities regulator can suspend or terminate the listing when illegal activities are found. This compares to the previous version in which companies carrying out significant legal violations would first suspend trading and then withdraw from the market. Accordingly, the two exchanges have also introduced detailed rules for delisting from them, stipulating that companies will be ousted from the market if any evidence is found of fraudulent IPOs, cheating in financial disclosures or law violations.

In November 2018, supplementary delisting rules were introduced as a follow-up measure after Shenzhen-listed Changsheng Bio-technology falsified data on rabies vaccines, drawing the attention of President Xi Jinping. The new delisting rules ban companies found guilty of financial fraud in their IPOs from re-listing forever. Companies that are delisted for other reasons need to trade in the over-the-counter (OTC) market before they can apply for relisting.

The idea of toughening the delisting rules is to shut the door behind uncompetitive companies on the one hand while opening the door to attract listings in the new technology and new economy sectors through the Star Market on the other, collectively to create a healthier flow of listed companies. However, with the open-door initiative having been postponed, the voice of the shutting door appears to have gone quiet, too.

### ***Reforms of QFII and RQFII programmes***

Foreign investors are not able to invest in domestic listed companies except by participating in QFII or RQFII programmes, unless they seek to be the strategic investor of a listed company as defined by the CSRC's Measures for the Administration of Strategic Investment in Listed Companies by Foreign Investors, which must seek to purchase at least 10 per cent of a listed company's outstanding shares at one time but will be subject to a 30 per cent cap of ownership in the same listed company. In addition, until recently, China's bond markets were generally restricted for foreign investors before the expansion of the QFII and RQFII schemes to allow foreign investors to invest in Chinese bonds.

Since the QFII regime was introduced in 2002, followed by the launch of the RQFII regime in Hong Kong in 2011, China has taken a step-by-step approach towards opening its capital markets to foreign investors. Recently, the CSRC has launched a new round of opening up the financial sector by seeking public comment from 31 January 2019 on the combined and amended Administrative Measures for Domestic Securities Investments by Qualified Foreign Institutional Investors, the Measures for the Pilot Programme of Domestic Securities Investment by RMB-Qualified Foreign Institutional Investors and their supporting rules. Key amendments of these new rules include, among others:

- a* a combination of the two regimes;
- b* a relaxation of the entry criteria;
- c* the expansion of the scope of investment;
- d* the optimisation of custodian management; and
- e* the strengthening of ongoing monitoring.

Most significantly, the investment scope of RQFIIs and QFIIs is expected to expand significantly from the currently limited assets categories such as:

- a* stocks and bonds traded on the SSE and SZSE;
- b* securities investment funds;
- c* stock index futures and fixed income products traded in the interbank market for inclusion of shares quoted on China's OTC market;
- d* depository receipts;
- e* commodity futures and options;
- f* private securities investment funds;
- g* financial futures for hedging purposes;
- h* bond repos; and
- i* foreign exchange derivatives.

Added to these measures, on 10 September 2019, the State Administration of Foreign Exchange (SAFE) announced the removal of investment quota limits for QFIIs and RQFIIs completely. As a result of this announcement, QFIIs and RQFIIs will no longer be required to apply for any investment quotas from SAFE. Instead, it is expected that a new QFII or RQFII only needs to make a SAFE registration with assistance from its onshore custodian. The SAFE registration will be used to open onshore cash accounts and accommodate the remittance and repatriation of funds onshore. Furthermore, aggregate investment quota limits that apply to a specific foreign country or region will also be removed. Although SAFE's announcement did not specify when the removal of investment quota limits will take effect, it did state that it would amend the relevant rules and regulations as soon as possible to implement its decision, which has already been approved by China's State Council.

These qualified institutional investor reforms, rather significant on their face, are consistent with the financial market opening-up reforms to further simplify management and facilitate operation, and governmental officials have said that they will further expand the new landscape for opening up the capital markets. However, in reality they may make little difference, because the programmes under which the caps operated were already becoming somewhat redundant. For instance, the quotas that have been removed had been in no danger of being breached for at least a decade, despite the fact that China had kept on expanding the quotas. According to the recent data, foreign institutions had applied for QFII investments worth US\$111.3 billion, only 37 per cent of the total quota, while applications for RQFII

were worth 693.3 billion yuan, just one-third of the 1.99 trillion yuan quota. Both equity and bond foreign investors had been relying more heavily on other cross-border channels with better arrangements in place, especially the Stock Connect and Bond Connect programmes, to allow easier access to trade in China. It was not the quotas that were constraining them from investing more through QFII and RQFII. From this perspective, the reforms are more importantly symbolically. The ease of access and scrapping of the quotas alone may not bring significant liquidity into domestic financial markets.

### ***Launch of the Shanghai-London Stock Connect***

Added to the market openness mechanism of Shanghai-Hong Kong Stock Connect and Shenzhen-Hong Kong Stock Connect, on 17 June 2019 the CSRC and the Financial Conduct Authority of the United Kingdom released a joint announcement of their approval in principle of the establishment of the Shanghai-London Stock Connect. On the same day, the London Stock Exchange held the launch ceremony for the westbound business of Shanghai-London Stock Connect and the listing of global depositary receipts (GDRs) issued by Huatai Securities Co, Ltd (Huatai), a company listed on both the SSE and Hong Kong Stock Exchange.

Although bearing the same badge of Stock Connect, Shanghai-London Stock Connect works fundamentally different from the two mechanisms already in place. First, while the previous two mechanisms, belonging to a secondary market trading scheme, allow investors on one side to trade stocks listed on the other side, Shanghai-London Stock Connect works to allow eligible companies listed on the two stock exchanges to issue, list and trade depositary receipts on the counterpart's stock market in accordance with the corresponding laws and regulations, and so is a scheme that covers both the primary market and secondary market. Second, the trading targets under the Shanghai-Hong Kong Stock Connect and the Shenzhen-Hong Kong Stock Connect are shares listed on the counterpart's market, whereas the trading targets under the Shanghai-London Stock Connect are depositary receipts listed on the local stock exchange.

However, the launch of Shanghai-London Stock Connect is recognised more to be of symbolic importance, and it probably is not a game changer for the Chinese or UK stock markets. It is believed that the link will probably be largely illiquid at the beginning, due in part to unresolved compatibility issues. For example, Shanghai has a 10 per cent daily trading limit while London has none. So far, just one company, Huatai, is using the connect. HSBC Holdings PLC has previously said it would consider a Chinese listing. A comparable programme in Germany, which allowed Chinese companies to issue depositary receipts in Frankfurt, met with a lacklustre response in October 2018. More than half a year later, appliance giant Qingdao Haier Co Ltd remains the only company to have done so, and trading volumes have been low.

## **ii Developments affecting derivatives, securitisations and other structured products**

### ***Innovations within the securitisation market***

Securitisations were introduced by several central government departments in China in 2005 through the Credit Asset Securitisation (CAS), a pilot programme, but was suspended in 2008 following the onset of the global financial crisis amid concerns relating to securitised assets. The CAS framework, normally used by banking and non-banking financial institutions, was restarted in 2012 with an initial quota of 50 billion yuan. This has since been increased to 500 billion yuan, pursuant to an announcement by the State Council on 13 May 2015. Despite the explosive growth of ABS issuances in China, existing laws permit only a limited class of

investors to subscribe to ABS issuances adopting the special purpose trust (SPT) structure; this closed group mainly consists of domestic banks, insurance companies, securities companies and mutual funds. When credit assets originated by a commercial bank are repackaged into ABS sold to other commercial banks on the interbank bond market, there is no true transfer of risk. The situation is more akin to an exchange of risk within the banking industry, with no real offloading of risk to the capital markets.

Several innovations have been seen in the Chinese securitisation markets. These include a programme of securitisation of non-performing loans (NPLs) and trust structure asset-backed notes issued by corporates in the interbank market; this is similar to the SPT structure under the CAS framework. This is a welcome development, since corporate issuers now have access to the more liquid interbank market. In addition, for the first time in several years, collateralised loan obligation issuances by banks (which merely moved corporate loan assets from one bank balance sheet to another) have accounted for a smaller share of ABS issuances, relative to other forms of securitisation. This is also a healthy development. On the other hand, existing regulations do not permit direct foreign investment into an onshore trust holding securitised assets. In addition, existing routes for foreign investors to access domestic ABS issuances are very restrictive. Since 2016, trust structure asset-backed notes (ABNs) have allowed corporates to access the more liquid China interbank securitisation market. Assets backing the notes are entrusted to a newly established SPT under the Trust Law. Specifically, the ring-fencing protection provided by the ABN trust structure is similar to that provided under the CAS scheme, which is regulated by the PBOC and CBIRC and which until recently was accessible only to bank and non-bank financial institutions. In addition, elsewhere in the Chinese domestic securitisation market, over the 2017 to 2018 period the securitisation of NPLs, and the development of commercial mortgage-backed securities, quasi-real estate investment trust framework and supply chain finance ABS, especially in the context of the rapid development of the PRC e-commerce market, are especially noteworthy.

### **iii Cases and dispute settlement**

In the past, the most effective legal remedy for misconduct or wrongdoing in the capital markets has always been to seek government intervention rather than private dispute resolution. During the past year, the CSRC has broken several records regarding the amounts of fines for misconduct in the secondary market (i.e., a record 1.8 billion yuan fine for a case of manipulation of a stock price was soon surpassed by a 5.5 billion yuan fine for another similar case). However, for wrongdoings before IPOs, the CSRC's punishment is still not much more than a slap on the wrist, especially considering that delisting rules might not be implemented in the way they are written. The legal remedies available to investors are also extremely limited. Under current Chinese securities and civil procedure laws, they may not sue a company and its intermediaries for fraud, and there is no effective mechanism for class action litigation for investors to take collective action. The lack of effective deterrents and the failure to provide effective protection for investors in China are in sharp contrast to the efficient investor protection mechanism in developed economies.

### **iv Relevant tax and insolvency law**

#### ***Plan for significant tax cut***

In November 2018, the Ministry of Finance and State Administration of Taxation jointly confirmed a three-year waiver of the value added tax (VAT) and corporate income tax on interest income received by overseas institutions from investing in Chinese bonds. At the

National People's Congress in March 2019, the government lifted its 2019 budget deficit target to 2.8 per cent of GDP from last year's 2.6 per cent, and cut business and personal taxes by 1.3 trillion yuan, which is more than the 1.1 trillion yuan seen in 2018's tax cuts. The government has also announced cuts in the VAT rate for manufacturing firms from 16 to 13 per cent, and has reduced the rate for transport and construction firms from 10 to 9 per cent. The calculation is that reducing the tax burden of households will mean that they become more confident in their consumption, and that the lower operating costs of businesses will make them more attractive to invest in. The demand impact may thus lead to more organic growth and less reliance on stimulus.

### ***Latest developments in the insolvency laws***

Slowing growth has led to an increasing bankruptcy caseload for China's court system, which is spilling over into foreign jurisdictions, including the Special Administrative Region of Hong Kong. In 2019, Shenzhen set up a bankruptcy court to handle cross-border cases, aimed at helping officials in Guangdong trace assets of bankrupt businesses in the mainland that have been transferred to Hong Kong. In 2018, according to the Supreme People's Court, nearly 7,000 bankruptcy cases were settled, more than the 6,257 bankruptcies seen in 2017. As early as 2016, anticipating larger bankruptcy caseloads, a number of provincial-level courts and governments announced plans for measures to help bankruptcy processes move more smoothly, efficiently and transparently. Although their approaches vary, measures being taken include simplifying the proceedings in minor and uncontested cases, establishing a special bankruptcy division within the courts and setting up information-sharing mechanisms. It remains to be seen how these measures will be implemented in practice, and what their impact will be on bankruptcy and reorganisation practices in China.

In August 2017, the CBIRC (then China Banking Regulatory Commission) told the fifth session of the 12th National People's Congress that it was preparing rules on bankruptcy risk management. The new rules were to push forward legal protection for close-out netting, the primary means of mitigating credit risks associated with OTC derivatives, according to the CBIRC, which said it would work with the International Swaps and Derivatives Association to establish a close-out netting arrangement for Chinese commercial banks. This reform, along with the introduction of a deposit insurance guarantee scheme in 2015, would provide additional clarity about investors' place in the credit structure of Chinese banks, which has been unclear due to the implicit government guarantee. The deposit insurance system guarantees accounts with deposits of up to 500,000 yuan. In February 2019, the CBIRC released draft rules for industry comment setting clear limits on the business areas in which bad debt managers could operate, including provincial level bad debt managers as well as the four dedicated NPL managers set up in 1999. The rules would allow the institutions to acquire, manage, operate and dispose of NPLs and engage in debt restructuring, debt-to-equity swaps and bankruptcy management, but prohibit the use of repo agreements that would allow banks to sell bad loans for future repurchase. In our opinion, given the relative clarity of the new rules for disposition of NPLs, regulators should consider allowing foreign financial firms to purchase NPLs directly from commercial banks.

### **v Role of exchanges, central counterparties and rating agencies**

There have been no significant changes to the role of the exchanges, central counterparties and rating agencies in China during the past year.

## vi Other strategic considerations

On the equities side, the global index provider Morgan Stanley Capital Investment (MSCI) announced in February 2019 that it would quadruple the weighting of Chinese mainland A-shares in its global benchmarks and add 168 mid-cap and 27 small-cap securities listed on the ChiNext Index. It plans to raise its inclusion factor of yuan-traded shares from 5 to 20 per cent in three stages from May to November 2019. Upon completion, Chinese stocks will account for a 3.3 per cent weighting in the *pro forma* MSCI Emerging Stocks Index. FTSE Russell (the trading name of Financial Times Stock Exchange International, the British provider of stock market indices and data services) announced in September 2018 that it would add shares to its FTSE Emerging Index in three phases from June 2019 to March 2020. A-shares are projected to account for 0.57 per cent of the FTSE Global All Cap Index after the completion of the first of the three phases.

Reacting in part to the opening-up policies of the Chinese government, Bloomberg confirmed in January 2019 that Chinese yuan-denominated government and policy bank securities would be added to the Bloomberg Barclays Global Aggregate Index starting in April 2019 and phased in over a 20-month period. The S&P Dow Jones Indices started to include eligible A-shares from September 2019, based on shares that are accessible via the northbound Stock Connect channels.

As flows increase, so too will the diversity of global investors participating in China's capital markets. However, we notice that despite the aforementioned reforms that have led to the index inclusions, there remain practical barriers that impede attracting more global institutional investors to China's equity capital markets. The following are all critical for the further strengthening and globalisation of China's equity market:

- a* adopting global standards for matters such as an effective closing auction mechanism;
- b* the development of an efficient stock borrow loan mechanism for hedging;
- c* the ability to offer QFII and RQFII investors the ability to sell through multiple brokers for best execution;
- d* improvements to the block trading mechanism; and
- e* the settlement of securities on a DVP basis.

## III OUTLOOK AND CONCLUSIONS

China's capital markets, already among the largest in the world, are playing a key role as the country becomes a consumption-driven economy, seeking to break through the middle-income trap as it deals with an ageing society and the threat of slower economic growth. As external pressures keep building, China's rise is no longer seen as an unqualified gain to the global system: in some quarters, it is perceived as a threat. China is also hampered by a economy that is slowing down from its double-digit growth performance in the 2000s, and concerns about rising debt levels of local governments and non-performing loan ratios at China's banks, both of which may be under-reported. The worsening of China's geopolitical and economic environment in many respects underlines the importance and urgency of continued reform in its capital markets, which if trade earnings are squeezed can serve as an alternative growth driver by mobilising domestic and foreign savings to create wealth through investment in new businesses and technologies. There is no single easy way out, but rather a constellation of interrelated actions leading to a larger goal. With so much at stake, it is anybody's guess how this will be achieved well, mainly from the top down. Maybe it is time to reflect on the nature of the capital market: after all, it is, first and foremost, a market.

# COLOMBIA

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## I INTRODUCTION

### i Legal structure

Pursuant to the Colombian Constitution, Congress has the power to prescribe the general legal framework within which the government and other authorities regulate the Colombian capital markets. The Constitution also permits Congress to authorise government intervention in the economy by statute. The agencies vested with the authority to regulate the financial system are the board of directors of the Colombian Central Bank, the Ministry of Finance, the Superintendency of Finance, the Superintendency of Industry and Commerce, and the Securities Market Self-Regulatory Organisation (SRO).

Consistent with the civil law system, laws, decrees and judicial decisions are organised as a subordinated set of rules. As such, at the top of the legal system in terms of hierarchy and applicability is the Constitution, and below are the laws enacted by Congress. Directly below the laws are decrees issued by the national government, which often regulate specific fields within the range of the provision of the law that authorises their issuance. Being deemed less important than in a common law system, the decisions of judges are subordinated to the laws and decrees on the grounds of which their positions are defined regarding specific issues.

This basic and general description of the Colombian legal system explains the features of the regulation of the capital markets on the basis of the active role of the government and the numerous interactions arising among participants, also taking into account the importance that has been constitutionally ascribed to the stability of the Colombian financial system. Colombia's capital markets are mainly governed by Law 964, issued by Congress in 2005, which provides the framework for the government's intervention. Following the general principles of Law 964, the government issued Decree 2555 in 2010, which consolidates the various regulations that were issued prior to 2010 to regulate the capital markets, and which – more importantly – automatically embraces any decrees issued afterwards in an effective attempt by the government to modernise the regulation and match it to international standards.

Law 964 provides the fundamental relevant concepts, but Decree 2555 became the most important source of rules for participants in the financial, securities and insurance activities described therein; in fact, each supervised financial entity (banks, insurance companies, credit rating agencies, etc.) will find the corresponding rules that govern its activities within Decree 2555. Likewise, every procedure before the Superintendency of

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Finance regarding authorisations or supervised matters of financial entities is governed by Decree 2555. Moreover, the Basic Legal Circular of the Superintendency of Finance develops the provisions contained in Decree 2555, providing a more detailed set of rules that govern the activities of financial entities.

Colombian securities markets are subject to the supervision and regulation of the Superintendency of Finance, which was created in 2005 following the merger of the Superintendency of Banking and Superintendency of Securities. All the powers and responsibilities of the former Superintendency of Banking and Superintendency of Securities were assigned to the newly created Superintendency of Finance. The Superintendency of Finance is an independent technical regulatory entity ascribed to the Ministry of Finance. It has the authority to inspect, supervise and control the financial, insurance and securities exchange sectors, and any other activities related to the use, investment and management of resources collected from the public. Accordingly, issuers of securities and their subsidiaries are subject to the control, supervision and regulation of the Superintendency of Finance as financial institutions as well as issuers of securities. In general terms, the Superintendency of Finance has the responsibility to supervise the Colombian financial system with the main purpose of preserving its stability, as well as protecting the users of financial and insurance services and investors in general.

In the exercise of the regulatory powers granted to the Superintendency of Finance, the Basic Legal Circular Letter and the Basic Financial and Accounting Circular Letter were issued in order to develop and regulate the provisions of the decrees issued by the government to govern financial, insurance and securities activities. Circular letters of the Superintendency of Finance are general communications of mandatory compliance intended to regulate and provide guidelines, and also set the doctrine and position of the Superintendency of Finance in its scope of supervision.

The Colombian Stock Exchange is the sole trading market for common and preferred shares. There are no official market makers or independent specialists on the Colombian Stock Exchange to ensure market liquidity; therefore, orders to buy or sell in excess of corresponding orders to sell or buy will not be executed.

Self-regulation in the capital markets was formally introduced in Colombia by Law 964 of 2005, and the SRO was created in June 2006. The SRO is a private entity that has the power to supervise, sanction and regulate those entities subject to self-regulation (i.e., including securities intermediaries and any entities that voluntarily submit themselves to self-regulation). The SRO's supervisory powers entitle it to review compliance with the applicable laws and regulations and to impose sanctions in the event of violations. The SRO may also propose regulations aimed at various matters, including conflicts of interest and improving the integrity and quality of the capital markets.

## **ii Specific issues**

### ***Minimum requirements of capital***

Decree 2555 is a technical compendium of rules regarding the Colombian financial system that aims to set out a comprehensive set of measures protecting the market's transparency and customers' security. The first issue that has broadly concerned the government is the minimum solvency indicators required by financial entities to legally undertake activities in Colombia. The capital structures of different financial entities must comply with minimum requirements that are calculated under precise rules specifically described in Decree 2555.



These rules are very strict when a new local or foreign financial entity plans to undertake a supervised activity in Colombia, but previously established financial entities must also periodically demonstrate their compliance with the capital minimums.

### ***Control over investments***

Another issue that has been extensively regulated is the investment limits of financial entities, particularly regarding the shares of other corporations. As a result of this regulation, affiliates of a financial entity may only be those expressly permitted under the corresponding rules according to the nature of each financial entity, and transactions of the financial entity may not stray outside the principal purpose of the financial entity, to avoid the risk of the entity entering a non-core business area.

In recent years, the Superintendency of Finance has assumed the duty of protecting the market from illegal financial activities that are mainly carried out by unauthorised parties or companies. In that regard, financial institutions must obtain the authorisation of the Superintendency of Finance before commencing operations. Any such authorisation given by the Superintendency of Finance to a financial entity is usually limited to the activities requested, fulfilling specific requirements, but may exclude other activities that might be considered illegal if they are undertaken, and may include authorisations for different financial activities.

### ***Material information***

Securities issuers must comply with the regulations regarding public information disclosure, which have been integrated into the Decree 2555 rules. According to the group of articles regarding public information disclosure, events that should have been taken into account by a prudent and diligent expert when buying, selling or keeping a security must be disclosed to the market. In addition, under Decree 2555, the aforesaid general rule is supplemented by specific situations that warrant disclosing information without completing a subjective analysis regarding the materiality of the event. The Superintendency of Finance has arranged an online system, SIMEV, through which such information must be disclosed to the market.

### ***Investment funds***

Under Decree 2555, investment funds have been subject to more extended regulation for the important reason that these instruments have garnered more attention from local and foreign investors. Investment fund administration is a task that only brokers, investment administration corporations and trust companies can perform. Moreover, securities of investment funds are not negotiated on the same platform used to negotiate stocks, as a specific negotiation platform has been developed in Colombia for listed investment fund securities. There is also regulation of specific types of investment fund, such as currency market, real estate, speculation and margin.

### ***Public tender offer rules***

Pursuant to Colombian law, the acquisition of the following should be made pursuant to the public tender offer rules:

- a* the beneficial ownership of 25 per cent or more of the outstanding shares with voting rights of a listed company; or

- b* the purchase of 5 per cent or more of the outstanding shares with voting rights by a shareholder or group of shareholders beneficially owning 25 per cent or more of the outstanding shares of a listed company.

Moreover, any beneficial owner included under (b) may only make an acquisition by tendering an offer directed at all the holders of the company's shares, following the procedures established by the government. These requirements do not need to be met under certain circumstances described in Decree 2555.

## **II THE YEAR IN REVIEW**

Between January 2019 and August 2019, the Colombian capital markets have witnessed 22 debt public offerings, three public tender offers and no equity offerings. In the context of sustained economic growth and the collapse in 2012 of the largest broker-dealer on the market, the government has faced multiple challenges. As a consequence, for the past few years there have been many developments affecting debt and equity offerings, as described below.

### **i Developments affecting debt and equity offerings**

The past two years have been difficult for the international market. Amid the international market conditions, Colombia has been able to sustain economic growth, representing multiple challenges for the government and its agencies. Regardless of the surprising economic conditions, the Colombian capital markets have been affected and have not been as active as they have been in the past.

During the year in review (August 2018 to August 2019), there have not been many developments affecting debt and equity offerings, as will be seen below. However, the Colombian stock exchange market has seen a new kind of issuance of debt: the green note.

In this regard, since 2017, some Colombian companies have begun to issue green notes in the Colombian stock exchange market. Green notes are defined as debt securities that are issued to raise capital specifically to support projects that contribute to environmental sustainability. The resources obtained by means of the issuance of green notes must be used only in productive projects that have environmental impacts. Entities such as Banco de Comercio del Exterior de Colombia (Bancóldex), Bancolombia, Celsia, ISA, Findeter and Davivienda, among others, have been pioneers in venturing into this market.

In the current year, the first sustainable notes were issued and offered in the Colombian public market by Findeter and Bancolombia. The main difference between green notes and sustainable notes is that sustainable notes are issued to support both projects that contribute to the environment and to society. Thus, sustainable notes are the genus, and green bonds are the species.

For a green note to be issued and labelled as such, a potential issuer must face an international certification process. In this process, an assessment is made to verify the ability of the potential issuer to issue a green note, if there are green projects in the region and if there is a robust environmental policy within the potential issuer.

Finally, green notes and sustainable notes are a growing market in Colombia that will continue to be relevant in terms of financing the sustainable development of the country.

### ***The fund management company investment regime***

In 2012,<sup>2</sup> Congress adopted the use of public–private partnerships (PPPs), mainly in public infrastructure contracts. Since then, the government has put its best efforts into promoting this framework.

In this vein, Decree 816 of 2014 modifies the investment regime for fund management companies. According to Articles 2, 3 and 4, funds with moderate, major and long-term risk profiles are able to invest 5, 7 and 5 per cent, respectively, of their assets in private equity funds in the event that these funds allocate 66 per cent of their resources to PPP infrastructure projects.

The same permission, *mutatis mutandis*, is given to private equity funds managed by stockbrokers registered in the public market, and to trust and life insurance companies.<sup>3</sup>

The government has developed and established a plan to develop infrastructure known as 4G (fourth generation roads).

### ***Inscription of securities in the secondary market***

Inspired by Rule 144A in the United States, some years ago the government adopted a secondary market as a way of facilitating and encouraging distribution to authorised investors of securities inscribed in a certain way in the National Registry of Securities and Issuers (RNVE).

Nevertheless, there has been a poor response within the market to this institution. Accordingly, Decree 1019 of 2014 introduced the following changes to the registration and operation of the secondary market:

- a* securities do not have to be graded by a ratings agency to register in the RNVE;
- b* securities registration in the RNVE is automatic, provided the issuers submit some basic information to the Superintendency of Finance; and
- c* with certain minor restrictions, the promotion of issuances directly or through professional brokers is allowed.

Finally, disclosure duties, after issuance, are limited to the requests of holders.

### ***Regulation on leveraged operations in collective portfolio management***

According to Decree 2555, joint portfolios can only be managed by stockbroker companies, trust companies or investment management companies. Before Decree 1068 of 2014, these collective funds were able to carry out leveraged operations up to the value of 100 per cent of their assets.

The new rule allows collective portfolio managers to make leveraged operations above this amount provided that they are accepted by a central counterparty (CCP) clearing house, and are encompassed by the by-laws of the clearing house.

Decree 1068 also set out a revised term (until 14 December 2014) for managers of joint funds to accomplish the requirements established in Decree 1242 of 2013.<sup>4</sup>

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2 Law 1508 of 2012.

3 Decree 816, Articles 5 and 6.

4 Relating to entities authorised to manage joint funds (i.e., only stockbroker companies, trust companies and investment companies) and their denomination as mutual investment management companies.

### ***Price stabilisation for initial public offerings***

The government issued Decree 2510 on 4 December 2014, updating Decree 2555 of 2010 by introducing some modifications and new chapters. With these amendments, it intends to establish a price stabilisation mechanism for initial public offerings of notes and shares. As defined, the main purpose is that of preventing or slowing down any fall in the market value of the security issued.

Only a previously contracted brokerage firm is allowed to act as a price stabiliser. There are two mechanisms under which brokers can operate as stabilisers in the Colombian markets: through the temporal transfer of securities or by adjudication of securities with the possibility of reacquiring them.

This same legal disposition provides a definition of short sale, and prescribes that the principles of the International Organization of Securities Commission determined for this kind of operation shall be observed. Even though this legal provision is vague regarding the terms and conditions applicable for the execution of a short sale operation, as it delegates this responsibility to the Superintendency of Finance, it does propose that the Colombian stock market regulations determine which securities can be considered as short sale operations and that those operations will always have to be indicated as such.

### ***Duty of advice***

The Ministry of Finance issued Decree 661 of 2018, which regulates the duty of advice every financial entity must undertake when offering securities to investors, including retail investors. The Decree pursues the protection of investors and the disclosure of possible conflicts of interest that may arise in the execution of operations in the capital markets. Moreover, it was issued with the purpose of clarifying the obligations and duties of transparency, information and advising regarding investors, in accordance with international standards.

Nevertheless, the response of market actors to the issuance of the Decree was negative. The Decree imposed burdens on financial entities that led to the discouragement of the offering of securities to retail investors. Likewise, the offering of securities to retail investors implies high operational cost that will not retribute taking into consideration the amounts traded by this kind of investor.

Currently, the Superintendence of Finance is working on the release of an external circular that will develop and regulate Decree 661 of 2018. To date, no external circular regarding this matter has been released by the Superintendency of Finance. Notwithstanding the aforementioned, the Capital Market Mission has advised the government to review and amend the Decree considering the proposed structure and the adverse effects the regulation may produce in regards to retail investors.

### ***Capital Market Mission of 2019***

In 2018, President Ivan Duque put together a group of experts to review and evaluate the Colombian capital markets, known as the Capital Market Mission. On 9 August 2019, the Capital Market Mission deliver to the President a document containing recommendations, suggestions and actions to guide public policy towards the deepening, development and revitalisation of the Colombian capital markets.

The approach of the Capital Market Mission to the Colombian capital markets highlighted the core problems. As a result, the Capital Market Mission provide certain

recommendations regarding the role of the authorities; the structure of the capital markets, including the possibility to admit a variety of market agents; and the securitisation markets, suggesting the creation of shelf offering for small and medium-sized companies' access.

## **ii Developments affecting derivatives, securitisations and other structured products**

The derivatives market was officially established in 2008. Since then, it has experienced accelerated growth, and the trading volume is growing exponentially each year. This dynamic growth has also been observed in securitisations and other structured products.

### ***External Circular DODM-144***

On 27 March 2014, the Central Bank released External Circular DODM-144 regarding derivatives operations. The changes introduced thereby consist of the modification of the requirements for external agents authorised to carry out derivatives operations with Colombian residents; a new format for reporting derivatives operations related to basic products and made between residents and external agents; and the variation of the term to report the derivatives operations to the Central Bank.

On 25 May 2018, the Central Bank released modifications to External Circular DODM-144. The modifications included more flexibility regarding delivery derivatives: prior to the modification, delivery derivatives were only allowed in certain events, and it was mandatory to comply with additional document reports. Every authorised external agent is also required to include close-out netting provisions in agreements subscribed to by Colombian residents. Moreover, as of 25 May 2018, authorised external agents and Colombian financial entities may carry out credit default swap derivatives.

Under this regulation, authorised external agents are those that have previously completed agreements with currency exchange market intermediaries, and those that have completed transactions on derivatives in the past year with net values over US\$1 billion.

### ***Simultaneous or temporary transfers of securities operations***

Decree 2878 of 2013, which came into force on 11 May 2013, introduced two major changes to the regulation of the temporary purchase of assets or repos.<sup>5</sup>

The first consists of the creation of a guarantee scheme for the benefit of the stock market, the trading system or the clearing houses, depending on the mechanism used for the transaction. The guarantees admissible to back up these transactions are treasury securities, certain stocks quoted on the public market, cash or fixed-income securities.

The second is a limitation on the number of shares on which repo transactions can be made. In fact, according to Article 7 of Decree 2878, the maximum percentage of shares that may be the object of a repo operation is 25 per cent of the total available in the market.

## **iii Cases and dispute settlement**

There are no recent disputes relating to cross-border financial market activity. However, this situation is subject to change as a result of the establishment of the Latin American Integrated Market (MILA).<sup>6</sup> In view of this, there are four issues that should be taken into account.

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<sup>5</sup> Operations for the simultaneous or temporary transfer of securities.

<sup>6</sup> The MILA exchange was launched on 30 May 2011 by Chile, Colombia and Peru.

***Limits on share purchases***

In Article 88 of the Organic Statute of the Financial System, the Superintendency of Finance consolidated its position regarding the quantitative and substantial limits to the purchase of shares in the public market. According to Article 88, any transaction by foreign or national investors purchasing 10 per cent or more of the shares issued by a financial institution under the surveillance of the Superintendency must have the prior approval of the Superintendent of Finance.<sup>7</sup>

***Requirements for advertising financial products or services***

The Concept of 28 March 2014 issued by the Superintendency of Finance contains the official interpretation of the rules governing the promotion and issuance of financial products and services by foreign nationals in Colombia. It sets out that all financial institutions and stock markets located outside the country must establish a representative office or undertake a correspondent agreement with a national broker-dealer to promote or advertise financial products and services within Colombia.<sup>8</sup> However, this general rule does not apply in the event that the interest in establishing a commercial relationship with a foreign institution comes from a Colombian resident, and this relationship is not a consequence of promotional activity in Colombia or targeted at its residents.

***Offerings outside the Colombian territory***

Article 6.12.1.1.1 of Decree 2555 specifically establishes that securities offerings made abroad will be submitted to foreign law. In recent years, many Colombian companies have successfully entered foreign markets seeking fresh resources for their activities.

***Protection for security holders in insolvency processes***

Notwithstanding the foregoing, Colombian law gives special protection to Colombian investors in the national market or abroad, as was proven in the insolvency process of a national company that issued notes in Luxembourg.<sup>9</sup> Article 50 of Law 1116 of 2006 excludes from the insolvency regime any acts or contracts related to the issuance of securities in Colombia or abroad.

***Colombia's interest in joining the OECD and the OECD's recommendations***

On 25 May 2018, Colombia became the 37th country to join the OECD. Pursuant to the recommendations made by the OECD, Colombia has reformed its judicial and legislative system, reduced informality in the labour market and reformed its corporate liability regimen, among other measures adopted.

Following recommendations made by the OECD, the government intends to reinforce some of its legal dispositions, such as the independence of the financial supervisor (the Superintendency of Finance), to grant more protection to the authority or supervisor, and to provide the supervisor with the appropriate tools so that he or she would be able to control

7 The Concept of 5 February 2014 issued by the Superintendency of Finance.

8 [https://webcache.googleusercontent.com/search?q=cache:5Xsn1PcLuW4J:https://www.superfinanciera.gov.co/descargas%3Fcom%3Dinstitucional%26name%3DpubFile1007626%26downloadname%3D2014021548\\_001.docx+&cd=1&hl=es&ct=clnk&gl=co](https://webcache.googleusercontent.com/search?q=cache:5Xsn1PcLuW4J:https://www.superfinanciera.gov.co/descargas%3Fcom%3Dinstitucional%26name%3DpubFile1007626%26downloadname%3D2014021548_001.docx+&cd=1&hl=es&ct=clnk&gl=co).

9 Superintendency of Corporations Act No. 405-001770, 2 September 2014.

financial conglomerates. This innovation regime has already begun with the implementation of Law 1870 of 2017, which defines a financial conglomerate as a set of institutions with a common parent company that includes two or more domestic or foreign entities involved in an activity regulated by the Superintendency of Finance.

Law 1870 grants the Superintendency of Finance several powers to improve the regulation and supervision of financial conglomerates in Colombia, and the controlling entities of financial entities domiciled in Colombia. This is a great innovation as, before Law 1870, the Superintendency of Finance could only supervise and control activities over financial entities incorporated in Colombia. Following the enactment of Law 1870, regulations applicable to financial conglomerates have been included in Decree 2555 through Decree 246 of 2018 and Decree 774 of 2018.

Moreover, Congress enacted Law No. 1735 of 2014, which created a new type of financial institution with the sole purpose of offering electronic deposits and payments: companies specialising in electronic deposits and payments (SEDPEs). Regulation of the operations of SEDPEs, as well as know your customer requirements, were included by the government in Decree 1491 of 2015 and in Decree 2076 of 2017.

### ***Corporate Governance Code***

The Superintendency of Finance, in an alliance with the Latin American Development Bank, presented a Corporate Governance Code to be implemented by companies from 2016. All Colombian issuers, such as Bancolombia, Porvenir, Nutresa, have now implemented it. The Code seeks to create sustainability to stimulate growth in the capital market and give access to more resources. This corporate guideline consists of 33 measures that group 148 recommendations related to the rights and equitable treatment of shareholders, general meetings of shareholders, the board of directors, control architecture, conflicts of interest, and the transparency of financial and non-financial information.

### **iv Relevant tax and insolvency law**

Law 1739 introduced an exception to the tax rules regarding the place of effective management, under which a foreign entity would not be deemed as a domestic entity for income tax purposes. Under this new exception, foreign entities that have issued stock or notes on the Colombian public market (or a foreign public market recognised by the Colombian tax administration) would not be considered as having their place of effective management in Colombia. This rule, which also covers entities subordinated to the notes or stock issuer, can be voluntarily waived by the subordinated entities, which in such a case will be treated as a domestic entity for income tax purposes.

Insolvency law has not undergone any substantial change since 2006, when Law 1116 was enacted, regarding which the following should be noted. Under Law 1116, cross-border insolvency procedures are recognised in Colombia in four situations:

- a* a foreign tribunal or foreign representative requests the assistance of Colombia in an insolvency procedure undertaken abroad;
- b* assistance is requested in a foreign country regarding an insolvency procedure that is being undertaken according to Colombian law;
- c* insolvency procedures of one debtor are being undertaken simultaneously in Colombia and in a foreign country; and

- d* creditors or any other interested parties abroad have the intention of requesting a new insolvency procedure or participating in a current insolvency procedure under Colombian law.

**v Role of exchanges, central counterparties and rating agencies**

A Latin American exchange is the most significant recent project to improve local capital markets. MILA seeks to unify the stock markets of Colombia, Chile, Mexico and Peru by creating a single stock market that allows the trading of shares of the most representative companies in the region. It is the result of an agreement signed between the aforementioned exchanges that is more an alliance than a merger, and its most important feature is that none of the exchanges of entry compromises its autonomy or independence in regulatory or administrative matters as a result of the agreement. Instead, investors can benefit from MILA through an intermediary by using the local platform in local currency, but can also reach the companies listed in any of the exchanges involved.

MILA has seen some difficulties in regards to the systematisation of the execution of operations and transactions: these arise from the different processes to execute transactions, such as the clearing and settlement process.

As providers of infrastructure for the securities market, companies that take on counterparty credit risk are regulated by Decree 2555 and supervised by the Financial Superintendency. A CCP is a company that exclusively performs activities related to transactions between investors, intermediaries and issuers. However, a CCP is authorised to provide its services to exchange transactions, and to effect transactions outside the stock market. Each time a CCP performs an operation, the regulation automatically assigns a zero credit risk exposure value to the operation; the same occurs when the CCP grants security over the operation.

The credit rating agencies also have a specific regulatory chapter under Decree 2555. This regulation has been made as an attempt to protect the market from non-independent ratings that could lead investors to take those ratings into account in their decision-making. As a result, Decree 2555 includes a complete set of rules applicable to credit rating agencies in terms of the professionalism of their analysts, isolated personnel structures of issuers and intermediaries, and codes of ethics and conduct that must be implemented within the credit rating agencies towards the conservation of very high standards of independence. Qualification procedures must follow the internal regulations issued by each credit rating agency, and must be previously approved by the Superintendency of Finance. Credit rating committees must also be created within each credit rating agency, and decisions are rigorously supervised by the Superintendency of Finance.

Pursuant to the commitments that Colombia has assumed under MILA, and to develop the integration of Colombian financial and securities markets, through Decree 2241 of 2015 and Decree 1756 of 2017, certain initiatives have been implemented by the authorities during the past three years to increase the range of securities that can be listed and traded on the Colombian Stock Exchange.



## vi Other strategic considerations

Consistent with recent experience, since the *Interbolsa* case,<sup>10</sup> the Superintendency of Finance has been reluctant to authorise the issuance of derivatives and other structured products.

Given this position, it is important that issuers be renowned participants in the market and show the authorities enough guarantees and experience to obtain approval for these operations.

It is also important to highlight that MILA represents an important and unprecedented opportunity to make successful issuances of securities, as has recently been demonstrated by several Peruvian companies.<sup>11</sup>

## III OUTLOOK AND CONCLUSIONS

As previously stated, MILA provides an unprecedented opportunity for participants in the Colombian capital markets. In that regard, the government issued Decree 2241 of 24 November 2015, by means of which it established the list of securities that may be quoted on foreign trading systems and sets forth the rules that modify the current exchange regime to promote its operation in an integrated market.

As stated by the Superintendency of Finance, the outlook for Colombia's market regulation is a strengthening of the risk-based supervision model. This model focuses on activities that pose major risks for each entity and its management.

From this perspective, and inspired by the Canadian model, the authorities periodically produce a risk profile for each entity and, based on the outlook, establish a set of prompt corrective actions. The seven risks that are evaluated periodically by the Superintendency of Finance are debt risks, market risks, liquidity risks, operational risks, laundering and financing of terrorism risks, insurance risks and reputational risks.

Even if the main advantage of this regulatory model is that it takes into account the special characteristics of each regulated entity and permits the development of new products in the market, a declaration by the Superintendency of Finance in 2014, paraphrasing Thomas Paine, remains pertinent: regulation is but a necessary evil for the market.

Finally, and taking into account the current sociopolitical context in Colombia, it is worth highlighting two proposals by the new government to strengthen the capital markets sector.<sup>12</sup> The first is to amend Law 964 of 2005, which regulates activities related to the use, management and investment of resources obtained from the public, through securities. This modification is based on the desire to adapt Colombian securities and financial regulations to the changes that have occurred in capital markets around the world, and to the technological developments within the securities and trading sectors in other countries. A second proposal

10 Until November 2012, Interbolsa was the largest operator in the local capital markets; in fact, prior to its liquidation, the company was involved in approximately 30 per cent (by volume) of the brokerage activities in the Colombian capital markets. Nevertheless, in the three years prior to the forced intervention of the government in its operations, the company carved out temporary transfer operations over specific stock that affected its solvency indicators in a major and unexpected way. As a result, in November 2012, Interbolsa was unable to pay a short-term loan of US\$10 million.

11 Namely, Vg ICBC Peru Bank SA, Aseguradora Magallanes, Financiera Nueva Visión, Compañía de Seguros de Vida Cámara and Rigel Perú SA.

12 See <https://www.dinero.com/pais/articulo/las-propuestas-de-duque-para-mejorar-el-mercado-de-capitales/261164>.

is to introduce other financial instruments and securities in such a way that more companies can access the Colombian stock exchange market as a financing instrument. Both of the proposals are covered in the document provided by the Capital Market Mission to President Ivan Duque, among others, as referred to above.

It is expected that the proposals of the Capital Market Mission will be submitted by the government for approval by Congress by means of the amendment of Law 964 of 2005 and other main laws pertaining to the financial and securities exchange sector.

# DENMARK

*Rikke Schiøtt Petersen, Morten Nybom Bethe and Knuth Larsen<sup>1</sup>*

## I INTRODUCTION

### i Structure of the law

The law governing the Danish capital markets is largely based on EU law. Accordingly, many Danish regulatory structures will be familiar to capital market practitioners in other EU Member States. The primary legislation of Danish capital markets is:

- a* the Capital Markets Act,<sup>2</sup> which, inter alia, regulates public offerings of securities;
- b* the Financial Business Act,<sup>3</sup> which regulates financial businesses, including portfolio management;
- c* the Act on Investment Associations, etc.,<sup>4</sup> which regulates the activities of Danish and foreign undertakings for collective investment in transferable securities (UCITS);
- d* the Act on Managers of Alternative Investment Funds,<sup>5</sup> which implements the EU Alternative Investment Fund Managers Directive and regulates the managers of alternative investment funds as well as the marketing of alternative investment funds;
- e* the EU Market Abuse Regulation<sup>6</sup> (MAR); and
- f* the EU Prospectus Regulation.<sup>7</sup>

A number of delegated acts (executive orders) issued pursuant to the foregoing Acts are also key. The most important executive orders include:

- a* the Prospectus Executive Order;<sup>8</sup>
- b* the Executive Order on Major Shareholders;<sup>9</sup>
- c* the Executive Order on Takeover Bids;<sup>10</sup> and
- d* the Executive Order on Conditions for Admission of Securities to Official Listing.<sup>11</sup>

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1 Rikke Schiøtt Petersen and Morten Nybom Bethe are partners and Knuth Larsen is an assistant attorney at Gorrissen Federspiel.

2 Consolidated Act No. 931 of 6 September 2019, as amended.

3 Consolidated Act No. 937 of 6 September 2019, as amended.

4 Consolidated Act No. 1154 of 19 September 2018, as amended.

5 Consolidated Act No. 1166 of 19 September 2018, as amended.

6 Regulation (EU) No. 596/2014 on market abuse, as amended.

7 Regulation (EU) No. 1129/2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market.

8 Executive Order No. 1170 of 25 October 2018 on Prospectuses.

9 Executive Order No. 1172 of 31 October 2017 on Major Shareholders.

10 Executive Order No. 1171 of 31 October 2017 on Takeover Bids.

11 Executive Order No. 1170 of 31 October 2017 on Conditions for Admission of Securities to Official Listing.

## **ii Stock exchange regulations**

In Denmark, securities can be admitted to trading and official listing on two marketplaces: Nasdaq Copenhagen and Nasdaq First North Growth Market (First North). Nasdaq Copenhagen is a regulated market, whereas First North is a multilateral trading facility (MTF) registered as a small and medium-sized enterprise (SME) growth market, and thus not subject to EU regulation applicable to regulated markets (e.g., the rules on regulated markets in Markets in Financial Instruments Directive (MiFID II), IFRS and the Transparency Directive).<sup>12</sup> Nasdaq Copenhagen is a separate legal entity incorporated under Danish law and a member of NASDAQ OMX Nordic, which in turn is part of NASDAQ OMX Group Inc.

Nasdaq Copenhagen has issued certain sets of rules, including rules for issuers of shares governing, inter alia, the requirements for admission to trading and official listing, disclosure requirements for issuers of shares and rules on internal rules and rules for issuers of bonds and other types of securities.

In addition to the rules contained in Nasdaq Copenhagen's rule book, rules governing admission to trading and official listing and ongoing reporting obligations, etc., are found in the Capital Markets Act, implementing relevant EU regulations including the Transparency Directive and MiFID II and supplementing other relevant EU regulations such as MAR.

## **iii Structure of the courts**

The Danish court system is based on a three-tier organisation of the ordinary courts: the district courts; the two high courts (the Eastern High Court and the Western High Court) and the Maritime and Commercial High Court; and the Supreme Court. Generally, any filing for litigation must be brought before the competent district court as the court of first instance with an option to appeal to the relevant high court. However, suits involving matters of principle may be referred to the High Court in the first instance, and suits regarding commercial matters may be brought directly before the Maritime and Commercial High Court, which has its seat in Copenhagen.

As an alternative to the traditional court system, the Danish Institute of Arbitration operates a permanent arbitration institution that assists in the resolution of different types of disputes in relation to both national and international arbitration. The Danish Institute of Arbitration may appoint arbitral tribunals for all matters of law that are considered arbitrable (i.e., not matters that must be brought before an ordinary court of law). Decisions and awards by an arbitral tribunal seated in Denmark are final and binding and not subject to judicial review, except for the reasons of invalidity as stated in the 1958 Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York Convention). Denmark is a contracting state to the New York Convention, and Danish arbitral awards are generally enforceable in other New York Convention contracting states.

## **iv Local agencies and the central bank**

The Danish Financial Supervisory Authority (FSA) is a governmental agency and part of the Ministry of Industry, Business and Financial Affairs. The FSA's main task is to supervise compliance by financial undertakings and issuers of securities as well as investors on the securities market.

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12 Directive 2013/50/EU of 22 October 2013.

The FSA is, *inter alia*, responsible for authorisation, supervision, the interpretation of rules applicable to financial undertakings and conducting on-site inspections of financial undertakings. The FSA is also responsible for the supervision of the applicable regulations on insider trading and price manipulation as well as applicable requirements to public offerings of securities (compliance with prospectus requirements, etc.).

In addition to its supervisory activities, the FSA has an important role in developing the applicable Danish financial legislation as it both assists the Ministry of Industry, Business and Financial Affairs with preparing draft bills for introduction to the Danish parliament and has widespread delegated authority to issue executive orders supplementing the relevant financial legislation. Finally, the FSA collects and communicates statistics and key figures for the financial sector.

Furthermore, the FSA is authorised to impose various sanctions on financial undertakings if supervision shows non-compliance with the applicable legislation. Available sanctions include payment of administrative fines, withdrawal of the relevant licence or ordering a financial undertaking to dismiss an executive manager or to order a member of a board of directors to resign. Breaches of financial legislation are also subject to criminal sanctions.

Danmarks Nationalbank is the central bank of Denmark. It is a self-governing, independent institution, and thus independent of the parliament and government. The independence of Danmarks Nationalbank is incorporated into the Danmarks Nationalbank Act of 1936, in that the bank's board of governors is solely responsible for determining monetary policy interest rates. Danmarks Nationalbank's three main objectives are to contribute to ensuring stable prices, safe payments and a stable financial system.

## **v Supervision and sanction**

In Denmark, the FSA is generally responsible for the supervision of compliance with the Capital Markets Act. The majority of cases are handled through the FSA, and only a small number of cases reach the ordinary courts. Depending on the nature of the violation of the Capital Markets Act, the common reaction from the FSA is to give a reprimand or issue a fine. Decisions made by the FSA can be brought before the Danish Company Appeals Board, and decisions from the Danish Company Appeals Board can be appealed to the Danish courts.

Recently, a number of cases concerning price manipulation have been brought before the Danish courts by the public prosecutor (e.g., against Parken Sport & Entertainment and its former CEO and chair (on 23 March 2017, the Eastern High Court found that the company was liable for a fine of 13 million kroner and sentenced the chair to imprisonment)) and various cases against former employees of Danish banks that went into bankruptcy during the financial crisis. Moreover, the FSA has an increased focus on potential violations by Danish financial institutions of the Act on Measures to Prevent Money Laundering and Financing of Terrorism.

In addition, Nasdaq Copenhagen supervises and can impose sanctions for violations of the rules issued by Nasdaq Copenhagen, and is responsible for activities on their markets being conducted in an adequate and appropriate manner.

## II THE YEAR IN REVIEW

### i Developments affecting debt and equity offerings

Recent years' initial public offering (IPO) activity in the Danish capital markets is characterised by a relatively small number of transactions compared to the Nordics in general; however, the IPOs that have taken place have been considerable in terms of market capitalisation compared to the Nordics generally.

Although share prices have increased significantly during 2019 – presumably having a positive effect on IPO pricing – there has only been one IPO on Nasdaq Copenhagen in 2019 to date: the IPO on 4 April 2019 of The Drilling Company of 1972 A/S.

A number of other capital market transactions have been completed in Denmark recently. Examples include the delisting of Nets in 2018 pursuant to the voluntary takeover bid by the US private equity firm Hellman and Friedman; European Energy A/S' issuance of €140 million of green bonds on Nasdaq Copenhagen, becoming the first Danish green bonds to be listed. Furthermore, in 2019 the majority shareholder in Arkil Holding A/S, J2A Holding, launched a tender offer to the B-shareholders. Subsequent to this, J2A Holding has announced its intention to squeeze out the remaining shareholders, after which it plans to have the company delisted.

Furthermore, with the introduction of SME growth markets as an MTF subcategory in MiFID II, 2019 saw Nasdaq First North being registered as a growth market, thus changing its name to Nasdaq First North Growth Market. The registration entails that administrative burdens for SMEs to list are relaxed, while the integrity of the market and investor protection remain the same. With this change, more SMEs are envisaged to list.

Share buy-back programmes continue to be a popular initiative for Danish listed companies.

### *Public takeovers*

The Danish takeover regime consists of the Capital Markets Act and the Executive Order on Takeover Bids, which collectively implement parts of the EU Takeover Bids Directive. In addition, the FSA has issued Guidelines<sup>13</sup> supplementing the Executive Order on Takeover Bids.

In January 2018, the Capital Markets Act entered into force (thereby repealing the Securities Trading Act) simultaneously with amendments to the Executive Order on Takeover Bids. The amendments to the Executive Order on Takeover Bids include:

- a* exceptions to the mandatory offer have been removed because they now are to be found in the Capital Markets Act;
- b* earlier requirements regarding offer advertising and the execution of offers have been removed; and
- c* linguistic amendments, primarily as a result of the Capital Markets Act repealing the Securities Trading Act.

<sup>13</sup> Guidelines No. 9849 of 3 October 2018.

### ***Financial sector***

The general view is that financial institutions in Denmark have landed on their feet after some extremely difficult years in light of the financial crisis, and that the additional requirements imposed (and to be imposed) on banks will provide for a more stable financial sector that should be better prepared for any new future challenges.

The Danish banking sector has in the past 30 years experienced significant consolidation, which was only intensified as a consequence of the financial crisis. The Danish banking sector is, however, still composed of a significant number of small and medium-sized banks and saving banks when compared to its Nordic peers, and it is expected that both funding and capital adequacy requirements as well as increased regulation will facilitate further consolidation in the Danish banking sector. In the past 10 years the number of banks, credit cooperatives and savings banks has more than halved. At the end of 2018, the total number had decreased to 65. We have also seen the transformation of saving banks into banks in order to obtain funding via official listing on Nasdaq Copenhagen.

Danish insurance companies have adjusted for the implementation of the Solvency II Directive<sup>14</sup> in Denmark. The Solvency II Directive was implemented into Danish legislation by Act No. 308 of 28 March 2015, amending the Financial Business Act, which entered into force on 1 January 2016, as well as a number of executive orders.

### ***The Alternative Investment Funds Managers Directive***

The EU Alternative Investment Fund Managers Directive<sup>15</sup> (AIFMD) was implemented in Denmark on 22 July 2013 by the Act on Managers of Alternative Investment Funds etc.,<sup>16</sup> as amended from time to time. For a foreign alternative investment fund (AIF) to be marketed to professional investors in Denmark, its manager (AIFM) must either passport its authorisation pursuant to the AIFMD (only available to EEA and EUAIFs managed by EU or EEA AIFMs) or obtain an approval from the FSA to market the AIF to professional investors in Denmark. Such marketing permit would also allow for marketing towards sophisticated investors. The term sophisticated investors covers the following entities or individuals: a manager, director or another employee with the AIFM, or AIFs managed by the AIFM; and an investor who makes a minimum initial investment or commitment of €100,000 (or currency equivalent) in the AIF, and declares in writing his or her acknowledgement and acceptance of the risks relating to the relevant commitment or investment.

It is also possible for AIFMs to obtain a special approval to be permitted to market AIFs towards retail investors in Denmark. The AIFMD and the AIF will have to comply with strict regulation before the AIF can be marketed towards retail investors. For example, the AIFM is required to appoint a representative with a registered office in Denmark.

### ***New rules affecting the Danish corporate bond market***

#### ***Securitisation***

In January 2014, certain sections of the Financial Business Act were adopted to enable banks to establish refinancing registers for securitisation purposes by issuing securities backed by pools of loans and credits to enterprises.

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14 Directive 2009/138/EC of 25 November 2009.

15 Directive 2011/61/EU of 8 June 2011.

16 Consolidated Act No. 1166 of 19 September 2018.

With the permission of the FSA, banks are able to establish refinancing registers and sell their rights in loans and credits to an authorised entity. Under these rules, registration of the transferred loans and credits constitutes perfection, and the ownership of the assets is transferred once the assets are reflected in the refinancing register. This stands in contrast to ordinary transfer of loans where notice to the debtor is required to perfect the transfer. Consequently, a bank's creditors cannot seek satisfaction on assets registered in the refinancing register.

In general, the register will often be established as a special purpose vehicle (SPV). An SPV buys commercial loans from a bank, and SPVs will be able to buy different groups of commercial loans from different banks. It is, therefore, possible for two or more small Danish banks to establish a joint SPV. Based on the assets in the SPV, the SPV will issue corporate bonds to investors. The bonds issued by the SPV must be at a minimum denomination of €100,000 (i.e., designed for either professional or institutional investors). To our knowledge, no Danish banks have yet made use of the possibility to establish such SPVs.

### ***Representatives and security agents***

In January 2014, an Act<sup>17</sup> was introduced that resolved past uncertainties with respect to trustees under Danish law by recognising the use of security agents and trustees in syndicated loans and, subject to certain conditions, the use of bondholder representatives and security agents in bond issues. It is now part of the Capital Markets Act. The rules provide that security interests can be granted directly in favour of a representative in relation to bond issues, and a security agent in respect of syndicated loans, acting on behalf of the secured parties from time to time, thus making perfection and preservation of security interests in connection with bond issues and syndicated loans more feasible.

As regards bond issues, the representative's main function is to protect and monitor the interests of the bondholders towards the issuer. The specific role and obligations of the representative will, with respect to each issuance, be established in an agreement entered into between the issuer and the representative for the benefit of the bondholders. This agreement would, inter alia, include provisions on enforcement, no-action clauses, establishment of security and limitation of liability of the representative. All actions taken by the representative will be binding on the bondholders from time to time without any further action required to be taken. To take advantage of the specific legislation in relation to bond representatives, the representative under each of the bond issues has to be registered with the FSA. Only companies with limited liability domiciled in Denmark, the EU or the EEA and certain other countries may act as a representative.

### ***Inside information and disclosure requirements***

The Capital Markets Act and executive orders issued thereunder govern the disclosure obligations for listed companies. However, the obligation to publicly announce inside information now solely follows from MAR. Pursuant to MAR, listed companies are required to publicly announce inside information (as defined in MAR) as soon as possible after the relevant event comes into existence. Certain exceptions apply, however, giving a listed company the right to delay publication of inside information in certain circumstances where publication could be detrimental to the interests of the listed company.

<sup>17</sup> Act No. 1613 of 26 December 2013.



### ***Implementation of the Recovery and Resolution Directive***

On 26 March 2015, the Danish parliament adopted the bills implementing the Resolution and Recovery Directive<sup>18</sup> (BRRD) and the Revised Deposit Guarantee Scheme Directive,<sup>19</sup> which entered into force on 1 June 2015. The general bail-in tool also came into effect on 1 June 2015. According to the implementation of the BRRD into Danish legislation, the previous applicable resolution schemes for Danish banks and credit mortgage institutions were repealed with effect as of 1 June 2015. The resolution and recovery of Danish banks and credit mortgage institutions is thus only subject to the BRRD as implemented in Denmark.

The BRRD also requires that European banks hold a certain minimum amount of bail-inable resources, the minimum requirement for own funds and eligible liabilities (MREL). The consequences of non-compliance with the MREL requirements are still unclear, and the MREL requirement for Danish institutions is expected to be based on the European Banking Authority methodology.

Danish credit mortgage institutions are exempt from the bail-in instrument and thus are not required to fulfil the MREL requirement. A credit mortgage institution is required to have a debt buffer of 2 per cent of its total non-weighted lending portfolio at all times. The debt buffer requirement can be fulfilled by using the following capital and debt instruments:

- a* CET1 capital;
- b* AT1 capital;
- c* Tier 2 capital; and
- d* unsecured senior debt.

The capital instruments used to fulfil the debt buffer may not be used at the same time to fulfil the own funds requirement, solvency need or requirement or the combined capital buffer requirement of an institution. If AT1, Tier 2 or other unsecured senior debt is used to fulfil the debt buffer, the instrument is required to have a maturity of at least two years, and there has to be a spread of the maturity dates of institutions' capital and debt instruments.

It is still unclear whether Denmark, despite being outside the eurozone, will join the European Banking Union and therefore be part of the Single Resolution Mechanism,<sup>20</sup> including the Single Resolution Fund.<sup>21</sup>

From June 2014, the FSA has every year appointed Danish systemically important financial institutions (SIFIs). In 2019, Spar Nord Bank A/S joined the SIFI list as a consequence of the deposit indicator threshold being lowered from 5 to 3 per cent. Thus, there are seven SIFIs in Denmark: Danske Bank A/S, Nykredit Realkredit A/S, Jyske Bank A/S, Nordea Kredit Realkreditaktieselskab, Sydbank A/S, Spar Nord A/S and DLR Kredit A/S. The SIFIs were identified in accordance with Section 308 of the Financial Business Act implementing various aspects of the CRD IV Directive. Institution-specific SIFI buffers between 1 and 3 per cent were set according to quantitative SIFI criteria and have been phased in gradually from 2015 to 2019. According to the political agreement on SIFIs from October 2013, the final capital requirements imposed on Danish SIFIs must be on par with

<sup>18</sup> Directive 2014/59/EU of 15 May 2014.

<sup>19</sup> Directive 2014/49/EU of 16 April 2014.

<sup>20</sup> Regulation (EU) No. 806/2014 of 15 July 2014.

<sup>21</sup> Regulation (EU) 2015/81 of 19 December 2014 specifying uniform conditions of application of Regulation (EU) No. 806/2014 of the European Parliament and of the Council with regard to *ex ante* contributions to the Single Resolution Fund.

the requirements applied by other comparable European countries. Consequently, the final level of the Danish SIFI capital buffer requirements is 1 to 3 per cent of their risk-weighted assets depending on their systemic importance.

## **ii Developments affecting derivatives, securitisations and other structured products**

### ***Derivatives***

There have not been any significant developments in Denmark in 2019 with respect to the Danish derivatives market. The main focus of financial institutions and counterparties has been to continue ensuring compliance with the applicable requirements of EMIR<sup>22</sup> and related technical standards.

### ***Securitisations***

Since the financial crisis, the Danish market for securitisations has hardly seen any activity, and the Danish securitisation market is not expected to experience any significant activity in the near future. This is despite the securitisation rules that entered into force in January 2014. At the EU level, a political agreement was entered into on 30 May 2017 regarding a regulation on simple, transparent and standardised securitisations and a regulation amending the capital requirements regulation to reflect securitisations being regulated in their own regulations. The Securitisation Regulation<sup>23</sup> has been effective since 1 January 2019, from which date relevant articles in the Capital Requirements Regulation concerning securitisation were repealed.

## **iii Cases and dispute settlement**

Very few capital markets-related disputes reach the ordinary courts. Most disputes and complaints are dealt with in the administrative system or by arbitration. However, investors from 19 countries in 2019 sued Danske Bank A/S, claiming damages of 3.1 billion kroner based on an alleged breach of the general disclosure obligation for listed companies. Pandora also faced a lawsuit initiated by investors claiming damages based on an alleged breach of the general disclosure obligation for listed companies. In 2016, the Eastern High Court ruled in favour of Pandora. Further, in the aftermath of OW Bunker's bankruptcy in November 2014 following its IPO in March 2014, several investor groups (both retail and institutional investors) proclaimed that they intended to initiate proceedings against relevant parties, including the former management. In 2019, investors were able to sign up for the class action lawsuit against the former management and Altor Equity Partners. The foreman of the investor group association has expressed that the Eastern High Court is expected to give its judgment at the earliest in autumn 2020, although probably later. Finally, see Section I.v for a description of recent price manipulation cases.

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22 Regulation (EU) No. 648/2012 of 4 July 2012.

23 Regulation (EU) No. 2402/2017 of 12 December 2017.

**iv Relevant tax and insolvency law**

***Danish tax principles***

The general rule is that corporations, irrespective of the period of ownership, are exempt from tax on dividends and capital gains on shareholdings provided that the shareholding is at least 10 per cent of the relevant company. Dividends received from shareholdings of less than 10 per cent in unaffiliated companies (portfolio shares) and capital gains on listed portfolio shares are subject to corporate income tax. However, only 70 per cent of dividends received on non-listed portfolio shares will be subject to corporate income tax. Capital gains on non-listed portfolio shares are exempt from taxation (exceptions and anti-avoidance rules apply). Dividends and capital gains on treasury shares are tax-exempt. Individuals are subject to tax on all dividends and capital gains on shareholdings.

For corporate entities, the tax on listed portfolio shares will be calculated and paid annually based on a mark-to-market principle, and taxation will take place on an accrual basis even if no shares have been disposed of and no gains or losses have been realised. The corporate tax rate has been gradually lowered to 22 per cent.

Individuals calculate their tax on all shares based on a realisation principle (exceptions apply). The tax rate for capital gains on shares and dividends is progressive and taxed at a rate of 27 per cent on the first 54,000 kroner in 2019 (for cohabiting spouses, a total of 108,000 kroner) and at a rate of 42 per cent on share income exceeding 54,000 kroner (for cohabiting spouses over 108,000 kroner).

For all non-tax residents, capital gains on shareholdings remain tax-exempt irrespective of ownership percentage and ownership duration (certain anti-avoidance rules relating to Danish withholding taxation of dividends or rules on permanent establishment may apply). Generally, foreign corporate shareholders are also exempt from tax on dividends if holding at least 10 per cent in a Danish company (exceptions and anti-avoidance rules apply). Dividends paid to foreign corporate shareholders holding less than 10 per cent and dividends paid to individuals are subject to Danish withholding tax at a rate of 27 per cent. A request for a refund of Danish withholding tax may be made if the dividend receiving company is a resident of a state with which Denmark has entered into a double taxation treaty.

Corporate entities are as a main rule subject to taxation on gains on ordinary claims, bonds, debt and financial debt contracts. Likewise, losses on such instruments are, as a general rule, deductible in full. With respect to intragroup financing, losses on receivables and gains on debts are, however, as a general rule tax-exempt. Corporate entities may elect to calculate the liable taxes on debt using a realisation principle. A mark-to-market principle must be applied for ordinary claims.

Individual investors are as a main rule subject to taxation on all capital gains on ordinary claims, bonds, debt and financial debt contracts if the gains exceed 2,000 kroner per year. Individual investors' right to deduct losses on ordinary claims is limited to losses exceeding 2,000 kroner, whereas the right to deduct losses on financial contracts is limited to gains on other financial contracts with a possibility to carry a loss forward to be offset against gains in subsequent income years.

For individual investors, the tax will as a main rule be calculated using a realisation principle. The taxpayer can apply for permission, and is in certain cases entitled to calculate the taxes on a mark-to-market principle.

On 12 November 2017, new tax rules were introduced aimed at encouraging further retail investment in shares for the benefit of undertakings. Denmark has been inspired by the Swedish and Norwegian model. Accordingly, a share savings account has been introduced

with a flat 17 per cent annual taxation on the mark-to-market year-end balance of the equity investments on the account. The maximum amount that may be deposited in an account is 50,000 kroner per year, subject to certain limitations. The new rules came into force on 1 January 2019.

### ***Insolvency***

The Danish Bankruptcy Act<sup>24</sup> governs the two main types of insolvency proceedings: restructuring and bankruptcy. The rules of restructuring were implemented in April 2011, thus there is still little jurisprudence on the subject. As part of Denmark's opt-outs to certain EU policies, Denmark is not bound by and has not acceded to the EU Insolvency Regulation.<sup>25</sup>

## **III OUTLOOK AND CONCLUSIONS**

Despite Brexit entailing market uncertainty, the Danish capital markets remain largely unaffected.

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24 Consolidated Act No. 11 of 6 January 2014, as amended.

25 Regulation (EC) No. 1346/2000 of 29 May 2000 on insolvency proceedings.

# FRANCE

*Olivier Hubert and Arnaud Pince<sup>1</sup>*

## I INTRODUCTION

The legislation governing French capital markets is designed to promote a flexible framework for issuing or trading capital market products while providing a high degree of legal certainty and a strong supervisory framework.

### i Legislative framework

French capital markets legislation has experienced strong developments in the context of both national and EU initiatives.

Most EU directives and regulations related to capital market transactions (e.g., the Money Market Fund Regulation, the Benchmark Regulation, the Packaged Retail and Insurance-based Investment Products Regulation, the Prospectus Regulation, the Market Abuse Directive and the Market Abuse Regulation, the Alternative Investment Fund Managers Directive (AIFMD) and others) have been implemented under French law, in addition to the Markets in Financial Instruments Directive (MiFID II), which came into effect on 3 January 2018, and the Regulation on over-the-counter (OTC) derivatives, central counterparties (CCPs) and trade repositories.<sup>2</sup>

The stock exchange is of course a key element of the French capital market infrastructure. Stock exchanges in France are operated by Euronext.

### ii Law governing the issuance of debt and equity securities

The general legal framework for securities offerings and the sale and subscription of securities traded on a stock market is enshrined in the Monetary and Financial Code (M&FC), the General Regulations of the French Financial Markets Authority (RG-AMF) and related implementing instructions. European regulations, and in particular the Prospectus Regulation (recently amended),<sup>3</sup> are also part of the French legal corpus regarding capital market transactions since they apply directly in France.

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<sup>2</sup> Regulation (EU) No. 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, CCPs and trade repositories, part of the European Market Infrastructure Regulation (EMIR) – a body of European legislation for the regulation of OTC derivatives.

<sup>3</sup> Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market.

When securities are issued and distributed on a cross-border basis, several laws may be applicable: the issuer's own law applies to certain matters, while other laws may be applicable to the terms and conditions of the relevant securities or to the distribution and placement of the securities. If the securities are listed, the relevant stock market law may also be applicable.

A French court would apply the securities issuer's own law, *lex societatis*, to the rights of the holders of equity securities. Capacity and authorities matters would also be governed by *lex societatis* in respect of debt securities. Therefore, the issuance of equity and debt securities by a French company would in this respect be governed by French law, and in particular by the French Commercial Code, the M&FC and the RG-AMF.

Contractual terms of bonds are subject to party autonomy, and if a transaction is international or cross-border, bonds may be governed by a foreign law chosen by the parties subject to any provisions that may be mandatory from a French public policy perspective.

As contemplated by Article 212-1 of the RG-AMF, before conducting a public offer of securities or seeking admission of securities to trading on a regulated market within the European Economic Area (EEA) and by extension in France, persons or entities making a public offer of securities in France need to prepare a draft prospectus and submit it for approval to the Financial Markets Authority (AMF) or the competent supervisory authority of another Member State of the European Community or a state party to the EEA agreement.

Where the AMF is not the competent authority to approve a prospectus, the supervisory authority that approved the prospectus will send the certificate of approval and a copy of the prospectus to the AMF,<sup>4</sup> with a French translation of the summary note, where appropriate.<sup>5</sup> Dispatch of that certificate to the AMF will be made at the request of the persons or entities seeking to offer securities to the public or to have securities admitted to trading on a regulated market in France.

A French issuer seeking admission of securities outside the EEA, however, would not be required to obtain approval from the AMF or from the competent supervisory authority of another EEA Member State if no offer to the public is contemplated in France or any other EEA Member States.

### iii The AMF

The AMF is divided into two bodies, a board and an enforcement committee, that operate separately and independently of one another. The board sets the AMF's policy and supervises its oversight function. It also acts as regulator and approves any amendment to the RG-AMF. In cases of infringement of the provisions of the M&FC or of the RG-AMF, the Secretary General of the AMF directs controls and investigations. At the end of an initial inquiry phase, the board opens a sanction procedure and may submit grievances to the enforcement committee. There is then an investigation procedure led by the enforcement committee, which may impose sanctions.

According to Article L621-15 of the M&FC, the enforcement committee may impose sanctions on professionals controlled by the AMF, individuals under the supervision of these professionals and other persons acting on their own.

The four roles entrusted to the AMF (regulation, authorisation, supervision and enforcement) place that authority at the core of the French financial regulatory system. The AMF sets the principles of organisation and operation that are applicable to market

<sup>4</sup> Articles 212-40 to 212-42 of the RG-AMF.

<sup>5</sup> Article 212-3 of the RG-AMF.

operators, such as Euronext Paris, authorises the creation of open-end and closed-end funds, and regulates capital market activities and disclosures by listed companies. It also extends visas for issues of debt and equity securities offered to the public or to be traded on an exchange.

In addition, an AMF ombudsman, which provides assistance to non-professional investors (consumers and non-profit associations), has been established along the same lines as the Swedish ombudsman model.

The aim of creating the AMF, which is vested with strong regulatory supervisory and enforcement authority, was to strengthen the protection of investors. In this regard, several decisions of the Supreme Court during the past few years have endorsed this position<sup>6</sup> and have strengthened the advisory duties of financial services providers to inform their clients of the risks linked to financial products. This obligation consists not only in informing a client, but also in assessing a client's ability to properly understand the nature of speculative operations under consideration.

In the interests of transparency, the duties of financial services providers and distributors have been increased, the general perception being that this is also justified by the market environment and the atmosphere of uncertainty produced by the 2008 financial crisis. Like other countries, France implemented its own institutional reform of its financial supervision system in 2008, and subsequently implemented the various European directives reforming the European financial framework.

The Prudential Control and Resolution Authority (ACPR) shares supervisory authority over investment firms with the AMF. Pursuant to the Banking Reform, the ACPR has been given the powers of resolution authority, and the scope of its powers and duties has been expanded accordingly. Among its extended powers, the ACPR can order the transfer of all or a portion of credits or deposits of credit institutions if the solvency or liquidity of institutions subject to its authority, or the interests of insured clients or their members, are in jeopardy or susceptible to being in jeopardy.

The AMF and the ACPR's investigative and supervisory powers have been strengthened, including through the authority to require documents and information from entities subject to their supervision to ensure the performance of their mission of monitoring and supervision.

The recent *Loi Pacte*, which was enacted on 22 May 2019 (*Pacte Law*), extends the prerogatives of the AMF in respect of sustainable finance by specifying that the AMF must ensure the quality of the information provided by management companies for the management of collective investment schemes on their investment strategy and their management of the risks related to the effects of climate change.

The AMF announced the creation of the AMF's Climate and Sustainable Finance Commission on 2 July 2019, which will bring together stakeholders on the subject of sustainable finance and assist the AMF in carrying out its regulatory and supervisory missions on issues related to sustainable finance.

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<sup>6</sup> See, in this respect, on [www.dalloz.fr](http://www.dalloz.fr): C cass, Ch com, 13 December 2011, 11-11.934; C cass, Ch com, 13 September 2011, 10-199.07; C cass, Ch civ, 15 February 2011, 10-12.185; C cass, Ch com, 17 May 2011, 10-30.650; C cass, Ch com, 3 May 2011, 10-14.865.

## II THE YEAR IN REVIEW

### i Recent developments affecting debt and equity offerings

Recent developments mainly relate to the implementation of the Prospectus Regulation on 21 July 2019 and to the emergence of a new regulation regarding cryptocurrencies, tokens and related transactions (initial coin offerings (ICOs)).

#### *Modification of the French legal and regulatory framework following the entry into force of the Prospectus Regulation on 21 July 2019*

Aimed at facilitating access to the market by companies without compromising on the information communicated to investors, the Prospectus Regulation (and two delegated regulations) fully entered into force on 21 July 2019. The Prospectus Regulation provides, inter alia, that:

- a* Member States can exempt offers of securities to the public with a total consideration in the European Union of between €1 million and €8 million (calculated over a 12-month period) from the requirement to publish a prospectus; in this respect, France decided to exempt offers of securities below the threshold of €8 million from the publication of a prospectus;
- b* a universal registration document detailing the issuer's business and financial position may be filed with a competent authority every year. This document may then be incorporated by reference into the prospectus. This mechanism (which has existed in France for many years) would enable issuers to have their prospectuses approved more quickly by a competent authority; and
- c* the prospectus summary is to be shortened to a maximum length of seven A4 pages. A set format will be required, based on the key information document for packaged retail and insurance-based investment products (PRIIPS), with four main sections specifying the following:
  - introductory warning language;
  - key information about the issuer;
  - key information about the securities; and
  - key information about the offer of securities to the public and admission to trading.

In this context, the AMF and the Treasury launched public consultations during the spring of 2019 on several amendments of French law and of the RG-AMF necessary for the correct 'negative' implementation under French law of the Prospectus Regulation. The proposed changes, concern in particular the following topics:

- a* defining the consequences under French law of the change in the definition of public offering of securities as it is now conceived by the Prospectus Regulation. The Prospectus Regulation actually extends the definition of offers to the public and includes in this definition offers that until now were not considered to be offers to the public under French law (such as private placements). Given this new definition, French regulations have to be adapted, with the objective in particular to allow, without additional constraint, the continuation of private placements and crowdfunding offers; and
- b* ensuring the 'negative' transposition of the Prospectus Regulation: this negative transposition involves, in particular, deleting or modifying numerous articles of the M&FC and of the RG-AMF that have now been replaced by directly applicable



provisions of the Prospectus Regulation. In addition, French regulations must be adapted to implement into domestic law the options left up to Member States (the language of the prospectus, the responsibility relating to the publication of a prospectus, commercial documentation and the document serving as an exemption from a prospectus in cases of merger, split-up or spin-off).

The ordinance modifying French law and the new provisions of the RG-AMF was enacted on 21 October 2019.

In September 2019, the AMF also consulted the public on a modification of its doctrine to be incorporated into a new handbook entitled Guide to preparing prospectuses and information to be provided in the event of a public offering or admission to trading of financial securities. Such guide will consist of three sections: information to be provided in prospectuses approved by the AMF as of 21 July 2019; information to be provided if no prospectus is required; and AMF positions and recommendations concerning the issuance and admission to trading of equity securities.

### ***Registration of securities through the use of blockchain***

France was the first country to introduce the mandatory and general dematerialisation of securities as early as 1984. In view of ongoing initiatives in Europe aimed at strengthening the integration of securities markets and at adopting a common approach to securities law, Ordinance No. 2009-15 was published on 8 January 2009. Through the enactment of this reform, the French legislature sought to modernise French securities law and reinforce its attractiveness, competitiveness and security. Dispositions on transfers of ownership, pledges, repurchased transactions, securities loans and security for financial obligations are brought together in Book II, Title I, Chapter I. A distinction is made in respect of financial instruments between securities (including both equity and debt instruments issued by stock companies, and participations in collective investment undertakings, all of which are susceptible to being credited to a securities account) and financial contracts (which correspond in essence to derivatives and forward financial instruments). Key modifications focus on strengthening ownership rights over securities credited to a securities account and protecting *bona fide* acquirers of securities.

Ordinance 2017-1674 of 8 December 2017 introduced a significant change to the legislation relating to the ownership and transfer of securities by allowing and recognising the validity of transfers of non-listed securities through a shared digital recording device, which refers to the blockchain technology also called distributed ledger technology. This digital registration has acquired the same legal value as a book-entry registration, and the type of registration is chosen by the issuer. Decree 2018-1226 dated 24 December 2018 provided implementing provisions for this new regime. This legal innovation made France a pioneer country in the acknowledgment and use of blockchain-based services.

### ***ICOs***

The Pacte Law introduced into French legislation a new legal framework for fundraising via the issuance of tokens (ICOs) that applies to tokens that are not classified as financial instruments. Prior to that, no specific rules applied to fundraising through the issuance of tokens. The Pacte Law enables the initiators of a project who so wish to submit an information document to the AMF for an optional visa that will be issued on condition that the issue of tokens meets the specified requirements outlined below.

A token is defined by the Pacte Law as any intangible property representing, in digital form, one or more rights that may be issued, registered, retained or transferred by means of a shared electronic recording device that identifies, directly or indirectly, the owner of such property (i.e., blockchain).

An ICO consists of proposing to the public, in any form whatsoever, subscription to these tokens. An ICO that is open to subscription by a restricted circle of less than 150 investors, acting on their own behalf, is not considered as being an offer of tokens to the public.

Token issuers who wish to carry out an ICO may apply for an approval from the AMF. To give its approval, the AMF shall verify whether the offering provides the following guarantees:

- a* the token issuer is incorporated as a legal entity established or registered in France;
- b* an information document (commonly called a white paper) has been drawn up in accordance with Article 712-2 of the RG-AMF and with AMF Instruction DOC-2019-06;
- c* the issuer has implemented a procedure enabling the monitoring and safeguarding of the funds raised by the ICO; and
- d* the token issuer has put in place a system to ensure compliance with its obligations relating to anti-money laundering and combating the financing of terrorism.

### ***Digital asset service providers***

The Pacte Law introduces a new regulatory framework applying to digital asset service providers (DASPs): it creates an optional licence for DASPs, which constitute a new category of regulated service providers licensed and placed under the supervision of the AMF.

The term digital assets comprises tokens issued through an ICO and virtual currencies as defined by European law (such as bitcoin). Financial instruments are excluded from this regime.

The activities that may be carried out by DASPs are, in particular, the following:

- a* custody of digital assets for third parties;
- b* purchase or sale of digital assets against legal tender or other digital assets (broker-dealers);
- c* operation of a digital assets trading platform (stock exchange); and
- d* other digital assets services such as the reception and transmission of third-party orders, third-party portfolio management, advice, underwriting and placing on or without a firm commitment basis.

Licensed service providers will be subject to a set of core rules common to all services (insurance or equity, internal control procedures, resilient IT system, transparent pricing policy, etc.) as well as a certain number of rules specific to the service offered.

As an exception to the above, service providers who wish to provide digital asset custody services to third parties or to purchase or sell digital assets in exchange for legal currency are subject to mandatory registration with the AMF.

### ***Strengthening the sanction regime relating to foreign investments***

The Pacte Law aims at strengthening the sanction regime relating to foreign investment screening by providing the Minister of Economy with a wider scope of sanctions and enforcement powers.

In particular, once a foreign investor fails to file for and obtain an investment authorisation when required by French regulations, in addition to civil sanctions of nullity, the Minister may, under the new rules, issue an injunction requiring the investor to file an application for investment authorisation, abandon the transaction and restore the previous situation at his or her own expenses or modify the transaction.

Furthermore, new powers are vested with the Minister of Economy in cases where conditions linked to a foreign investment authorisation are not fulfilled or are breached by an investor. Remedial measures include the revocation of an initial authorisation, the imposition of new conditions to be complied with within a specified time frame or the obligation to meet initial conditions.

In cases where national interests are likely to be jeopardised, the Minister has the right to take provisional, conservatory measures to protect national interests. These may include:

- a* a suspension of voting rights;
- b* a prohibition or limitation on the distribution of dividends or other remuneration attached to shares;
- c* a restriction on the free disposal of all or certain assets; or
- d* the appointment of a representative authorised to veto any decision of a corporate body whose expenses are covered by a company concerned.

In advance of the Pacte Law, the government adopted a decree in November 2018 that came into force on 1 January 2019. This decree expands the prior authorisation regime to new strategic sectors such as those involving space operations, electronic and computer systems required for public security purposes and data storage activities, and research and development in the fields of cybersecurity and artificial intelligence,

## **ii Developments affecting derivatives, securitisations and other structured products**

### ***Derivatives and the Netting Law***

The French netting regime of derivatives (i.e., the Netting Law) is governed by the provisions of Article L211-36 to L211-40 of the M&FC, which transposed into French law the EU Collateral Directive, as amended. It is applicable, inter alia, to financial obligations resulting either from transactions on financial instruments (within the meaning of Articles L211-1-I and D211-1A of the M&FC) if at least one of the parties to the transactions is a qualifying party (credit institutions, investment services providers, etc.), or from any contract giving rise to cash settlement or to delivery of financial instruments if both parties to the contract are qualifying parties.

As far as transactions involving financial instruments are concerned, Article L211-1 of the M&FC defines financial instruments (which include financial securities such as shares and other securities issued by stock companies; debt instruments, other than payment instruments and loan notes; and units or shares in collective investment undertakings) and financial contracts (also known as forward financial instruments, which are further defined in Article D211-1-A of the M&FC)).

If both parties are qualifying parties under the Netting Law, the scope of qualifying transactions is wider and includes any financial obligations that result from any contract giving rise to cash settlement or to delivery of financial instruments. Accordingly, all financial obligations resulting from transactions on financial instruments are included in the scope of qualifying transactions in that case.

Article L211-36-II of the M&FC extends the scope of application of the Netting Law to instruments that may not fall within the scope of the definition of financial instruments under MiFID II.<sup>7</sup> Article L211-36-II of the M&FC provides that, for the sole purposes of the Netting Law, options, futures, swaps and any forward contracts other than those mentioned in Article L211-1-III of the M&FC (i.e., MiFID-qualifying forward financial instruments) are considered as forward financial instruments provided that they give rise, in the context of trading, to registration by a recognised clearing house or to periodical margin claims.

Note that the Banking Reform contemplates that when exercising rights available under the resolution tools vested in the ACPR, the ACPR may order the transfer of one or more business units by operation of law under the regime of universal transfer of patrimony to a third party, or of asset rights and obligations to a bridge institution. It is specified that, notwithstanding any legal or contractual provision to the contrary, contracts related to transferred activities are continued, and no termination or set-off may occur solely as a result of a transfer or assignment.

It is further specified that transactions governed by contracts covered by Article L211-36-1 of the M&FC (which covers transactions on financial instruments including derivatives, repos and securities lending transactions), when transferred under the resolution tool regime to a third party or to a bridge institution, may only be transferred as a whole. Termination rights (close-out netting) may not be exercised solely on the ground that a resolution measure has been exercised unless a transfer pursuant to the exercise of the resolution powers does not cover such contracts. Furthermore, in the exercise of its resolution authority, the ACPR may elect to suspend the exercise of termination and close remedies under contracts governed by Article L211-36-1 in respect of all or part of the relevant contract concluded with the entity under resolution until midnight on the business day following the publication of the ACPR's motivation for the suspension.

When contracts have been transferred as stated above within the scope of the exercise by the ACPR of its resolution authority, this would, in our view, permit the exercise of termination rights post-transfer in the event of the occurrence of a post-transfer default.

Arrangements are also contemplated to ensure that such transfer may not affect the operation of systems governed by Article L330-1 et seq. of the M&FC (covering interbank payment systems and delivery versus payment designated systems where only part of but not all assets, rights and obligations are so transferred to another person).

The French netting and collateral regime has recently been modified by Sapin Law II, which extended the French close-out netting regime to financial obligations between a CCP, a clearing member and a client; allows third parties to post collateral; and provides an effective segregation of collateral posted as initial margin pursuant to Article 11 of the European Market Infrastructure Regulation (EMIR).

The collateral exchange requirements apply to financial entities dealing in derivatives and to non-financial firms whose derivatives positions exceed the clearing threshold. They apply to all OTC derivative contracts that are not centrally cleared. They are progressively taking effect, following an agreed schedule that started in February 2017.

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<sup>7</sup> As these instruments do not fall within the scope of application of MiFID II, they cannot benefit from the provisions of MiFID II relating to the European passport.

The Pacte Law introduces new measures specifically concerning derivatives:

- a* the Pacte Law extends the material scope of the Netting Law provisions described above to various operations including, inter alia, units mentioned at Article L. 229-7 of the Environment Code, foreign exchange spot transactions and transactions on precious metals (including gold, silver, etc.),
- b* in view of an anticipated termination of the passport rights of UK credit institutions after Brexit, the Pacte Law provides a mechanism of ‘replication’ of the master agreements executed with such UK credit institutions that are currently in force; this mechanism will allow, under certain conditions, the parties to such master agreements to terminate the existing agreements and execute similar agreements with an EU (non-UK) credit institution; and
- c* it provides a derogation to Article 1343-2 of the French Civil Code relating to the compounding of interest (pursuant to which the capitalisation of interest is permitted only where said interest has accrued for at least one year); this derogation allows the compounding of interests on periods shorter than one year when calculated pursuant to a market master agreement.

### ***Implementation of EMIR***

EMIR was published in 2012. It affects all entities active in the EU derivatives market whether they use derivatives for trading purposes, to hedge themselves against a particular risk or as part of their investment strategy.

EMIR imposes three main obligations on market participants, namely:

- a* clearing via a CCP of certain OTC derivatives entered into between certain market participants;
- b* reporting of all derivative transactions to a trade repository that were entered into since, or that were outstanding on, 16 August 2012; and
- c* subjecting OTC derivatives that are not cleared via a CCP to risk mitigation obligations, which include, in particular:
  - the timely confirmation of transactions;
  - performing of daily mark-to-market valuations of transactions;
  - having dispute resolution processes in place;
  - engaging in portfolio reconciliation;
  - considering portfolio compression; and
  - exchanging collateral.

The last stage of implementation of EMIR (i.e., collateral requirements for non-centrally cleared derivatives) has progressively taken effect from February 2017.

Mandatory central clearing is a risk mitigation technique. When a contract is cleared, a CCP is interposed between the two parties to an OTC derivative contract. The aim of clearing is to promote financial stability by reducing counterparty credit risk (as parties become exposed to the CCP’s credit risk instead of each other’s) and operational burdens, as well as increasing transparency and standardising the default management process. The clearing obligation under EMIR will only apply if the relevant OTC derivative is of a class that has been declared subject to the clearing obligation by the European Commission and the European Securities and Market Authority (ESMA) and is entered into between any

combination of financial counterparties (FCs) and non-financial counterparties (NFCs) that are above certain thresholds (NFC+s) (or certain entities established outside the European Union that would be an FC or NFC+ if they were established within the EU).

### ***Cryptocurrency derivatives***

On March 2018, the AMF released a legal analysis that it had carried out on cryptocurrency derivatives. As a result of this analysis, in certain cases, cryptocurrency derivatives may be classified as financial instruments pursuant to Article D211-1 A I of the M&FC, and therefore are subject to the related regulation thereof, in particular the requirement for participants who market those products to be regulated and to be authorised to provide investment services, compliance with EMIR and a ban on advertising on certain financial contracts.

### ***Securitisation and the skin-in-the-game rule***

In the wake of the 2008 financial crisis, regulations regarding the calculation of capital requirements of credit institutions and investment firms have been amended to include a 5 per cent retention requirement for originators of securitisations.

This retention requirement, often referred to as the skin-in-the-game rule, was initially set out in two separate sets of amendments to the Capital Requirement Directive (referred to as CRD II and CRD III), and transposed under French banking regulations by way of an amendment to an Order dated 20 February 2007.

The provisions of Regulation (EU) 2017/2402 of 12 December 2017 lay down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation, which entered into force on 1 January 2019. This Regulation establishes, inter alia, harmonised due diligence and transparency requirements for investors. It also prohibits resecuritisations, and creates a label and a legal framework for simple, transparent and standardised securitisations, which allows preferential prudential treatment. More importantly, it establishes a new direct obligation to retain a 5 per cent material net economic interest. Implementing and delegated acts of this text are still awaited.

The obligation for the originator, sponsor or original lender to retain a 5 per cent stake is a material consideration for institutions resorting to securitisation, and one that may influence the appetite of market participants for the acquisition of securities in such a securitisation.

### ***Revamping of the securitisation legislation***

By Ordinance 2017-1432, of 4 October 2017, which entered into force on 3 January 2018, the French legislator has created a broad category of debt funds named financing vehicles, which regroups the existing securitisation vehicles (OT) and a new category of regulated funds named specialised financing vehicles falling within the scope of AIFM that may benefit from the European long-term investment fund label.

This Ordinance also introduced the possibility for French securitisation funds to grant loans to non-financial companies and to enter into loan sub-participations. These funds may also benefit from the Dailly Law assignment regime, which is a simplified way of transferring professional receivables that was formerly reserved to credit institutions.

### ***High frequency trading***

The Banking Reform regulates high frequency trading (HFT) by specifying that any person using automatic trading systems must:

- a* report to the AMF the use that has been made of such systems to generate, buy and sell orders of securities issued by companies that have their head office in France;
- b* ensure that the order directed to a regulated market or a multilateral trading facility is traceable;
- c* keep a record of any element allowing a link to be established between a given order and the algorithms used to determine that order; and
- d* keep a record of the algorithms used to elaborate the orders transmitted to the markets, and transmit those algorithms to the AMF upon request.

In addition, the Banking Reform provides for new duties applicable to market operators or persons who operate multilateral trading facilities to ensure that their systems have the capacity to handle the number of orders generated by automatic trading systems, so as to permit orderly trading under highly volatile market conditions. There must be mechanisms in place to permit the suspension or rejection of orders exceeding set thresholds or otherwise in the event of manifestly erroneous trades. There must be procedures in place of such a nature as to maintain the orderly functioning of the markets.

### ***New rules on algorithm trading: MiFID II***

Algorithm trading and HFT have been regulated by the M&FC since MiFID II was transposed into French law on 23 June 2016. The entry into force of the Directive, which was delayed until 3 January 2018, provides for:

- a* implementation of a harmonised regime of minimum tick sizes based on the price and liquidity of stocks, deposit certificates and exchange traded funds traded on European trading platforms;
- b* strengthening of the organisational requirements of market actors using algorithm trading to ensure their trading systems' resilience. These requirements include imposing on investment companies the obligation to notify the competent authority and test the algorithms they use, and for trading platforms to implement the necessary measures to enable the realisation of these tests, the identification of the algorithms used by their members by marking orders or the suspension of the provision of direct electronic access by a member. Market actors using HFT are subject to the obligation to maintain and deliver, on request, to the competent authority their order data;
- c* supervision of the market-making activity with the introduction of common minimum requirements applicable to anyone wishing to exercise this activity, and requirements to ensure that device platforms are fair and non-discriminatory and provide for incentive mechanisms during stress periods; and
- d* supervision of the fee structures of trading platforms that need to be transparent, fair and non-discriminatory.

### ***Trading of agricultural commodities***

The Banking Reform introduces new regulations with a view to fighting excessive speculation in relation to trading of agricultural commodities. The AMF is vested with the authority to set, as from 1 July 2015, thresholds of positions that a single person may hold in financial instruments, the underlying assets of which include an agricultural commodity. In 2017,

it issued several positions setting such position limits for certain commodities traded on Euronext (Position 2017-12) and Powernext (Position 2017-11). The AMF will also be responsible for specifying exemptions to the thresholds where positions are taken for hedging purposes.

Furthermore, persons whose positions exceed thresholds specified in the RG-AMF for financial instruments that include underlying assets of an agricultural commodity will be subject to specific daily reporting to the AMF. Aggregated positions will be published weekly by the AMF.

### iii Cases and dispute settlement

#### *Non bis in idem*

The French Constitutional Council, in a landmark decision following the jurisprudence of the European Court of Human Rights in its *Grande Stevens* decision, ruled on 18 March 2015 that the same person could no longer be prosecuted and condemned twice for the same facts by the Association française des marchés financiers, the Enforcement Committee and a French criminal court.<sup>8</sup>

In its decision, the Constitutional Council considered as being unconstitutional the legal provisions setting forth criminal prosecution for insider trading offences, and those providing for administrative prosecution for insider trading breaches, on the grounds that the criminal and administrative definitions of insider trading are similar, aim at punishing the same facts and protect the same public interest.

Until this decision and well-established jurisprudence, cumulating administrative and criminal sanctions were deemed consistent with both the French Constitution, provided, however, that the total penalties did not exceed the maximum possible amount under either offence.

The 18 March 2015 Constitutional Council decision was deemed to have an immediate effect, including on individuals who had already been sentenced or prosecuted by the French financial markets authority or a French criminal court.

Questions remained as to how and when criminal courts would align their case law; in two decisions dated 6 and 18 May 2015, the Paris Criminal Court applied this new principle to cumulative prosecutions under market abuses where the AMF had already prosecuted the case, even if defendants had not been sanctioned by the AMF (this was notable in the *EADS* case). These decisions concern insider trading cases, but should also cover market manipulation and false information-spreading offences.

The censored provisions were amended by a law dated 21 June 2016 that reorganised the M&FC relating to market manipulation. The new provisions maintain a duality of procedures with administrative and criminal prosecutions, but creates a referral mechanism to ensure that a person is not prosecuted and condemned twice for the same acts. Therefore, a prosecutor cannot bring a criminal prosecution for insider trading when the AMF has already started an administrative prosecution against the same person and for the same offence. Similarly, the AMF cannot start an administrative sanction procedure when the prosecutor has already started a criminal prosecution for the same market manipulation. However, both

<sup>8</sup> Cons const, No. 2014-453/454 and No. 2015-462.



the AMF and the criminal courts can start prosecution after mutual consultation. In the absence of an agreement, both parties are heard by the General Prosecutor of the Paris Court of Appeal, who renders a decision on allowing the criminal proceedings.

It is important to point out that this law also modifies the sanctions applicable for market manipulation by raising them to five years' imprisonment and up to €100 million in fines. This amount may be increased up to 10 times the amount of the benefit derived from the manipulation, without the fine being inferior to this benefit.

### ***Derivatives: liabilities of financial intermediaries***

A number of cases have also addressed the issue of the duty of a financial intermediary to inform its counterparty of the way it will be remunerated in respect of hedging arrangements concerning commodities. In one case, the issue at stake was the setting up by a bank, at the request of its client, of hedging transactions against a decline in the nickel price in the form of zero-premium options. The client was challenging the underwriting and implementation conditions of these transactions. The Paris Court of Appeal, in a decision dated 26 September 2013, ruled that the bank had the duty to inform its client of the way it was going to be remunerated and ordered the bank to pay damages (US\$8 million) to its client for breach of its duty of information.

In its decision dated 17 March 2015, the French Supreme Court quashed the Court of Appeal decision and referred the parties before the same, but differently composed, Court of Appeal.

The Supreme Court ruled in particular that the Court of Appeal breached Article 1147 of the Civil Code by considering that the bank was bound by a duty to inform its client of the methods it was using to draw benefit from the transactions.

On 4 May 2010, the Supreme Court ruled on a matter arising from Lehman-related prime brokerage transactions, in which Lehman Brothers International (Europe) (LBIE) acted as prime broker for a French alternative investment fund (AIF) and a French credit institution acted as a depository.<sup>9</sup> Following the LBIE insolvency, the investment fund requested that the credit institution act as a depository to redeliver the assets to fund investors under prime brokerage with LBIE. The credit institution had filed an appeal against an AMF injunction to redeliver those assets. The Paris Court of Appeal upheld the AMF injunction and the Supreme Court confirmed that decision, all on the basis of overriding public policy considerations. It also dismissed on the same grounds defences raised under the provisions of Article 5.2 of the EU Collateral Directive regarding resort by the collateral taker to the remedy of set-off where the security collateral arrangement so provides. The Supreme Court disapplied the provisions of the prime brokerage agreement in respect of the right of use that prohibited the resort to setting-off the value of equivalent collateral against the discharge of financial obligations.

The liability of a depository in the context of a French AIF using prime brokerage services is governed by the provisions of Ordinance No. 2013-676, of 25 July 2013, (Article L214-24-10 of the M&FC), which transposes the AIFMD into French law.<sup>10</sup>

<sup>9</sup> C cass, Ch civ, 4 May 2010, 09-14.976.

<sup>10</sup> Article 21, Subparagraph 12 et seq. of the AIFMD.

### ***Margin disclosure obligations applying to investment service providers***

The issue of whether an investment service provider is required to disclose its remuneration and profit margins to its counterparty contracting party has been subject to several judicial decisions in France. In a decision dated 26 September 2013, the Paris Court of Appeal considered that an investment service provider should inform clients of banks' margins relating to the hedging transaction they had entered into. However, this decision was overruled by the Supreme Court in a judgment dated 17 March 2015, where the judges considered that the investment service provider, as a party to a hedging agreement against the risk of fluctuation in commodity prices, was not required to disclose the expected profit to the other party.

### ***UBS case: solicitation on the French territory***

One notable case in 2018 and 2019 in the French judicial landscape was the *UBS* case. In this case, UBS AG was found guilty of unlawful solicitation of clients on the French territory and helping them to implement tax evasion schemes by the French Court of First Instance of Paris, which sentenced it to pay €3.7 billion in penalties and €800 million of damages. The Court also found the French branch of UBS guilty of complicity in the same illegal actions, ordering it to pay €15 million in penalties.

These penalties could constitute a turning point in the judicial repression of banking and financial institutions involved in illicit activities. Indeed, this amount of penalties is without precedent in France. As a matter of comparison, in the same case, the French Prudential and Control Authority<sup>11</sup> sentenced UBS France to a €10 million penalty,<sup>12</sup> and in a case similar to *UBS*, HSBC agreed in 2017 to pay €300 million to settle a long-running investigation for the same charges through a *convention judiciaire d'intérêt public*, which is the French equivalent to an American deferred prosecution agreement, introduced under French law by Sapin Law II.

Although UBS appealed the decision, it might be a sign of the repression of unlawful financial solicitation in France.

### ***Euro medium-term notes qualification***

Euro medium-term notes (EMTNs) are debt instruments that have a shorter maturity than bonds and that bear a fixed or floating interest rate or a yield linked to an index or a formula, and a repayment amount that is fixed, variable or linked to a formula or index. Although EMTNs are not directly regulated by French law, it is commonly admitted that they fall within the category of debt securities within the meaning of Article L 211-1 of the French Monetary and Financial Code.

In a case brought before the Paris Court of Appeal, it was argued by an investor who bought an EMTN through its life insurance contract that a structured EMTN does not qualify as a bond (obligations) since its repayment amount could be for less than its nominal amount and thus was not a financial instrument eligible to life insurance contracts. The Court of Appeal followed this reasoning and condemned the insurer to pay damages to the investor. This decision was quashed by the French Court of Cassation in a decision of 23 November 2017 on the grounds that the qualification of a security as a bond (obligations) is not subject to the full repayment of the relevant security.

11 The ACP became the ACPR in 2013. It is an administrative authority and not a judicial authority.

12 In a decision dated 25 June 2013.

This decision clarified a debated legal issue in a way that brings more legal certainty as to the legal and tax regime regarding EMTNs in France.

### ***Inside information***

In 2018, the sanction board of the AMF rendered several decisions regarding insider dealing.

In particular, in a decision of the enforcement committee of the AMF of 24 October 2018, the AMF ruled that knowledge of the forthcoming publication of a press article giving substance to a rumor may constitute inside information, provided that this knowledge meets the conditions of precision, non-publicity and significant influence on the stock price. These conditions were met in the case at hand given the reputation of the journalist and the precision of the rumour, and the context of the market made this rumour credible and therefore sensitive for the market. However, the rumour itself was not deemed to be inside information.

With the knowledge of a rumour being inside information, a journalist being at the source of such information is therefore considered to be an insider, and could not disclose this information other than for the purpose of journalism. By disclosing this information to a single person, the journalist breached the obligation to refrain from disclosing or using inside information and committed a market abuse.

As a result of this case, and in accordance with Article 21 of the Market Abuse Regulation (MAR) regarding disclosure or dissemination of information in the media, in order for an authority to assess whether a journalist has committed a market abuse, the authority must review the code of conduct applying to the journalist and whether the code of conduct prohibited the way the journalist dealt with the financial information that he or she produced or disseminated.

### ***Market manipulation***

In 2018 and 2019 the enforcement committee of the AMF also rendered several decisions regarding market manipulation.

Provisions regarding market manipulation were provided in the RG-AMF that have now been replaced by equivalent provisions of MAR. In a case dated 16 July 2018, the enforcement committee of the AMF had the opportunity to clarify how MAR provisions could only apply to market manipulations that occurred before MAR's entry into force if such provisions are more lenient in accordance with the *in mitius* retroactivity principle.

The market manipulation that was sanctioned in this case was carried out on the MATIF, which is the regulated market for derivatives products in France, and resulted in particular from sell orders placed by a company on a futures contract 'in the last 10 seconds before closing, at a distance very close to the last buyer limit . . . on the smallest possible amount and having a period of validity limited to the same day'. This approach was repeated each day for more than four months with a few exceptions, and had the effect of reducing the bid ask spread.

Although selling orders were not cancelled, they had little chance to be executed, and therefore the AMF assimilated such low probability to the cancellation of an order. The market manipulation was therefore evidenced as, in accordance with Article 12.1(a) of MAR, the transactions consisted in placing an order to trade or any other behaviour 'which gives, or is likely to give, false or misleading signals as to the supply of, demand for, or price of, a financial instrument'.

#### **iv Insolvency law**

Insolvency, composition or rehabilitation proceedings in France are proceedings of judicial reorganisation and judicial liquidation governed by the bankruptcy provisions contained in the Commercial Code. Since 2006, these proceedings have been supplemented by a safeguard proceeding as a result of the enactment of the Safeguard Law. Pursuant to the Safeguard Law, No. 2010-1249 of 22 October 2010, effective 1 March 2011, the judicial reorganisation proceeding, the judicial liquidation proceeding and the safeguard proceeding are supplemented by an accelerated financial safeguard procedure, which allows a debtor to reach a voluntary restructuring agreement with its primary financial creditors (financial institutions and bondholders) on an accelerated basis. This corresponds roughly to the equivalent of a US Chapter XI prepackaged reorganisation plan.

The Ordinance of 12 March 2014 introduced an accelerated safeguard proceeding.

French insolvency proceedings are initiated by a judgment admitting a debtor to the safeguard proceeding or otherwise declaring a debtor insolvent and ordering its judicial reorganisation or liquidation under the appropriate proceeding.

A safeguard proceeding introduced pursuant to the provisions of Article L620-1 et seq. of the Commercial Code is available on demand to a debtor who, while not meeting the insolvency test, justifies the existence of difficulties that it is unable to overcome and that may lead to its insolvency. It is aimed at facilitating the reorganisation of an enterprise, leading to the continuation of its business, job preservation and discharge of its liabilities.

A reorganisation phase approved by judgment is followed by an appraisal period. During the latter, the debtor remains in possession as it is administered by its managers. However, the bankruptcy judgment may appoint one or more judicial administrators whose duties are to monitor the debtor in respect of its management or to otherwise assist the debtor in any managerial acts.

Under Articles L631-4 and L640-4 of the Commercial Code, the opening of judicial reorganisation or liquidation proceedings is requested by the insolvent debtor within 45 days of the date of insolvency, provided it has not applied for the opening of conciliation proceedings within that period.

The French Commercial Court also has jurisdiction to order such proceedings on its own initiative or at the request of the public prosecutor or a creditor.

The accelerated financial safeguard procedure allows a debtor to reach a voluntary restructuring agreement with its primary financial creditors (financial institutions and bondholders). This procedure enables a debtor to move from the conciliation procedure into the accelerated safeguard procedure when it proves to the French Commercial Court that the restructuring plan ensures the continuity of the company and has a good chance of being approved, within a short period of time (see below). The restructuring plan must be adopted by a majority of two-thirds of the claims in the committee (consisting of banks and financial institutions) and in the bondholders' general meeting, if any. This procedure is shorter than the ordinary safeguard procedure, and lasts one month from the opening of the procedure with a possible extension of one further month only.

Under Article L631-1 of the Commercial Code, an inability to meet current liabilities with current assets constitutes the insolvency test. However, it may be noted that, for credit institutions, there is a specific insolvency test that is defined as the inability to meet payments

either immediately or in the immediate future.<sup>13</sup> In addition, under Article L613-27 of the M&FC, a safeguard proceeding, a judicial reorganisation proceeding or a judicial liquidation proceeding may only be opened against a credit institution, a payment institution or an investment firm by a commercial court having jurisdiction following conforming advice by the ACPR.

A period of appraisal also applies in respect of a judicial reorganisation proceeding. As in a safeguard proceeding, the period of appraisal starts from the date of the bankruptcy judgment and may, subject to the court's determination, extend for a period of up to 18 months. During this time, a reorganisation plan is prepared by the judicial administrator appointed in the bankruptcy judgment. The plan contemplates continuation of the activities of the debtor and, as the case may be, the termination, addition or assignment of one or several activities (provided that the assignment is subject to the provisions relating to judicial liquidation proceedings).

At any time during the appraisal period, the court may order, upon application of the debtor, the judicial administrator, the representative of the creditors, the controller or the public prosecutor or *sua sponte*, the partial closing down of a business.

The court may convert the safeguard proceeding into a judicial reorganisation proceeding if a debtor meets the insolvency test, the safeguard proceeding or the judicial reorganisation proceeding (as the case may be) into a judicial liquidation proceeding if the reorganisation of the debtor appears to be manifestly impossible otherwise, or if the assignment of its assets is otherwise contemplated either as a whole or separately.

At or prior to the expiry of the appraisal period, the court either approves a plan or declares the judicial liquidation of the debtor. The judicial liquidation may be ordered without the benefit of a prior appraisal period when the relevant business has ceased its operations or when a judicial reorganisation appears to be manifestly impossible. A liquidator is then appointed.

## **v Role of exchanges, CCPs and rating agencies**

### **CCPs**

Article L440-1 et seq. of the M&FC provides that clearing houses ensure monitoring of positions, margin calls and, if need be, mandatory liquidation of positions. A clearing house is required to have the status of a credit institution, and its operating rules are approved by the AMF, the French markets and the securities regulator.

The Banking Reform modifies the legal regime applicable to French clearing houses, with particular attention to the conditions under which, in the event of default by a participant, a clearing house may transfer the position and collateral of the participant's clients to another participant.

Relations between the clearing house and participants are governed by contract. Banque Centrale de Compensation is an LCH SA entity licensed as a bank through which clearing operations are carried out, operating under the LCH trade name.

LCH SA today is a wholly owned subsidiary of LCH Group Holdings Ltd, of which 57.8 per cent of the shares are owned by the London Stock Exchange.

<sup>13</sup> Article L631-26 of the M&FC.

LCH SA has been designated by the Minister of Finance as a system under the EU Settlement Finality Directive as transposed in France under Article L330-1 et seq. of the M&FC.

To reduce the systemic risk posed by derivatives in compliance with G20 commitments relating to clearing standardised OTC derivatives, EMIR was adopted and came into force on 16 August 2012. It lays down clearing and bilateral risk management requirements for OTC derivative contracts, reporting requirements for derivative contracts and uniform requirements for the performance of the activities of CCPs and trade repositories.

LCH SA, under its Rule Book, guarantees performance with regard to its participants. The ACPR assimilates a clearing house to a payment infrastructure.

As mentioned above, Banque Centrale de Compensation is licensed as a bank or credit institution for the purposes of the EU Banking Directive. As such, it is also subject to mandatory reserve obligations under the European Central Bank (ECB) Regulation.<sup>14</sup>

Under the provisions of the M&FC, it is mandatory for a clearing house to be licensed as a credit institution, and this has been confirmed by the Banking Reform.

Being subject to reserve requirements also entitles Banque Centrale de Compensation to ECB money.<sup>15</sup>

Although already subject to EMIR, a CCP is also subject to comprehensive requirements, including in the areas of capital and compliance. These requirements fall short, however, of requiring that a CCP be licensed as a credit institution. Authorisation as a CCP is granted by the competent authority of the Member State in which it is established.

### **Rating agencies**

The French regulatory environment relating to rating agencies is governed by Regulation (EC) No. 1060/2009 on credit rating agencies of 16 September 2009, as modified by Regulation (EU) No. 513/2011 issued on 11 May 2011, which reinforces the direct supervision and control powers limited in the first version (Rating Regulation).

The Rating Regulation imposes on rating agencies duties to:

- a* avoid conflicts of interest and to require an increasingly high degree of independence from stakeholders within the rating process;
- b* improve rating quality by achieving higher standards in respect of methodology;
- c* improve governance and internal controls of rating agencies; and
- d* introduce rules to improve the transparency of the rating process regarding the rated entity as a *sine qua non* condition to win public confidence in financial markets.

On 30 May 2012, four Commission delegated regulations establishing regulatory technical standards for credit rating agencies were published. These technical standards out:

- a* the information to be provided by a credit ratings agency in its application for registration with ESMA;
- b* the presentation of the information to be disclosed by credit rating agencies in a central repository so that investors can compare the performance of credit rating agencies in different rating segments;
- c* how ESMA will assess rating methodologies; and

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<sup>14</sup> Regulation No. 2818/98 of the European Central Bank.

<sup>15</sup> General documentation on Eurosystem monetary policy instruments and procedures, p. 10.

- d* the information that credit rating agencies must submit to ESMA, and at what time intervals, for it to supervise compliance.

Ratings used either for regulatory purposes or in a prospectus to be used for admission to trading on a regulated market must be issued by credit rating agencies established in the European Community and registered in accordance with the Rating Regulation. A credit agency may, subject to certain conditions, endorse a credit rating issued in another country. Exemptions to endorsement are subject to certain conditions. Such credit rating agencies must apply for certification.

It was further provided that, by 7 June 2010, each Member State should designate a competent authority for the purpose of the Rating Regulation. The AMF was designated by Law No. 2010/1249, of 22 October 2010, as the competent French authority for registration and supervision of credit rating agencies.

Key provisions of Regulation (EU) No. 462/2013 of the European Parliament and of the Council of 21 May 2013, amending Regulation (EC) No. 1060/2009 on credit rating agencies, contemplate that:

- a* ratings will be published on a European rating platform;
- b* ratings of sovereign bonds will be limited and made more transparent;
- c* financial institutions will have to strengthen their own credit risk assessment; and
- d* the risk of conflicts of interest will be mitigated.

It may be noted that, until recently, French law provided for a specific liability regime for credit rating agencies that was distinct from the one provided in the EU regulations. However, this regime was abrogated by Law No. 2018/727, of 10 August 2018, to align its legislation with EU law.

As a result of the economic crisis and of the EU legal framework governing rating agencies, the three agencies dominating the French rating market (Moody's, Standard & Poor's and Fitch) have reorganised their structures, which has reinforced their supervisory activity. The rating agencies in France had already substantially modified their methodology relating to bonds in 2009 so that estimated liquidity risk could be taken into account and addressed.

### III OUTLOOK AND CONCLUSIONS

The French financial system has emerged stronger from the turmoil of 2007 to 2009, although a few institutions have been subject to severe stress.

The focus on universal banking, combining a robust retail banking sector (which benefits from strong shareholder support) with corporate investment banking activities operating in a well-established regulatory and supervisory environment, has been at the root of France's ability to overcome the severe difficulties and substantial losses of the past few years.

The events of the past 10 years have shown that remedies for a global crisis lie in global (and regional) actions. The need to improve the supervisory framework at the EU level, in close coordination with Member States, has become compelling. The adoption, therefore, of Basel III measures has constituted a particular challenge in the context of strengthening regulatory capital levels. The entry into force of CRD IV and CRR was expected to strengthen the trend towards disintermediation, together with enhanced recourse to capital market instruments and securitisation.

The long-awaited creation of pan-European supervision authorities, including the European Banking Authority, ESMA and the European Insurance and Occupational Pensions Authority, has helped address the compelling need for supervision at European level. However, it also appears that in a post-Brexit context, it is time to streamline the governance framework at the EU level, and in this respect the European Commission made a legislative proposal to review the European Supervisory Authorities. This was supported by the AMF in a position paper of February 2018, in which it proposed a few adjustments to the proposal to enhance harmonisation across the European Union, a supervisory convergence and uniform interpretation of the European regulations.

An outlook of the near future of capital markets has been provided by the AMF in a recent report on the markets and risk outlook for 2019 in which the following trends are highlighted:

Over the past year, the financial markets landscape has deteriorated, with a slowdown in world GDP, growing uncertainties and geopolitical tensions. In this respect, the valuation of financial assets nevertheless remains very high, and the (admittedly temporary) fall in equity markets at the end of 2018 illustrates the factors that could potentially trigger a correction: an upward revision of the risk premium or new expectations regarding monetary policy standardisation.

Changes underway in the financial markets bring new risks, such as the underachievement of the transparency objective under MiFID II, a concentration of transactions in the closing auction on Euronext and a boom in private equity funds. The risks linked to derivatives markets, meanwhile, seem to be easing, and knowledge of AIFs continues to improve (AIFM reporting);

The international environment is also a source of vulnerabilities both in the short term with Brexit, and in the longer term with the risk of a less cooperative environment: market fragmentation, regulatory competition and a race to the bottom. The risk for the financial sector might also come from its inability to adapt to all these changes, to which the challenge of the energy transition and digital transition can also be added.

The risk of an interest rate snapback seems low since the prospect of monetary normalisation has faded away. On the contrary, it is precisely the risk of interest rates remaining too low and for too long that prevails, along with the related drawbacks: an inability of the markets to price time and risks in order to guide investors, savers torn between zero-yield bank deposits (a new record in France at €61 billion in 2018), bubbles and the search for the sort of unrealistic yields that can only turn out to be scams; in addition, this context of low interest rates is exerting pressure on actors' margins, raising questions over their business models and, by focusing clients' attention on the level of fees, favouring the development of passive management methods.

The financial sector finds itself facing multiple upheavals bringing risks of brutal disruptions; in the short term, Brexit is adding to these transition vulnerabilities, even though the French authorities have been quite active in enacting measures for adapting to this new situation and preserving access to major London market infrastructure and clearing capabilities. In a more subtle way, the reform of benchmark interest rates will force market participants to make numerous adjustments and adaptations in their systems.



# GERMANY

*Stefan Henkelmann and Lennart Dahmen*<sup>1</sup>

## I INTRODUCTION

### i Structure of the law

The German understanding of capital markets is the market for financial instruments (within the ambit of Annex I, Section C of the Markets in Financial Instruments Directive<sup>2</sup> (MiFID II))<sup>3</sup> and the ‘grey capital market’ that conceptually includes any financial products that are not technically financial instruments in the narrow sense (mostly for lack of tradability in a legal sense, such as stakes in closed-ended fund structures outside the Alternative Investment Fund Managers Directive (AIFMD),<sup>4</sup> which are legally partnership interests and shares in limited liability companies). Although this dichotomy is becoming ever more blurred since numerous grey capital market financial products are deemed to be financial instruments within the ambit of the Banking Act (KWG) for certain (quite limited) regulatory purposes, and some now fall within the ambit of the German transposition of the AIFMD (in the Capital Investment Code (KAGB), which provides a unified framework for all kinds of undertakings for collective investment in transferable securities and alternative investment funds), it still continues to be useful for analytical purposes.

While the market for financial instruments in the narrow sense is very densely regulated in respect of market access and market behaviour, the grey capital market is more sparsely regulated, except for the accounting directives (which indiscriminately apply to both issuers of financial instruments and originators of other financial products), the AIFMD and the PRIIPs Regulation,<sup>5</sup> harmonised EU capital markets law almost exclusively aims to regulate markets for financial instruments, and German law basically follows this approach, except for:

- a* a special prospectus requirement for financial products of the grey capital market;
- b* a special licensing requirement (hardly more than mere registration) for distributors of such products;
- c* certain structural requirements for such products; and
- d* the power of the Federal Financial Supervisory Authority (BaFin) to ban certain products (as an *ultima ratio* measure) and certain misleading sales promotion.

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<sup>2</sup> Directive 2014/65/EU on markets in financial instruments.

<sup>3</sup> Transferable securities, money market instruments, units in collective investment undertakings, multiple classes of derivatives, contracts for difference and emissions allowances.

<sup>4</sup> Directive 2011/61/EU.

<sup>5</sup> Regulation (EU) No. 1286/2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs).

The former light touch regulation of the grey capital market had already been somewhat fundamentally changed in the context of the transposition into German law of the AIFMD by the KAGB, which made all kinds of collective investment schemes subject to fund regulatory law (albeit with limited effect unless the AIFMD thresholds for assets under management are met) basically finally came to an end as a result of the Small Investor Protection Act, which partly anticipated the German transposition of MiFID II and partly further tightened the grip over grey capital market financial products.

The capital markets law is a body of laws and standards that directly or indirectly regulate the capital markets regarding market access, market behaviour and market-related behaviour of market participants and thereby safeguard their efficiency. It has an interdisciplinary profile, being implemented through a vast and somewhat unsystematic body of administrative, civil and criminal law provisions at both the supranational (European) and national levels. Administrative policies (such as BaFin's Issuer Guidelines, circulars and other publications, and certain publications of the European Securities and Markets Authority and the former Committee of European Securities Regulators) play a highly important role in practice: they provide a minimum level of comfort to market participants although they merely reflect the respective authority's interpretation of the law – which is not necessarily correct – and are not binding on the courts. Standards set by private standard setters (such as the International Accounting Standards Board, the German Accountancy Standards Committee and the German Institute of Auditors) have high practical impact. The vast field of over-the-counter (OTC) derivatives is almost exclusively dominated by standard forms of agreements proposed by private institutions such as the International Capital Market Association, the International Swaps and Derivatives Association and the Federal Association of German Banks, but market infrastructure law and regulations (the European Market Infrastructure Regulation (EMIR) and MiFID II) have certain repercussions on documentation and trading.

German capital markets law is, to a large extent, harmonised with EU capital markets law: more than 85 per cent of the relevant provisions are either directly applicable EU law (e.g., the Market Abuse Regulation (MAR)) or are based on EU law. The Securities Trading Act (WpHG) – sometimes called 'the constitution of the German capital market' – the Deposit Protection Act and the Investor Compensation Act, the Stock Exchange Act (BörsG) and the Stock Exchange Admission Regulation (BörsZulV), the Securities Prospectus Act (WpPG), the Securities Acquisition and Takeover Act (WpÜG), the accounting provisions of the Commercial Code and the KAGB are substantially or even entirely based on EU directives, implementing the Investment Services Directive, the AIFMD, the Financial Markets Directives, the Transparency Directive, the Settlement Finality Directive, the Investor Compensation Directive, the Prospectus Directive, the Directive on the Admission of Securities to Official Stock Exchange Listing, the Accounting Directives and the Undertakings for Collective Investment in Transferable Securities Directive. While in the past EU directives almost exclusively provided for minimum harmonisation and left ample leeway for national legislators to provide for stricter rules at the national level – which the German legislator sometimes did – they now mostly provide for maximum harmonisation, meaning that Member States must follow the levels prescribed by the European Union and have no discretion to introduce stricter rules.

The core parts of German capital markets law are codified in the WpHG and the WpÜG, which basically deal with market comportment issues relating to the market for financial instruments; and in the KWG, the BörsG, the BörsZulV and the WpPG, which basically deal with market access issues relating to the market for financial instruments and

to distributors active in this market. The market compartment regulation in the WpHG is basically a transposition of the MiFID II regime. The regulatory framework for the sale of structured products is provided by the PRIIPs Regulation – in force since the beginning of 2018 – which is directly applicable in Germany. The WpPG – the German transposition of the Prospectus Directive<sup>6</sup> – is supplemented by the Capital Investment Act (VermAnlG), which replaced the former Sales Prospectus Act and provides for a prospectus requirement for investments that are not technically securities in a narrow sense, such as stakes in certain commercial undertakings, profit participation interests, subordinated loans and structured deposits, and thereby covers virtually all the grey capital market. In addition to the prospectus requirement, the VermAnlG also provides that the relevant (retail) products must have a minimum maturity and a minimum notice period so as to avoid liquidity issues and outright runs, which occurred when very short-maturity subordinated profit participations rights were used to refinance long-term renewable energy investments, and prohibits the distribution of retail products that require subsequent additional capital contributions.

The direct or indirect distribution of non-self-issued financial instruments to (retail, wholesale and institutional) customers is a regulated financial service that requires a licence under the KWG or a passported European licence, and involves regulatory supervision by BaFin and the German Federal Bank (Bundesbank).<sup>7</sup> Except for the licensing requirement for providers of collective securities management (which is aimed at certain financial products related to collective investment schemes – such as stakes in closed-end securities trading funds and self-issued bonds linked to the performance of managed securities portfolios – that would otherwise fall into an unregulated gap between financial portfolio management within the ambit of the KWG and investment fund administration within the ambit of the KAGB), these licensing requirements are transpositions of Article 5(1) of MiFID II (requirement for authorisation); however, investment advice, investment brokering and best-efforts underwriting may be provided by tied agents (i.e., persons not holding a financial services licence themselves, but acting under the umbrella of the licence held by a deposit-taking credit institution or a securities trading firm) if the conditions set out in Article 29 of MiFID II are met. A tied agent acting in Germany under the umbrella of a deposit-taking credit institution or a securities trading firm from another European Economic Area country would not be deemed a German branch of that foreign firm, to the effect that the foreign firm would only have to hold a European passport for cross-border services into Germany.

Cross-border financial services that are provided in Germany from other countries are deemed regulated financial services in Germany if the German market is actively targeted, meaning that financial promotion (solicitation) is directed into Germany. Whether this is the case depends on a complex bundle of criteria, mainly driven by customer protection concerns. As a consequence, foreign firms not holding a European passport are basically banned from actively providing cross-border financial services into Germany unless they use a German fronting bank or a client initiates a reverse solicitation. There are some exceptions with respect to certain activities of Swiss banks under a German–Swiss memorandum of understanding of 16 August 2013.

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6 Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading.

7 Investment advice, investment brokering, contract brokering, underwriting, financial portfolio management, proprietary trading or collective securities management, depending on the nature of the service.

Naked short sales of shares and eurozone public debt instruments admitted to trading on a regulated market in Germany, and cash-settled credit derivatives the reference asset for which is eurozone public debt, are banned under Regulation (EU) No. 236/2012 on short selling and certain aspects of credit default swaps, which replaces the former German framework. Further, there are notification and publication obligations for net-short positions in shares admitted to trading on a regulated market in Germany exceeding certain thresholds. A naked short sale within the ambit of the law occurs when the seller of the shares or debt instruments is not the owner of the securities or does not have an unconditionally enforceable claim for delivery of a corresponding number of securities by the end of the day on which the respective transaction occurs. The short-selling ban provides an exemption for short sales by an investment services company or similar organisation domiciled abroad if and to the extent the company acts as a market maker or hedges positions resulting from certain trades with customers. The ban on public debt credit derivatives provides an exemption for short sales by an investment services company or similar organisation domiciled abroad, if and to the extent that the company acts as a market maker. Any market participant intending to make use of such exemptions must notify BaFin immediately, specifying the financial instruments concerned. The short-selling ban applies extraterritorially. Further, BaFin is empowered to temporarily prohibit or suspend trade in certain financial instruments, in particular with regard to derivatives whose value directly or indirectly derives from the price of shares or eurozone public debt instruments admitted to trading on a regulated market in Germany, if their structure and effect are, from an economic perspective, equivalent to short-selling and do not lead to the reduction of a market risk.

Distribution of certain grey capital market financial products only requires a licence (basically little more than a mere registration) from the competent local trade board under the Industrial Code (GewO), and does not involve regulatory supervision by BaFin or the Bundesbank (except for the applicable prospectus regime, and BaFin's power to ban certain products and certain misleading advertising). As with financial services, the licensing requirement is triggered if the German market is actively targeted in the context of cross-border distribution from abroad.

The provision of regulated financial services without a proper licence (or European passport) is a criminal offence under the KWG and a tort under the Civil Code.

Investors in German bank debt should be aware of the effects of the bank resolution and bail-in regime under the German Restructuring and Resolution Act, which transposes the Bank Recovery and Resolution Directive (BRRD)<sup>8</sup> into German law. In 2015, the German legislator subordinated senior unsecured bonds of banks to help German banks to meet the minimum requirement for own funds and eligible liabilities and the total loss absorbing capacity. In other European countries, banks could continue to issue preferred senior bonds that were priced differently from the lower-ranking German subordinated senior bonds. To achieve a level playing field for German bank issuers and to implement an amendment of the BRRD effective as of 28 December 2017 with the aim of improving consistency between creditor hierarchies across the European Union, the German legislator amended the KWG (Section 46f, Paragraphs 6, 7 and 9) to allow for two different classes of senior bonds. Since 21 July 2018, German banks can choose to issue senior-preferred and senior non-preferred bonds. If the terms and conditions of the securities to be issued do not provide otherwise,

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8 Directive 2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms.

issues since 21 July 2018 count as senior preferred issues. Only if it is explicitly stated in the terms and conditions of the securities shall the lower non-preferred ranking apply to a new issue (senior non-preferred).

Under the new regime, senior unsecured bonds issued before 20 July 2018 (inclusive) now rank *pari passu* with senior non-preferred bonds. They lost European Central Bank (ECB) eligibility as of 31 December 2018. However, this grandfathering is only available for issues prior to 16 April 2018.

It is expected that numerous German banks will make use of the new asset class of senior preferred bonds, because those issues will benefit from a higher issue rating and will be less expensive. In addition, new senior preferred bonds are eligible as ECB collateral.

## **ii Structure of the courts**

The German court system consists of five distinct structures, each of which is basically three-tiered with its own supreme court (i.e., each consists of a trial court, a court of appeal and a supreme court). In addition to the hierarchy of the ordinary (civil and criminal) courts, there are separate systems of labour, administrative, tax and social security courts. The legality of administrative actions can be challenged before the administrative courts (tax courts and social security courts being specialised administrative courts), whereas disputes between private persons (and between private persons and the state and its subdivisions, if these are not acting in an administrative capacity) are dealt with by the ordinary courts (and the labour courts if a dispute stems from a labour contract or collective labour issues). Thus, lawsuits against BaFin for the purpose of challenging a regulatory measure would have to be brought before the administrative courts, whereas disputes between market participants are to be litigated before the ordinary (civil) courts. In the ordinary (civil) courts, there are special chambers for commercial affairs at the trial court level, where a professional judge sits with two commercial experts chosen for their specific expertise.

## **iii Supervisory agencies**

BaFin is the supervisor for any and all issues related to financial instruments, whereas the grey capital market is (extremely sparsely) supervised by the local trade boards under the GewO (with BaFin only being competent for the approval of prospectuses and the banning of products and certain misleading advertising). Under an operational agreement between BaFin and the Bundesbank, the latter is assigned most of the operational tasks of day-to-day supervision of banks and financial services providers. The Bundesbank's responsibilities notably include evaluating the documents, reports, annual accounts and auditors' reports submitted by the institutions, and carrying out regular audits of their operations. The Bundesbank holds both routine and *ad hoc* prudential discussions with institutions. The supervision of trading in financial instruments by BaFin serves the objectives of market transparency, market fairness and investor protection. The stock exchange supervisory authorities of the federal states are responsible for the supervision of compliance with stock exchange regulations. BaFin's competences with regard to credit institutions within the ambit of the Capital Requirements Regulation<sup>9</sup> are now partly superseded by the ECB under the Single Supervisory Mechanism.

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9 Regulation (EU) No. 575/2013.

#### **iv Trends reflected in decisions from the courts and other relevant authorities**

It is fair to say that banks and financial intermediaries currently have a somewhat difficult standing with the courts and the regulator (and the legislator): there is a broad consensus (which is to a large extent the consequence of severe hindsight bias) that applicable standards should be tightened to the detriment of the former. As in the aftermath of any financial crisis, investors are inclined to forget about the true reasons for their investment decisions, plaintiffs' lawyers search for 'put options by law' to allow for ill-fated investments to be unwound and, by (retroactively) tightening standards of disclosure and advice, the courts seem quite willing to 'help' investors who seem to have been milked or bilked. The focus is mostly on mis-selling, but another big issue is the validity of the terms and conditions underlying certain financial products under the law on unfair contract terms. The Small Investor Protection Act and the German transposition of MiFID II have further tightened the grip over grey capital market financial products and tackled the distribution of financial products.

## **II THE YEAR IN REVIEW**

Legislative and regulatory activity and activism in the area of the capital markets now mainly occur at the European Union level, to the effect that there has been relatively little development at the purely national level. However, developments at the European level and the (planned, yet delayed) withdrawal of the United Kingdom from the European Union (Brexit) have had an effect on legislation and market trends in Germany.

#### **i Developments affecting the distribution of financial instruments in general**

The delayed Brexit has been a source of uncertainty for the capital markets, including the German market. A 'no-deal' Brexit without a transition agreement between the United Kingdom and the EU could severely impact trading on, and access to, the capital markets in Europe. Similar to other markets, many financial institutions that currently operate across Europe from the UK have established a 'foot on the ground' in Germany, either by opening up subsidiaries or by transfers of their existing branches to a continental European platform. However, at the time of writing, it is still uncertain if a solution for a coordinated Brexit, now further delayed, can be agreed.

The German legislator has passed transitional laws that may ease the burden and that are tailored to ensure the orderly continuing of trading activities on the capital markets, which may also include derivative transactions with UK counterparties. However, uncertainties remain, as these laws give wide-ranging authority to BaFin to pass transitional measures. The exact scope and details of the transitional provisions remain uncertain. Market participants will be well advised to closely monitor how their portfolio of offerings may be affected by Brexit.

The regime applicable to the public offering of securities has been further amended and harmonised through the introduction of the new Prospectus Regulation.<sup>10</sup> The Prospectus Regulation replaces the previous Prospectus Directive<sup>11</sup> and its national transpositions. The

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10 Regulation (EU) 2017/1129 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market.

11 Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading.

revised regime is designed to reinforce investor protection by ensuring that all prospectuses, wherever issued in the EU, provide clear and comprehensive information while at the same time making it easier for companies to raise capital throughout the EU on the basis of approval from a single competent authority.

2019 also saw BaFin making use of its powers and authorities under the European Short Selling Regulation:<sup>12</sup> earlier this year, BaFin imposed a short-selling ban on the shares of a German financial institution that had recently been elevated to Germany's main stock index. The decision of the regulator marked the first time that BaFin has exercised its intervention powers under the Short Selling Regulation in an individual case, and has been watched with concern and scrutinised by market participants and scholars. It may be seen as an indication of the regulator taking a more active stance but, at the same time, was specific to the unusual circumstances that were specific to the trading activity in relation to that relevant issuer.

However, BaFin and the government have indeed taken a more robust stance on the distribution of certain financial instruments. BaFin is keeping a close eye on marketing practices of financial instruments sold to retail investors, and may also utilise its intervention powers under MiFIR. In a similar vein, the government recently published a position paper under which it contemplates the prohibition of such products for the grey capital market that are regulated under the *VermAnlG*.

Additionally, increased offerings of crypto tokens and the underlying distributed ledger technology have been points of regulatory and governmental attention. The government is in the process of evaluating the possibility of issuing securities electronically. As it currently stands, securities under German law are usually securitised through issuing a global certificate to be kept with a central securities depository, which itself is a specifically regulated credit institution. A government position paper published earlier this year explores whether (and to what extent) this traditional system could be fundamentally overhauled. While the paper takes care to ensure that regulation would be technology-neutral, it appears that the government has specifically considered issuances of electronic securities on blockchain and distributed ledger technology.

Moreover, the same paper builds on previous BaFin guidance to discuss and consider the regulation of public offerings of certain crypto tokens. Under the discussion paper, the government considers regulating the public offering of utility tokens and cryptocurrencies or waiting for further developments on the European level that may ensure far-reaching harmonisation of the offering of such products.<sup>13</sup>

## ii Cases

In September 2018, the Higher Regional Court of Berlin held that bitcoin does not qualify as a financial instrument within the meaning of the *KWVG*; therefore, trading of bitcoin does not require any financial services licence. This decision deviates from the regulatory practice of BaFin, which generally classifies bitcoin as a financial instrument (unit of account) and therefore makes trading of bitcoin subject to licence requirements. While the Higher Regional Court expressed the view that BaFin went beyond its competency when it classified bitcoin as

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12 Regulation (EU) No. 236/2012 on short selling and certain aspects of credit default swaps.

13 ESMA published advice on initial coin offerings and cryptoassets in January 2019: [https://www.esma.europa.eu/sites/default/files/library/esma50-157-1391\\_crypto\\_advice.pdf](https://www.esma.europa.eu/sites/default/files/library/esma50-157-1391_crypto_advice.pdf).

units of account, the German regulator did not change its regulatory practice in this regard. It appears that the German legislator is backing BaFin's view by introducing draft legislation pursuant to which bitcoin shall be classified as financial instruments (see Section III).

### **iii Role of exchanges and central counterparties**

Central counterparty (CCP) clearing for OTC derivatives is still a focus with regard to the implementation of EMIR, CRD IV<sup>14</sup> and MiFID II. The German Banking Association has published several standard form documents as annexes to the German framework agreement for derivatives that address certain EMIR requirements and facilitate clearing. Aspects regarding bilateral OTC derivatives and margining requirements also remain in focus.

## **III OUTLOOK AND CONCLUSIONS**

Following on from the developments during 2018 that saw the coming into force of various European directives, 2019 has been a comparatively quiet year. The coming into force of the Prospectus Regulation had been long expected and did not cause great uncertainty as compared to the transposition of MiFID II and the related MiFIR just 18 months earlier. However, developments at the European level will continue to drive further European harmonisation, which will have a significant impact on capital markets laws and regulations and financial instruments traded on the capital markets in Europe, including Germany.

In addition, developments on the national level will continue. BaFin has begun the process of updating its Issuer Guidelines in which the regulator provides additional guidance on various areas of European and national law. BaFin is following a modular approach, and has recently submitted the chapter on the application of the MAR for public consideration and consultation.

It appears that the increased regulation of crypto tokens and related activities will be an area of regulatory focus. In contrast to the above-mentioned decision of the Higher Regional Court of Berlin, legislative measures indicate that the level of regulation will only increase. Most recently, the government published a draft act on the transposition of the Fifth Anti-Money-Laundering Directive<sup>15</sup> introducing, inter alia, the custody of cryptoassets as a new licensable activity, and setting out an extensive definition of cryptoassets, generally confirming the view of the German regulator on their nature as financial instruments (see above).

One of the major outstanding legislative issues in Germany that was originally scheduled for 2018/2019 is a far-reaching reform of the regulation of brokers of highly regulated products (funds registered for public distribution and similar products) that were previously subject only to light-touch regulation by local trade authorities. Under the legislative proposal, such brokers will be subject to BaFin supervision and will need to comply with certain obligations resulting from MiFID II. However, this project has been delayed, and current plans envisage the coming into force of the relevant ordinance as of 1 January 2020.

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14 CRD IV is made up of the Capital Requirements Directive (2013/36/EU) and the Capital Requirements Regulation (No. 575/2013).

15 Directive (EU) 2018/843 of the European Parliament and of the Council of 30 May 2018 amending Directive (EU) 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing.



# JAPAN

*Akihiro Wani and Reiko Omachi<sup>1</sup>*

## I INTRODUCTION

### i Structure of financial laws and regulations in Japan

The Financial Instruments and Exchange Act (FIEA)<sup>2</sup> and the Cabinet Order and Cabinet Office Ordinances thereunder are the most basic and important direct regulations on capital markets in Japan. The FIEA regulates financial instruments business and financial transactions, including securities offerings and distributions, for the purpose of maintaining the fairness of the capital markets, protecting investors and developing the economy. There are no overarching laws that regulate all financial institutions, which means that each type of institution is regulated separately. For example, banks are regulated by the Banking Act,<sup>3</sup> securities firms are regulated by the FIEA and insurance companies are regulated by the Insurance Business Act.<sup>4</sup> The FIEA is still important, however, even for financial institutions that are regulated by laws other than the FIEA, because those laws may refer to provisions of the FIEA that are then applied to such institutions *mutatis mutandis*. As a result, these institutions are in effect also regulated by the principles of the FIEA in many respects, for example when conducting securities and derivatives transactions.

There are several other laws and regulations that specifically govern certain types of financial transactions, including derivatives transactions, securitisations, structured products, investment funds, trusts and partnerships, including the Commodity Derivatives Act,<sup>5</sup> the Act on Investment Trusts and Investment Corporations,<sup>6</sup> the Limited Partnership Act for Investment,<sup>7</sup> the Act on Securitisation of Assets,<sup>8</sup> the Trust Act<sup>9</sup> and the Companies Act.<sup>10</sup>

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2 Act No. 25 of 1948, as amended.

3 Act No. 59 of 1981, as amended.

4 Act No. 105 of 1995, as amended.

5 Act No. 239 of 1950, as amended.

6 Act No. 198 of 1951, as amended.

7 Act No. 90 of 1998, as amended.

8 Act No. 105 of 1998, as amended.

9 Act No. 108 of 2006, as amended.

10 Act No. 86 of 2005, as amended.

## **ii The role of regulatory and supervisory agencies and the central bank in the Japanese capital markets**

The Financial Services Agency (FSA) is responsible for, inter alia, ensuring the stability of the Japanese financial system, developing the financial industry, protecting investors and carrying out surveillance over securities transactions. The FSA delegates powers relating to securities registration to local finance bureaus (LFBs) and to daily market surveillance, inspections of financial instruments firms, inspections of disclosure documents and related activities to the Securities and Exchange Surveillance Commission (SESC).

The commodity derivatives business is regulated by either the Ministry of Economy, Trade and Industry (METI) or the Ministry of Agriculture, Forestry and Fisheries (or both), depending on the type of underlying commodity.

The Bank of Japan, which is the country's central bank, is independent of the government, including the FSA, as is the case with central banks in many other jurisdictions. Its mission mainly focuses on the implementation of monetary policy, treasury and government securities-related operations.

Additionally, there are several self-regulatory organisations whose membership consists of financial institutions. Among them, the Japan Securities Dealers Association (JSDA) is the most representative and important organisation in the Japanese capital markets. It promotes sound business development and protects investors by ensuring that securities transactions by its members are conducted fairly and smoothly.

## **iii Financial dispute resolution**

Several options exist for resolving financial disputes in Japan: judiciary proceedings in court, arbitration procedures at an arbitral tribunal and alternative dispute resolution (financial ADR) procedures.

Usually, a party to a financial transaction is able to sue the counterparty in court, and once a court procedure is chosen, the parties will be entitled to a decision by a district court and two instances of appeal to the High Court and the Supreme Court.

Alternatively, a party may elect arbitral institutions, including the Japan Commercial Arbitration Association or the International Chamber of Commerce, for arbitral awards that are deemed to be final and binding by the courts. Japan is a member of both the ICSID Convention and the New York Convention, and Japan's Arbitration Act<sup>11</sup> is based on the UNCITRAL Model Law.

In addition to court and arbitral procedures, an investor may seek settlement of a financial dispute by choosing the financial ADR procedure, which is a simplified and expeditious resolution system.

## **iv Scope of jurisdiction**

In general, it is believed that Japanese laws and regulations do not apply to activities by foreign companies outside Japan as the scope of jurisdiction should be limited to the Japanese territory. With respect to cross-border cases, however, there is no provision that specifies the extent of the application of financial laws and regulations, and the scope of the powers of

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<sup>11</sup> Act No. 138 of 2003, as amended.

regulatory authorities is still open to interpretation. Even so, it is almost always the case that Japanese laws and regulations apply when a foreign company solicits an investor who resides in Japan, even from outside Japan (see Section II.i).

In practice, the FSA maintains close and constant contact with the regulators of foreign countries. Financial institutions should pay careful attention to the relevant overseas regulations as well as the Japanese regulations.

## II THE YEAR IN REVIEW

### i Developments affecting debt and equity offerings

#### *Framework for legislation or regulation on debt and equity offerings*

To conduct a debt or equity offering (whether primary or secondary), a securities registration statement (SRS), mainly consisting of information about the securities being offered and about the issuer, must be filed with the director-general of the relevant LFB, unless the offering constitutes a private placement that is exempt from disclosure obligations (private placement exemption).

Two major private placement exemptions are the small-number exemption (which may be available when solicitations are made to no more than 49 investors in Japan) and the professional investor exemption (which may be available when solicitations are made only to qualified institutional investors (QIIs) or specified investors defined in the FIEA). Detailed conditions for each exemption differ depending on the type of security being offered.

Once a company has filed an SRS with the LFB as described above, it becomes subject to continuous disclosure obligations and must file annual securities reports, semi-annual or quarterly reports, and extraordinary reports with the LFB, as all listed companies in Japan must do.

Money-lending activities from overseas to residents in Japan are restricted mainly under the Money Lending Business Act<sup>12</sup> and the Usury Act.<sup>13</sup> In brief, direct lending from overseas to residents in Japan is prohibited except when a foreign bank uses a licensed branch or a licensed agent under the Banking Act, or when a borrower is an affiliate company of the lender. This restriction does not apply if the borrowing is made in the form of a bond issuance.

The FIEA, which imposes restrictions on the solicitation of certain securities transactions directed at residents in Japan (including offerings, purchases and sales of securities, but excluding securities lending and repo transactions), applies regardless of whether the solicitation is domestic or from overseas. This means that direct solicitation for securities transactions is permitted without satisfying licensing requirements only when it is directed at QIIs such as banks, financial instruments business operators (FIOs) and insurance companies. All other direct solicitation for securities transactions directed at residents in Japan is strictly prohibited by the FIEA and requires agency or intermediary services by a licensed FIO. Similar but different standards apply to the solicitation of derivatives transactions from overseas (which are also controlled by the FIEA). In any event, careful legal due diligence is highly recommended before entering into securities transactions with residents in Japan.

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12 Act No. 32 of 1983, as amended.

13 Act No. 195 of 1954, as amended.

### ***Recent developments in regulations***

#### *Amendments to the disclosure rules*

On 31 January 2019, the FSA amended the Cabinet Office Ordinance on Disclosure of Corporate Affairs to rectify shortcomings that many annual and other periodic securities reports have, with a formulaic presentation of general financial information that lacks specific descriptions on corporate strategy. It intends to enhance annual securities reports to include narrative and non-financial descriptions. In the securities report under the amended rule:

- a* with respect to the section about management policies and strategies, the inclusion of, inter alia, the management's perceptions of market conditions, competitive advantages, major products and services and customer base is now required;
- b* regarding the section about the risks of the business, a description of the degree and timing about the likelihood of a risk materialising, the potential impact of that risk on the business and countermeasures against risks is required;
- c* with regard to accounting estimates and assumptions, a description of the management's perceptions regarding the uncertainty of the estimates, and of the assumptions used in such estimates, and the potential impact of possible changes on business results arising from such uncertainty, is required;
- d* regarding the section about executive compensation, a description of compensation programmes and policies (including information on performance-linked compensation) and the outcome of such programmes is required;
- e* regarding stocks held by the company for political, cross-holding or other reasons, a description of the method of reviewing whether there is a rational reason for such holdings is required; and
- f* regarding the section about audits, details on the activities of the board of corporate auditors, the tenure of the auditing firm and any fee paid to an auditing firm belonging to a network (network firm) need to be disclosed.

In addition, the FSA published the Principles for the Disclosure of Narrative Information and the Reference Casebook of Good Practices on the Disclosure of Narrative Information on 19 March 2019. The FSA is encouraging corporations to enhance their disclosure beyond mere compliance with regulatory formalities so that it should be useful for investment decisions and for constructive dialogue between investors and corporations.

Further to the above, by an amendment to the Cabinet Office Ordinance on Disclosure of Corporate Affairs on 21 June 2019, a description of an auditor's opinion in unusual situations will be upgraded and improved. More specifically, in the event that an accounting auditor is replaced by a newly appointed accounting auditor, corporations would be required to describe the opinions of the corporate auditors and of the accounting auditor to be replaced, and also the substantive reasons for the change of accounting auditors, in the extraordinary report. Incidentally, the disclosure requirements for an issuance of certain stock compensation have also been revised. Under the revised rules, the obligation to file securities registration statements under the FIEA is exempted if shares with a restriction on transfer for a certain period are solicited from or offered to the directors, officers or employees of the issuing company or a wholly owned subsidiary. Instead of filing a securities registration statement, an extraordinary report is required to be submitted in the same way as per stock options. According to the FSA, these amendments are part of a strategy for strengthening corporate governance, making it easier for companies to introduce stock-based compensation

such as restricted shares or performance shares referred to in the Guidebook for Introducing Incentive Plans for Sustainable Corporate Growth as Board Members' Compensation to Encourage Companies to Promote Proactive Business Management published by the METI.

#### *New exemption from takeover bid rules*

Under Japanese law, in principle, a tender offer is not required in the case of securities transactions on the Japanese financial instruments exchange market. On the contrary, to secure transparency and fairness of securities trading, the FIEA makes it obligatory to follow the takeover bid (TOB) regulations in the case of certain transactions made outside of the Japanese financial instruments exchange market, and it was considered that securities transactions conducted on foreign financial instruments exchange markets fell under those cases.

In this regard, the FSA amended the Cabinet Order of the FIEA on 29 April 2019. By this amendment, transactions that are traded on foreign financial instruments exchange markets, and considered non-detrimental to investor protections, are not subject to TOB regulations under the FIEA even if securities obtained therein are not purchased by means of tender offers.

#### *Margin trading on proprietary trading systems*

Margin transactions were assumed to be conducted only on financial instruments exchanges, and the FSA held the view that margin transactions on proprietary trading systems (PTSs) were not allowed. However, on 1 April 2019, the FSA lifted the ban on margin trading on PTSs by amending the Cabinet Office Ordinance of the FIEA and the Comprehensive Guidelines for Supervision of Financial Instruments Business Operators (Supervisory Guidelines). With these amendments, a financial instruments business operator (FIO) that operates PTSs is required to take preventive measures regarding conflicts of interest and appropriate measures equivalent to the self-regulatory functions of stock exchanges by which, for example, a PTS operator needs to publish data regarding transaction balances of margin trading and to investigate trading participants on the status of their compliance with the trading rules.

#### *Curtailling settlement risks*

For some years, the JSDA has been actively advancing efforts to shorten settlement cycles for Japanese government bonds (JGBs) and stock trades to facilitate and strengthen the functioning of the capital markets. As a result, the settlement cycle of JGBs has been shortened from T+2 to T+1 since 1 May 2018, and the new stock settlement cycle T+2 has been implemented since 16 July 2019.

#### *Financial benchmarks*

To implement recommendations by the Financial Stability Board (FSB), the FIEA was amended in May 2015 to introduce a new regulatory framework for organisations (financial benchmark administrators) that set financial benchmarks, such as the Tokyo Interbank Offered Rate (TIBOR). Under the FIEA, the FSA may designate an entity as a financial benchmark administrator that is then required to establish and observe operational rules consistent with the principles for financial benchmarks of the International Organization of Securities Commissions (IOSCO) regarding its systems of governance, the quality of its benchmarks,

the quality of methodology and accountability. A financial benchmark administrator is subject to supervision by the FSA (not the SESC), including on-site inspections. Each reference bank or financial institution that submits rate data is subject to and monitored for compliance with the code of conduct (including the avoidance of conflicts of interest) agreed upon with the financial benchmark administrator. Manipulative activities by FIOs or registered financial institutions (RFIs) are prohibited and sanctioned. The FSA has designated the JBA TIBOR Administration (JBATA), a subsidiary of the Japanese Bankers Association, as a financial benchmark administrator. JBATA engages in the calculation, publication and administration of JBA TIBOR.

In July 2017, JBATA implemented a JBA TIBOR reform in line with the principle of IOSCO, expecting that financial indices would be based on actual transactions rather than virtual ones. With the implementation of this reform, a new financial index (TIBOR+) has been introduced that is defined as the average of interest rates that reference banks or financial institutions deem as prevailing actual market rates ‘assuming transactions between prime banks’ in the Japan unsecured call market. All reference banks need to calculate their reference rates following the integrated and clarified calculation or determination process prescribed in the rules determined by JBATA. From these facts, TIBOR+ can be interpreted to reflect the actual funding cost of the reference banks or financial institutions. Although TIBOR+ currently consists of Japanese Yen TIBOR and Euroyen TIBOR, the consolidation of those rates to Japanese Yen TIBOR is now under consideration.

In addition to the above, the Bank of Japan is preparing for the adoption of a risk-free rate (RFR), namely the Tokyo Overnight Average Rate (TONA), which is an uncollateralised overnight call rate. Although some other countries are considering a transition from interbank offered rates, such as LIBOR to RFRs, Japan pursues the multiple rate approach recommended in the FSB Report – TIBOR+ and TONA – which means that TONA will not replace TIBOR. The RFR is intended to be used as an alternative to TIBOR+ as it is stable, easy to understand and already widely used in the wholesale derivative markets. The Bank of Japan will continue the discussion of planning for the best practice of TONA to be established by the end of 2021.

Apart from the above, a study group under the Bank of Japan is discussing preparations for the discontinuation of LIBOR. It is expected that the discontinuation of LIBOR may have a significant impact on the financial markets in Japan as well as other major countries. The study group issued a Public Consultation on the Appropriate Choice and Usage of Japanese Yen Interest Rate Benchmarks on 2 July 2019 and will continue discussions after soliciting comments from a wider range of relevant parties. In addition, the FSA has created a new webpage to disseminate information relevant to the discontinuation of LIBOR, and has expressed its stance of supporting the financial market during the transitional period.

## **ii Developments affecting derivatives, securitisations and other structured products**

### ***Framework for legislation or regulation***

The FIEA is the most basic and fundamental instrument of regulation applicable across the spectrum regarding derivatives, securitisations and other structured products. There are also other laws governing these products, such as the Act on Investment Trusts and Investment Corporations, the Limited Partnership Act for Investment, the Act on Securitisation of Assets, the Trust Act and the Companies Act. Other related laws and regulations may apply depending on the type of product.

In 2006, the FIEA underwent radical amendments (it was formerly the Securities and Exchange Act), as did the Commodity Derivatives Act (formerly the Commodity Exchange Act) in 2011. The main purpose of these amendments was to provide more complete protection for investors and to improve and enhance the convenience of participating in the Japanese market. While these amendments introduced strict and rigid regulations for investor protection, there are exceptions for rules and regulations that are applicable to financial instruments businesses targeting only professional investors, QIIs or commodity derivatives professionals. In other words, the rules and regulations applicable to the financial instruments business can differ depending on the type of investor. The FSA has also promoted a considerable number of further amendments to the FIEA in recent years to implement agreements reached at the G20 summits, which aim to strengthen the global financial system by fortifying prudential oversight, improving risk management, promoting transparency and continuously reinforcing international cooperation.

### ***Recent developments in regulations***

#### *Margin requirements on derivatives*

In light of statements made by leaders at G20 summits calling for improvements in over-the-counter (OTC) derivatives markets, there have been several legislative and regulatory developments intended to implement new policies regarding central clearing, trade reporting, margin requirements and trading platforms since 2012. The following reforms on OTC derivatives markets have been implemented in more recent times. For more about central clearing and trade reporting, see Section II.iv.

On 1 September 2016, non-cleared margin rules under the Cabinet Office Ordinance of the FIEA became effective, by which the margin requirements for non-centrally cleared derivatives stipulated by the Basel Committee on Banking Supervision and IOSCO (BCBS-IOSCO) have been implemented. These rules require that FIOs engaged in Type I financial instruments business (Type I FIOs) and RFIs post and collect initial margin (IM) and variation margin (VM) to and from counterparties on a bilateral basis, with some exceptions. For both IM and VM, there have been phase-in periods during which margin obligations apply to a given entity only if certain *de minimis* thresholds are met by the average during the preceding three months of the month-end aggregate notional amounts of the entity's non-cleared OTC derivatives, OTC commodity derivatives and physically settled foreign exchange forwards and swaps (determined on a consolidated group basis). From 1 September 2019 to 31 August 2020, IM obligations are applied to entities with an initial *de minimis* threshold of ¥105 trillion. Thereafter, IM obligations will be applied to entities with an initial *de minimis* threshold of ¥7 trillion from 1 September 2020 to 31 August 2021, which will be lowered to ¥1.1 trillion on 1 September 2021, which will be the first day of the final portion of the IM phase-in period. After the IM phase-in period ends on 1 September 2021, IM will be required if:

- a* the average during the preceding year of the month-end aggregate notional amounts of the entity's OTC derivatives (on an unconsolidated basis) is ¥300 billion or more; and
- b* the average during the preceding year of the month-end aggregate notional amounts of the entity's non-cleared OTC derivatives, OTC commodity derivatives and physically settled foreign exchange forwards and swaps (determined on a consolidated group basis) is ¥1.1 trillion or more.

The VM phase-in period ended on 1 March 2017. Currently, VM is required if the average during the preceding year of the month-end aggregate notional amounts of the entity's OTC derivatives (on an unconsolidated basis) is ¥300 billion or more.

Parties may agree bilaterally to introduce a minimum transfer amount as long as it does not exceed ¥70 million for the sum of IM and VM.

Even if Type I FIOs and RFIs are below the *de minimis* threshold for VM, they are still required by the FSA's Supervisory Guidelines to establish internal systems reasonably designed for the appropriate posting and collection of VM in line with BCBS-IOSCO's final report.

On 25 April 2019, the FSA updated the regulatory notice designating foreign margin rules for non-centrally cleared OTC derivatives pertaining to the adoption of substituted compliance based on equivalence assessments. This regulatory notice intends to avoid the duplicative application of Japanese and foreign margin requirements. Based on dialogue between the FSA and foreign authorities, the regulatory notice newly designates margin rules applicable to the countries under the European Economic Area Agreement as rules deemed equivalent to the corresponding margin rules of Japan. Prior to this update, foreign margin rules that are under jurisdiction of the US Commodity Futures Trading Commission (CFTC), the Office of the Superintendent of Financial Institutions (Canada), the Australian Prudential Regulation Authority, the Hong Kong Monetary Authority and the Monetary Authority of Singapore have been respectively designated.

#### *Close-out netting upon an event of default of insolvency*

In relation to IM requirements, the bill to amend the Close-out Netting Act<sup>14</sup> has passed at the Diet and will be enforced before 1 September 2020; that was expected to be the first day of the final portion of the IM phase-in period for non-centrally cleared derivatives. Under the current Close-out Netting Act, collaterals in the form of borrowing or lending assets are validly netted out even if the counterparty goes insolvent, but the Act does not provide for the validity and enforceability of the close-out netting arrangement of collaterals in a form of a pledge. Therefore, especially under the Japanese corporate reorganisation proceedings, there had been a concern that collateral taking the form of a pledge is subject to the restriction under the corporate reorganisation procedure and is not fully enforceable. By this amendment, however, the Close-out Netting Act will clearly stipulate that a close-out netting arrangement of collateral taking the form of a pledge would be enforceable under any Japanese insolvency proceedings, including corporate reorganisation proceedings. It should be noted that the applicable scope of collateral taking the form of a pledge would be expected to be limited to those posted as IM, considering that this amendment is to be made in order to satisfy requirements under the non-cleared margin rules issued by BCBS-IOSCO that IM must be immediately available to the collecting party in the event of the counterparty's default, regardless of any form of IM collateral. The enforcement order and the Cabinet Office ordinances of the Close-out Netting Act relating to this amendment are still under discussion.

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<sup>14</sup> Act No.108 of 2008, as amended.



### *Regulation of shadow banking*

Based on an FSB report entitled Strengthening Oversight and Regulation of Shadow Banking, published in 2013, the FSA has made some amendments to the regulation of shadow banking. In addition to those amendments, on 1 July 2019, the Cabinet Office Ordinances on the FIEA were amended to reflect the Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos of the FSB's report, which mainly regulates the reinvestment of cash collateral provided under securities lending or repos with maturity or liquidity transformation or leverage risks in order to follow FSB policy. Typically, under the amendment, FIOs engaging in investment management business are required to upgrade the content of the reinvestment reports for their customers by adding certain elements to the statutory limits pertaining to the reinvestment of cash collaterals and setting certain requirements regarding the assessment or management of the value of collaterals.

### *Real estate funds and real estate investment trusts*

In the investment management business, transactions between two funds, where one fund investing in the other fund has the same FIO acting as investment manager, have been basically prohibited for the purpose of preventing conflicts of interest, with some exceptions. In the case of real estate funds or real estate investment trusts (REITs), such transactions had been allowed when all investors gave their consent. This restriction was relaxed through an amendment of the Cabinet Office Ordinance on the FIEA on 5 June 2019 in view of the increasing number of investors investing in real estate funds or REITs. Under this amendment, transactions between two real estate funds or REITs investing in other funds have become allowed if all rights holders of the funds are composed only of QIIs, the transaction price is calculated by appraisal or other reasonable method, and more than two-thirds of all right holders has given their consent.

### *Japan–China exchange-traded fund connectivity scheme*

Japan Exchange Group, Inc (JPX), a holding company of Tokyo Stock Exchange, Inc (TSE) and Shanghai Stock Exchange, have agreed to collaborate on a scheme for linking the exchange-traded fund (ETF) markets of both exchanges. The Japan–China ETF Connectivity scheme aims to create more opportunities for cross-border securities investment between Japan and China, and feeder ETFs of ETFs investing in Japanese or Chinese assets are able to be listed on the market in the other country. The trading under this scheme is based on qualified foreign institutional investor (QFII) and qualified domestic institutional investor (QDII) quotas especially created for the scheme. A Japanese investment management company to which a QFII or QDII quota has been allocated by the Chinese regulator is allowed to set up cross-border funds to invest in ETF products in China. Eligible target ETFs will initially be limited to those ETFs that track stock indices, and they must satisfy liquidity requirements and have been listed for more than one year. Similarly, feeder ETFs of TSE-listed ETFs in Shanghai will allow Chinese investors to indirectly invest in Japan.

## **iii Relevant tax and insolvency law**

### ***Tax law***

In general, all corporations in Japan are subject to treatment as taxable entities. Foreign corporations are liable to pay certain types of corporate tax and income tax on domestic-sourced income, which vary depending on whether a foreign corporation has a

permanent establishment in Japan. Non-corporate forms that are sometimes used as a vehicle for financial transactions, such as general partnerships, limited liability partnerships or trusts, are, in principle, fiscally transparent for Japanese tax purposes. However, in a tax dispute regarding whether a limited partnership established under the laws of the state of Delaware (Delaware LP) is a corporation for Japanese taxation purposes, the Supreme Court ruled on 17 July 2015 that a Delaware LP constitutes a corporation under Japanese tax law. This ruling stated that whether a foreign limited partnership is regarded as a corporation under Japanese tax law shall be determined on a case-by-case basis, and it did not refer to any other foreign limited partnership.

It should also be noted that the government emphasises the OECD/G20 BEPS project aiming to tackle and prevent base erosion and profit shifting (i.e., tax avoidance strategies exploiting gaps and mismatches in tax rules to artificially shift profits to low-tax or no-tax locations) for the past few years. Under the 2019 Tax Reform Act, in line with the recommendations in BEPS Actions 4 and 8, restrictions on interest deductions (earning stripping rules) and the transfer pricing legislation will be revised. Further, the controlled foreign company income taxation regime that had been amended in the 2017 and 2018 Tax Reform Act was further amended by the 2019 Tax Reform Act to make necessary adjustments in terms of foreign tax laws or practices.

Apart from the above, the following reforms on domestic taxation that may affect foreign or domestic investors have recently been implemented.

First, a period of tax exemptions for interest income arising from repo transactions of book-entry JGBs or certain foreign bonds having high liquidity between specified financial institutions and specified foreign companies has been extended for another two years to 31 March 2021. The purpose of these tax exemptions is to encourage foreign investors to participate in Japanese repo markets.

Second, a Japanese version of an individual saving account (ISA) system, called NISA, was introduced in 2014, which makes investments of up to ¥1.2 million per year tax-free if the investment was made through an ISA. An investor can hold an ISA as a tax-exempt account for a maximum of five years falling within the period from 2014 to 2023. In January 2018, a new type of ISA, called the instalment-type NISA, was introduced for individuals who hope to build up their assets through instalment-type investments. An investor in this type of ISA can make investments of up to ¥400,000 per year tax-free, and can hold an ISA for a maximum of 20 years for the period running from 2018 to 2037. The government continues to proactively promote the use of NISAs, because these accounts steadily increase individuals' participation in the stock market and have attracted the interest of retail investors.

Third, with regard to cryptocurrencies defined in the Payment Services Act (PSA),<sup>15</sup> the valuation of cryptocurrencies for individuals at fiscal year end, and the valuation method and recognition methods of capital gains or losses and other matters concerning cryptocurrencies for companies, have been or will be clarified under the 2019 Tax Reform Act and any relevant rules to be issued.

With respect to consumption tax, the tax rate was raised from 8 to 10 per cent on 1 October 2019. Although this tax is not directly applicable to financial transactions, the rate increase may have broader implications for the Japanese economy, including the financial markets.

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15 Act No. 59 of 2009, as amended.

### ***Insolvency law***

The insolvency laws in Japan consist of the Bankruptcy Act,<sup>16</sup> the Civil Rehabilitation Act,<sup>17</sup> the Corporate Reorganisation Act,<sup>18</sup> the Companies Act and the Act Concerning the Special Provisions for the Reorganisation of Financial Institutions.<sup>19</sup> In addition, in line with the international agreement reached at the FSB and G20 Cannes Summit on 4 November 2011, the Deposit Insurance Act<sup>20</sup> was revised to provide for an orderly resolution and recovery regime covering banks, securities companies, insurance companies, financial holding companies and similar entities that are experiencing financial difficulties. This regime gives the Prime Minister the authority to suspend the application of any termination provisions of certain financial agreements and to close out netting provisions for a period of time that the Prime Minister designates. The Prime Minister thus has the ability to implement a kind of temporary stay for a designated period to enable a troubled financial institution to transfer its assets to an acquiring financial institution or a bridge financial institution.

Since 2014, there have been no material amendments to the above-mentioned insolvency laws. Regarding the revision of Close-out Netting Act setting forth the enforceability of close-out netting of financial transactions under the insolvency proceedings, see Section II.ii.

With regard to the Principles on Loss Absorbing and Recapitalisation Capacity of G-SIBs (Global Systemically Important Banks), under a resolution published by the FSB, the FSA has published a draft of a new pronouncement designating entities subject to the total loss absorbing capacity (TLAC) requirements among FIOs that are subsidiaries of foreign companies. The draft of the new pronouncement also stipulates that the required standards for internal TLAC and qualification requirements that should be satisfied by those FIOs. The final pronouncement is scheduled to be enforced on 31 March 2020.

#### **iv Role of the exchanges, central counterparties and rating agencies**

In principle, the FIEA regulates financial instruments exchanges, financial instruments clearing organisations (central counterparties (CCPs)) and rating agencies. The Commodity Derivatives Act (CDA) regulates commodity exchanges.

The JPX is the largest company operating financial instruments exchange markets to provide market users with venues for cash equity trading through its subsidiary, TSE, and for derivatives trading through Osaka Exchange, Inc (OSE, formerly known as the Osaka Securities Exchange). The TSE also offers companies an alternative listing framework to meet the needs of professional and other investors, which consists of Mothers, JASDAQ, the TOKYO PRO Market and the TOKYO PRO-BOND Market. In addition to providing market infrastructure, the JPX also provides clearing and settlement services through a CCP, the Japan Securities Clearing Corporation (JSCC), and conducts trading oversight to maintain the integrity of the markets. Finally, the JPX is scheduled to commence commodity trading operations in the first half of fiscal 2020 after making Tokyo Commodity Exchange Inc (TOCOM), a wholly owned subsidiary.

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16 Act No. 75 of 2004, as amended.

17 Act No. 225 of 1999, as amended.

18 Act No. 154 of 2002, as amended.

19 Act No. 95 of 1996, as amended.

20 Act No. 34 of 1971, as amended.

Other than above, there are four financial instruments exchanges (Nagoya Stock Exchange, Sapporo Securities Exchange, Fukuoka Stock Exchange and Tokyo Financial Exchange (TFX)) and one commodity exchange (Osaka Dojima Commodity Exchange.)

### ***Exchanges***

There have been no material amendments to regulations for financial instruments exchanges under the FIEA or for commodity exchanges under the CDA recently.

On a practical level, the government has been pushing for the creation of an integrated exchange to make the JPX become more competitive among global financial hubs for a long time, while the TOCOM was reluctant to become a subsidiary of the JPX and was seeking alternative survival strategies amid Japan's shrinking commodities market. After long talks, the JPX and the TOCOM agreed in March 2019 that they will merge their businesses by transferring most of the futures listed on the TOCOM – precious metals, rubber, agricultural products and sugar – to the OSE. At the same time, as the METI plans to launch an energy market, the JPX and the TOCOM have agreed that oil futures currently listed on the TOCOM will not be transferred to the OSE, and that they will continue considering listing electricity and liquefied natural gas futures on the TOCOM. In the first half of fiscal year 2020, the merger and transferring proceedings will be completed and the new operation will be started under the consolidated exchanges.

Apart from traditional financial instruments exchanges, cryptocurrency exchange services have been newly regulated by the amended PSA<sup>21</sup> or the FIEA (see Section II.v).

### ***CCPs***

Since November 2012, FIOs and RFIs have been required to clear certain types of OTC derivatives transactions via the mandatory use of central clearing under the FIEA.

Under the current FIEA, the types of OTC derivatives transactions that are subject to mandatory clearing are credit default swaps (CDS) on Markit iTraxx Japan referencing the credit of no more than 50 Japanese corporations, and plain vanilla yen-denominated interest rate swaps (IRS) referencing three-month or six-month JPY LIBOR or Euro JPY TIBOR, which are eligible for clearing services provided by a Japanese CCP (i.e., the JSCC). However, certain transactions, such as transactions with a party that is not an FIO or RFI, transactions that are booked in a trust account or transactions between affiliates, may be exempt from mandatory use of a CCP.

With respect to client clearing, CDS or IRS transactions with a party that is not a clearing participant of a CCP may be exempt from mandatory clearing. However, IRS transactions are subject to mandatory clearing (through client-clearing services) when one or both parties is an FIO or RFI that is registered with the FSA. Registration is required when the monthly average outstanding notional amount of OTC derivatives is ¥300 billion or more, or when the monthly average outstanding notional amount of property booked in a trust account of an FIO or RFI is ¥300 billion or more.

On a practical level, the JSCC provides clearing services for many listed products, such as OTC derivatives (CDS and IRS) and OTC JGB transactions traded on any financial instruments exchange in Japan.

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21 Act No. 59 of 2009, as amended.

With respect to commodity derivatives transactions, the Japan Commodity Clearing House Co, Ltd (JCCH) provides clearing services for transactions conducted at any commodity exchange, and OTC commodity derivatives transactions. The TFX also provides clearing services for products listed on the TFX, and is planning to provide new clearing services for OTC FX transactions.

In line with the integration of the JPX and the TOCOM (see above), clearance functions of the JSCC and JCCH will also be integrated by the first half of fiscal year 2020.

### ***Swap execution facilities***

The FSA and the CFTC issued a joint statement regarding the comparability of certain derivatives trading venues in the US and Japan on 12 July 2019. The CFTC will exempt certain electronic derivatives trading facilities (electronic trading platforms (ETPs)) regulated by the FSA from the requirement to register with the CFTC as swap execution facilities (SEFs), and the FSA will also facilitate the authorisation process of foreign ETP and SEF operators for the derivative platforms authorised and supervised by the CFTC. The FSA and the CFTC aim to work cooperatively across borders to promote growth and innovation while supporting financial stability in the field of the cross-border swaps trading framework.

### ***Transaction information and trade repositories***

Since November 2012, certain financial institutions, CCPs and trade repositories have been required to report OTC derivatives transaction information to the FSA under the FIEA. The FSA uses this data to regularly publish information regarding the number of transactions and total amounts. The DTCC Data Repository Japan has provided trade depository services in Japan as a foreign trade repository under the FIEA since March 2013.

## **v Other strategic considerations**

### ***Fintech and cryptoassets***

The FSA is promoting the development of fintech. To date, the FSA has made amendments to the Banking Act, the FIEA and the PSA to facilitate fintech-related business in financial sectors. The need for multiple amendments reflects the fact that financial institutions are subject to different regulations depending upon which sector the institution belongs to (see Section I.i). The FSA also published the Discussion Paper on Dialogues and Practices Regarding IT Governance at Financial Institutions on 14 March 2019. In light of the growing importance of optimising IT systems at financial institutions in carrying out their respective strategies to enhance corporate values, the Paper mainly outlines key discussion points when the FSA holds dialogues on IT governance with financial institutions.

Since April 2019, it has become necessary to be registered as a cryptocurrency exchange service provider, which has to be a stock company or a foreign cryptocurrency exchange service provider having at least one office in Japan, and to have a minimum capital amount of ¥10 million for a cryptocurrency exchange service defined as any business relating to (1) the sale and purchase or exchange of cryptocurrencies, (2) an intermediary agency or delegation for a sale and purchase or exchange of cryptocurrencies, and (3) the management of users' money or cryptocurrencies in connection with (1) or (2). A registered cryptocurrency exchange service provider is under certain obligations, including:

- a* to keep customer information secure;
- b* to provide users with sufficient explanations so that they can make informed decisions;

- c* to segregate users' assets from its own assets;
- d* to maintain books and records; and
- e* to submit an annual business report, and be subject to the anti-money laundering and combating the financing of terrorism (AML/CFT) regulations, including the Act on Prevention of Transfer of Criminal Proceeds.

There have been incidents of customer cryptocurrencies leakages as well as inadequacies in the management systems of service providers. In addition, some cryptocurrencies have become targets for speculative investments as the price thereof has been fluctuating, and margin trading and fundraising transactions using cryptocurrencies such as initial coin offerings (ICOs) or security token offerings (STOs) are emerging. Meanwhile, the FSA considered the regulations on these businesses through a discussion at the study group on cryptocurrency exchanges, and they were also discussed with the Japan Virtual Currency Exchange Association (JVCEA), which is the national cryptocurrency industry group, to make it begin industry self-regulation, which was introduced in late 2018.

Given these situations, the amendments to the PSA to be enforced in the first half of 2020 newly regulate that cryptoasset exchange or custody services (dealing with cryptoassets other than highly liquid tokens representing electronically transferrable rights (security tokens)) must be registered as a cryptoasset exchange servicer (replacing the current cryptocurrency exchange service provider) under the PSA, and a cryptoasset exchange servicer will be subject to self-regulation under the JVCEA. It is also required to maintain customers' cryptoassets in a safe and secure method like an offline wallet (cold storage), and hold its own cryptoassets of the same type and quality as those of customers that shall be segregated from other assets. Furthermore, new regulations on advertisements of or solicitations for cryptoasset transactions will be implemented, and new regulations on cryptoasset margin trading will be introduced that are similar to foreign exchange margin trading. Not only that, OTC derivative transactions referring to cryptoassets will be specifically regulated by the FIEA, because cryptoassets will be newly designated as financial instruments that are regulated by the FIEA.

With respect to security tokens, any electronically transferrable rights representing profits or losses arising from cryptoassets issued in the STO or other investment schemes will be regulated as Type I securities under the FIEA. This means that the offering or trading of such rights through the STO or other collective investment schemes defined under the FIEA will be subject to disclosure requirements applicable to securities transactions under the FIEA. As a result, a person engaged in a business relevant to derivative transactions or offering or trading relevant to security tokens will need to be registered as Type I FIO in principle. Additionally, the amended FIEA will prohibit unfair trading and price manipulation involving cryptoassets. The FSA also amended the section on virtual currency (cryptoasset) exchange services under the Guidelines for Administrative Processes in September 2019, which intends to ensure appropriate business management structures and appropriate responses in the event of fraudulent leakage of assets and to add some supervisory focal points pertaining to ICO or STO.

Alongside this, the FSA is considering a financial systemic reform relating to the payment and settlement intermediary services, and it is expected that a reform bill to be created based on the report published by the Financial System Council on 26 July 2019 will be submitted to the Diet in 2020.

### ***Corporate governance reform***

Overall, the government has been making efforts on corporate governance reform that is highlighted as one of the most important points in Prime Minister Abe's growth strategy. Typically, in 2014, the Companies Act was amended to enhance corporate governance and to establish a subsidiary governance framework. Thereafter, while the amended Companies Act has promoted corporate governance of Japanese corporations, such as increasing the number of outside directors at listed companies, the government continues to seek a desirable approach that can further substantively strengthen corporate governance. In this context, the METI revised the Practical Guidelines for Corporate Governance Systems in September 2018 and newly formulated the Practical Guidelines for Group Governance Systems in June 2019. Not only that, the Ministry of Justice is expected to submit a bill to the coming Diet session to amend the Companies Act for the purpose of rationalisation of the procedures for shareholders' meetings to make them more efficient and to improve on transparency in determining executive compensation. Concurrently, the FSA has held regular follow-up meetings about the Stewardship Code and Corporate Governance Code to review those codes and practice.

### ***Anti-money laundering***

2019 will mark the fourth round of joint Financial Action Task Force–Asia/Pacific Group on Money Laundering mutual evaluations of Japan with an on-site visit scheduled from 28 October 2019, and the results will be discussed during the plenary session scheduled for June 2020. Given the 2008 report on the third mutual evaluation stating that Japan was still non-compliant with some of the 40 recommendations, the FSA and financial institutions have taken actions. Over the past year, in particular, the National Police Agency and the FSA have amended the Ordinance for Enforcement of the Act on Prevention of Transfer of Criminal Proceeds to add or amend methods of verification of customer identification data of natural persons to be completed online or conducted on a non-face-to-face transaction basis. The FSA also revised the Guidelines for Anti-Money Laundering and Combating the Financing of Terrorism on 10 April 2019, and encourages financial institutions to appropriately manage the risk of AML/CFT by, among other things, clarifying customer risk assessments as a required action for financial institutions under the customer due diligence section of the Guidelines. It should be noted that the risk-based approach is newly introduced in the Guidelines. Self-regulatory organisations like the JSDA and the Japanese Bankers Association have prepared and disseminated practical manuals or Q&As that describe points to be noted for financial institutions.

### ***Sustainable development goals and environment, society and governance investments***

In recent years, Japanese companies have been raising awareness about their sustainable development goals (SDGs) and facing trends of the expansion of international environment, society and governance (ESG) investments that would take into consideration not only financial information of target companies but also information on target companies' efforts for the environment, society and governance. In light of this trend, the government is promoting the incorporation of SDGs into the management strategies of corporations, and the SDGs Promotion Headquarters headed by the Prime Minister formulates an action plan

every year. Under the government's policy, the METI launched an SDG management and ESG investment study group, which has issued its final report. The FSA has also conducted research regarding the corporate disclosure of ESG information.

### ***Other matters***

With respect to personal information protection, the Act on the Protection of Personal Information<sup>22</sup> was amended in 2017 to bring the level of protection of personal data up to global standards. Given that, in January 2019 Japan and the European Commission mutually recognised each other's personal data protection system as equivalent. Japan and EU enjoy solid protection of their personal data when transferred, while all their companies can benefit from free data transfers to each other's economies.

Furthermore, the Civil Code<sup>23</sup> has been amended and will be implemented on 1 April 2020. The Civil Code is the fundamental law that provides for rules regarding legal relationships between contract parties or acts of tort. Financial institutions should be more careful about these changes to basic laws.

## **III OUTLOOK AND CONCLUSIONS**

Although there exists a strong fear in the market that a crash is coming soon globally, caused by the US–China trade war, nothing has happened yet thanks to good economic conditions in the US. Having said that, it is rumoured that once the crash arrives, Japanese small and medium-sized regional banks will be heavily hit, because they already have been damaged by the lower (or negative) interest rate policy of the Bank of Japan to achieve quantitative and qualitative easing, and by the rapid depopulation of the regions that these banks have been serving. To strengthen their competitiveness, mergers or the stepping over of lower level business alliances among many regional banks are expected to accelerate under the leadership of the FSA. However, mergers of regional banks may trigger the deterioration of services for the people living in such areas. The concept of fiduciary duty is recommended by the FSA to be implemented at financial institutions such as banks and securities companies as soft law, but how to implement such duty in the problematic regional areas is a big challenge.

It should be also noted that the benchmark reform in or outside Japan may affect Japanese financial institutions in the near future. The benchmark reform in Japan in line with IOSCO's principles is mostly complete with regard to TIBOR, which consists of Japanese Yen TIBOR and Euroyen TIBOR (see Section II.i), and TIBOR has been operated in a quite stable and reliable way. On the other hand, the preparation of the RFR in Japan recommended by the FSB is still under construction. TONA will be the first RFR for the Tokyo markets, but the creation of TONA, with tenors such as six-month TONA, is a difficult task. We believe it will take some time for TONA to be ready to go as an RFR.

At the same time, the shutdown of LIBOR, scheduled for the end of 2021, will have a considerable impact on various types of financial products traded in or outside Japan. International Swaps and Derivatives Association (ISDA) is in the process of establishing fallback procedures for such cessation, but financial products not referring to ISDA are

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22 Act No. 57 of 2003, as amended.

23 Act No. 89 of 1896, as amended.



outside of such procedures. While the FSA has already given the market warnings about moving to other benchmarks or to adopt the fallback provisions, the reaction of the market is still slow, as it is in other areas of the world.

Finally, it must be mentioned that the Diet passed a bill in June 2019 to amend the PSA and the FIEA to cope with the development of the situation surrounding cryptoassets (see Section II.v.). These amendments indicate that Japan is one of the front-running countries in trying to regulate cryptoassets in a reasonable way, but there still seems to be many challenges. As one example, ICOs have become officially recognised in Japan by the amendment, but the requirements are so difficult to satisfy, and therefore ICOs will be very hard to achieve in practice.

# KUWAIT

*Abdullah Alharoun*<sup>1</sup>

## I INTRODUCTION

A seismic shift in the regulation of capital market activities in Kuwait took place on 21 February 2010, the date the National Assembly (the Kuwaiti parliament) enacted the Capital Markets Authority Law (CMA Law).<sup>2</sup> The CMA Law created a new and independent body, the Capital Markets Authority (CMA), and provided the basis for the CMA's establishment, aims and goals, in addition to a new legal framework to fill a lacuna in the law.

The CMA Law is considered by prominent experts and practitioners as the most complex legislation enacted in the recent history of Kuwait. The primitive infrastructure of capital markets' regulation prior to the CMA,<sup>3</sup> coupled with the hasty, unplanned enactment of the law, led to inevitable obstacles preventing a smooth transition into the new regulatory framework and resulted in its rigid impractical application. The complexity stems from the fact that the CMA Law innervates and complements public and private laws, such as the Civil Law, the State Audit Bureau Law, the Penal Law, the Companies Law and the Central Bank's Law, as well as their respective by-laws and regulations.

On 10 May 2015, Law No. 22 of 2015 (CMA Law Amendment) was enacted, which contains amendments to 64 articles out of the 165 articles that make up the CMA Law. The CMA Law amendment came into force on 10 November 2015. On 9 November 2015, the CMA issued its improved by-laws, which were a polar shift from their predecessors and include substantial changes to the regulatory regime and processes within the CMA to bring it in line with International Organization of Securities Commission (IOSCO) standards. In May 2017, IOSCO rendered its decision to grant the CMA full member status.

After nearly a decade since its inception and following a tumultuous period since its inauguration, the CMA and market participants appear to have reached a stable level of establishing conventions, precedents and acceptable practice. The CMA by-laws comprise clear and easy-to-navigate regulations in the form of an organised unified code, which substantially includes all relevant regulations.

Since May 2017, the CMA, the Kuwait Clearing Company KSCC (KCC) and the only stock exchange in the country, the Boursa Kuwait, have embarked on a multiphase exercise

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2 Law No. 7 of 2010 on Establishing the Capital Markets Authority and Regulating Securities Activities.

3 A few fragmented laws, such as Law No. 31 of 1990 and the Kuwait Stock Exchange (KSE) regulations.

to develop the market. As a by-product of such focused exercise, FTSE Russell, MSCI and S&P Dow Jones have all decided to upgrade the Boursa Kuwait and classify it as an emerging market.

### **i Structure of the law**

The CMA Law consists of 13 chapters. It starts by outlining the organisational structures and regulatory frameworks of the CMA, securities exchanges and clearing agencies. In Chapters 5 to 9, it regulates organised securities activities, licensing of parties engaging in capital market activities, acquisitions and minority rights and collective investment schemes, and the formalities and procedures related thereto. The CMA Law also provides extensive guidance on the conditions and requirements for disclosures and market announcements. The legislation concludes with general and transitional rules.<sup>4</sup>

### **ii Structure of the courts**

The CMA Law provides language for the creation of specialist courts, which have jurisdiction over all matters subject to the CMA Law. Article 108 stipulates that the court of first instance will be 'the Capital Markets Court, the location of which shall be decided by virtue of a decree from the Minister of Justice with the approval of the Supreme Judiciary Council'. The Capital Markets Court comprises two circuits: a penal circuit that has jurisdiction over all penal cases arising from matters subject to the CMA Law; and a circuit that oversees civil, commercial and administrative matters subject to the CMA Law.

In addition, Article 112 of the CMA Law stipulates that penal and non-penal circuits at the courts of appeal will have jurisdiction over appeals arising from the court of first instance. The highest court of appeal with respect to matters subject to the CMA Law is the Court of Appeal, and the Court of Cassation, normally the highest court of appeal, has no jurisdiction. The purpose of such approach is thought to be to streamline the process and reach final judgments in an expeditious manner.

## **II THE YEAR IN REVIEW**

### **i Debt and equity offerings**

Compared to its Gulf Cooperation Council (GCC) peers, the Kuwaiti capital market has been one of the better performers.<sup>5</sup> The news about the market review and upgrades of Kuwait as an emerging market on the FTSE Russell, MSCI and S&P Dow Jones indices is expected to significantly increase the allocation of foreign capital to the country.

In absolute terms, equity offerings have been on the shy side, with no significant offerings in the past 10 years. Such shy offerings were characterised by a few public shareholding

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<sup>4</sup> For example, Article 155 of the CMA Law stipulates that: 'the supervisory and control role referred to under this Law shall be transferred to the CMA within six months from the date of publishing the CMA Law executive by-laws. Thus the supervisory and control role of the Executive Committee of the Kuwait Stock Exchange shall be brought to an end.'

<sup>5</sup> The Boursa Kuwait and Tadawul (KSA) are the better performers in terms of cumulative total returns since January 2018.

companies in which the state is the main investor.<sup>6</sup> As a step in the right direction, a couple of high-profile private sector initial public offerings (IPOs) were announced and completed in 2015 and more recently in 2018 in the services and consumer products sectors.<sup>7</sup>

Conversely, the arena of debt capital markets issuances originating from Kuwaiti entities have witnessed a healthy resurgence. Kuwait's debt capital markets offerings in 2016, 2017, 2018 and the first half of 2019 can be described as relatively busy. This was spearheaded by the state's establishment of an unlimited global medium-term note programme and an inaugural dual-tranche, US dollar-denominated international debt capital markets issuance thereunder of US\$8 billion of notes in aggregate by the state, acting through the Ministry of Finance and represented by the Kuwait Investment Authority. Further, almost all Kuwaiti banks have embarked on debt capital market programmes and issued Basel III-compliant bonds and *sukuk* to strengthen their capital base.

In addition, the foregoing is seen as a direct result of the CMA's efforts to streamline its regulations and internal procedures for debt and equity offerings under the CMA rules. This is especially topical in the face of challenging market conditions, regional political instability and low oil prices. This year, it is envisaged that more corporate issuers will tap the capital markets for funding, and the mix would include both publicly traded and private (i.e., closed shareholding) companies.

## ii CMA regulations

In addition to the CMA Law Amendment, the CMA has completely overhauled its executive by-laws through the adoption of a unified code format (often referred to as the CMA Handbook). The CMA Handbook is well organised, logically structured and contains rules, procedural steps and template forms spread over 16 modules, each tasked with regulating a specific section as follows:

- a* a glossary of defined terms;
- b* the CMA;
- c* enforcement of the law;
- d* exchanges and clearing agencies;
- e* capital markets activities and registered persons;
- f* internal policies and procedures for licensed persons;
- g* clients' funds and assets;
- h* conduct of business;
- i* mergers and acquisitions;
- j* disclosures and transparency;
- k* dealing in securities;
- l* listing rules;
- m* collective investment schemes;

6 An example of an aforementioned IPO is the Kuwait Health Assurance Company, and Shamal Az-Zour Al-Oula for the building, execution, operation, management and maintenance of the first phase of Az-Zour Power Plant KSC, in which the state has a minority interest and 50 per cent of the issued shares are offered to Kuwaiti citizens at par.

7 The placement and listing of Mezzan Holding's shares on the Boursa Kuwait on 11 June 2015: [www.mezzan.com/news/mezzan-holding-debuts-on-the-kuwait-stock-exchange](http://www.mezzan.com/news/mezzan-holding-debuts-on-the-kuwait-stock-exchange) and placement and listing of Integrated Holding Company K.S.C.P. shares on the Boursa Kuwait on June 2018: <https://nbkcapital.com/2018/nbk-capital-230-oversubscription-ihcs-private-placement/>.

- n* market practices;
- o* corporate governance; and
- p* anti-terrorism and anti-money laundering.

### ***The Market Development Project***

Since May 2017, the CMA has embarked on a focused regulatory reform exercise with the aim of ‘diversification of Investment products and Instruments’ and developing the market: the Market Development Project (MDP). The MDP has introduced new market segments and circuit breakers, and has enhanced the overall process of holding, transferring, settling and exercising rights over securities. In particular, the rules relating to listing securities were streamlined in favour of a more dynamic market. In April 2018, the Boursa Kuwait issued a comprehensive new Rule Book (which was significantly supplemented and updated in April 2019) comprising substantially the regulation of all the Boursa Kuwait’s operations.

The Rule Book is organised into 11 chapters as follows:

- a* general provisions and glossary of terms;
- b* objective and obligations of the exchange;
- c* exchange management;
- d* registered persons in the exchange and service providers;
- e* general duties of integrity, fair dealing and due care;
- f* disaster recovery rules;
- g* listing rules;
- h* market segmentation and index rules;
- i* system trading rules;
- j* cases exempt from trading systems; and
- k* exchange members disciplinary proceedings.

As part of the third phase of the MDP, the Boursa Kuwait introduced specific initiatives to improve the execution of exempt and off-market trades together with a trading platform for mutual funds and real estate investment trusts. A more advanced stage is planned to introduce, among other things, a central counterparty (CCP), repo regulations and processes, and instructions on the division of client accounts into sub-accounts.<sup>8</sup>

### ***The CMA Law amendment***

It appears that the overall aim of amending the CMA Law is to confer greater rule-making powers to the CMA. The CMA Law Amendment delegates several matters that used to be rigidly regulated by the executive by-laws, and grants the CMA the authority to make further rules and exceptions.

The CMA Law Amendment has amended many of the definitions in the CMA Law and included new ones. For example, one of the most important definitions that were added was the definition of dealing in securities, which was drafted broadly. Technical errors were also remedied: the definition of private placement used to be limited to ‘closed shareholding companies, or in the event of increasing the capital of an existing company’. This limitation has now been omitted.

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<sup>8</sup> CMA press release dated 28 November 2019, ‘Announcement on the Timeline for the Third Phase of the Market Development Project’.

One of the major changes was exempting the rules of transfer of ownership and dealing in securities from the provisions of Articles 508, 992 and 1053 of the Civil Code and Articles 231, 232, 233 and 237 of the Commercial Code.<sup>9</sup> These articles regulate the procedures related to public policy with respect to the sale and ownership of encumbered assets. In the fast-moving environment of securities markets, the procedures in the aforementioned articles in the Civil and Commercial Codes, which require, inter alia, the involvement of the courts in granting a sale or ownership order, are outdated and do not provide equitable outcomes.<sup>10</sup>

The CMA Law Amendment aims to bring the CMA Law in line with the many subsequent pieces of legislation that were enacted by the Kuwaiti parliament, such as the new Companies Law in 2012, the Promotion of Investment Law in 2014 and the Public Private Partnership Law in 2014. Finally, the CMA Law Amendment creates an express tax exemption in Article 150 on proceeds arising from securities, including but not limited to, bonds, *sukuk* and all other similar securities, regardless of the issuer.

### ***Preferred shares***

The CMA by-laws in Module 11 – Chapter 13 contain provisions regulating preferred shares, making Kuwait the first GCC country to regulate preferred shares, which are defined as ‘shares that are granted specific privileges with respect to voting, profits, liquidation proceeds or any other rights provided that the shares of the same type shall be equal in terms of the rights, privileges and restrictions’.<sup>11</sup> Module 11 – Chapter 13 deals with regulating the issuance, trading, conversion and redemption of preferred shares. In addition, it regulates the rights of the holders of such shares, and their ongoing obligations and disclosure requirements.

Module 11 – Chapter 13 also lists the minimum eligibility requirements for issuances and issuers, which require, inter alia, that all subscribed shares of the issuer be fully paid up, and that the aggregate of the issued capital and the value of the new issuance do not exceed the authorised share capital of the issuer. Detailed regulations are included with respect to the offering documents and method of offering. As per Module 11 – Chapter 13, preferred shares may only be issued following the approval of the extraordinary general meeting of the issuer, and such approval must expressly mention the type of rights attached to such preferred shares. Module 11 – Chapter 13 restricts the offering method for offering preferred shares to private placements and only to professional clients (as defined in the CMA by-laws). However, by way of discretionary exceptions, public offerings are permitted provided prior approval of the CMA on the issuance and prospectus is obtained.

### ***Regulation of mergers and acquisitions***

The CMA by-laws dedicate a stand-alone module within the CMA Handbook to regulate mergers and acquisitions. The regulation of mergers and acquisitions was previously spread over various fragmented sources that were often criticised by the market as rigid, not clearly outlined and containing ambiguous procedures. Module 9 introduced a consolidated regulatory framework in an aim to eliminate ambiguity and introduce clear procedures. In fact, Module 9 contains appendices that have clear steps for each type of merger and acquisition contemplated by the by-laws, such as mergers in general, voluntary tender offers,

9 Law No. 67 of 1980 (as amended) and Law No. 68 of 1980 (as amended).

10 The amendments in this regard are modelled on French Law No. 364 of 2006 and Egyptian Law No. 88 of 2003 (in particular, Article 105).

11 Reiterating the definition of preferred shares in the Companies Law.

non-cash voluntary tender offers, competitive (interloping) offers and mandatory tender offers. In an interesting and unprecedented regulatory format, Module 9 contains guidance flowcharts to assist investors in calculating their 'indirect shareholding in a publicly listed company'. The foregoing is crucial in the context of events triggering mandatory tender offers that create a rule mandating 'a person who acquires, directly or indirectly, more than 30% of the securities admitted to trading of a listed shareholding company' to 'submit an offer to purchase all the remaining shares traded in the exchange' within 'thirty days from the date of such person's acquisition'.

The CMA by-laws also tackle criticisms of the previous mergers and acquisitions regulatory framework in that they create exemptions to the aforementioned mandatory tender offer rules. Some of the exemptions are more fluid than others. For example, the CMA has the discretion to exempt an investor from launching a mandatory tender offer citing public policy or public interest reasons. Other exemptions include, *inter alia*, arriving at a shareholding in excess of 30 per cent owing to debt restructuring, or a capital increase (where other shareholders refrain from participating in a manner commensurate with their existing pre-increase shareholding).

In the same vein, Module 9 has also revamped the rules regarding the allowable trading percentages of parties controlling listed companies (otherwise known in the market as 'creeping rules') by increasing their flexibility. The creeping rules are applicable to persons (natural or otherwise) categorised as controlling parties of publicly traded companies. Therefore, it is applicable to persons who either previously executed an acquisition under the CMA rules, persons who obtained control prior to the promulgation of the CMA Law or exempt persons from mandatory tender offers. As such, Module 9 is applicable to all shareholdings exceeding 30 per cent of voting rights in a publicly traded company. The regulation provides a cap on the permitted purchase and sale of shares. While the previous rules set a 2 per cent limit on the increase or decrease of the annual shareholding of a controlling party in the event such shareholding is in excess of 30 per cent but less than 50 per cent, the new rules make the 2 per cent movement limit on a semi-annual rather than an annual basis.

Similarly, Module 9 reinstitutes the rules for shareholdings equal to or greater than 50 per cent held by controlling by allowing a creeping of 5 per cent semi-annually under the new rules rather than annually under the old rules. It is crucial to point out that in the event a controlling party purchases shares in excess of the allowable percentages, it must submit a mandatory tender offer. However, a controlling party who has submitted a mandatory or voluntary tender offer would not be subject to the creeping rules and may increase their shareholding in any percentage.

### ***Corporate governance***

The first iteration of the Corporate Governance Rules (CGRs) issued by the CMA by virtue of Resolution No. 25 of 2013 on 27 June 2013 was not received well by the market. This is due in part to the CMA's heavy-handed approach in the enforcement efforts of such rules, and the markets' lack of awareness thereof. In response to the aforementioned approach, the market, led principally by the Chamber of Commerce and with the participation of many other market players such as the Union of Investment Companies, organised a campaign to pressure the CMA to adopt a more lenient regulation taking into consideration the peculiarities of the Kuwaiti market in addition to approaching the regulations from the perspective of an enlightened investor model.

Responding to the market's backlash, the CMA decided to delay the enforcement of the CGRs from 31 December 2014 to 30 June 2016.<sup>12</sup> At that time, the CMA has already publicly declared its intention to overhaul its regulatory framework. As such, on 30 June 2015, Resolution No. 25 of 2013 was expressly repealed by the new CGRs issued by Resolution No. 48 of 2015. When the CMA by-laws were issued in November 2015, the new CGRs were included as part of the CMA Handbook, housed in the stand-alone Module 15.

The new CGRs came to force on 30 June 2016. With the exception of some mandatory rules, the new CGRs adopt substantially comply or explain regulatory principles. To make compliance easier, the CMA has introduced an online portal to streamline the reporting obligations of entities subject to the CGRs.

### ***Dealing in securities***

In comparison with the old framework, the CMA by-laws consolidate substantially all the rules related to the issuance, offering and subscription of securities in Module 9. The basic premise of the rules in Module 9 of the CMA Handbook revolves around outlining the internal and external approvals required from an issuer of securities together with the standards required in offering documents. One of the highlights of Module 9 is the introduction of a chapter on the establishment of special purpose companies to act as issuers, in addition to the introduction of the concept of financial trusts for the purpose of the structuring of *sukuk*.

As a general rule under the CMA by-laws, all securities' issuances, whether on a public or private placement basis, require the following from the CMA as a condition precedent: an issuance approval and a prospectus approval.<sup>13</sup>

In contrast with other regional securities frameworks, there are very few exemptions<sup>14</sup> under the CMA by-laws, and the CMA appears to adopt an active regulatory approach. The CMA appears to aim to regulate foreign<sup>15</sup> and guaranteed issuances insofar as the obligor or issuer is in Kuwait by introducing the same regulatory burdens on direct and indirect issuances by a Kuwaiti obligor.

### **iii Cases and dispute settlement**

Kuwait does not adhere to the doctrine of binding precedents, and the CMA Law, being only seven years old, has yet to establish accepted legal principles as are the case with more developed areas of the law. Kuwait does not report the majority of its cases, and there is no publicly available database that can be consulted to ascertain the latest decisions in a given area of the law.<sup>16</sup>

For the purpose of expeditious resolution and settlements of disputes, the CMA, as mandated by the CMA Law, has formed the Complaints and Grievances Committee (CGC), which is concerned with receiving and processing complaints against persons subject to the

12 CMA press release, 30 April 2014: [www.kuna.net.kw/ArticleDetails.aspx?id=2374934&Language=ar](http://www.kuna.net.kw/ArticleDetails.aspx?id=2374934&Language=ar).

13 The latter is applicable if there was a decision to market the securities in Kuwait.

14 The current CMA by-laws do not recognise issuances under a programme (i.e., in the context of debt capital market issuance). The only exemption to obtain CMA approval to issue securities is the issuance of shares (that is, ordinary and not preferred shares).

15 If the issuer is a special purpose vehicle outside of Kuwait but guaranteed by an obligor Kuwaiti entity, then, *prima facie*, CMA approval to issue would be required.

16 With the exception of the Collection of legal principles issued by the Court of Cassation, published by the Ministry of Justice, which often lags behind by about a year.



CMA Law, and grievances appealing decisions by the CMA. The CGC has the right to decide, reserve the matters it reviews or refer them to the Disciplinary Council within the CMA.<sup>17</sup>

The Disciplinary Council, which is presided over by a member of the judiciary, has the objective of hearing grievances referred from the CGC and has the power, inter alia, to reverse such decisions. Further, the CMA by-laws allow the CMA to amicably settle cases for which the courts have yet to issue a ruling.

#### **iv Relevant tax and insolvency law**

##### ***Taxation***

Kuwait has a very simple and clear tax regime, which is not as convoluted as those in many other jurisdictions that are more dependent on the taxpayer for purposes such as funding national programmes and balancing budgets. Kuwait has a tax department at the Ministry of Finance called the Department of Income Tax, which oversees all matters relating to taxation. As a general rule, taxation in Kuwait is always imposed on net profits (e.g., there is no tax imposed on capital gains or inheritance). However, the Kuwaiti tax regulators have been criticised for their inconsistent application of the tax laws and regulations. Further, while Kuwait has a wide network of double taxation treaties, the implementation of those treaties by the Kuwaiti courts requires more development.

##### ***Income tax***

The most substantial applicable tax is corporate income tax, regulated by Decree No. 3 of 1955 (as amended by Law No. 2 of 2008) (Income Tax Law). The Income Tax Law stipulates that all corporate bodies, notwithstanding their form (whether shareholding (KSC) or with limited liability (WLL) compared with other tax laws mentioned below), that are operating in Kuwait are subject to a 15 per cent net income tax. Income tax is applied on earnings arising from activities such as profits realised on any contract partially or fully executed in Kuwait, commissions from commercial representation or intermediary agreements, provision of services, or commercial or industrial activities. Income tax is calculated after deducting certain expenses such as depreciation, wages, salaries, employees' end-of-service indemnities and head office expenses, in accordance with the specifications of the applicable regulations.

Returns, however, realised as a result of deals on the Boursa Kuwait either directly or indirectly, through portfolios or investment funds, are exempt from income tax. In fact, pursuant to the CMA Law Amendment, such exemption was further expanded to returns arising from any securities.<sup>18</sup> Pursuant to the Income Tax Law, all ministries, authorities, public bodies, companies, societies, individual firms, any natural person and others as specified by the executive rules and regulations may retain 5 per cent of the contract price or each payment made to parties with whom they have entered into contracts, agreements or

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17 The Disciplinary Council was established pursuant to Article 140 of the CMA Law. During the financial year 2018/2019, the CGC received a total of 12 complaints and seven grievances. Only three complaints and two grievances remained unresolved within the year.

18 This new exemption has yet to be tested by the Kuwaiti courts: the provision in the law stipulates 'Without prejudice to the tax exemptions from the prescribed tax on profits arising from disposal of Securities issued by companies listed in the Exchange, returns in respect of Securities, bonds, financial *Sukuk* and all other similar Securities, regardless of the issuer, shall be exempted from taxes'. It is also not clear from a plain reading of the provision whether it extends to all securities or only those from companies listed on the Boursa Kuwait.

transactions. Non-adherence to such obligation by the parties concerned will subject them to a penalty of bearing the tax not paid by the company subject to the tax law. Finally, although the Income Tax Law does not differentiate between foreign and local persons with regards to its applicability, its current method of enforcement only applies to foreign corporate persons and equities in Kuwaiti companies. The former application does not consider GCC nationals foreign.

### ***National labour support tax***

Law No. 19 of 2000 concerning the support and encouragement of Kuwaitis to work in the private sector creates a national labour support tax (NLST). The NLST is applied on companies listed in the KSE and imposes a 2.5 per cent tax on their annual net profits. The purpose of this tax is to fund national programmes to support the part of the Kuwaiti workforce that opts to work for the private sector.

### ***Zakat tax***

The *zakat* tax imposes an obligation to pay 1 per cent of the annual net profit generated by any Kuwaiti shareholding company, whether public, closed, listed or non-listed (i.e., WLLs are not subject to *zakat* tax<sup>19</sup>). The Zakat Tax Law exempts certain shareholding companies from the payment of the *zakat* tax, such as companies wholly owned by the state and companies that are subject to the Income Tax Law.

### ***Contribution to the Kuwait Foundation for the Advancement of Science***

Kuwaiti shareholding companies (closed or publicly traded) contribute 1 per cent of their annual net profits to the Kuwait Foundation for the Advancement of Science (KFAS). This contribution is the main source of funding of the KFAS. It is debatable whether this contribution constitutes a tax duly levied by Kuwait, but in practice most companies comply with this contribution.<sup>20</sup>

### ***Insolvency laws***

The Kuwait insolvency and bankruptcy regime is mainly housed in Decree Law No. 68 of 1980 issuing the Commercial Code. It deals with the topic as a whole and has a few special rules dealing with the bankruptcy of companies (in Articles 670 to 684); however, given the current commercial climate, the law has been subject to severe criticism, and is considered to hamper progress as it is still based on the old Egyptian Commercial Code and has not been updated. Therefore, Kuwait had seldom declared bankruptcies with respect to big companies, and the law in its current form overlaps very little with capital market activities.

However, in response to the financial crisis, Kuwait promulgated Decree Law No. 2 of 2009 (Financial Stability Law). The Financial Stability Law lists the conditions under which, if satisfied, the state will guarantee the decline in the 'balances of the financial investments portfolio and the balances of the real estate investment portfolio, outstanding in the banks records as at 31 December 2008'.<sup>21</sup> The Financial Stability Law has also created a new circuit

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19 Law No. 46 of 2006, Concerning Payment of Zakat Tax.

20 Kuwait Government Online (2013), 'Introduction to doing business in Kuwait': [www.e.gov.kw/sites/kgenglish/portal/pages/visitors/DoingBusinessInKuwait/GoverningBody\\_OverView.aspx](http://www.e.gov.kw/sites/kgenglish/portal/pages/visitors/DoingBusinessInKuwait/GoverningBody_OverView.aspx).

21 Article 4 of Law No. 2 of 2009.

at the court of appeal to oversee requests for the restructuring of companies, and states that such requests must be met on an urgent basis. If a company makes a request pursuant to the Law and the judge who presides over the circuit has registered his or her approval thereon, the company will be temporarily protected from all judicial and enforcement proceedings in respect of its obligations.

This temporary period is valid until the court approves the restructuring plan of the company or rejects the request for restructuring. Some companies have made requests without merit just to be covered by the legal protection period (which, due to the slow nature of the judiciary, lasted longer than was intended according to the provisions of the law);<sup>22</sup> however, very few companies genuinely in this situation have chosen to benefit from this law as a result of market-specific characteristics and unfavourable local attitudes towards the notion of bankruptcy.

This, in addition to the gap between local and international standards, has prompted the World Bank to take part in a project launched in March 2014 to work directly with the government. The project aims to ameliorate the main issues concerning Kuwait's insolvency law and the frameworks regarding debtor and creditor matters. The collaboration intends to provide support on a new legal framework for enterprise bankruptcy and streamlining judicial approvals for 'distressed debt workout plans' in addition to the creation of a specialist commercial court run by a commercially savvy and trained judiciary, which is something the country lacks.<sup>23</sup> One collaboration has already been announced, and the Ministry of Commerce and Industry has published in various newspapers a draft of the new Insolvency Law, which contains provisions on restructuring companies, the appointment of receivers and the suspension of insolvency procedures. However, at the time of writing, the draft Insolvency Law has yet to be debated in the Kuwaiti parliament in order to become law.

## **v Role of exchanges, CCPs and rating agencies**

Prior to the enactment of the CMA Law, the Boursa Kuwait, by virtue of the Amiri Decree issued on 14 August 1983, was created and granted independent legal personality. It was also entrusted with regulatory securities activities through the KSE Executive Committee (KSEC). The KSEC issued all the rules and regulations regulating securities' activities, but following the enactment of the CMA Law, the Boursa Kuwait came under the CMA's oversight, rolling back its authority to regulate.

On 27 April 2014,<sup>24</sup> and in accordance with the CMA Law, a public shareholding company, the Boursa Kuwait Company KSC, was established in an effort to privatise the stock exchange. In 2019, following a public auction, a consortium consisting of Athens Stock Exchange,<sup>25</sup> Arzan Financial Group, First Investment Company and National Investments

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22 The court's company restructuring circuit decided on 24 July 2014 to remove the Investment Dar (once the country's flagship financial institution) from the protection given under the Financial Stability Law soon after its enactment.

23 World Bank (2013) press release: 'World Bank supports strengthening of Kuwait's insolvency and creditor/debtor regime': [www.worldbank.org/en/news/press-release/2013/06/03/world-bank-supports-strengthening-of-kuwait-insolvency-and-creditor-debtor-regime](http://www.worldbank.org/en/news/press-release/2013/06/03/world-bank-supports-strengthening-of-kuwait-insolvency-and-creditor-debtor-regime).

24 The date the notice of the company's establishment was published in the Official Gazette.

25 Being a qualified international operator.

Company were awarded a 44 per cent stake in the Boursa Kuwait. Pursuant to Article 33 of the CMA Law, 50 per cent of the Boursa Kuwait's shares will be offered to the Kuwaiti citizens in a public offer during the fourth quarter of 2019.

In terms of CCPs, according to the CMA Law, the establishing, licensing, managing and operating of clearing houses is subject to the CMA's approval and continuous oversight. The law confers to the CMA substantial authority to regulate licensed clearing houses to the extent that no rule, policy or amendments shall be considered valid unless approved by the CMA.<sup>26</sup> The Kuwait Clearing Company is the most prominent clearing house in Kuwait. It provides several services, among which are:

- a* clearing and settlement services;
- b* derivatives markets clearing and risk management;
- c* dematerialisation and rematerialisation of securities;
- d* pledging and mortgage accounts;
- e* trustee services; and
- f* subscription management services of IPOs.<sup>27</sup>

As mentioned above, as part of the MDP, the CMA is expected to introduce and regulate a CCP in 2020.

### III OUTLOOK AND CONCLUSIONS

The CMA, as a relatively new regulator, has been increasingly busy in the past few years organising its internal structures and phasing in its regulatory activities to become effective and to bridge the gap between accepted local practices and international standards. What has been the subject of increasing criticism during its short lifespan has been the attitude it has adopted, characterised by the rigid application of the law and often slow response times when it comes to granting the required licences for persons to carry out their business. The responses from the regulators must be better outlined, explained and substantiated. However, in particular from 2016 to date, the CMA has been seen to streamline its internal processes and take a risk-based approach to its rules, particularly in the sphere of new and repeat debt and equity issuances. In addition, the MDP being a consolidated collaborative effort by the CMA, the Boursa Kuwait and the KCC MDP is testament to the regulator's commitment to develop, diversify and open the market for regional and international investors. Professionals can now utilise established modern rules regulating securities' activities in Kuwait.

It has also been recommended that clear and easily accessible practical guides and databases be created for such practices and administrative decisions. This is consistent with the CMA's published goals of increasing the awareness of stakeholders from the investment and legal perspectives, in addition to the CMA's mandate of improving the Authority's performance in all its departments and raising its levels of efficiency and effectiveness. This must also be done in collaboration with other governmental and private sector entities.

On the positive side, many developments have taken place from 2016 to date. The most publicised of these were the complete overhaul of the CMA's regulatory framework following the introduction of the CMA Handbook and, most recently, the MDP. The CMA and the Boursa Kuwait have taken the unprecedented step to issue exposure drafts seeking public

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<sup>26</sup> As per Article 54 of the CMA Law.

<sup>27</sup> Kuwait Clearing Co, KSC (2014), services, [www.maqasa.com/index\\_e.htm](http://www.maqasa.com/index_e.htm).

commentary prior to the adoption of their rules. It appears that the regulation of capital markets in Kuwait has been the subject of several reforms, and the attitude of the regulator in since 2016 has shifted to a more collaborative, consultative and transparent approach.

We believe that the CMA should review the effectiveness of the CMA by-laws on a regular basis. The review should assess whether such by-laws (or parts thereof) achieve their intended objectives and take into consideration the practical feedback of market participants. Further, it is critical for the regulators in Kuwait to streamline their processes and not create double-burden rules. For example, the interplay between the rules of the CMA and those issued by the Central Bank of Kuwait needs to follow a practical framework to alleviate inefficient enforcement.

Finally, the regulatory reforms can be seen as being directly responsible for the membership of the CMA in IOSCO, and more recently the upgrades of Kuwait by FTSE Russell, MSCI and S&P Dow Jones as an emerging market.<sup>28</sup> The classification of the country as a secondary emerging market is seen as a positive step to welcoming international investors into Kuwait, which creates a pressing need for the continuation of regulatory reform in the Kuwaiti regulatory frameworks.

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28 The Boursa Kuwait (2019), retrieved on 9 September 2019 from [https://www.boursakuwait.com.kw/MSCI/index\\_en.html](https://www.boursakuwait.com.kw/MSCI/index_en.html).

# LUXEMBOURG

*Frank Mausen, Henri Wagner and Paul Péporté<sup>1</sup>*

## I INTRODUCTION

Key international players consider Luxembourg, one of the few AAA-rated countries, to be among the most attractive business centres in the world. With approximately 135 registered banking institutions, a successful investment fund industry with approximately 3,871 funds managing net assets of approximately €4,404 billion and a dynamic insurance sector, Luxembourg offers a full range of diversified and innovative financial services.

### i Legal system

Luxembourg is a parliamentary democracy headed by a constitutional monarch, the Grand Duke. The Grand Duke and the government (headed by the Prime Minister) exercise executive power, and legislative power is vested in the Chamber of Deputies, a unicameral legislature of 60 directly elected members. A second body, the Council of State, composed of 21 ordinary citizens appointed by the Grand Duke, advises the Chamber of Deputies on the drafting of legislation.

The Constitution is the supreme law of Luxembourg.<sup>2</sup> Luxembourg's legal system is based on civil law; a number of laws are based on French or Belgian legislation.

Laws are enacted by the Chamber of Deputies and promulgated by the Grand Duke. The Constitution confers the Grand Duke with the power to adopt the necessary regulations and orders for the implementation of laws. The Grand Duke may, however, not suspend laws or dispense their implementation.

The Grand Duke can also authorise the government to make ministerial regulations in respect of limited technical issues.

Certain public bodies have the power to adopt special regulations within their field of competence. These bodies must act within the limits that have been previously defined by the legislature. Administrative circulars offer guidance on the interpretation of laws, especially in tax law matters.

Case law is not binding in Luxembourg; the law does not recognise the rule of precedent that applies in Anglo-Saxon legal systems. Judges can, however, refer to case law to found their decisions. In the absence of Luxembourg case law, judges may turn to Belgian, French or even German case law for tax law matters.

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2 The current Constitution was adopted on 17 October 1868.

## **ii Judicial system**

The Luxembourg judicial system is divided into a judicial branch and an administrative branch. Next to these two branches is the Constitutional Court, the aim of which is to rule by way of judgment on the conformity of particular laws with the Constitution, except for those that sanction international treaties.

The judicial branch is headed by the Supreme Court of Justice, which comprises the Court of Cassation, a Court of Appeal and a department of public prosecution. The Court of Cassation is primarily responsible for hearing cases that seek to overturn or set aside decisions given by the various benches of the Court of Appeal, and judgments by courts of last resort.

The country is divided into two judicial districts and three townships, and each has respectively a district court or a lower court, or both. The district court hands down decisions in ordinary law and hears all cases other than those falling expressly within the competence of another jurisdiction. It is competent for most appeals cases against judgments rendered by the lower court operating within the court's judicial district. The presidents of the district courts, or the magistrates appointed to them, hear interlocutory applications and render interim orders in urgent cases, civil or commercial.

Unless otherwise provided for by law, appeals can be lodged with the Administrative Court against decisions rendered by the Administrative Tribunal, or other administrative jurisdictions that have been granted specific jurisdiction. The Administrative Tribunal decides on claim introduced against administrative measures or decision in cases of:

- a* incompetence;
- b* acting in excess of authority;
- c* improper exercise of authority;
- d* breaches of the law or of procedures designed to protect private interests;
- e* appeals against administrative decisions in respect of which no other remedy is available in accordance with laws and regulations; and
- f* appeals against administrative measures having a regulatory character, irrespective of the authority from which they emanate.

## **iii Regulatory bodies in the financial sector**

The Luxembourg financial sector supervisory authority (CSSF) regulates the financial services sector. It is responsible for investigating possible wrongdoing, and bringing enforcement actions against credit institutions and professionals in the financial sector (PFS) for breaches of applicable law. It has the widest powers to supervise and control Luxembourg credit institutions and the PFS. The CSSF cooperates with foreign supervisory authorities on prudential supervision matters. Circulars and regulations issued by the CSSF complete the legislative framework of the Luxembourg financial sector.

The CSSF also supervises the securities markets and receives complaints from investors. It is the Luxembourg competent authority for approving prospectuses that are compliant with the Prospectus Regulation,<sup>3</sup> certain provisions of which were implemented in Luxembourg by an act dated 16 July 2019 on prospectuses for securities (Prospectus Act). The CSSF furthermore monitors the compliance of issuers with their obligations arising under the act

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3 Regulation (EU) 2017/1129 on prospectuses for securities.

dated 11 January 2008 on transparency obligations, as amended (Transparency Act), and the Market Abuse Regulation,<sup>4</sup> certain provisions of which have been implemented into Luxembourg law by an act dated 23 December 2016 relating to market abuse.

Finally, the CSSF participates, at a European Union and international level, in negotiations concerning the financial sector, and coordinates the implementation of governmental initiatives and measures to bring about an orderly expansion of activities of the financial sector.

The Luxembourg central bank (BCL) has a dual role: it is an integral part of the European System of Central Banks and the Eurosystem, on the one hand, and it is the central bank of Luxembourg, on the other. The BCL is responsible for implementing the monetary policy in Luxembourg decided by the Governing Council of the European Central Bank (ECB) and, among other things, for payment systems and clearing of settlement systems, cash operations and financial stability.

The Luxembourg Finance Ministry has general competence over the financial services sector (including tax legislation and financial legislation).

## **II THE YEAR IN REVIEW**

### **i Developments affecting debt and equity offerings<sup>5</sup>**

#### ***Public offers***

No offer of transferable securities may be made to the public in Luxembourg without the prior publication of a prospectus approved by the CSSF or a competent foreign authority.

Depending on the type of offer and of the securities offered, different regimes apply. The Prospectus Regulation, which has applied in its entirety across all EU Member States since 21 July 2019, with related Level 2 delegated acts and Level 3 guidance, comprises the new EU prospectus regime (PDIII). Public offers that are not covered by the Prospectus Regulation are governed by Part III, Chapter 1 of the Prospectus Act applying to simplified prospectuses. The main difference between the two regimes is that only public offers made under the Prospectus Regulation can benefit from the European passport for securities. Part III, Chapter 1 is used for public offers in Luxembourg only.

Generally, a prospectus or a simplified prospectus must contain all the information that enables prospective investors to make an informed assessment of the contemplated investment. The contents and format of a prospectus governed by the Prospectus Regulation are determined by the European Commission Regulation (EU) 2019/980<sup>6</sup> (Regulation

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<sup>4</sup> Regulation (EU) 596/2014 on market abuse.

<sup>5</sup> The reader should note that this chapter is not dealing with the Regulation (EU) 2016/1011 of the European Parliament and of the Council of 8 June 2016 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds and amending Directives 2008/48/EC and 2014/17/EU and Regulation (EU) No. 596/2014 (Benchmark Regulation) and Regulation (EU) No. 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No. 236/2012.

<sup>6</sup> Commission Delegated Regulation (EU) 2019/980 of 14 March 2019 supplementing Regulation (EU) 2017/1129 of the European Parliament and of the Council as regards the format, content, scrutiny and approval of the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market, and repealing Commission Regulation (EC) No. 809/2004.



2019/980). Part III prospectuses are drafted on the basis of Regulation 2019/980 if they are used for a public offer or on the basis of the rules and regulations (ROI) of the Luxembourg Stock Exchange (LxSE) if they are used for an admission to trading.

Where an offer to the public is made in Luxembourg only, any prospectus governed by the Prospectus Regulation must be drawn up in English, German, French or Luxembourgish (multilanguage prospectuses are also generally accepted). Where an offer to the public is made in more than one EU Member State including Luxembourg, the prospectus shall also be drawn up either in a language accepted by the competent authorities of each of those EU Member States or in a language customary in the sphere of international finance, at the choice of the issuer. The language of a document incorporated by reference does not need to be the same as that of the prospectus (the person applying for approval to passport the prospectus must, however, ensure compliance with the language regime of the host Member State) provided that the language of the document incorporated by reference is one of the four languages accepted by the CSSF, and that the readability of the prospectus is not compromised.

The Prospectus Regulation provides for exemptions from the obligation to publish a prospectus for certain offers.<sup>7</sup> In addition to these, the Luxembourg legislator used the possibility to opt for the additional exemption offered to EU Member States under the Prospectus Regulation. Accordingly, the Prospectus Act exempts from the obligation to draw up a prospectus offers to the public for a total amount not exceeding €8 million.<sup>8</sup> Prior notification of such exempted transactions to the CSSF is required, and for public offers below €8 million but equal to or higher than €5 million,<sup>9</sup> the Prospectus Act requires the publication of an information note. The obligation to publish a prospectus does not apply to offers to the public of certain types of securities (such as, under certain conditions, securities offered or allotted (or to be allotted) to existing or former directors or employees by their employer whose securities are already admitted to trading on a regulated market or by an affiliated undertaking).

On 19 July 2019, the CSSF published Circular Letter 19/724 outlining the technical procedures regarding submissions of documents to the CSSF.<sup>10</sup>

### **Listings**

The admission to trading of securities requires the prior publication of a prospectus in accordance with the Prospectus Act. The regime applicable for admissions to trading varies, to a great extent, according to the market on which the admission to trading is sought. Issuers can either request an admission to trading on the regulated market (within the meaning of MiFID II<sup>11</sup>) of the LxSE or the Euro MTF market. Depending on the type of

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7 For instance, offers addressed solely to qualified investors, offers of securities addressed to fewer than 150 natural or legal persons other than qualified investors per Member State, offers of securities addressed to investors who acquire securities for a total consideration of at least €100,000 per investor, and offers of securities the denomination per unit of which amounts to at least €100,000.

8 Total consideration of each offer in the EU in a monetary amount calculated over a period of 12 months.

9 Ibid.

10 Submissions of approvals must be filed in PDF format via email at [prospectus.approval@cssf.lu](mailto:prospectus.approval@cssf.lu). Other filings will need to be made at [prospectus.filing@cssf.lu](mailto:prospectus.filing@cssf.lu), whereas final terms must be filed via the platform available on <https://finalterms.apps.cssf.lu/> and universal registration documents via email at [URD.filing@cssf.lu](mailto:URD.filing@cssf.lu). Finally, queries on the Prospectus Act should be made to [prospectus.help@cssf.lu](mailto:prospectus.help@cssf.lu).

11 Directive 2014/65/EU of 15 May 2014 on markets in financial instruments.

securities for which an admission to trading on the regulated market is sought, the Prospectus Regulation (certain provisions of which are implemented by Part II of the Prospectus Act) or Part III, Chapter 2 of the Prospectus Act is applicable. Only prospectuses approved under the Prospectus Regulation can benefit from the European passport. The competent authority for the approval of a listing prospectus under the Prospectus Regulation is the CSSF, whereas the LxSE governs the approval of simplified prospectuses under Part III, Chapter 2 of the Prospectus Act.

The Euro MTF market is the LxSE's alternative market. It is not considered a regulated market in the sense of MiFID II. For admissions to trading on the Euro MTF market, Part IV of the Prospectus Act applies and essentially refers to the ROI as regards the relevant provisions for the content and format of the prospectus to be produced. A prospectus that is drafted in accordance with Regulation 809/2004, however, is also acceptable for a Euro MTF listing prospectus. Euro MTF prospectuses are approved by the LxSE. The Euro MTF market is a multilateral trading facility (MTF) (as defined in MiFID II) and not just a listing place. The main advantage for an issuer to seek admission to trading for its securities on the Euro MTF market is that the stringent disclosure, transparency and reporting obligations under the Transparency Act do not apply. The Market Abuse Regulation does, however, apply to the Euro MTF market. The Euro MTF market is eligible for the Eurosystem operation (ECB) and eligible for investments made by Luxembourg investment funds (undertakings for collective investment in transferable securities (UCITS)). More than 35,000 securities were admitted to trading on both markets of the Luxembourg Stock Exchange. More than 26,000 listed debt securities makes it the number 1 ranked stock exchange for international bond listings.

The Luxembourg Stock Exchange also features a third listing venue called the Securities Official List (SOL). An admission to SOL is a pure listing without admission to trading. The listed securities will appear on the Official List of the Luxembourg Stock Exchange. Admission to SOL is subject to compliance with a specific rulebook that provides for lower requirements in terms of disclosure and documentation than the Prospectus Act or the Prospectus Regulation. In addition thereto, neither the Transparency Act nor the Market Abuse Regulation (MAR)<sup>12</sup> apply to SOL.

At the end of 2018, the Luxembourg Stock Exchange launched two professional segments available on the regulated and Euro MTF markets which only professional investors can access, thus providing issuers with some advantages in terms of compliance with their MiFID II and PRIIPs obligations.

### ***Dematerialised securities***

The act dated 6 April 2013 on dematerialised securities (Dematerialisation Act) has modernised Luxembourg securities law by introducing a complete legal framework for dematerialised securities to keep pace with market developments.

The Dematerialisation Act draws on the French, Swiss and Belgian regimes. However, in contrast to these regimes, the dematerialised form of securities will exist in addition to the traditional bearer and registered forms of securities. Dematerialised securities will thus constitute a third type of securities, and an issuer will be free to choose from among the three.

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12 Directive 2014/57/EU on criminal sanctions for market abuse.

The Dematerialisation Act lays down the legal framework for the dematerialisation of securities, which are either equity or debt securities issued by Luxembourg joint-stock companies or common funds or debt securities issued under Luxembourg law by foreign issuers. The Dematerialisation Act does not provide for compulsory dematerialisation but for compulsory conversion if an issuer so decides. Dematerialisation will be achieved by the registration of the securities in an account held by a single body (a liquidation body or a central account keeper).

The Dematerialisation Act is at the forefront of the field of dematerialisation as it has closely aligned the Luxembourg regime with the Unidroit Convention on substantive rules for intermediated securities dated 9 October 2009, as well as, to a certain extent, the works of the European Commission in relation to the future securities law directive.

The Luxembourg framework on dematerialisation offers greater flexibility and choice for issuers and market participants, increases the speed of transfers by eliminating operational complexities and the risks inherent in the handling of physical securities, and reduces settlement and custody costs.

### ***Immobilisation of bearer shares and units***

The Luxembourg Act on the Immobilisation of Bearer Shares and Units (Immobilisation Act) came into force on 18 August 2014. The Immobilisation Act purports to adapt Luxembourg legislation to the recommendations of the Financial Action Task Force and the Global Forum on Transparency and Exchange of Information for Tax Purposes in terms of identification of holders of bearer shares and units. At any time, the availability of information regarding the identity of bearer shareholders or unitholders must be guaranteed while still preserving the confidentiality of such information towards third parties and other shareholders or unit holders. The new regime applies to bearer shares and units, irrespective of whether they are listed, issued by Luxembourg companies or contractual funds. Bearer shares and units must be deposited with a depositary established in Luxembourg that is subject to anti-money laundering requirements. A transitional period of six months is provided for bearer shares and units that were issued prior to the entry into force of the Immobilisation Act. Depositaries and directors and managers of companies and management companies of contractual funds who fail to comply with the new requirements may incur civil or criminal sanctions. The Immobilisation Act also applies to companies that have issued registered shares where the share register is not held at their registered office or where otherwise the share register does not comply with the requirements of the act dated 10 August 1915 on Commercial Companies, as amended (Companies Act). Criminal sanctions will be imposed in the event of a breach of the relevant legal provisions applying to share registers.

### ***Shareholders' rights***

In August 2019, Luxembourg implemented the second shareholders' rights directive, SRD II,<sup>13</sup> and introduced new obligations for companies whose shares are admitted to trading on a regulated market established or operating in an EU Member State, and for intermediaries, institutional investors, asset managers and proxy advisers that are interacting with them. Accordingly, an act dated 24 May 2011 relating to the exercise of certain shareholder rights at

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13 Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement.

general meetings of listed companies (Shareholder Rights Act) has been amended in particular to require that listed companies establish a remuneration policy for directors, submit it to the non-binding advisory vote of shareholders and publish it on their website. To help shareholders monitor the application of the remuneration policy, listed companies must also produce an annual remuneration report (to be published on their website) describing how the remuneration policy has been implemented and giving an overview of the remuneration granted to each individual executive.

The listed companies must further submit material<sup>14</sup> transactions with related parties for approval to the management body of a company and publicly disclose such transactions no later than at the time of the conclusion of a transaction.

The Shareholder Rights Act, as recently amended, also fostered shareholders' transparency by giving the right to listed companies to request any intermediary in a chain of intermediaries to provide information on the identity of their shareholders and by requiring shareholders that are institutional investors and asset managers to develop and publicly disclose an engagement policy (that is, a policy describing how they integrate shareholder engagement in their investment strategy). Institutional investors and asset managers must, on an annual basis, publicly disclose how their engagement policy has been implemented. Institutional investors must further disclose on their website certain elements of their equity investment strategies and of their arrangements with their delegated asset managers, and how their equity investment strategies and arrangements take into account and contribute to the medium to long-term performance of the relevant listed companies.

For the first time, proxy advisers are required to make available on their website their code of conduct (or explain why they do not have one) and, if applicable, report on its implementation each year. Additionally, they must disclose at least once a year certain information in connection with the preparation of their research, advice and recommendations regarding votes.

### ***Companies Act***

The Companies Act has been modernised: a number of existing practices have been embedded into law and a series of new mechanisms and instruments have been introduced. From a capital markets perspective, the attractiveness of private limited liability companies as issuance vehicles has been increased by allowing them to carry out public offers of debt securities. Other requirements that gave raise to concern, for instance, the requirement for audit reports in the context of convertible debt securities issuances, have been removed. The Companies Act now also allows the issuance of shares with different nominal values, and provisions on tracker shares have been embedded into the Luxembourg Civil Code.

### ***MAR***

Since 3 July 2016, MAR has replaced the initial market abuse act of 2006. Simultaneously, various implementing and regulatory technical standards adopted by the European Commission have come into effect. The Market Abuse Regulation is complemented by

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<sup>14</sup> Transactions with related parties are material if their publication and disclosure are likely to have a material impact on the economic decisions of a listed company's shareholders and if they could create a risk for the company and its shareholders who are not related parties, including minority shareholders. The question as to what is material will have to be carefully analysed on a case-by-case basis by the relevant corporate bodies in light of the specific factual setup of the relevant company and transaction.

CSMAD.<sup>15</sup> The CSMAD, together with certain provisions of the Market Abuse Regulation, have been implemented into Luxembourg law by an act dated 23 December 2016 on market abuse. The most important change is the application of the market abuse rules to a wider scope of trading venues: those rules now also apply to MTFs and organised trading facilities as further defined in MiFID II.

The Market Abuse Regulation prohibits any person who possesses inside information from using that information by acquiring or disposing of, or trying to acquire or dispose of, for his or her own account or for the account of a third party, either directly or indirectly, financial instruments to which that information relates. This also includes the cancellation or changing of an order placed before the person in question had the relevant information. The Market Abuse Regulation further requires issuers to make public inside information that directly concerns them. Inside information means information of a precise nature that has not been made public relating, directly or indirectly, to one or more issuers or to one or more financial instruments, and that, if it were made public, would be likely to have a significant effect on the prices of those financial instruments or on the price of related derivative financial instruments.

Information is likely to have a significant effect on price if it is information of a kind that a reasonable investor would be likely to use as part of the basis of his or her investment decisions. Information shall be deemed to be of a precise nature if it indicates a set of circumstances that exists or that may reasonably be expected to come into existence, or an event that has occurred or that may reasonably be expected to occur, where it is specific enough to enable a conclusion to be drawn as to the possible effect of that set of circumstances or event on the prices of the financial instruments.

Inside information given to a specific third party need not be disclosed to the public where there is a duty of confidentiality between the issuer and that third party (imposed by law, regulation, statute or contract).

The protection of investors requires public disclosure of inside information (unless an issuer is entitled to delay the disclosure of inside information) to be as fast and as synchronised as possible between all investors. A delayed disclosure of inside information must be notified to the relevant national competent authority. Inside information (which must be in the French, English or German language) must be notified through mechanisms that allow reasonably efficient broadcasting of such information to the public. Neither the Market Abuse Regulation nor its implementing technical standards provide a definitive set of mechanisms and means of publication to be used but they contain a list of mandatory information to be included in any announcement of inside information. In addition, issuers are required under the Market Abuse Regulation to post all published inside information on their respective websites for a period of at least five years.

Besides the prohibitions on insider dealing, the Market Abuse Regulation also incriminates market manipulation. Stabilisation measures, buy-back programmes as well as market soundings must also be analysed in light of the market abuse regime.

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15 Directive 2014/57/EU on criminal sanctions for market abuse.

### ***Transparency Act***

The Transparency Act (which implemented the European Directive 2004/109/EC dated 15 December 2004, as amended by Directive 2013/50/EU, on the harmonisation of transparency requirements into Luxembourg law) applies to issuers for which Luxembourg is the home Member State and whose securities are admitted to trading on a regulated market (thereby excluding the Euro MTF market).

Directive 2013/50/EU of the European Parliament and of the Council of 22 October 2013 has been transposed into Luxembourg law by an act dated 10 May 2016, which extends the definition of issuer to clarify that issuers of non-listed securities that are represented by depositary receipts admitted to trading on a regulated market also fall within the scope of the Transparency Act. Further, the law amends a number of definitions (including the definition of home Member State) and introduces new administrative sanctions. The rules on the disclosure of major shareholdings have been reinforced, and the scope of financial instruments linked to shares that are covered by these requirements has been broadened. Finally, it is interesting to note that the quarterly financial reporting obligations and the requirement to notify new loan issuances have been removed.

Issuers falling under the scope of the Transparency Act are mainly obliged to publish annual financial reports, half-yearly financial reports and, if applicable, an annual report on payments made to governments. The Transparency Act 2008 also complements the Market Abuse Regulation by defining the methods of disclosure of inside information that falls within the definition of Regulated Information for issuers having their securities listed on a regulated market.

The above publication requirements in respect of annual financial reports and half-yearly financial reports do not apply to an issuer that issues exclusively debt securities admitted to trading on a regulated market, the denomination per unit of which is at least €100,000 (or its equivalent in another currency).

The Transparency Act distinguishes between regulated information and unregulated information. Issuers of securities admitted to trading on a regulated market are required to disclose, store and file regulated information (such term being defined in CSSF Circular Letter 08/337, as amended). In other words, an issuer is required to publish regulated information, store the regulated information with an officially appointed mechanism (OAM) for the central storage of regulated information (in Luxembourg, the LxSE has been appointed as OAM) and file the regulated information with the CSSF.

Article 17 of the Transparency Act sets out additional ongoing disclosure requirements relating to general meetings and the exercise of voting rights that are applicable to an issuer of debt securities, and that aim at ensuring equal treatment for all holders of debt securities that are in the same position.

Equal treatment is one of the two key legal aspects to be assessed by an issuer that intends to buy back its debt securities. Abiding by the provisions on market abuse is the second.

Historically, the CSSF favoured an extensive interpretation of the principle of equal treatment. By reference to the very wording of the relevant legal provision (that is, equal treatment must be ensured ‘in respect of all the rights attaching to those debt securities’), the CSSF considered that the right of a holder of debt securities to participate in an offer by, or on behalf of, the issuer to buy back the debt securities is, in principle, a right attaching to the debt securities.

The CSSF now adopts a narrower reading of the notion of equal treatment to bring it in line with the practice applicable on other relevant markets. In short, the CSSF considers that the words 'rights attaching to' debt securities do not include the right to receive an offer to buy the securities made by or on behalf of the issuer. Thus, an offer can lawfully be made to some but not all holders of a series of debt securities and the issuer may propose different terms to different investors. This possibility is also of importance for exchange offers, to which the CSSF's position also applies.

## **ii Developments affecting derivatives, securitisations and other structured products**

### ***Short selling***

The Short Selling Regulation<sup>16</sup> is directly applicable in EEA Member States (including Luxembourg). The Short Selling Regulation lays down a common regulatory framework for all EEA Member States with regard to the requirements relating to short selling and credit default swaps. In Luxembourg, the Short Selling Regulation is complemented by an act dated 12 July 2013 on short selling of financial instruments and implementing the Short Selling Regulation (Short Selling Act), as well as CSSF Circular 12/548, as amended by CSSF Circular 13/565 (CSSF Circular 12/548). The Short Selling Regulation imposes (among other things) obligations on natural or legal persons to notify to the relevant competent authority (in Luxembourg, the CSSF) and, as applicable, disclose to the public net short positions in relation to the issued share capital of companies that have shares admitted to trading on a trading venue, and in relation to issued sovereign debt and uncovered positions in sovereign credit default swaps, each that reach or fall below the relevant notification thresholds specified in the Short Selling Regulation.

The CSSF has developed a web-based platform<sup>17</sup> for the notifications and disclosures of net short or uncovered positions covered by the Short Selling Regulation. Exemptions for market making activities and primary market operations, as permitted under the Short Selling Regulation, can be applied for by sending a notification of intent form (set out in CSSF Circular 12/548) to the CSSF by post or by email.<sup>18</sup>

The Short Selling Act also clarifies and extends the powers of the CSSF over, and with respect to, natural and legal persons that are subject to the Short Selling Regulation but that are not otherwise subject to the prudential supervision of the CSSF. In particular, the Short Selling Act provides to the CSSF:

- a* on-site inspection powers (subject to certain conditions);
- b* the power to obtain information and documents necessary for the discovery of truth in relation to acts prohibited by the Short Selling Regulation;
- c* the power to impose sanctions, including administrative fines of up to €1.5 million. If, however, the relevant person has drawn from the offence committed a pecuniary benefit (whether direct or indirect), the administrative fine may not be less than the amount of such benefit but not more than five times such amount; and
- d* the power to make public any sanction imposed by the CSSF (except where such disclosure would seriously jeopardise the financial markets).

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16 Regulation (EU) No. 236/2012 of the European Parliament and of the Council of 14 March 2012 on short selling and certain aspects of credit default swaps.

17 Which may be accessed at <http://shortselling.cssf.lu>.

18 [shortselling@cssf.lu](mailto:shortselling@cssf.lu).

### ***Security interests***

An act dated 5 August 2005 on financial collateral arrangements, as amended (Collateral Act 2005), provides for an attractive legal framework for security interests, liberalised rules for creating and enforcing financial collateral arrangements, and protection from insolvency rules. It applies to any financial collateral arrangements and covers financial instruments in the widest sense as well as cash claims and receivables.

The Collateral Act 2005 also provides for transfers of title by way of security and recognises the right of a pledgee to re-hypothecate pledged assets. This enables the pledgee to use and dispose of the pledged collateral. Contractual arrangements allowing for substitution and margin calls are expressly recognised by the Collateral Act 2005, and are protected in insolvency proceedings in which security interests granted during the pre-bankruptcy suspect period can be challenged.

The Collateral Act 2005 was amended in May 2018 (in connection with the implementation MiFID II) to exclude inappropriate use of title transfer collateral arrangements. Credit institutions and investment firms must not, in connection with the provision of investment services, conclude a transfer of title by way of security with retail clients (as referred to therein) to guarantee the obligations of such clients.

Credit institutions and investment firms must properly consider, and be able to demonstrate that they have done so, the use of transfers of title by way of security in the context of the relationship between a client's obligations to the credit institution or investment firm and the client's assets that are subject to a transfer of title by way of security.

When considering and documenting the appropriateness of the use of a transfer of title by way of security arrangement, credit institutions and investment firms shall take into account all of the factors set out in Article 13-1 of the Collateral Act 2005.

When using transfers of title by way of security, credit institutions and investment firms shall further highlight to professional clients and eligible counterparties the risks involved and the effects of any transfer of title by way of security on the client's financial instruments and funds.

When implementing a transfer of title by way of security of, or a pledge (with a right of use) over, financial instruments, the conditions with respect to the re-use of financial instruments received as collateral as set out in Article 15 of Regulation (EU) 2015/2365 of the European Parliament and of the Council of 25 November 2015 on transparency of securities financing transactions and of reuse and amending Regulation (EU) No. 648/2012 should also be considered (where applicable).

Under the Collateral Act 2005, financial collateral arrangements are valid and enforceable even if entered into during the pre-bankruptcy suspect period.

The Collateral Act 2005 confirms that the insolvency safe harbour provisions also apply to foreign law-governed collateral arrangements entered into by a Luxembourg party, which are similar (but not necessarily identical) to a Luxembourg financial collateral arrangement. Furthermore, receivables pledges are validly created among the contracting parties and binding against third parties as from the date of entering into the pledge agreement. The Collateral Act 2005 also provides for an efficient appropriation mechanism by allowing the collateral taker to appropriate the pledged assets (at a price determined prior to or after the appropriation of the asset) and to direct a third party to proceed with the appropriation in lieu of the collateral taker.



### ***Netting***

According to the Collateral Act 2005, set-off between assets (financial instruments and cash claims) operated in the event of insolvency is valid and binding against third parties, administrators, insolvency receivers and liquidators, or other similar organs, irrespective of the maturity date, the subject matter or the currency of the assets, provided that set-off is made in respect of transactions that are covered by bilateral or multilateral set-off provisions between two or more parties.

Articles 141 and 143 of the Luxembourg act dated 18 December 2015 relating to, among other things, the recovery, resolution and liquidation of credit institutions and certain investment firms, as amended (BRR Act 2015) dealing with netting, will come into play where credit institutions are a party to the relevant agreement and affect the enforceability of netting without prejudice to the application of Articles 66, 67 (as applicable) and 69 of the BRR Act 2015.

Furthermore, termination clauses, clauses establishing a connection between assets, close-out netting provisions and all other clauses stipulated to allow for set-off are valid and binding against third parties, administrators, insolvency receivers and liquidators, or other similar organs, and are effective notwithstanding:

- a* the commencement or continuation of reorganisation measures or liquidation proceedings, irrespective of the time at which such clauses (including set-off clauses) have been agreed upon or enforced; and
- b* any civil, criminal or judicial attachment or criminal confiscation, as well as purported assignment or other disposition of, or in respect of, such rights.

Set-off made by reason of enforcement or conservatory measures or proceedings, including one of the proceedings set out in (b) above, is deemed to have occurred before any such measure or proceeding applies.

With the exception of provisions on over-indebtedness, Luxembourg law provisions relating to bankruptcy, and Luxembourg and foreign provisions relating to reorganisation measures, liquidation proceedings, attachments, other situations of competition between creditors or other measures or proceedings set out in (a) and (b) above, are not applicable to set-off contracts and do not affect the enforcement of such contracts.

According to Article 208 of the BRR Act 2015 and Article 200 of the Collateral Act 2005, the Collateral Act 2005 shall apply without prejudice to Part I of the BRR Act 2015 and Part IV of the Banking Act 1993 on the legislation of another EU Member State implementing BRRD (as defined below). In particular, Articles 10, 11, 13, 14, 18, 19 and 20 (1) to (3) of the Collateral Act 2005 shall not apply:

- a* to any restriction on the enforcement of financial collateral arrangements, any restriction on the effect of a security financial collateral arrangement or any close out netting or set-off provision that is imposed by virtue of Part I, Title II, Chapters VI or VII of the BRR Act 2015 (that is, the provisions relating to resolution tools and write down of capital instruments) or by virtue of the legislation of another Member State pursuant to the relevant provisions of Directive 2014/59/EU of the European Parliament and of the Council dated 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No. 1093/2010 and (EU) No. 648/2012, of the European Parliament and of the Council (BRRD); nor

- b* any restriction that is imposed by virtue of similar powers under the law of another Member State with a view to facilitating the resolution of an entity referred to under Article 1, Paragraph 2, Subparagraph c), Item iv), and Subparagraph (d) of the Directive 2002/47/EC of the European Parliament and of the Council dated 6 June 2002 on financial collateral arrangements by providing safeguards that are at least equivalent to the safeguards under Articles 61 to 70 of the BRR Act 2015.

### ***High-yield bonds***

Luxembourg has seen a considerable increase in high-yield bonds issued by Luxembourg finance vehicles and generally admitted to trading on the LxSE over the past couple of years. For structuring reasons, it is often not the parent entity of a group that issues the high-yield bonds but a dedicated Luxembourg special purpose finance vehicle that is a direct or indirect subsidiary of the parent entity. To strengthen the credit rating of high-yield bonds, an issue is usually guaranteed by the parent and all or some of its subsidiaries.

Under applicable Luxembourg law, a guarantor needs to be described as if it were the issuer of the guaranteed bonds. This implies that detailed financial information needs to be given in respect of each guarantor; however, the guaranteeing subsidiaries may be located in jurisdictions where there is no requirement, for instance, to produce annual accounts, or where the accounts are not prepared in English, French or German. Providing this information in respect of all guaranteeing subsidiaries in an acceptable form may be burdensome and costly. Following requests from the industry, the CSSF accepts that the individual accounts of the guaranteeing subsidiaries are replaced by the consolidated financial statements of the group (to which the guaranteeing subsidiaries belong), provided that:

- a* the guarantees concerned are unconditional and irrevocable (without prejudice to legal provisions applicable in the jurisdictions of the guaranteeing subsidiaries);
- b* the guaranteeing subsidiaries represent at least 75 per cent, but not more than 100 per cent, of the group's net assets or of the group's earnings before the deduction of interest, tax and amortisation expenses; and
- c* the prospectus includes in the risk factor section a brief description of the reasons explaining the omission of separate financial information for the guaranteeing subsidiaries.

The LxSE generally follows the CSSF approach when approving prospectuses for high-yield bonds but tends to apply a more flexible approach regarding the above thresholds provided that the interests of investors are, in the opinion of the LxSE, adequately protected.

### ***Capital adequacy requirements***

An act dated 5 April 1993 on the financial sector, as amended (Banking Act 1993) has been amended to implement the CRD IV Package (as defined below) into Luxembourg law. The CSSF, as the national competent authority for the supervision of capital requirements that are applicable to credit institutions and the PFS, is still in the process of updating the amended Circular 07/290 applicable to Luxembourg investment firms and Luxembourg branches of non-EU investment firms.

Since 1 January 2014, CRR,<sup>19</sup> with its implementing and delegated Commission regulations, is directly applicable in all EU Member States. In the event of conflict between the provisions of the CRR and the provisions of the national legislation, the provisions of the CRR prevail. CSSF Regulation No. 18-03 (repealing CSSF Regulation No. 14-01) on the implementation of certain discretions contained in Regulation (EU) No. 575/2013 deals with the discretions left under the CRR to the national legislation. In addition, CSSF Circular 15/618 implements the European Banking Authority Guidelines on materiality, proprietary and confidentiality and on disclosure frequency under Article 432 Paragraph 1, Article 432 Paragraph 2 and Article 433 of the CRR, respectively.

The CRR is supplemented by Directive 2013/36/EU of the European Parliament and of the Council dated 26 June 2013 concerning the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (CRD IV, and together with the CRR, the CRD IV Package) and its implementing and delegated Commission Regulations.<sup>20</sup> Clarifications for investment firms in the framework of the transposition into Luxembourg law of CRD IV and CRR were included in CSSF Circular 15/606. CRD IV has been transposed into Luxembourg law mainly by an act dated 23 July 2015 (amending the Banking Act 1993). The provisions of the Banking Act 1993 that have been amended by the act dated 23 July 2015 are further complemented by the following CSSF Regulations:

- a* CSSF Regulation No. 15-01 (on the calculation of institution-specific countercyclical capital buffer rates);
- b* CSSF Regulation No. 15-02 (relating to the supervisory review and evaluation process that applies to CRR institutions);
- c* CSSF Regulation No. 15-04 (on the setting of a countercyclical buffer rate);
- d* CSSF Regulation No. 15-05 (on the exemption of investment firms qualifying as small and medium-sized enterprises from the requirements to maintain a countercyclical capital buffer and capital conservation buffer);
- e* CSSF Regulation No. 16-01 (on the automatic recognition of countercyclical capital buffer rates during the transitional period); and
- f* CSSF Regulation No. 18-06 (repealing CSSF Regulation No. 17-04) (concerning systematically important institutions authorised in Luxembourg).

In addition, CSSF Circular 15/620, CSSF Circular 15/622 and CSSF Circular 15/625 provide further details on CRD IV as implemented by an act dated 23 July 2015.

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19 Regulation (EU) No. 575/2013 of the European Parliament and the Council dated 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No. 648/2012.

20 The CRD IV Package was updated on 7 June 2019 by Directive (EU) 2019/879 (BRRD II) and Directive (EU) 2019/878 (CRD V Directive), Regulation (EU) 2019/876 and Regulation (EU) 2019/877 (together, CRD V Package). The new CRD V Package implements, among other things, the Financial Stability Board's total loss absorbing capacity standards for global systemically important banks into EU law. Although most of the provisions of the CRD V Package will enter into force only as from 2021, some transitional regimes have been designed to be applicable before that date. BRRD II and CRD V will still have to be implemented into Luxembourg law.

### ***The European Market Infrastructure Regulation***

In Luxembourg, derivative contracts are regulated under the European Market Infrastructure Regulation (EMIR)<sup>21</sup> and its various implementing and delegated Commission regulations, which are legally binding and directly applicable in all Member States.

An act dated 15 March 2016, as amended, transposing, inter alia, EMIR, lays down the powers of supervision, intervention, inspection, investigation and sanction granted to the CSSF and the Luxembourg Insurance Commission as the national competent authorities for the implementation of EMIR.

EMIR was recently amended<sup>22</sup> following a review by the European Commission's regulatory fitness and performance programme (REFIT) and negotiations between the European legislators. EMIR (in its REFIT form) entered into force on 17 June 2019.

In Luxembourg, EMIR is further complemented by CSSF Circular 13/557 of 23 January 2013, which merely clarifies certain provisions of EMIR and CSSF Circular 19/723 clarifying the MiFID II definitions of commodity derivatives used in EMIR. The purpose of EMIR is to introduce new requirements to improve transparency and reduce the risks associated with the derivatives market. As such, EMIR applies to all financial counterparties (FCs) and non-financial counterparties (NFCs) as defined under EMIR (regardless of whether they cross the clearing threshold or are subject to the clearing obligation, as applicable) that enter into derivative contracts. EMIR also applies indirectly to non-European counterparties trading with European counterparties or, under certain conditions, to non-European counterparties trading with each other where such trade has a direct, substantial and foreseeable effect within the European Union. All FCs and NFCs above a certain clearing threshold (or subject to the clearing obligation) have to clear over-the-counter (OTC) derivative contracts with a central counterparty (CCP) authorised or recognised under EMIR pertaining to a class of OTC derivatives that has been declared subject to the clearing obligation by the European Commission. Contracts not cleared by a CCP are subject to operational risk management requirements and bilateral collateral requirements. EMIR establishes common organisational, conduct of business and prudential standards for CCPs as well as organisational and conduct of business standards for trade repositories.

EMIR also requires FCs and NFCs to report details of their derivative contracts, whether traded OTC or not, to a trade repository.

With regard to a trade entered into between an FC and an NFC that is below the clearing threshold, the FC will, as of 18 June 2020, be solely responsible and legally liable for reporting on behalf of both counterparties (although such NFC may opt to undertake this reporting), whether traded OTC or not, to a trade repository. With regard to trades entered into by investment funds, managers of alternative investment funds (AIFs) and UCITS will, as of 18 June 2020, be responsible and legally liable for the reporting obligations of the UCITS or AIFs under their management. Counterparties to intragroup trades made between an FC and an NFC that is below the clearing threshold (and under certain conditions relating

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21 Regulation (EU) No. 648/2012 of the European Parliament and of the Council of 4 July 2012 on over-the-counter (OTC) derivatives, central counterparties (CCPs) and trade repositories, as amended.

22 Some of the amendments relate, among other topics, to the definition of financial counterparties, to the restrictions of clearing obligations, to changes to the clearing threshold for non-financial counterparties and also to trade reporting.

to group governance) may also be exempt from reporting such trades to the extent that they notify the competent authorities of their intention to apply this exemption (the competent authorities may oppose this exemption within three months of receiving a notification).

### **iii Cases and dispute settlement**

In a case where the CSSF has refused to approve the appointment of an individual as a bank manager, who subsequently claims damages from the CSSF on the basis of the CSSF's wrongdoing, the Constitutional Court held in a judgment dated 1 April 2011<sup>23</sup> that the statutory in tort liability regime applicable to the CSSF, which presupposes gross negligence by the CSSF and deviates from ordinary civil liability, which allows damages to be sought for wrongdoing, is not contrary to the constitutional principle of equality before the law. Therefore, a plaintiff must establish that the damage that he or she has suffered is caused by the CSSF's gross negligence to seek the CSSF's liability and to claim damages.

Luxembourg courts consistently confirm the efficiency of Luxembourg financial collateral arrangements established by the Collateral Act 2005. For instance, it was held that:

- a* a (Luxembourg) criminal attachment over pledged assets does not prevent the effectiveness of a Luxembourg law-governed pledge subject to the Collateral Act 2005 and its enforcement by the pledgee;
- b* insolvency proceedings involving the pledgor have no effect on the enforcement of the pledge;
- c* courts are not permitted to impose provisional measures that interfere with the enforcement of financial collateral arrangements;
- d* a pledge over shares in a Luxembourg bank account is enforceable, despite concurrent and inconsistent foreign court proceedings that purport to suspend the pledge; and
- e* the enforcement of a pledge over the shares in a company upon the occurrence of an enforcement event specified in the pledge agreement is possible notwithstanding that the secured debt was not yet due and that the creditor had not claimed the repayment of the secured debt.

### **iv Relevant tax and insolvency law**

#### ***Taxation***

Luxembourg companies are subject to corporation taxes at a combined tax rate (including corporate income tax, municipal business tax and the solidarity surcharge) of 24.94 per cent in the municipality of Luxembourg for the fiscal year ending 31 December 2019. They are assessed on the basis of their worldwide profits, after deduction of allowable expenses and charges, determined in accordance with Luxembourg general accounting standards (subject to certain fiscal adjustments and to the provisions of applicable tax treaties). Ordinary Luxembourg companies (LuxCos) are subject to a wealth tax at a rate of 0.5 or 0.05 per cent, assessed on the estimated realisation value of their assets on the wealth tax assessment date, after deduction of any business-related debts. LuxCos are also subject to a Luxembourg

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23 Constitutional Court, 1 April 2011, No. 63/11, <http://data.legilux.public.lu/eli/etat/leg/acc/2011/04/01/n1/jo>.

minimum wealth tax. Such minimum wealth tax is also applicable to Luxembourg companies that are subject to the act dated 22 March 2004 on securitisation, as amended (Securitisation Act 2004) (LuxSeCos).<sup>24</sup>

LuxCos carrying out a financial activity are assessed on the basis of an arm's-length profit margin. This profit is expressed as a percentage of a LuxCo's indebtedness. Thus, a LuxCo will always realise an arm's-length profit on the financial transactions entered into, in light of the functions performed and the risks taken, and in accordance with general market conditions. A law dated 23 December 2016 clarifies the concept of the arm's-length principle by introducing a new Article 56bis into Luxembourg's income tax law.<sup>25</sup> In addition, the Luxembourg direct tax administration issued Circular LIR 56/1-56bis/1 (Circular), replacing Circulars LIR 164/2 and 164/2-bis, which sets the Luxembourg tax framework for intragroup financing transactions. The clarification in Luxembourg of formal transfer-pricing rules for intragroup financial transactions was expected by the financial sector and strengthens the overall tax-transparency of Luxembourg. The Circular endorses the OECD Transfer Pricing Guidelines and keeps Luxembourg in line with international standards in the area of transfer pricing. In addition, the Circular clarifies the process for applying for an advance pricing agreement (APA). In this context, it should be noted that the general legal framework and the procedural formalities applying to APA filings are set out in the Luxembourg general tax law<sup>26</sup> and a Grand Ducal regulation.<sup>27</sup> If a LuxCo enters into an intragroup financing transaction coming within the scope of the Circular, it has to comply with a number of requirements set out in the Circular (such as substance requirements, minimum equity at risk, transfer-pricing report, etc). The Circular also confirms that, as of 1 January 2017, the Luxembourg tax administration would no longer be bound by APAs issued for the tax years post 2016, which were based on rules applicable before the introduction of the new Article 56bis into the Luxembourg income tax law.

The obligations assumed by a LuxSeCo towards its investors (holding equity or debt securities) and any other creditors are considered tax-deductible expenses. Therefore, a financial transaction entered into by a LuxSeCo, if properly structured, should not give rise to any corporation taxes subject to, among others, the interest limitation rule. The Luxembourg tax administration does not require a LuxSeCo to realise a minimum profit margin.

Management services rendered to LuxSeCos are exempt from VAT. This is not the case for management services that are provided to LuxCos.

Both LuxCos and LuxSeCos benefit from the wide network of tax treaties entered into by Luxembourg from a Luxembourg standpoint.

In the field of tax evasion and tax avoidance, Luxembourg ensures compliance with its European and international engagements by adopting instruments impacting international tax planning and structuring in Luxembourg.

In this context, Luxembourg has signed the OECD's multilateral convention, which entered into force on 1 August 2019, to implement tax treaty-related measures to prevent base erosion and profit shifting.

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24 Note that as of 1 January 2016, the minimum corporate income tax has been abolished and replaced by a minimum wealth tax that applies under similar conditions and amounts as the previous minimum corporate income tax.

25 Income tax law, dated 4 December 1967, as amended.

26 Section 29a of the Luxembourg general tax law, dated 22 May 1931, as amended.

27 Grand-Ducal Regulation dated 23 December 2014.

In addition, an act dated 21 December 2018 implemented into Luxembourg tax law the provisions of the anti-tax avoidance directive, ATAD I.<sup>28</sup> Its main provisions consist of the interest limitation rule, the controlled foreign companies rule, hybrid mismatches rule, exit tax provisions and general anti-abuse rule.

On 29 May 2017, the Council adopted a second anti-tax avoidance directive ATAD II.<sup>29</sup> This directive amends ATAD I by setting up a dissuasive regime regarding hybrid mismatches with third countries and broadening its scope to cover hybrid private equity mismatches, hybrid transfers, imported mismatches, dual residence mismatches and reverse hybrid mismatches. The rules will be applicable in Luxembourg from 1 January 2020 at the latest except for the reverse hybrid mismatches rule, which will be applicable from 1 January 2022. On 8 August 2019, the government submitted to parliament a bill in respect of ATAD II.<sup>30</sup>

### ***Insolvency law***

Insolvency situations are governed by a set of rules that have been elaborated by courts and legal literature around the cardinal principle of the *pari passu* ranking of creditors. Under the applicable Luxembourg law, it is possible for a company to be insolvent without necessarily being bankrupt. If a company fails to meet the two cumulative tests of bankruptcy – the cessation of payments and the loss of creditworthiness – it is not deemed bankrupt. The judgment declaring bankruptcy, or a subsequent judgment issued by the court, usually specifies a period not exceeding six months before the day of the judgment declaring the bankruptcy. During this period, which is commonly referred to as the suspect period, the debtor is deemed to have already been unable to pay its debts generally, or to obtain further credit from its creditors or third parties. Payments made, as well as other transactions concluded or performed, during the suspect period, and specific payments and transactions during the 10 days before the commencement of that period, are subject to cancellation by the Luxembourg court upon proceedings instituted by the Luxembourg insolvency or bankruptcy receiver.

Luxembourg insolvency proceedings have, inter alia, the following effects:

- a* as a matter of principle, bankruptcy judgments do not result in automatic termination of contracts, except for *intuitu personae* contracts (i.e., contracts for which the identity of the counterparty or its solvency are crucial). Contracts therefore continue to exist in full force unless the insolvency receiver chooses to terminate them. Termination by reason of insolvency may also be effectively provided for in a contract; and
- b* once a company has been declared bankrupt, unsecured creditors and creditors with a general priority right are no longer permitted to take any action based on title to movables and immovables, or any enforcement action against the bankrupt company's assets. Actions may only be exercised against the insolvency receiver.

The foregoing does not apply in the following cases:

- a* creditors may, notwithstanding the bankruptcy of a company, initiate proceedings against the co-debtors of the company;

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28 Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax-avoidance practices that directly affect the functioning of the internal market.

29 Council Directive (EU) 2017/952 of 29 May 2017 amending Directive (EU) 2016/1164 as regards hybrid mismatches with third countries.

30 Luxembourg bill No. 7466 dated 8 August 2019.

- b* secured creditors may still enforce their rights after a bankruptcy adjudication; and
- c* creditors of new debts, contracted by the insolvency receiver, may still initiate proceedings to have their rights recognised and enforced.

Special insolvency regimes apply to, among others:

- a* credit institutions and certain investment firms as defined in the BRR Act 2015 and their respective branches in another Member State;
- b* other professionals in the financial sector (as defined in the Banking Act) that are managing funds for third parties;
- c* financial institutions, enterprises and parent companies, which are covered by Part I of the BRR Act 2015 in the case of application of the resolutions tools and powers set out in Part I of the BRR Act 2015 (the institutions and entities referred to under (a) to (c) above are herein referred to as BRR entities). Articles 120 et seq. of the BRR Act 2015 provide for special reprieve from payment and liquidation regimes for BRR entities.

Reprieve from payment may be applied for if the global performance of an undertaking's business is compromised, in the event that the undertaking is unable to obtain further credit or fresh monies or no longer has any liquidity, whether there is a cessation of payments, or in the event that a provisional decision has been taken to withdraw the undertaking's licence. In these circumstances, the CSSF may request the court to apply reprieve from payment proceedings to the undertaking. The reprieve from payment cannot exceed six months, and the court will lay down the terms and conditions thereof, including the appointment of one or more persons responsible for managing the reorganisation measures and supervising the undertaking's activities.

A petition for liquidation may be filed either by the public prosecutor or the CSSF. This will typically occur in a situation where a reprieve from payment cannot cure an undertaking's difficult financial situation, where the undertaking's financial situation is so serious that it can no longer satisfy its creditors or where the undertaking's licence has been permanently withdrawn. The court will appoint a judge-commissioner and one or more liquidators. The court may decide to apply bankruptcy rules in respect of the liquidation and, accordingly, fix the suspect period (which may date back no more than six months before the date of filing the application for reprieve from payment). The court as well as the judge-commissioner and the liquidators may decide to vary the mode of liquidation initially agreed upon. The liquidation procedure is terminated when the court has examined the documents submitted to it by the liquidators and the documents have been reviewed by one or more commissioners. Voluntary liquidation by an entity is possible only where the CSSF has been notified thereof by the undertaking one month before notice is given to hold an extraordinary general meeting of the shareholders called to consider the voluntary liquidation.

The Original EU Insolvency Regulation<sup>31</sup> has been replaced by the Recast EU Insolvency Regulation.<sup>32</sup> The Recast EU Insolvency Regulation applies in Luxembourg (among others) to

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31 Council Regulation (EC) No. 1346/2000 of 29 May 2000 on insolvency proceedings, as amended.

32 Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings (recast), as amended). The Recast EU Insolvency Regulation applies to insolvency proceedings opened on or after 26 June 2017. Where insolvency proceedings were opened before 26 June 2017, the Original EU Insolvency Regulation applies. The Recast EU Insolvency Regulation entered into force on 26 June 2015, and the majority of its provisions apply as from 26 June 2017.



commercial companies other than credit institutions, insurance undertakings, and investment firms and other firms, institutions or undertakings covered by Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding-up of credit institutions,<sup>33</sup> and establishes common rules on cross-border insolvency proceedings based on principles of mutual recognition and cooperation. In broad terms, the Recast EU Insolvency Regulation provides that main insolvency proceedings are to be opened in the Member State where the debtor has the centre of its main interests. These proceedings will have universal scope and encompass a debtor's assets throughout the European Union (subject to secondary proceedings opened in one or more Member States, although those proceedings will be limited to the assets in that state and will run in parallel to the main proceedings). A Luxembourg party will in principle be subject to the Luxembourg insolvency proceedings if it has its centre of main interests (COMI) in Luxembourg. The COMI is presumed, in the case of a company or legal person, to be the place of its registered office.

## **v Role of exchanges, central counterparties and rating agencies**

### ***LxSE***

The LxSE was incorporated on 5 April 1928 as a *société anonyme*, and the first trading session took place on 6 May 1929; in November 2000, it entered into a cooperation agreement with Euronext. The LxSE is managed by a board of managers appointed by the general meeting of the LxSE's shareholders.

The LxSE is the competent body for all decisions and operations relating to the admission of securities, their suspension, withdrawal and delisting, the maintenance of its official list, the transfer of securities from one market to another, and all the continuing obligations of issuers. It is the operator of the regulated market-denominated LxSE and of the Euro MTF market. The main activities of the LxSE are listing, trading, distribution of financial reports for the investment funds industry, trade reporting and data vending.

The LxSE primarily specialises in the issue of international bonds (for which it is ranked first in Europe), with more than 26,000 debt securities listed. The LxSE maintains a dominant position in European bond issues, with the majority of all cross-border securities in Europe being listed in Luxembourg. More than 60 countries list at least some of their sovereign debt in Luxembourg, while Luxembourg is also a market for debt from large organisations such as the European Bank for Reconstruction and Development, the European Investment Bank, the European Union and the World Bank. The LxSE's main equity index is called the LuxX Index, which is a weighted index of the 10 most valuable listed stocks by free-floated market capitalisation.

### ***Clearstream Luxembourg***

Clearstream Banking, SA in Luxembourg is one of the major European clearing houses through which more than 2,500 banks, financial institutions and central banks worldwide exchange financial instruments. It is wholly owned by Clearstream International SA, which is a wholly owned subsidiary of the Deutsche Börse Group. Clearstream Banking ensures that cash and securities are promptly and effectively delivered between trading parties. It also

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33 Insolvency proceedings concerning UCITS as defined in Directive 2009/65/EC of the European Parliament and of the Council and AIFs as defined in Directive 2011/61/EU of the European Parliament and of the Council are equally excluded from the scope of the Recast EU Insolvency Regulation.

manages, administers and is responsible for the safekeeping of the securities that it holds on behalf of its customers. Over 300,000 domestic and internationally traded bonds, equities and investment funds are currently deposited with Clearstream Banking. Clearstream Banking settles over 250,000 transactions daily and is active in 58 markets.

Clearstream Banking is often described as a bank for banks. Basically, its duty is to record transactions between the accounts of different participants in Clearstream Banking, and use that data to calculate the relative financial positions of participants in relation to each other.

### ***LuxCSD***

LuxCSD, a new central securities depository for Luxembourg, is jointly (50–50) owned by the Luxembourg central bank and Clearstream Banking. LuxCSD provides the financial community with central bank money settlement services as well as issuance and custody services for a wide range of securities, including investment funds.

LuxCSD was designated a securities settlement system by the Luxembourg central bank, which is a requirement to operate under the protection of the Settlement Finality Directive, and has received European Central Bank approval for its Securities Settlement System being eligible for use in collateralisation Eurosystem credit operations.

### ***Rating agencies***

Currently, no Luxembourg-based rating agency exists.

## **vi Other strategic considerations**

### ***Recognition of trusts***

An act dated 27 July 2003 relating to trust and fiduciary contracts, as amended, recognises trusts that are created in accordance with the Convention on the Law Applicable to Trusts and on their recognition made at The Hague on 1 July 1985 and that are legal, valid, binding and enforceable under the law applicable to trusts.

### ***Securitisation Act 2004***

In adopting the Securitisation Act 2004, Luxembourg has given itself one of the most favourable and advanced pieces of European legislation for securitisation and structured finance transactions. According to the Securitisation Act 2004, securitisation means a transaction by which a Luxembourg securitisation undertaking (in the form of a LuxSeCo or a fund managed by a management company) acquires or purchases risks relating to certain claims, assets or obligations assumed by third parties, and finances the acquisition or purchase by the issue of securities, the return on which is linked to these risks.

The Securitisation Act 2004 distinguishes between regulated and unregulated securitisation undertakings. A securitisation undertaking must be authorised by the CSSF and must obtain a licence if it issues securities to the public on a continuous basis (these two criteria applying cumulatively). Both regulated and unregulated securitisation undertakings benefit from all the provisions of the Securitisation Act 2004.

A securitisation undertaking must mainly be financed by the issue of instruments (be it equity securities or debt securities) that qualify as securities under their governing law.

The Securitisation Act 2004 does not contain restrictions as regards the claims, assets or obligations that may be securitised. Securitisable assets may relate to domestic or foreign,

movable or immovable, future or present, tangible or intangible claims, assets or obligations. It is also accepted that a securitisation undertaking may, under certain conditions, grant loans directly. Very advantageous provisions for the securitisation of claims have been included in the Securitisation Act 2004.

To enable the securitisation of undrawn loans or loans granted by the securitisation undertaking itself, the Banking Act 1993 exempts such transactions from a banking licence requirement. Furthermore, transactions that fall within the scope of the application of the Securitisation Act 2004 (such as, for example, credit default swaps) do not constitute insurance activities that are subject to Luxembourg insurance legislation.

The Securitisation Act 2004 allows the board of directors of a securitisation undertaking to set up separate ring-fenced compartments. Each compartment forms an independent, separate and distinct part of the securitisation undertaking's estate and is segregated from all other compartments of the securitisation undertaking. Investors, irrespective of whether they hold equity or debt securities, will only have recourse to the assets encompassed by the compartment to which the securities they hold have been allocated. They have no recourse against the assets making up other compartments. In the relationship between investors, each compartment is treated as a separate entity (unless otherwise provided for in the relevant issue documentation). The compartment structure is one of the most attractive features of the Securitisation Act 2004, as it allows the use of the same issuance vehicle for numerous transactions without the investors running the risk of being materially adversely affected by other transactions carried out by the securitisation undertaking. This feature allows securitisation transactions to be structured in a very cost-efficient way without burdensome administrative hurdles. It is important to note that there is no risk-spreading requirement for compartments. It is hence possible to isolate each asset held by the securitisation undertaking in a separate compartment.

The Securitisation Act 2004 also expressly recognises the validity of limited recourse, subordination, non-seizure and non-petition provisions.

Rating agencies are very comfortable with transactions structured under the Securitisation Act 2004 as legal counsel can usually issue clean legal opinions.

From a tax perspective, there is full tax-neutrality for securitisation undertakings (for further information, see Section II.iv above).

The CSSF has published an frequently asked question (FAQ) document setting out guidelines regarding transactions that a securitisation undertaking may enter into. Although these guidelines only apply to securitisation undertakings regulated by the CSSF, the tax administration tends to apply them to unregulated securitisation undertakings as well to decide whether their transactions qualify as securitisation transactions. The CSSF has confirmed in the FAQs, by reference to a FAQ document published by the European Commission on 25 March 2013,<sup>34</sup> that an issuer that exclusively issues debt instruments does not constitute an AIF and hence does not fall within the ambit of the AIFMD.<sup>35</sup> In addition, according to the CSSF, securitisation undertakings issuing structured products that provide a synthetic exposure to assets (for instance, shares, indices, commodities) based on a set formula and that acquire underlying assets or enter into swap arrangements only with a view to hedging their payment obligations with regard to investors in structured products

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34 Questions on Single Market Legislation/Internal Market; General question on Directive 2011/61/EU; ID 1169, Scope and exemptions.

35 Directive 2011/61/EU on alternative investment fund managers.

may, subject to the criteria set out in guidance issued by the European Securities and Markets Authority, be considered as not being managed according to an investment policy and would hence fall outside the scope of the AIFMD.

It is interesting to note that an email address<sup>36</sup> has been created to discuss queries concerning the Securitisation Act 2004 with the CSSF.

At the European level, the STS Regulation<sup>37</sup> sets common rules on securitisation and creates a harmonised set of foundation criteria for simple, transparent and standardised securitisations. An act dated 16 July 2019 implements, among other things, provisions of the STS Regulation into Luxembourg law. The STS Regulation and its implementing measures will, however, have no impact on securitisation structures regulated under the Securitisation Act 2004 and falling outside the very limited scope of the STS Regulation. The rules of the STS Regulation are indeed limited to tranchised securitisation structures that repackage credit risks (as further defined in the STS Regulation).

### ***Covered bonds***

A covered bond is a debt security issued by a covered bond bank and guaranteed by a cover pool specifically allocated to these securities. To date, the issuance of covered bonds is restricted to covered bond banks, which must limit their principal activities to the granting of loans that will be specifically secured and that will be refinanced by way of issuing covered bonds. Other activities may only be performed on an ancillary basis.

Covered bond banks are subject to the prudential supervision of the ECB or, as applicable, the CSSF, and the specific supervision of an approved special statutory auditor appointed by the CSSF upon recommendation of the covered bond bank that supervises the coverage assets in respect of covered bonds.

Five types of covered bond may be issued by covered bond banks:

- a* public sector bonds, guaranteed by claims against, or guaranteed by, public entities (i.e., Member States of the EU, the EEA, the OECD or non-OECD states that fulfil certain credit rating criteria), the state sector or public local entities;
- b* mortgage bonds, guaranteed by rights in or security interests over real estate;
- c* movable property bonds, guaranteed by movable property rights or movable property collateral;
- d* cooperative covered bonds, guaranteed by claims against or debt securities issued by cooperative banks from the EU, the EEA or the OECD that participate in an institutional protection scheme meeting the requirements of the Banking Act 1993; and
- e* since early 2018, green covered bonds. These new green covered bonds, or renewable energy covered bonds, are guaranteed by rights in assets or securities linked to renewable energy, which include all energy produced from non-fossil renewable sources (i.e., wind energy, solar energy, thermal, geothermal, hydrothermal and marine energy (energy produced from non-fossil renewable sources)).

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<sup>36</sup> securitisation.questions@cssf.lu.

<sup>37</sup> Regulation (EU) 2017/2402 of 12 December 2017 laying down a general framework for securitisations and creating a specific framework for simple, transparent and standardised securitisations.

Bonds and other similar debt instruments issued by credit institutions established in a Member State of the EU, the EEA or the OECD or in a non-OECD state that fulfils certain credit rating criteria and that are secured by claims against public sector entities, by rights *in rem* over real estate, movable property, movable or immovable assets generating renewable energy, rights of substitution in essential project contracts or claims against or debt securities issued by cooperative banks may, subject to certain conditions, also serve as coverage assets. In addition, the coverage assets may encompass bonds or other debt securities issued by a securitisation undertaking and derivatives entered into for hedging purposes only (under certain circumstances).

Covered bond banks benefit from a derogation in the bankruptcy legislation whereby creditors have direct access to a bank's assets in cases of insolvency. The coverage assets may not be attached or seized by creditors of the covered bond bank other than the holders of the covered bonds.

Luxembourg covered bond banks may either be subject to reprieve from payment or liquidation proceedings under the Banking Act 1993. As from the commencement of any of these proceedings, one or more *ad hoc* managers appointed by the district court will manage the outstanding covered bonds and the coverage assets. The covered bonds and the corresponding coverage assets will not be affected by the above proceedings, in that the coverage assets underlying and securing covered bonds will be segregated from all other assets and liabilities of the covered bond bank. Reprieve from payment proceedings may also be opened in respect of any of the estate compartments established for each category or type of covered bond.

The success of the Luxembourg covered bond regime is based on different factors. First, given the international dimension of the Luxembourg covered bond framework, Luxembourg covered bond banks may lend to borrowers in all OECD countries. Second, Luxembourg covered bond banks may not only lend to states and regional entities but also to public undertakings where a state, or regional or local authorities exercise a direct or indirect influence. This is important, because it means that Luxembourg covered bond banks can reach a different but very lucrative segment in the world of public finance. As a result, a Luxembourg covered bond bank may practice an international diversification policy, with the result that Luxembourg covered bonds are less vulnerable to the risk of downgrading of sovereign ratings. Cover pools in Luxembourg are thus very dynamic and can be directed to target risk minimisation.

### ***Luxembourg limited partnership***

An Act dated 12 July 2013 (which implements the AIFMD) has modernised the Luxembourg limited partnership regime by reference to the Anglo-Saxon limited partnership, which is a popular investment vehicle for structuring venture capital or private equity investments.

There are three types of partnerships in Luxembourg: the common limited partnership (CLP), an *intuitu personae* partnership with legal personality; the newly introduced special limited partnerships (SLP), an *intuitu personae* partnership without legal personality; and the partnership limited by shares (SCA), a joint-stock company with partnership features.

Only technical adjustments have been made to the SCA regime as the SCA already benefits from an attractive regime with respect to the level of protection and control granted to the initiator of the structure. The SCA has already been widely used in investment structures.

The regime applicable to CLPs has been thoroughly overhauled to encourage the use of this type of investment vehicle. Furthermore, a new type of investment vehicle, the SLP,

which benefits from a favourable structural and tax regime, has been introduced. The SLP is an *intuitu personae* partnership that has no legal personality and that is subject to few statutory provisions. Most of its features may be freely determined in the limited partnership agreement entered into between the unlimited partners and the limited partners.

The key points of the new limited partnership regime (for CLPs and SLPs) are as follows:

- a* the identity of limited partners may remain confidential;
- b* the management of a limited partnership is entrusted to one or more managers, who may or may not be unlimited partners;
- c* the limited liability of a partner is not jeopardised if that partner performs internal management duties only;
- d* the rights of partners in the partnership are evidenced either by securities or by entitlements recorded in partnerships accounts; and
- e* there are no statutory restrictions on the issue and reimbursement of partnership interests; on the sharing by partners in the profits and losses; on the distributions to partners, whether in the form of profit distributions or reimbursements of partnership interests; on the voting rights; or on transfers of partnership interests.

By revamping its partnerships regime to address the current needs of market players, Luxembourg has further strengthened its position as one of the top European jurisdictions for the domiciliation of investment structures.

### **vii Future legislative changes**

#### ***Luxembourg trust***

The government is discussing the possibility of introducing the notion of a trust similar to the English trust or the Dutch *Stichting* into the Luxembourg legal framework with a view to strengthen, among other things, the Luxembourg wealth management sector. Discussions inspired by the works of the Haut Comité de la Place Financière, an advisory body to the government in matters concerning the financial sector, are currently ongoing at a national level.

#### ***Insolvency law***

The government is proposing an overhaul of the Luxembourg insolvency regime with a view to its modernisation. A bill to that effect is currently pending in Parliament providing for a legal framework prioritising (where practicable) the preservation or reorganisation of a debtor's business as opposed to the liquidation thereof. The proposed amendments include:

- a* the implementation of various mechanisms that help companies in financial difficulties to avoid bankruptcy proceedings and allow them to preserve their business;
- b* giving a second chance to businesspeople who in the past have acted in good faith, but nevertheless are subject to insolvency proceedings, to open a new business;
- c* preventing businesspeople whose business has failed and who have acted in bad faith from setting up new businesses;
- d* the implementation of mechanisms to protect employees and preserve jobs; and
- e* the amendment of certain specific provisions of the bankruptcy procedure with a view to its modernisation and the abolishment of certain obsolete insolvency procedures (e.g., controlled management and reprieve from payment) that are not (or are very rarely) used in practice.

### III OUTLOOK AND CONCLUSIONS

These continue to be challenging times. The financial crisis changed first into an economic recession and then into a public finance crisis. Although signs of recovery can be seen on the horizon for an increasing number of countries, the global economy remains fragile for various reasons (including the political instability in the Middle East and the slowdown of the economies of the BRIC<sup>38</sup> and Next Eleven<sup>39</sup> countries).

International bodies such as the International Monetary Fund (IMF), the Financial Action Task Force (FATF), the OECD and the European authorities want to set aside the competitive distortions that result from a regulatory playing field that is not level, and try to eradicate weaknesses in regulation and supervision that might adversely affect the stability of the international financial systems, by moving towards a single rulebook.

The financial sector plays a key role in Luxembourg's economy, and the Luxembourg authorities (especially the CSSF) strive to find the right balance between increased supervision and the need for sufficient room to manoeuvre to allow the financial sector to breathe and develop. The Luxembourg authorities recognise that the trend is towards a common supervisory culture and a harmonised application of a single rulebook that deprives them of large parts of their flexibility in the regulation and supervision of the financial sector.

To maintain the attractiveness of Luxembourg in a context where the regulatory framework becomes more and more harmonised, there are clear signals that the Luxembourg authorities want to differentiate themselves from their foreign counterparts via quality of service, responsiveness and approachability. The Luxembourg authorities are putting a particular focus on maintaining Luxembourg's role as the leading international renminbi (Chinese currency) centre in the eurozone, with six major Chinese banks now having established their European headquarters in Luxembourg, and one of the leading Islamic finance centres in Europe. Further, the Ministry of Finance has relaunched the Haut Comité de la Place Financière to create an institutionalised platform for the exchange of information between key stakeholders of the financial markets and the government, with a view to ensuring that Luxembourg stays at the forefront of economic and financial developments. Several working groups have been set up by the Haut Comité de la Place Financière to modernise Luxembourg's legal framework (including banking, fund, fintech and securitisation legislation) to respond to the needs of the markets and their players.

Since the Brexit vote, many UK-based financial actors have been looking for alternative locations to establish their operations. Luxembourg's key advantages include:

- a* the continued affirmation of an AAA rating for long-term and short-term sovereign credit;
- b* sound public finances;
- c* a rapid regulatory process;
- d* the business friendly attitude of the authorities;
- e* the leading position of the Luxembourg investment fund industry in Europe;

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38 Brazil, Russia, India and China.

39 Bangladesh, Egypt, Indonesia, Iran, Mexico, Nigeria, Pakistan, the Philippines, Turkey, South Korea and Vietnam.

- f* a large network of double taxation treaties;
- g* efficient immigration procedures; and
- h* Luxembourg being recognised as an innovative hub for fintech.

These features make Luxembourg a natural choice for locating new businesses and maintaining access to the European financial markets.



# MEXICO

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## I INTRODUCTION

The Mexican securities regulatory framework includes federal regulations, general laws and specific rules applicable to all capital markets participants. The National Banking and Securities Commission (CNBV) is the central regulator of the Mexican Stock Exchange, Bolsa Mexicana de Valores (Bolsa) and Bolsa Institucional de Valores (BIVA) (jointly, Stock Exchange) and of all other capital markets participants, such as underwriters, broker dealers, issuers and custodians. The key capital markets statutes include the Securities Market Law, which provides the general operational framework for securities commercial acts, and the general rules and regulations issued by the CNBV (particularly relevant are the General Provisions Applicable to Issuers and Other Participants of the Securities Market (General Provisions) and the General Provisions Applicable to Entities and Issuers Regulated by CNBV that Contract External Audit Services for Basic Financial Statements), Banco de México (the Mexican Central Bank) and the Stock Exchange, which include:

- a* general regulations applicable to issuers of securities and other market participants;
- b* the Stock Exchange Internal Regulations;
- c* BIVA Internal Regulations;
- d* Indeval (the central securities depository for the Mexican securities market) Internal Regulations;
- e* general regulations applicable to the Stock Exchange; and
- f* general regulations applicable to broker-dealers.

The General Law of Negotiable Instruments and Credit Transactions provides the regulatory regime for the special purpose vehicle that is widely used in securitisations transactions: the Mexican trust. It also sets forth the basic rules applicable to trust certificates, which are used in many Mexican structured finance transactions and also regulated by the Securities Market Law as fiduciary stock certificates. A separate legal framework that is important to consider when working on a capital markets transaction are the mutual funds regulations, including the investment regime governing specialised retirement fund investment companies and the general financial provisions of the pension fund system.

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Other legislative and regulatory regimes may apply depending on the type of underlying assets involved, for example civil legislation when dealing with mortgages, special requirements and formalities for the transfer of certain types of receivables, and requirements for the transfer of receivables by local or municipal governments.

The General Provisions, which also apply to securitisations transactions, are considered the most important secondary rules relating to securities, after the Securities Market Law.

Further regulations enacted by the CNBV and the Stock Exchange may apply to public offerings related to securitisations. The CNBV acts as the main supervisory and regulatory authority in connection with publicly issued securities.

The main finance regulator in Mexico is the Ministry of Finance and Public Credit (Ministry). The Ministry is responsible for facilitating transactions and promoting the development, expansion and competitiveness of the market. The Ministry acts through the CNBV, which is an independent agency and the main regulator of the Stock Exchange. Some of its most important powers include:

- a* the supervision and regulation of market participants;
- b* the authorisation of public and private offerings;
- c* investigating, requesting information and issuing advice and warnings to market participants;
- d* approval of the internal operation of the Stock Exchange; and
- e* managing and overseeing the National Securities Registry.

The Pension Funds System Commission (Consar) is particularly important in the securities market in Mexico as it overviews and authorises (together with the Ministry and Banco de Mexico) the investment regime, levels of liquidity and market risk for pension fund managers, which are institutional investors that typically participate in these types of transactions.

## **II THE YEAR IN REVIEW**

### **i Developments affecting debt and equity offerings**

#### ***Mexican presidential elections***

On 1 July 2018, presidential elections took place in Mexico, and the new President, Andrés Manuel López Obrador, took office on 1 December 2018. Mr López was elected on the back of his focus on shaking up the status quo of the country. Some of his first decisions after taking office included cancelling the New Mexico City Airport, the most important infrastructure project of the past few years. Some of President López's decisions have reduced investor confidence in Mexico, de-accelerating capital markets transactions in the country.

#### ***Proposed amendments to the investment regime of specialised retirement fund investment companies and the general financial provisions of the pension fund system***

The past year saw several regulatory changes being proposed by the CNBV, the Ministry and Consar. There is an upcoming overhaul of the investment regime of specialised retirement fund investment companies and the general financial provisions of the pension fund system, and such amendments will impact investments of pension funds in the capital markets. A bill was introduced and approved by Congress, and is subject to approval under the legislative process. Some of the most relevant proposed amendments include the following:

- a* a new operating model for pension fund managers whereby they will operate through specialised investment funds of retirement funds that replace the specialised retirement fund investment companies;
- b* specialised investment funds of retirement funds will have access to greater investment opportunities than specialised retirement fund investment companies, including the possibility of investing directly in securities registered in the National Securities Registry not offered through a public offering (subject to certain conditions);
- c* fees charged by pension fund managers will have an additional component that will be calculated on the basis of the investment returns received by pension holders through their investments in the specialised investment funds of retirement funds; and
- d* pension holders will be allowed to withdraw their voluntary deposits from their retirement funds at any time.

### ***United States–Mexico–Canada Agreement***

The United States–Mexico–Canada Agreement (USMCA) was signed in late 2018 by the President of the United States, the President of Mexico (at that time, Mr Enrique Peña Nieto) and the Canadian Prime Minister. USMCA includes relevant changes to the free trade agreement entered into among the parties in 1994 known as the North America Free Trade Agreement. Some of the most relevant changes include changes for automakers, stricter labour and environmental standards, intellectual property protections and digital trade provisions. USMCA is pending approval from the legislatures of the United States and Canada. USMCA is likely to be ratified in the US Congress this year, which will be viewed favourably by global investors and should be a positive sign for the Mexican economy.

### ***Tax incentives for initial public offerings and interest payments to non-resident holders of corporate bonds***

Pursuant to a Presidential Decree issued by Mr Lopez, in 2019, 2020 and 2021 a reduced 10 per cent income tax rate may be applied by Mexican resident individuals, and by non-resident individuals or entities, on the profits obtained by such taxpayers from the sale of shares issued by Mexican companies that qualify as Mexican residents for tax purposes, provided that such sale takes place through an authorised stock exchange and other relevant conditions are complied with. The Decree also provides a new tax incentive applicable to those Mexican residents who are required to apply a withholding tax on interest paid to non-resident holders of publicly traded bonds issued by Mexican-resident companies placed through an authorised stock exchange, consisting of a tax credit equivalent to 100 per cent of said withholding tax (which will be creditable only against such withholding tax). The credit will be available provided that no tax is withheld upon when making the payment to non-residents, who must reside in countries that have entered into a tax treaty or into a broad agreement for the exchange of information with Mexico; it is also established that the credit will not give rise to a refund or offset against other taxes.

### ***Relevant capital markets transactions***

Some of the most relevant recent capital markets transactions include:

- a* Promecap Acquisition Company, SAB de CV, issued a second special purpose acquisition company (SPAC) for 5,577.93 million pesos in a global initial public offering (IPO);
- b* Sherpa Capital, SAPI de CV, Asesor en Inversiones Independiente and Actinver Casa de Bolsa, SA de CV, Grupo Financiero Actinver, División Fiduciaria issued an exchange traded fund called QVGMEX;
- c* three new FIBRAs (investment trust vehicles under Mexican law dedicated to the acquisition and development of real estate assets in Mexico intended for leasing) were placed into the market (Fibra Storage, Fibra Educa and Fibra Upsite); and
- d* Grupo Casa Sabe, SAB de CV and Rassini, SAB de CV delisted their shares from the Stock Exchange.

In addition to the local exchange, the Stock Exchange manages the International Trading System, which is an electronic conduit to trade shares listed on other stock exchanges. Over the past 12 months, 455 new foreign companies were listed on the International Trading System, including Pinterest and Uber. Foreign companies may be listed on both Stock Exchanges together with local companies.

### **ii Developments affecting derivatives, securitisations and other structured products**

New instruments and products have recently arrived to the Mexican capital markets, and existing products have been made more sophisticated by market participants, with over 76 equity development certificates (CKDs); 18 CERPIs (investment project trust certificates that are issued through a trust and placed through the Mexican Securities Market); 16 FIBRAs; three FIBRA Es (investment vehicles intended for energy and infrastructure projects that issue trust certificates (CBFEs) listed on the Stock Exchange; and two special purpose acquisition companies (SPACs) listed on the Stock Exchanges. The Mexican capital markets have entered into a new stage of complexity and regulatory challenge that will create interesting new ventures in the years to come.

### ***SPACs***

In August 2017, Vista Oil & Gas, SAB de CV launched the first SPAC on the Stock Exchange for 11,689 million pesos, and in March 2018, Promecap Acquisition Company, SAB de CV listed the second SPAC in the Stock Exchange for 4,407 million pesos with the purpose of investing funds in family-owned companies, private equity and public companies engaged in fast-growing sectors over a 24-month period.

SPACs are publicly-traded vehicles that are formed to facilitate a business combination. They are also called 'blank cheque companies'. SPACs issue units that are listed on the Mexican securities markets, which consist of shares and warrants (or portions of warrants). Warrants have the shares of a public company as underlying assets. Each whole warrant entitles the holder to purchase one share of common stock upon a business combination at a preferential price. Warrants act as compensation for investors.

Approval by shareholders is required to execute a business combination. Primarily institutional (including Mexican pension funds) and retail investors participate in these kinds of offerings. A public offer may be carried out globally (Mexican public offer plus Rule 144 A/Reg S). Sponsors acquire founder or insider units, typically resulting in the ownership of a percentage of common stock of the company.

Some of the advantages of SPACs include:

- a* timing: the time period for listing a SPAC (90 days) is faster than for listing of an IPO (nine to 10 months);
- b* flexibility: the regulatory requirements for SPACs are more flexible and less restrictive than those of IPOs; therefore, SPAC managers have more flexibility in conducting their business; and
- c* tax structure: contributions for future capital increases are treated as debt for Mexican tax purposes, which facilitates reimbursement to investors in the event that the SPAC is not successful. Essentially, SPACs provide a sponsor with immediate access to funding to conduct a specific transaction (merger, acquisition or asset sale) within a 12 to 24 month time frame, and once the transaction is completed, a new publicly traded company shall be formed.

### ***CERPIs***

CERPIs (just as CKDs do) resemble the model of international private equity funds, with corporate structures that rely heavily on the expertise and track record of the general partner (GP) or fund manager. CERPIs typically invest in real estate, private equity, debt, energy and infrastructure, and potential sponsors may be, among other things, private equity funds, real estate developers, asset managers and energy services providers.

Through CERPIs, GPs or fund managers may access resources from Mexican pension funds to be invested or co-invested in projects outside Mexico. Projects shall remain under the management scope of the sponsor or manager of the CERPI. The foregoing is possible due to the above-mentioned recent amendment to the investment regime for specialised retirement fund investment companies.

CERPIs provide for less stringent corporate requirements and approvals of investors, giving GPs and fund managers more flexibility to manage a fund; however, at least 10 per cent of a fund's maximum authorised amount must be invested in Mexico, and a 2 per cent mandatory co-investment by the sponsor or manager in each sponsored project is required. CERPIs provide flexible corporate governance because different series of CERPIs may be issued, including preferred series.

### ***FIBRAs***

FIBRAs are similar to real estate investment trusts (REITs) in the United States. This vehicle provides a new investment opportunity for investors.

The current legal structure of a FIBRA stems from a series of reforms enacted over the past several years to:

- a* various provisions of the Mexican tax laws and regulations;
- b* securities legislation;
- c* the investment regime of the Mexican pension fund administrators enabling tax-friendly investment in FIBRAs by Mexican pension funds; and
- d* annual omnibus tax regulations issued by the Ministry of Finance.

The main benefits of investment in a FIBRA (relative to other investments) are:

- a* the potential for a high return on investment (on a cash basis) due to the requirements for distribution of net taxable income, and the potential for capital appreciation of real estate trust certificates (CBFIs) commensurate with increases in value of the real properties held by the FIBRA;

- b* access to the Mexican real estate market as an investment option through a security that may be traded easily and has a readily identifiable market price;
- c* broader diversification with respect to geographic exposure and property type for investors seeking to invest in the Mexican real estate market or generally for their investment portfolio;
- d* FIBRAs may serve as a vehicle to attract foreign investment into Mexico; and
- e* applicable tax benefits. FIBRAs must distribute at least 95 per cent of net taxable income to investors on an annual basis.

As previously mentioned, between 2018 and 2019 three FIBRAs were launched in Mexico: Fibra Upsite, Fibra Educa and Fibra Storage.

A particularly positive aspect of FIBRAs (as opposed to CKDs) is that they have regularly been structured both with a national listed tranche on the Stock Exchange and with a foreign tranche issued through Rule 144-A and Reg-S regulations. The foregoing has permitted the diversification of the investor base, which is otherwise dominated by Mexican pension funds (pension fund managers).

Recently, investors have pushed for a change in the management structure of FIBRAs to internalise their external advisers and managers following the United States model of REITs, most of which have an internal management structure.

### **FIBRA E**

One of the key features of a FIBRA E is the tax benefits that it provides its investors, as the investment vehicle and the portfolio companies through which investments are held in such infrastructure and energy assets are deemed transparent from a tax perspective. The vehicle is a hybrid that draws on two US financial products: REITs and master limited partnerships. Mexico adopted its own version of REITs in 2001, under the name of FIBRAs, as described above. As provided by the Securities Law, the CBFEs shall grant their holders a *pro rata* property right with respect to trust assets.

Under a FIBRA E, a corporate sponsor will contribute to the FIBRA E equity interest in certain Mexican legal entities (promoted companies) that own and operate assets for the performance of specific activities, namely infrastructure, electricity (generation, distribution, and transmission) and energy. The sponsor will receive cash or CBFEs in return for its contribution to the FIBRA E. To structure the contribution of the applicable assets and the operation of the business of the FIBRA E, relevant tax, legal and accounting issues must be taken into account. Regulatory and contractual approvals such as licences, permits, public grants and concessions, and debt covenants must also be taken into consideration.

In August 2017, the Mexican securities regulator issued its approval for the first multi-FIBRA E registration programme for a total issuance amount of up to 50,000 million pesos. The programme will allow the sponsor, CKDIM, to create sectoral FIBRA Es for energy and infrastructure projects.

In February 2018, the Federal Electricity Commission placed the first FIBRA E focused on the energy sector. The issuing trust will receive 100 per cent of the collection rights under a certain commercial operation agreement for electric power transmission, and the proceeds from the issuance will be used to modernise and expand the national transmission grid. The public offering was placed in the Stock Exchange and in other international markets. Again in 2018, another FIBRA E was issued for the construction of the new Mexico City International

Airport. However, construction of the new airport was cancelled by the Mexican federal government, and an early redemption of the CBFEs was approved by the certificate holders in early 2019.

### ***CKDs***

The most common and highly used structured instruments in Mexico as of today are CKDs, which are trust certificates listed and traded on the Stock Exchange whose purpose is to serve as a means of investment in companies, and in infrastructure, real estate and industrial projects. CKDs grant the right to participate in a portion of the proceeds, assets or rights that comprise the trust assets. The CKD trust shall have the purpose of investing in projects or in equity of target companies.

CKDs do not provide an unconditional payment obligation of principal and interest, as they are equity-like securities. They impose certain corporate governance obligations similar to those of publicly traded companies. If their investment regime allows, Mexican and foreign investors are allowed to invest in CKDs as long as they state in writing to the placement agent or the underwriter that they are aware of the risks associated with these types of notes.

The vast majority of CKD issuances that have come to market in Mexico during the past few years have been aimed towards the infrastructure and real estate industries, although the applicable law allows for the funds raised through CKDs to be invested in other areas. As previously indicated, the success of a CKD heavily relies on the management team in charge of identifying and developing the respective projects.

The first generation of CKDs are about to start their divestment and liquidation processes, moving into exits and asset sales and other divestiture options that will create new opportunities and challenges in the capital markets.

### **iii Cases and dispute settlement**

The CNBV has the main jurisdiction regarding oversight and regulation of the activities of all capital markets participants; its supervisory authority includes powers to sanction in cases of non-compliance and powers to enforce such sanctions. Any resolution entered into by the CNBV may be appealed before federal administrative courts using a writ for *amparo* proceedings. However, any disputes existing between financial firms and consumers must be first resolved by Condusef, the National Commission for the Defence of Users of Financial Services.

### ***Increased antitrust oversight***

As a result of recent reforms to the antitrust law, Cofece, the Mexican Antitrust Commission, now has enhanced powers, and has increased its oversight and investigative activity, with a number of investigations that have concluded with record fines. In 2017, Cofece launched an investigation against banks and other financial intermediaries for potential collusion and manipulation of the primary and secondary markets. The investigation prompted the CNBV to commence a similar investigation. The Cofece and CNBV investigation is expected to conclude in the second semester of 2019.

#### **iv Relevant tax and insolvency law**

There are very specific rules that apply to Mexican trusts that should be carefully analysed when implementing a securitisation or a structured finance transaction. In the case of securitisations, it is generally intended that the transfer of assets into a trust is treated as a sale for legal but not for tax purposes, inasmuch as the settlor of the assets retains a right to reacquire the transferred assets once payment of the corresponding securities has been made. The trust should not be classified as a separate entity for tax purposes. Intermediaries and brokers must determine and withhold the income tax applicable on income earned by securities holders.

In general, the tax regime applicable to securitisations and structured finance transactions is defined by the terms and nature of the securities being issued, and tends to be the same as or similar to the regime applicable to the assets underlying the securities or type of structure.

#### **v Role of exchanges, central counterparties and rating agencies**

##### ***Role of exchanges***

Any stock exchange operating in Mexico requires an approval by the Ministry of Finance and the favourable opinion of Banco de México and the CNBV. Any concession granted to create and operate a stock exchange must be provided considering the better development of the market. To date, two exchanges operate in Mexico: Bolsa and BIVA, both located in Mexico City. They are both supervised by the CNBV and their own independent committees, and they each have the ability to sanction their members and even delist certain securities, subject to first obtaining the opinion of the CNBV.

The two exchanges have issued their own internal regulations that establish their internal procedures for listings of all kinds of instruments, along with terms and conditions for trading, record-keeping, information publishing, and listing and maintenance fees.

##### ***Central counterparties***

Providing the service of central counterparty (CCP) is considered a public service under Mexican regulations; therefore, a public concession granted by the Ministry of Finance and the favourable opinion of Banco de México and the CNBV are required.

Only two concessions by the federal government have been granted to operate CCPs in Mexico; Contraparte Central de Valores, which clears transactions on Bolsa and BIVA, and Asigna, Compensación y Liquidación, which is the CCP for the Mexican Derivatives Exchange (MexDer), for derivatives transactions. Banco de México has exclusive powers to supervise all CCPs in Mexico, as well as approving the operations of any CCP.

##### ***Rating agencies***

Rating agencies in Mexico require authorisation from the CNBV to operate as such. Their main purpose is the habitual and professional rendering of services consisting of the analysis, opinion, evaluation and reporting of the credit quality of securities. The authorisation granted by the CNBV is non-transferable under any circumstances.

Rating agencies are supervised by the CNBV and must follow the processes and methods established by the CNBV through the issuance of general provisions.



### **III OUTLOOK AND CONCLUSIONS**

The Mexican capital markets have developed exponentially over the past decade, particularly in terms of regulations and new instruments designed to attract investment to projects and additional value for both companies and investors. Pension fund managers remain the main investors in the sort of transactions described in this chapter. Although the sophistication of the Mexican capital markets is reaching the top of its game and continues to improve, heightened policy uncertainty has slowed (and in some cases stopped) new issuances in the Mexican Stock Exchange. While tax, infrastructure and economic reforms over the past several years have helped stabilise the country, international and local investors face uncertainty from some of the new presidential administration's policies. Most recently, policy uncertainty increased after the cancellation of the New Mexico City Airport, which was meant to be financed by a FIBRA E issuance in 2017. The USMCA has aided the economy; however, it is yet to be ratified by the legislatures of the United States and Canada.

# NETHERLANDS

*Marieke Driessen and Niek Groenendijk<sup>1</sup>*

## I INTRODUCTION

### i General overview

As the Netherlands is an EU Member State, Dutch capital markets law and regulation are heavily influenced by EU law. EU Directives are implemented in Dutch law, generally in time and without substantial deviation, while EU Regulations have direct effect in the Netherlands, including the Prospectus Regulation.<sup>2</sup> Most of the EU Directives relevant to the capital markets (including the Capital Requirements Directive<sup>3</sup> and the Transparency Directive)<sup>4</sup> have been implemented in the Dutch Financial Supervision Act, which sets out the main licensing and other requirements for participants in the financial markets. Legislative acts, such as the Dutch Financial Supervision Act, are adopted by the Dutch parliament and often delegate the power to stipulate detailed rules to ministers of the government by way of decrees and regulations.

### ii Regulatory authorities

The Dutch capital markets are supervised by the Dutch Authority for the Financial Markets (AFM), which focuses on supervision of the financial markets and its participants, and the Dutch Central Bank (DCB), which focuses on the prudential supervision of financial institutions, with certain (intervention) powers reserved to the Minister of Finance. Since the introduction of the EU Banking Union, certain large Dutch credit institutions are under the direct supervision of the European Central Bank regarding prudential matters, whereas other Dutch credit institutions remain under the direct supervision of the DCB (with the European Central Bank conducting indirect supervision through the DCB).

The supervisory authorities may conduct industry-wide or institution-specific investigations and may impose administrative sanctions, including administrative fines and the publication of findings and fines. The authorities may also refer (suspicions of) criminal offences or crimes to the public prosecution service, which may then conduct its own investigation and bring criminal charges through the criminal court system. Where areas of

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2 Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017.

3 Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms.

4 Directive 2013/50/EU of the European Parliament and of the Council of 22 October 2013 amending Directive 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market.

Dutch or EU capital markets law are not clear, the AFM in particular may issue guidance in the form of guidelines applicable to the market generally, or interpretations applicable to a given case. It will generally not provide the latter on a no-names basis.

Ultimately, the Dutch courts interpret and enforce Dutch capital markets law, which may overturn decisions of the supervisory authorities (which they do on occasion).

### **iii Litigation**

The Netherlands has a reputation for an independent, high-quality and generally efficient court system that operates on the basis of a pragmatic code of civil procedure. Litigation before the courts is based on the principle of party autonomy where, subject to certain exceptions, the jurisdiction of the courts is limited to the claims, arguments and defences submitted to the courts by the relevant parties. Judges play an active role in case management and fact finding. Court proceedings do not allow for US-style discovery, with the exception of a few, narrowly defined instances only.

Litigation is generally conducted before the courts of first instance, with the possibility of appeal as to both fact and law to the courts of appeal, and a further possibility to appeal – on the grounds of law, but not fact – to the Supreme Court of the Netherlands. Dutch courts may refer doubts about the correct interpretation or application of EU law to the EU courts or questions about the correct interpretation or application of Dutch law to the Supreme Court.

For the Dutch equity capital markets in particular, an important specialised court is the Enterprise Chamber of the Amsterdam Court of Appeals, which may, for example, conduct internal investigations in respect of Dutch companies at the initiative of certain shareholders holding a *de minimis* shareholding, for example in the context of takeover bids.

In recent years, the Netherlands has positioned itself as a hub for the resolution of international civil and commercial disputes, in the fields of both arbitration and litigation. The Netherlands Commercial Court (a division of the Amsterdam courts) was created on 1 January 2019, allowing court proceedings to be conducted in English before the Dutch courts in Amsterdam.

## **II THE YEAR IN REVIEW**

There have been extensive legal and regulatory changes affecting capital market transactions and market participants during 2018 and 2019. Some of the most significant developments affecting the capital markets generally, the debt capital markets specifically and the equity capital markets in particular are described below. This overview concludes with legal and regulatory developments affecting financial institutions active in the capital markets.

## i Developments affecting capital markets generally

In 2018 and 2019, the European and Dutch capital markets were affected by the entry into force of the Markets in Financial Instruments Directive (MiFID II)<sup>5</sup> and the Markets in Financial Instruments Regulation (MiFIR),<sup>6</sup> certain elements of the Prospectus Regulation<sup>7</sup> and the Benchmarks Regulation.<sup>8</sup>

### *MiFID II and MiFIR*

A major focus of capital market participants were the changes brought by MiFID II, which affected the licensing of market participants, documentation and capital markets transactions directly in a significant way for years to come.

### *Product governance: target markets*

MiFID II introduced a new product governance regime applicable to firms that manufacture financial instruments (manufacturers) or distribute the same to end investors (distributors), or both.

For the purposes of MiFID II, manufacturers are MiFID firms ‘that create, develop, issue and/or design financial instruments, including when advising corporate issuers on the launch of new financial instruments’<sup>9</sup> whereas distributors are MiFID firms ‘that offer or sell financial instruments and services to clients’.<sup>10</sup>

As such, any MiFID firm issuing financial instruments may be considered to be a manufacturer. However, the position is less clear in relation to managers and underwriters. Owing to the broad scope of the definitions of the terms manufacturer and distributor, the common view is that, in the context of a typical issuance of debt instruments, the (joint) lead managers involved may qualify as both manufacturers and distributors (or co-manufacturers and distributors), whereas more passive managers potentially only qualify as distributors (and not as manufacturers). That said, this is not a hard rule that can be observed in all circumstances. An assessment will always need to be made, for each case, as to who is a manufacturer and who is a distributor (or both) with regard to the activities performed by the relevant managers and underwriters.<sup>11</sup>

5 Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments.

6 Regulation (EU) No. 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments.

7 Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market.

8 Regulation (EU) 2016/1011 of the European Parliament and of the Council of 8 June 2016 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds.

9 Commission Delegated Directive (EU) 2017/593 of 7 April 2016, Recital 15.

10 Id.

11 Note that in the context of Euro Commercial Paper programmes, a common market understanding seems to have arisen that in certain cases the relevant arranger and dealers are not to be considered manufacturers (although an assessment will always need to be made on a case-by-case basis). This may be the case in particular when parties take a more administrative role and do not advise the issuer on the structuring of the products issued under the programme.

### ***MiFID II requirements applicable to manufacturers***

A manufacturer of financial instruments must, among other things:

- a* identify a target market for the relevant financial instruments, ensuring that the distribution strategy is consistent with the target market and taking reasonable steps to ensure that the financial instruments are distributed to the target market;
- b* regularly assess whether the relevant financial instrument remains consistent with the needs of the identified target market;
- c* provide distributors with information on, among other things, the appropriate distribution channels and the identified target market in order for the distributors to understand and recommend or sell the relevant financial instruments in a proper manner; and
- d* enter into a written agreement with co-manufacturers (including third-country firms and non-MiFID firms, which perform the same activities as a manufacturer) outlining their mutual responsibilities. A written agreement is typically included in the subscription or underwriting agreement on the basis of industry standards developed by the International Capital Markets Association.

### ***MiFID II requirements applicable to distributors***

Pursuant to MiFID II, a distributor of financial instruments must, among other things, identify its own target market and distribution strategy using the information obtained from manufacturers and information about their own clients;<sup>12</sup> and provide manufacturers with information about sales and, where appropriate, other information that would support the manufacturers in their product review.

As distributors, in practice, rely on information given to them by the manufacturers of financial instruments when recommending or selling financial instruments, the MiFID II product governance rules are likely to affect a large number of transactions with an EEA nexus – where the financial instruments are to be distributed within the EEA – even where the issuer and entities performing the function of manufacturer are not subject to MiFID II themselves. As such, identifying a target market and forming an appropriate distribution strategy is something that non-EEA firms and issuers will need to take into consideration going forward if there is an intention to reach EEA investors.

In the context of the above, it can be noted that the AFM deems a variety of complex financial products as not suitable for marketing to retail clients. For example, contingent convertible securities (CoCos) are deemed not suitable for retail clients unless on an advised basis, contracts for differences are deemed suitable only if certain conditions specified in a decision issued by the AFM have been satisfied<sup>13</sup> and binary options – a product which in the view of the AFM almost always leads to losses in the long term – are deemed not suitable for retail investors in any case whatsoever.<sup>14</sup>

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12 Although, where an MiFID firm acts as both a manufacturer and distributor, only one target market assessment is required.

13 Decision dated 18 April 2019, to temporarily restrict the marketing, distribution or selling of contracts for differences to retail clients in accordance with Regulation (EU) No 600/2014.

14 Decision dated 18 April 2019, to prohibit the marketing, distribution or sale of binary options to retail clients in the Union in accordance with Regulation (EU) No 600/2014.

### ***Underwriting and placing***

MiFID II also introduced additional requirements on MiFID firms underwriting and placing financial instruments relating to conflicts of interest that may arise between MiFID firm placing and underwriting financial instruments and its issuer-client.

Conflicts identified in the context of the provision of underwriting and placing services include, among others, the following situations:<sup>15</sup> corporate finance advice provided prior to underwriting and placing (which requires adequate prior disclosure of the available financing alternatives), pricing and allocation of financial instruments (which are both subject to policy and transparency requirements), the combination of underwriting and distribution or the existence of a previous credit relationship (with both required to be addressed in conflict of interest policies and being subject to organisational requirements).

### ***Inducements***

Prior to the coming into force of MiFID II, the Netherlands had already introduced an inducement ban prohibiting MiFID firms from paying or receiving inducements (directly or indirectly) in connection with the provision of investment and ancillary services to non-professional investors (subject to limited exceptions)<sup>16</sup> meaning that, in general, only direct payment by a non-professional client for the investment services is permitted. The Dutch inducement ban applies to all MiFID firms providing investment or ancillary services in the Netherlands, with the exception of EEA MiFID firms providing such services in the Netherlands solely on a cross-border basis pursuant to the EEA passporting regime, and continues to apply in addition to the MiFID II rules described below.

In addition to the Dutch inducement ban, the enactment of MiFID II has introduced a regime that applies to inducements received by MiFID firms in connection with the provision of all investment services to all types of investors (unlike the Dutch inducement ban, which only applies to investment services provided to non-professional investors). However, the inducement regime does not apply to execution-only investment services provided to eligible counterparties.<sup>17</sup> Under the MiFID II inducement regime, MiFID firms are generally prohibited from paying or being paid any fee or commission, or providing or being provided with any non-monetary benefit in the context of the provision of an investment or ancillary service by a party other than to or by the client (or a person acting on behalf of the client).<sup>18</sup>

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15 In general, see Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014, Articles 16(3), 23 and 24.

16 See the Market Conduct Supervision Financial Institutions Decree, Article 168a. Exceptions apply, among other things, to inducements that enable or are necessary for the provision of the investment service, (e.g., custody costs, settlement and exchange fees, regulatory levies or legal fees) and minor non-monetary benefits within the meaning of Commission Delegated Directive (EU) 2017/593 of 7 April 2016, Article 12(3), provided the client is informed of such minor non-monetary benefits prior to the commencement of the provision of the services. Further specific exceptions apply to underwriting and placing investment services, provided that certain transparency requirements are met, the inducement enhances the quality of the investment service, and the inducement does not lead to conflicts of interest and does not impair the MiFID firm's duty to act in accordance with the best interests of its non-professional client.

17 Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014, Article 30(1).

18 Contrary to the Dutch inducement ban, MiFID firms are allowed to receive inducements from third parties provided they forward such amounts directly to their client.

An exception applies, however, where the payment or benefit is designed to enhance the quality of the service, and does not impair the MiFID firm's duty to act honestly, fairly and professionally in accordance with the best interest of its client.<sup>19</sup>

Stricter requirements apply where the MiFID firm has informed its client that it is providing independent investment advice and where the MiFID firm is providing the investment service of portfolio management, in which case the MiFID firm is not entitled to receive non-monetary benefits (other than certain minor non-monetary benefits<sup>20</sup> that are capable of enhancing the quality of service provided to a client and are disclosed to the client), and may only accept and receive fees, commissions or monetary benefits received from third parties in the context of such services where they are transferred in full to the client as soon as reasonably possible after receipt.<sup>21</sup>

### **Research**

One significant change introduced by MiFID II is that investment research<sup>22</sup> is now expressly considered to be a non-monetary benefit (even where there is no clear inducement possibility, because, for example, the provider of the investment research does not offer any execution services). This has had a significant impact on MiFID firms providing portfolio management services and independent investment advice given that such firms are, in principle, not allowed to receive non-monetary benefits except under very limited circumstances as described above. Under MiFID II, investment research shall not be considered a prohibited inducement, however, where the investment research is paid by the MiFID firm out of its own resources, or where the investment research is paid for from a separate research payment account controlled by the MiFID firm,<sup>23</sup> provided that certain conditions regarding the operation of the account are met.<sup>24</sup>

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- 19 Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014, Article 24(9). In addition, similar to the Dutch inducement ban, exceptions apply to, among other things, payments or benefits that enable or are necessary for the provision of the relevant investment services (e.g., custody costs, settlement and exchange fees, regulatory levies or legal fees) (Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014, Article 24(9)).
- 20 Within the meaning of Commission Delegated Directive (EU) 2017/593 of 7 April 2016, Article 12(3).
- 21 Commission Delegated Directive (EU) 2017/593 of 7 April 2016, Article 12(1).
- 22 Within the context of MiFID II, investment research should be understood broadly, covering material and services regarding financial instruments or other assets, the (potential) issuers thereof, or the material or services that are closely tied to a specific industry or market so that it informs a view in relation to financial instruments and other assets and issuers within that sector. The key elements for material and services to qualify as investment research is that they must explicitly or implicitly recommend or suggest an investment strategy, and provide a substantiated opinion as to the current or future value or price of the financial instruments or assets, or otherwise contain analysis and original insights and reach conclusions based on new or existing information that could be used to inform an investment strategy and be relevant and capable of adding value to the MiFID firm's decisions on behalf of the relevant clients. See Commission Delegated Directive (EU) 2017/593 of 7 April 2016, Recital 28.
- 23 Commission Delegated Directive (EU) 2017/593 of 7 April 2016, Article 13.
- 24 These conditions are that the research payment account is funded by a specific research charge to the client; as part of establishing a research payment account and agreeing the research charge with its clients, the MiFID firm sets and regularly assesses a research budget as an internal administrative measure; the MiFID firm is held responsible for the research payment account; and the MiFID firm regularly assesses the quality of the research purchased based on robust quality criteria and its ability to contribute to better investment decisions. See Commission Delegated Directive (EU) 2017/593 of 7 April 2016, Article 13(1)(b).

In practice, many large portfolio managers have opted to absorb the costs of investment research themselves, although no uniform practice throughout Europe can be discerned at this moment. For example, various large portfolio managers have also opted to set up a research payment account, or have opted to pay for research through a combination of both a research payment account and their own resources.

### ***The Prospectus Regulation***

The Prospectus Regulation was published in the Official Journal of the European Union on 30 June 2017, entering into force on 20 July 2017. All of the provisions of the new Regulation have effect since 21 July 2019, with certain provisions having taken effect at an earlier date.

#### *Revisions to the exceptions to the obligation to publish a prospectus*

Under the Prospectus Regulation, the obligation to publish a prospectus is still triggered when securities are offered to the public or admitted to trading on a regulated market situated or operating within an EEA Member State. However, certain exceptions to this obligation already existed under the Prospectus Directive, some of which have been expanded or restricted under the Prospectus Regulation.

#### *Fungible issues*

As of 20 July 2017, the requirement to publish a prospectus does not apply to the admission to trading on a regulated market of securities fungible with securities already admitted to trading on the same regulated market, provided that the securities represent, over a period of 12 months, less than 20 per cent of the number of securities already admitted to trading on the same regulated market.<sup>25</sup> (This exception is up from 10 per cent under the equivalent exception under the Prospectus Directive.) In addition, contrary to the equivalent exception under the Prospectus Directive, the exception under the Prospectus Regulation applies to all securities and not only to shares, meaning that tap issues for listed notes (that are not being offered to the public) may now benefit from the exception, provided that the issuer remains compliant with the aforementioned 20 per cent limit.

#### *Conversion*

As of 20 July 2017, additional restrictions are imposed on the exception to the obligation to publish a prospectus for admission to trading on a regulated market in connection with shares resulting from the conversion or exchange of other securities or from the exercise of the rights conferred by other securities. Under the Prospectus Directive, this conversion exception was not subject to any sort of quantitative limit, whereas under the Prospectus Regulation, the exception only applies where the resulting shares represent, over a period of 12 months, less than 20 per cent of the number of shares of the same class already admitted to trading on the same regulated market (subject to certain exceptions, notably where a prospectus was

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25 Ibid., Article 1(5)(a).



published for the securities that had been converted, and where the conversion shares qualify as certain types of capital instruments under the Capital Requirements Regulation<sup>26</sup> or the Solvency II Directive<sup>27</sup>).<sup>28</sup>

### *Small offers of securities*

As of 21 July 2018, the Prospectus Regulation prescribes that the Prospectus Regulation shall not apply to an offer of securities to the public with a total consideration in the EEA of less than €1 million, which shall be calculated over a period of 12 months.<sup>29</sup> In addition, the new Regulation provides for the option of allowing Member States, at their discretion, to exempt offers in the EEA of up to €8 million over a period of 12 months. The Dutch legislator has made use of this Member State option, setting the maximum amount at €5 million (up from €2.5 million), meaning that offers of securities to the public with a total consideration in the EEA of less than €5 million over the past 12 months does not require the publication of a prospectus under Dutch law. For the purposes of calculating the maximum amount, the offerings of the issuer and its affiliates shall be aggregated.

For offerors to make use of this exception, Dutch law prescribes that the offeror must notify the AFM of the offering prior to its commencement, and simultaneously provide the AFM with certain information regarding the issuer, the offeror and the offering, and an information document in the form prescribed by law.<sup>30</sup> In addition, if the offer is not solely made to qualified investors, additional standard exemption disclosure language is required to be included in documents regarding the offering for offerors to make use of this exception.

### ***The Benchmarks Regulation***

In the wake of various benchmarks-related scandals, the Benchmarks Regulation was introduced in 2016, with the majority of the provisions applying from 1 January 2018 onwards (subject to certain transitional provisions that apply until 1 January 2020). It applies to the provision of benchmarks, the contribution of input data to a benchmark and the use of a benchmark within the EEA.

The key term is benchmarks, which for the purposes of the Benchmarks Regulation is defined as:

*a* any index<sup>31</sup> by reference to which:

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26 Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms.

27 Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II).

28 The Prospectus Regulation, Article 1(5)(b) and Article 1(5) second Subparagraph.

29 Ibid., Article 1(5)(b) and Article 1(3).

30 Exemption Regulation Dutch Financial Supervision Act, Article 53(4). The requirement to provide the information document does not apply to offerors that are subject to the PRIIPs Regulation and managers of investment firms that are required to provide a prospectus to investors on the basis of the Financial Supervision Act, Article 4:371(1).

31 For the purposes of the Benchmarks Regulation, an index is any figure that is published or made available to the public, and regularly determined entirely or partially by the application of a formula or any other method of calculation, or by an assessment, and on the basis of the value of one or more underlying assets or prices, including estimated prices, actual or estimated interest rates, quotes and committed quotes, or other values or surveys. See Regulation (EU) 2016/1011, Article 3(1)(1) and, for further guidance, Commission Delegated Regulation (EU) 2018/65 of 29 September 2017.

- the amount payable under, or the value of, a financial instrument for which a request has been made for admission to trading, or that is traded, on a regulated market, multilateral trading facility or organised trading facility, or that is traded via a systematic internaliser;<sup>32</sup> or
  - the amount payable under a consumer credit agreement within the scope of the Consumer Credit Directive<sup>33</sup> or a consumer credit agreement relating to residential immovable property within the scope of the Mortgage Credit Directive<sup>34</sup> (each being a financial contract as defined in the Benchmarks Regulation);
- is determined; or
- b* an index that is used to measure the performance of an investment fund, an alternative investment fund (AIF) or an undertaking for the collective investment of transferable securities (UCITS) with the purpose of tracking the return of the index or of defining the asset allocation of a portfolio or of computing the performance fees.<sup>35</sup>

For the purposes of the Benchmarks Regulation, benchmarks are further divided into critical, significant and non-significant benchmarks. The type of benchmark determines, for example, the regulatory framework within which an administrator must operate: the administrators of non-significant benchmarks are subject to fewer mandatory provisions of the Benchmarks Regulation than administrators of critical and significant benchmarks. The Benchmarks Regulation also provides for certain provisions to ensure the continuity of certain critical benchmarks (such as EURIBOR, EONIA and LIBOR),<sup>36</sup> going as far as to enable the competent authorities to require the mandatory administration of such benchmarks where the relevant administrator intends to cease the administration thereof; or, where a competent authority believes that the representativeness of a critical benchmark is put at risk, require supervised entities<sup>37</sup> (such as credit institutions, investment firms and certain investment funds and investment fund management companies) to contribute input data to the critical benchmark (regardless of whether the supervised entity has previously provided input data to the benchmark).

### *Provision of benchmarks*

The Benchmarks Regulation governs the provision of benchmarks, which is defined as administering the arrangements for determining a benchmark; collecting, analysing or processing input data for the purpose of determining a benchmark; and determining a benchmark through the application of a formula or other method of calculation or by an assessment of input data provided for that purpose.<sup>38</sup>

Any person who has control over the provision of a benchmark is considered an administrator for the purposes of the Benchmarks Regulation.<sup>39</sup> This includes parties such

32 Regulation (EU) 2016/1011, Article 3(1)(3).

33 Directive 2008/48/EC of the European Parliament and of the Council of 23 April 2008 on credit agreements for consumers.

34 Directive 2014/17/EU of the European Parliament and of the Council of 4 February 2014 on credit agreements for consumers relating to residential immovable property.

35 Regulation (EU) 2016/1011, Article 3(1)(16).

36 See Commission Implementing Regulation (EU) 2017/2446 of 19 December 2017.

37 As referred to in Regulation (EU) 2016/1011, Article 3(1)(17).

38 Regulation (EU) 2016/1011, Article 3(1)(5).

39 Ibid., Article 3(1)(6).

as ICE Benchmark Administration Limited in relation to LIBOR and the European Money Markets Institute in relation to EURIBOR and EONIA. Administrators are subject to various transparency, governance and conflicts of interest requirements under the Benchmarks Regulation, and will need to be authorised by the competent authority of the Member State where the person is located (or in the case of the (intended) provision of non-significant benchmarks or non-critical benchmarks (provided by supervised entities other than administrators) and registered with the competent authority. The names of the administrators so authorised or registered will be included in a register for benchmarks and administrators maintained by the European Securities and Markets Authority (ESMA) pursuant to Article 36 of the Benchmarks Regulation.

A provider of a benchmark that is not located in the EEA is, in principle, not bound by the provisions of the Benchmarks Regulation. However, subject to the transitional provisions of the Benchmarks Regulation, supervised entities will only be able to use the benchmarks (including non-EEA benchmarks) provided by the non-EEA person within the EEA if the person and the benchmark are included in the register maintained by ESMA as referred to above or, pending an equivalence decision by the European Commission, the benchmark has been recognised by the relevant competent authority in the Member State of reference in accordance with the Benchmarks Regulation.<sup>40</sup> Alternatively, an EEA administrator may request the endorsing of a non-EEA benchmark to make it available for use by supervised entities within the EEA.<sup>41</sup>

#### *Contribution of input data to a benchmark*

The Benchmarks Regulation governs the contribution of input data to a benchmark, which is defined as the provision of any input data not readily available to an administrator (or to another person for the purposes of passing to an administrator) that is required in connection with the determination of a benchmark and is provided for that purpose.<sup>42</sup>

The Benchmarks Regulation requires administrators to prepare a code of conduct regarding the provision of input data – specifying, among other things, the contributor's responsibility in relation to the input data it provides – and administrators are required to satisfy themselves (continuously) that contributors comply with the code of conduct.<sup>43</sup> However, direct obligations are imposed on supervised contributors (i.e., supervised entities that contribute input data to an administrator located in the EEA) under the Benchmarks Regulation, making them, among other things, subject to adequate governance and control requirements, specifically to avoid conflicts of interest.<sup>44</sup>

#### *Use of a benchmark*

The Benchmarks Regulation governs the use of benchmarks, which is defined as:<sup>45</sup>

- a the issuance of a financial instrument that references an index or a combination of indices;

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<sup>40</sup> Ibid., Articles 31 to 33 (inclusive).

<sup>41</sup> Ibid., Article 34.

<sup>42</sup> Ibid., Article 3(1)(8).

<sup>43</sup> Ibid., Article 15.

<sup>44</sup> Ibid., Article 16.

<sup>45</sup> For these purposes, financial instrument refers to a financial instrument for which a request has been made for admission to trading, or that is traded, on a regulated market, a multilateral trading facility or

- b* the determination of the amount payable under a financial instrument or financial contract by referencing an index or combination of indices;
- c* being party to a financial contract that references an index or combination of indices;
- d* the provision of a borrowing rate calculated as a spread or mark-up over an index or a combination of indices and that is solely used as a reference for a financial contract; or
- e* the determination of the performance of an investment fund through an index or combination of indices for the purpose of tracking the return of the index or combination of indices, of defining the asset allocation of a portfolio or of computing the performance fees.<sup>46</sup>

Pursuant to the Benchmarks Regulation, supervised entities may only use benchmarks that are provided by EEA administrators that are included in the register of benchmarks and administrators maintained by ESMA or included in the aforementioned register. However, certain transitional provisions apply pursuant to which supervised entities may continue to use existing benchmarks (as used prior to 1 January 2018 (the date of application of the Benchmarks Regulation)) provided by non-registered or authorised EEA administrators, respectively benchmarks that are not included in the aforementioned register:

- a* in the case of benchmarks provided by EEA index providers until 1 January 2020 or where the index provider submits an application for authorisation or registration, unless and until authorisation or registration is refused; and
- b* in the case of benchmarks provided by non-EAA index providers: as a reference for financial instruments, financial contracts or for measuring the performance of an investment fund that already references the benchmark in the EEA, or that add a reference to benchmarks prior to 1 January 2020, unless the European Commission has adopted an equivalence decision or unless an administrator has been recognised, or a benchmark has been endorsed.

#### *Additional requirements for users of benchmarks that are supervised entities*

Under the Benchmarks Regulation, supervised entities are required to produce and maintain robust written plans setting out the actions that they would take in the event that a benchmark materially changes or ceases to be provided.<sup>47</sup> If feasible and appropriate, such plans are required to feature the nomination of an alternative benchmark to be used, indicating why it would be suitable. In practice, however, there are no readily available commonly used benchmarks such as LIBOR and EURIBOR, let alone an alternative that can readily be determined in advance.

Supervised entities are required to reflect their written plans, as referred to above, in their contractual relationships with clients (so not necessarily in all documentation with counterparties). In terms of existing documentation, ESMA requires supervised entities to amend their existing contractual relationships on a best-efforts basis.<sup>48</sup> An amendment can,

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an organised trading facility, or that is traded via a systematic internaliser and a financial contract refers to a consumer credit agreement within the scope of Directive 2008/48/EC or a consumer credit agreement relating to residential immovable property within the scope of Directive 2014/17/EU.

<sup>46</sup> Regulation (EU) 2016/1011, Article 3(1)(7).

<sup>47</sup> Ibid., Article 28(2).

<sup>48</sup> Questions and Answers on the Benchmarks Regulation, ESMA70-145-11 (Version 9), Answer 8.1.

in practice, often be executed by updating the applicable general terms and conditions, but in many circumstances supervised entities will need to contact their clients to amend certain contractual documentation in place between themselves and their clients.

### *Changes to prospectuses*

Where the object of a prospectus to be published under the Prospectus Regulation<sup>49</sup> relates to transferable securities or other investment products that reference a benchmark, the issuer, offeror or person asking for admission to trading on a regulated market is required, under the Benchmarks Regulation, to ensure that the prospectus includes clear and prominent information stating whether or not the benchmark is provided by an administrator included on the register for benchmarks and administrators maintained by ESMA.<sup>50</sup>

Commonly, certain market participants have included risk factors in prospectuses dealing with the risk of termination of, and material amendments to, benchmarks and risks associated therewith.

### *Benchmark reform*

The transition away from quoted benchmarks to risk-free rates has been a hot topic in the Netherlands throughout 2019. The termination of LIBOR as of the end of 2021 and the amendment of EURIBOR, EONIA and other benchmarks has led to scrutiny by the regulators of the transitioning plans of financial institutions. Following the Dear CEO letter of the UK FCA and the Bank of England to UK financial institutions,<sup>51</sup> the AFM and the DCB sent a Dear CEO letter to Dutch financial institutions<sup>52</sup> requesting them to provide detailed information on their benchmark transition plans by 17 June 2019. The European Central Bank sent a similar letter to EU financial institutions on 3 July 2019.<sup>53</sup>

Although an established market practice has yet to evolve, bond market documentation now commonly features terms and conditions that include fallback scenarios in line with the requirements of the Benchmarks Regulation and best practices formulated by the European Central Bank, such as the inclusion of an adjustment spread mechanism meant to bridge any differences between an original benchmark and its replacement so as to avoid a value transfer upon the occurrence of a replacement event. A lot of uncertainty, however, remains. Market participants are still struggling with the issue as to how an adjustment spread is to be calculated – for example, on a historic or forward-looking basis – and questions continue to be raised as to which market participants would be willing to act as an independent third party benchmark replacement agent.

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49 Regulation (EU) 2017/1129)) or the UCITS Directive (Directive 2009/65/EC, as amended).

50 Regulation (EU) 2016/1011 of the European Parliament and of the Council of 8 June 2016, Article 29(2). This requirement is without prejudice to outstanding prospectuses approved under the Prospectus Directive prior to 1 January 2018 and prospectuses approved prior to 1 January 2018 under the UCITS Directive. The underlying documents shall be updated at the first occasion or at the latest within 12 months of that date. See Regulation (EU) 2016/1011, Article 52.

51 'Dear CEO LIBOR letter', Financial Conduct Authority, 19 September 2018. See <https://www.fca.org.uk/news/statements/dear-ceo-libor-letter>.

52 'AFM en DNB wijzen markt op belang overgang naar alternatieve benchmarks', AFM, 25 April 2019. See <https://www.afm.nl/nl-nl/nieuws/2019/apr/alternatieve-benchmarks>.

53 'Banks' preparation with regard to interest rate benchmark reforms and the use of risk-free rates', European Central Bank (ECB), 3 July 2019. See [https://www.bankingsupervision.europa.eu/press/letterstobanks/shared/pdf/2019/ssm.benchmark\\_rate\\_reforms\\_201907.en.pdf?8f331a1bb36298a22adcb65e5c41bc8b](https://www.bankingsupervision.europa.eu/press/letterstobanks/shared/pdf/2019/ssm.benchmark_rate_reforms_201907.en.pdf?8f331a1bb36298a22adcb65e5c41bc8b).

We expect a lot of activity regarding benchmark reform in the years to come, with existing bond documentation being amended and continued refinement of interest provisions dealing with interest calculations using risk-free rates as well as the potential development of forward-looking risk-free rates.

### ***Market Abuse Regulation***

The new Market Abuse Regulation, which applies as from 4 July 2016, introduced a number of changes relevant to capital market transactions, the most of significant of which related to the introduction of an EEA-wide market soundings regime. Market participants made a significant effort to get to grips with the new market sounding rules throughout 2016 and 2017, implementing policies and procedures to log inside information, insiders, transactions and market soundings.

## **ii Developments affecting (structured) debt capital markets specifically**

### ***The Packaged Retail and Insurance-based Investment Products Regulation***

Effective as of 1 January 2018, the Packaged Retail and Insurance-based Investment Products (PRIIPs) Regulation aims to make in-scope products more transparent and comparable in an effort to make these types of products and their features, as well as their associated risks and cost, more understandable for retail investors. The products within the scope of the PRIIPs Regulation are either packaged retail investor products or insurance-based investment products (which are beyond the scope of this chapter).

#### *Packaged retail investor products*

For the purposes of the PRIIPs Regulation, packaged retail investors products are defined as ‘an investment . . . where, regardless of the legal form of the investment, the amount repayable to the retail investor is subject to fluctuations because of exposure to reference values or to the performance of one or more assets which are not directly purchased by the retail investor’.<sup>54</sup> The manner in which this term is defined is rather broad, and identifying whether a particular product qualifies as a packaged retail investor product may not always be straightforward, especially because products that are within the scope of the PRIIPs Regulation are primarily determined by products that are specifically referred to as being out of scope (such as deposits (or certificates that represent deposits), other than structured deposits<sup>55</sup>).<sup>56</sup>

Given the definition of packaged retail investor products, it is clear that fixed rate bonds were never within the scope of the PRIIPs Regulation as fixed rates bonds do not depend on a reference value. However, the position on straightforward floating rate notes (such as bonds that reference LIBOR or EURIBOR) was less clear upon the introduction of PRIIPs, as these type of products could technically fall within the scope of the aforementioned definition. It was nevertheless not long before a market consensus arose that these types of vanilla floating rate bonds should not be considered within scope, and that basic features such as guarantees or simple put or call options would not, on their own, render vanilla fixed and floating

54 Regulation (EU) No. 1286/2014 of the European Parliament and of the Council of 26 November 2014, Article 4(1).

55 See Directive 2014/65/EU, Article 4(1)(43).

56 See Regulation (EU) No. 1286/2014, Article 2(2).

rate bonds to be within the scope of the PRIIPs Regulation.<sup>57</sup> On the other hand, products that are typically considered to be within scope are products such as fund units, structured products and contracts for difference.

### *Main obligations under the PRIIPs Regulation*

The PRIIPs Regulation imposes various obligations on persons manufacturing, advising on or selling PRIIPs. The three main obligations for the purposes of this chapter are for the PRIIP manufacturer to draw up a key information document (KID); for the PRIIP manufacturer to regularly review (and, as appropriate, revise) the KID; and for a person advising on or selling a PRIIP to provide the retail investors with a KID.

The PRIIP manufacturer<sup>58</sup> (which would typically include the issuer, but could potentially also include other persons advising on the features or issuance of the PRIIP, such as lead managers) is required to draw up a three-page KID in accordance with the requirements of the PRIIPs Regulation and publish the same on its website.<sup>59</sup> The KID should be drawn up before a PRIIP is made available to retail investors<sup>60</sup> so that the retail investors are able to understand, and can take into account, the information on the PRIIP.<sup>61</sup>

The Netherlands has not made use of the Member State options that KIDs should be notified *ex ante* to the AFM, or to accept KIDs in other languages, meaning that KIDs used in the Dutch market should always be in Dutch.<sup>62</sup>

### *The Securitisation Regulation*

The Securitisation Regulation came into force on 17 January 2018 and is applicable from 1 January 2019. The main change brought about by the Securitisation Regulation is that a concept is introduced of securitisations complying with the standards of being a simple, transparent and standardised (STS) securitisation, which may benefit from favourable regulatory treatment,<sup>63</sup> whereas issuers, originators and sponsors will be responsible for designating a transaction as STS-compliant among themselves.

In 2019 we saw originators, sponsors and original lenders getting to grips with the Securitisation Regulation risk retention, due diligence and reporting requirements, as well as the first STS securitisations being launched.

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57 International Capital Market Association, Quarterly Report, 12 October 2016, Fourth Quarter, Issue 43, page 26.

58 Meaning any entity that manufactures PRIIPs or any entity that makes changes to an existing PRIIP, including, but not limited to, altering its risk and reward profile or the costs associated with an investment in a PRIIP. See Regulation (EU) No. 1286/2014, Article 4(4).

59 See Regulation (EU) No 1286/2014, Article 5.

60 Ibid., Article 5(1).

61 Commission Delegated Regulation (EU) 2017/653 of 8 March 2017, Recital 24.

62 See Regulation (EU) No. 1286/2014, Articles 5(2) and 7(1).

63 Note that commercial mortgage-backed securities transactions have been carved out from being capable of qualifying as simple, transparent and standardised transactions.

### ***Alternative Investment Fund Managers Directive and repackaging transactions***

Various asset-backed transactions, in particular with a pass-through structure, remain subject to a risk of the issuer or special purpose vehicle qualifying as a manager of an AIF within the meaning of AIFMD,<sup>64</sup> exposing it and associated parties to significant fines, other penalties and regulatory intervention.

#### ***Scope of the AIFMD***

The rules and obligations as laid down in the AIFMD apply to persons who manage an alternative investment fund (an AIFM). An AIFM performs at least risk management or portfolio management for the AIF. An AIF is in turn defined as a collective investment undertaking (including investment compartments thereof) that raises capital from a number of investors with a view to investing it in accordance with a defined investment policy for the benefit of those investors, and does not require a licence under the UCITS Directive.<sup>65</sup> This definition is quite broad and could apply to a number of entities, including issuers of structured financial instruments that would normally not be considered as investment funds. Further guidance can be found in ESMA's Guidelines on key concepts of the AIFMD,<sup>66</sup> to which the AFM adheres.<sup>67</sup>

The regulatory authorities of several other EU jurisdictions have clarified that certain structured finance vehicles from their jurisdiction are beyond the scope of the AIFMD or have issued guidance that a straightforward exemption applies to the extent that issued instruments qualify as debt. This is not the case in the Netherlands. Although the AFM has made it clear that an entity will not qualify as an AIF if investors provide debt to the issuer, it has also noted that 'capital raised with investors under the sole label of debt, is not regarded as debt, if, taking into consideration the legal and/or economic characteristics of such capital and the rights and obligations belonging to investors, in reality such capital is a form of equity'.<sup>68</sup> This has led to market uncertainty for structures where, for example, redemption amounts or other payouts fluctuate according to the performance of a basket of collateral.

#### ***Audit committees and structured finance vehicles***

Pursuant to the Audit Directive,<sup>69</sup> public-interest entities are required to have an audit committee, which is a standalone body or a committee of the administrative or supervisory board that performs an internal audit function. For the purposes of the Audit Directive, public interest entities are EEA entities whose transferable securities (including debt securities) are

64 Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers.

65 Ibid., Article 4(1)(a).

66 Guidelines on key concepts of the AIFMD, ESMA/2013/600.

67 Pursuant to the ESMA Guidelines, if any one of the composite elements of the definition of AIFs as referred to above is not satisfied, a structure would not qualify as an AIF for the purposes of the AIFMD. However, these same guidelines also stipulate that the absence of one or more of the characteristics under each of the elements in the definition of an AIF does not conclusively demonstrate that a structure is not an AIF if the presence of all the concepts is otherwise established. See Guidelines on key concepts of the AIFMD, ESMA/2013/600, page 30, paragraph 5.

68 'Q&A on the AIFMD', AFM, 17 November 2017, page 11 – see <https://www.afm.nl/nl-nl/professionals/doelgroepen/aifm/aifm/faq>.

69 Directive 2014/56/EU of the European Parliament and of the Council of 16 April 2014 amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts.



admitted to trading on a regulated market of any EEA Member State, credit institutions,<sup>70</sup> insurance undertakings<sup>71</sup> and certain entities that are designated as such by EEA Member States.

The Audit Directive includes an option pursuant to which Member States may elect to exempt certain public interest entities from the obligation to have an audit committee, including, among others, those of which the sole business is to act as an issuer of asset-backed securities<sup>72</sup> (provided the entity explains to the public (e.g., in its annual report) the reasons for which it considers it not appropriate to have either an audit committee or an administrative or supervisory body entrusted to carry out the functions of an audit committee).<sup>73</sup>

The Netherlands has made use of the Member State option referred to above. However, the exemption from the obligation of having an audit committee for public interest entities the sole business of which is to act as issuer of asset-backed securities has been implemented by means of a decree<sup>74</sup> featuring an exemption that refers to entities for securitisation purposes, rather than tracking the wording of the Audit Directive, causing some uncertainty as to the scope of the exemption as laid down in Dutch law.

For these purposes, an entity for securitisation purposes is defined as an undertaking:

- a* that is not a credit institution;
- b* that has been established for the benefit of one or more securitisations;
- c* whose activities are limited to what is necessary for those securitisations;
- d* whose establishment serves to separate its obligations from the obligations of the initiating party;<sup>75</sup> and
- e* whose owners can unconditionally pledge or sell their participation.

A securitisation, in turn, is defined as a transaction or scheme in which the credit risk of a receivable or collection of receivables is divided into at least two tranches, the payments made in the context of the transaction or scheme depend on the performance of the receivables or the collection of receivables, and the ranking of the tranches determines the allocation of losses during the course of the transaction or scheme.<sup>76</sup>

As such, the Dutch implementation is significantly more restrictive than the exemption contemplated by the Audit Directive itself. In particular, the requirement that the entity is established for the purposes of engaging in tranching transactions would disqualify straightforward repackaging vehicles from relying on the exemption to have an audit committee.

The relevant explanatory memorandum relating to the Dutch implementation of the aforementioned exemption does not explain why the Dutch legislator has opted for its restrictive approach, instead suggesting that the legislator simply wished to make use of the exemption for certain issuers of asset-backed securities as referred to in the Audit Directive. The Dutch capital markets have dealt with this uncertainty by having repackaging vehicles install an audit committee, taking the safe route rather than risking non-compliance.

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70 Within the meaning of Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013, Article 3(1), except those referred to in Article 2 of that Directive.

71 Within the meaning of Council Directive 91/674/EEC of 19 December 1991, Article 2(1).

72 Within the meaning of Commission Regulation (EC) No. 809/2004 of 29 April 2004, Article 2(5).

73 Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006, Article 41(6)(c).

74 Decree on the Instalment of Audit Committees.

75 i.e., the (indirect) originator or the undertaking that buys receivables and subsequently securitises them.

76 Decree on Prudential Rules Dutch Financial Supervision Act, Article 1.

### iii Developments affecting equity capital markets specifically

#### *Draft bill regarding cooling-off periods for listed companies*

In light of recent increased shareholder activism and hostile takeover bids, the Dutch legislator published a draft bill for consultation on 7 December 2018 relating to the introduction of a right for Dutch listed companies to invoke a cooling-off period when faced with a hostile takeover bid, or a request to table a proposal for the appointment, suspension or dismissal of one or more managing or supervising directors (or a proposal to change any provisions in the articles of association relating to the same) where the same would not (in the opinion of the board of managing directors) be in the interest of the company and its connected business. Any such decision of the board of managing directors would be subject to the approval of the board of supervisory directors (if present).

Under the terms of the draft bill, the cooling-off period may last up to 250 days counted from the day of the bid, or respectively the proposal. This cooling-off period is intended to give the board of managing directors more time to carefully consider the takeover bid or the proposal and to take stock of the various positions of its stakeholders. For these purposes, the board of managing directors is required to consult shareholders representing at least three per cent of the issued shares and (if present) the board of supervisory directors and the works council during the cooling-off period. In addition, after the cooling-off period, the board of managing directors is required to report on the actions taken during the cooling-off period, which report should be made available for viewing to the shareholders of the company.

Shareholders, under certain circumstances, may have a right to petition the Dutch Enterprise Chamber to revoke the cooling-off period. However, the Enterprise Chamber will only do so if the board of managing directors could not have reasonably considered that the bid, or respectively the proposal, was at the time not in the interest of the company and its connected business.

#### *Shareholder Rights Directive II*

The Shareholder Rights Directive II<sup>77</sup> will likely be implemented into Dutch law in 2019, although the 10 June 2019 implementation deadline has not been met by the Dutch legislator. The Shareholder Rights Directive II will introduce various significant changes in shareholdership throughout the EEA, including the introduction of:

- a* requirements for listed companies to draw up a remuneration policy that shareholders can vote on, as well as a requirement to prepare an annual remuneration report;
- b* increased powers of listed companies to request information from intermediaries to identify their shareholders;
- c* requirements on intermediaries to facilitate the exercise of shareholder rights as well as various requirements relating to the costs levied by them for certain services rendered;
- d* requirements for listed companies to require approval for material transactions with related parties from the general meeting of shareholders or the board of supervisory directors, as well as a requirement to disclose the completion of such transactions;
- e* requirements for institutional investors and asset managers to formulate and disclose policies on shareholder engagement, as well as a requirement to disclose annually how this policy was enacted in practice;
- f* requirements on proxy advisers to develop codes of conduct.

<sup>77</sup> Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017.

#### iv Developments affecting financial institutions issuing securities

##### *Contingent convertibles*

In 2014 (in respect of credit institutions) and in 2015 (in respect of insurance undertakings), the Dutch legislator implemented certain changes to Dutch tax law allowing for the tax deductibility of coupons paid on CoCos, creating a level playing field for Dutch issuers compared to their EU counterparts in relation to the issuance of regulatory capital (in particular, Additional Tier 1 instruments).

Shortly thereafter, questions were raised as to whether the CoCo tax treatment would constitute illegal state aid to Dutch credit institutions and insurance undertakings. This resulted in the European Commission requesting the Netherlands, on 22 June 2018, to take measures to address what it deemed illegal state aid risks. On 27 June 2018, the State Secretary for Finance published a letter in which he announced that the tax deductibility of coupons paid on CoCos is abolished with effect from 1 January 2019, citing, among other things, the risks identified by the European Commission.

The risk that the tax deductibility of coupons paid on CoCos is lost as a result of illegal state aid claims is not a risk that is exclusive to the Netherlands, as various other EU Member States also allow this form of tax deductibility in their tax legislation. In his letter of 27 June 2018, the State Secretary for Finance noted that the European Commission had indicated that it would also look into other EU Member States that had implemented specific tax-deductibility rules on CoCos for the benefit of the financial sector. The state aid queries raised by the European Commission in respect of the Netherlands may therefore have a knock-on effect for other EU Member States in a similar position in the coming years.

##### *Senior non-preferred debt*

On 27 December 2017, a directive amending the Bank Recovery and Resolution Directive (BRRD)<sup>78</sup> was published in the EU Official Journal pursuant to which a new rank of debt instruments was introduced in relation to entities subject to BRRD – referred to as senior non-preferred debt – to be redeemed immediately after senior unsecured liabilities (such as deposits and other ordinary senior liabilities) and before subordinated liabilities (such as Additional Tier 1 and Tier 2 capital instruments).<sup>79</sup> The bill implementing the senior non-preferred asset class in the Netherlands came into effect on 14 December 2018.

The Dutch legislator has followed what is now commonly known as the French approach, pursuant to which entities subject to BRRD may elect, on a case-by-case basis, whether to issue instruments as senior preferred or senior non-preferred (or even more subordinated, such as Tier 2 instruments), and existing instruments remain unaffected. This can be contrasted with the German approach, pursuant to which existing senior debt instruments were immediately and retroactively demoted from their senior status to senior non-preferred status following implementation of the senior non-preferred debt asset class in Germany.

<sup>78</sup> Directive 2014/59/EU (on the recovery and resolution of credit institutions and investment firms).

<sup>79</sup> The aim of these changes to BRRD was to facilitate the issuance of sufficient bail-inable liabilities so that entities subject to BRRD could comply with any applicable global (total loss absorbing capacity) and European (minimum requirement for own funds and eligible liabilities) requirements in relation to minimum amounts of bail-inable liabilities.

### **III OUTLOOK AND CONCLUSIONS**

As a result of the UK Brexit vote, many capital market players have been looking to the Netherlands as their gateway to Europe, for a number of reasons, including the attractiveness of Dutch law, Dutch courts, the good reputation of the Dutch supervisory authorities, and the stability and efficiency of the government. We expect the Dutch capital markets also to do well in the years to come.

In general, the Dutch capital markets will be affected by further proposed legal and regulatory changes including in the context of benchmark reform, the EU Capital Markets Union, a proposal for a revised EU covered bond framework, proposals for a European green and environment, society and governance (ESG) financing framework as well as Omnibus 3 proposals. In the context of these changes, we would expect the continuing benchmark reform and the proposals for a European-wide green and ESG financing framework to have the most significant impact on the Dutch market and on documentation.

# NEW ZEALAND

*Deemle Budhia and Ling Yan Pang<sup>1</sup>*

## I INTRODUCTION

New Zealand's capital markets are primarily regulated under the Financial Markets Conduct Act 2013 (FMC Act). All offers of financial products must be made under the FMC Act. The Financial Markets Authority (FMA) is the principal regulator in respect of financial products and financial services, and is responsible for enforcing the FMC Act and other financial markets legislation.

### i Structure and regulation

New Zealand has a legal system based on English common law. New Zealand's laws include legislation made by Parliament, rules made by local authorities and the common law, which is developed by judges. Legislation made by Parliament overrides common law. The court system is a hierarchy that includes two appeal courts (the highest of which is the Supreme Court) whose decisions are binding on courts below them in the hierarchy.

Offers of financial products are regulated by the FMC Act and regulations made under the FMC Act (Regulations). The FMC Act and the Regulations:

- a* impose fair-dealing obligations on conduct in both the retail and wholesale financial markets;
- b* set out the disclosure requirements for offers of financial products;
- c* set out a regime of exclusions and wholesale investor categories in connection with the disclosure requirements;
- d* set out the governance rules that apply to financial products; and
- e* impose a licensing regime.

A summary of the FMC Act provisions applicable to offers of financial products in New Zealand is provided in this chapter.

### ***The FMC Act***

#### *Financial products*

Under the FMC Act, an offer of financial products for issue requires disclosure to investors unless an exclusion applies to all persons to whom the offer is made. Certain specified offers of financial products for sale will also require disclosure to investors.

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<sup>1</sup> Deemle Budhia is a partner and Ling Yan Pang is a senior associate at Russell McVeagh. The authors would like to thank and gratefully acknowledge the assistance of Victoria Jones.

There are four categories of financial products: debt securities, equity securities, managed investment products and derivatives, each of which is separately defined. A managed investment product refers to an interest in a managed investment scheme, which is broadly defined to include any scheme:

- a* the purpose or effect of which is to enable participating investors to contribute money to the scheme to acquire an interest in the scheme;
- b* where the interests are rights to participate in or receive financial benefits produced principally by the efforts of others; and
- c* where participating investors do not have day-to-day control over the operation of the scheme.

The definition of derivatives is wide and explicitly includes transactions that are commonly referred to in New Zealand or overseas financial markets as futures contracts, forwards, options (other than options to acquire by way of issue equity securities, debt securities or managed investment products), swap agreements, contracts for difference, margin contracts, rolling spot contracts, caps, collars, floors and spreads.

The FMA has the power to declare that a security that would not otherwise be a financial product is a financial product of a particular kind.

#### *Regulated offers*

An offer of financial products that requires disclosure is a regulated offer. An offer that is not a regulated offer will still be subject to the general fair dealing provisions in the FMC Act.

The disclosure required in relation to each financial product is set out in the Regulations and is tailored according to the characteristics of the particular product being offered.

#### ***Other legislation and legislative bodies***

Other key statutes regulating New Zealand's financial sector include the Financial Reporting Act 2013, the Companies Act 1993 (Companies Act), the Financial Service Providers (Registration and Dispute Resolution) Act 2008 (FSPA), the Financial Markets Authority Act 2011, the Financial Advisers Act 2008 (FAA), the Reserve Bank of New Zealand Act 1989 (RBNZ Act), the Insurance (Prudential Supervision) Act 2010 (IPS Act), the Non-bank Deposit Takers Act 2013 (NBDT Act), the Financial Markets Supervisors Act 2011 and the Anti-Money Laundering and Countering Financing of Terrorism Act 2009 (AMLA). The recently enacted Financial Services Legislation Amendment Act 2019 (FSLA Act) will repeal the FAA and introduce a new financial adviser regime in New Zealand.

The principal regulatory bodies for New Zealand's financial sector are:

- a* the FMA, whose principal objective is to promote and facilitate the development of fair, efficient and transparent financial markets. The FMA's functions include monitoring compliance with, and investigating conduct that constitutes or may constitute breaches of, financial markets legislation, and licensing and supervising authorised financial advisers, qualifying financial entities, licensed independent trustees and licensed supervisors; and
- b* the Reserve Bank of New Zealand, which is responsible for the prudential regulation of banks, non-bank deposit takers and insurance providers.

Under the FMC Act, a person making a regulated offer of debt securities is required to appoint a licensed supervisor and enter into a trust deed with that supervisor, and issuers of regulated managed investment products under the FMC Act are required to register the managed

investment scheme, appoint a licensed supervisor and licensed manager, and enter into a governing document. The licensing regime in respect of supervisors is set out in the Financial Markets Supervisors Act 2011, which includes compliance and reporting obligations for licensed supervisors and permits the FMA to remove a supervisor in certain circumstances.

## **ii Authorisation and licensing**

There are no direct government controls on the issuing of financial products in New Zealand, either by domestic or foreign companies. However, market participants may need to obtain registrations or authorisations when participating in New Zealand's capital markets, depending on the type of activity an entity is proposing to conduct in New Zealand.

### ***Overseas company registration***

The Companies Act requires any company incorporated outside New Zealand that is carrying on business in New Zealand to register as an overseas company. Whether a particular activity or activities constitute carrying on business will be a question of fact and degree. Registration as an overseas company is a relatively simple process, although there are continuing compliance obligations for overseas companies, including the requirement to lodge annual returns with the Registrar of Companies and (for entities of a certain size) to prepare and file financial statements.

### ***Financial service provider registration***

Subject to certain limited exceptions, the FSPA requires any person who carries on the business of providing a financial service and is ordinarily resident in New Zealand, has a place of business in New Zealand or is required to be a licensed provider under a licensing enactment (which includes registered banks, authorised financial advisers, certain licensed supervisors and others) to be registered for that service on the publicly available Financial Service Providers Register (FSP Register). Financial service providers that provide financial services to retail clients must also join an approved dispute resolution scheme, subject to certain limited exceptions.

The definition of financial services is broad and includes, inter alia:

- a* a financial adviser, broker, licensed non-bank deposit taker or registered bank;
- b* any person participating in a regulated offer as the issuer or offeror of financial products;
- c* any person acting in the capacity of an issuer, supervisor or investment manager in respect of a regulated product;
- d* any person acting as a custodian or offering a licensed market service;
- e* an operator of a financial products market; and
- f* any person that trades financial products or foreign exchange on behalf of another person.

Most participants in the financial services industry in New Zealand will be required to register under the FSPA. Registration is a simple process, and registered entities are required to pay annual fees depending on the nature of the financial services being provided. Pursuant to incoming amendments to be made by the FSLA Act, businesses will be required to have a stronger connection to New Zealand to register on the FSP Register. For example, the FSPA will not apply merely because a business' financial services are accessible by persons in New Zealand; and the FSPA will not apply if the financial services provider does not have a place of business in New Zealand and is not providing its services to any retail client in New Zealand.

### ***Financial advisers***

A person who provides financial adviser services (or broking services) in the ordinary course of his or her business to clients in New Zealand is currently required to comply with certain disclosure, conduct and registration requirements under the FAA. The requirements apply regardless of where the person providing the financial adviser service is resident, is incorporated or carries on business.

A person is deemed to provide a financial adviser service if he or she gives financial advice, provides an investment planning service or provides a discretionary investment management service. Financial advice is given when a person makes a recommendation or gives an opinion in relation to acquiring or disposing of a financial product (which would include equity securities and debt securities).

Financial adviser services exclude, inter alia:

- a* any form of communication made by or on behalf of an issuer of financial products that is not a regulated offer because of a relevant exclusion (which includes offers to wholesale investors);
- b* providing or making available a product disclosure statement, other limited disclosure document or information from a register entry or advertisement under the FMC Act; and
- c* financial adviser services covered by a market services licence for discretionary investment management services.

The FAA imposes different requirements depending on the types of products being advised on, the intended audience (whether wholesale or retail) and the type of advice (personalised or generic class advice). For example, the requirements for a financial adviser providing personalised financial advice to a retail client will be more onerous than the requirements for a provider of class advice to wholesale clients.

Once the relevant provisions of the FSLA Act come into force, the FAA will be repealed and a new regulatory regime for the provision of financial advice established through amendments to the FMC Act. The key elements of the new regulatory regime are that:

- a* all persons who provide financial advice services (known as financial advice providers) must be licensed by the FMA. The licensing requirement does not apply if the service is not provided to any retail client. Financial advice providers may be entities or individuals that give regulated financial advice to their clients on their own account or engage other persons to give regulated financial advice to their clients on their behalf;
- b* persons who may be engaged by a financial advice provider to give regulated financial advice are financial advisers, nominated representatives or other persons engaged through interposed persons;
- c* a Code of Conduct will apply to all persons who give regulated financial advice to retail clients. The Code of Conduct was approved in May 2019, and sets standards of ethical behaviour, conduct, client care and competence, knowledge and skill; and
- d* in addition to the Code of Conduct, duties also apply to all persons who give regulated financial advice, whether to retail or wholesale clients, including the duty to give priority to clients' interests and disclose certain information to clients (although the required information is likely to vary for wholesale and retail clients).

The new regime (including the Code of Conduct) is expected to come into force in June 2020, with a transitional period expected to end in June 2022. During the transitional



period, financial advice providers will need to hold, and all persons giving regulated financial advice will need to be covered by, a transitional licence. The FMA has announced that it will begin accepting transitional licence applications from 4 November 2019.

### ***Bank or insurance company registration***

Registration as a New Zealand registered bank is not required to provide banking or financial services, or to offer or sell financial products in New Zealand. However, pursuant to the RBNZ Act, no person can carry on any activity (directly or indirectly) in New Zealand using a name or title that includes a restricted word, which are bank, banker and banking, or any derivatives thereof (including any translation of those words into another language). The IPS Act contains a similar prohibition in relation to the use of insurance, assurance, underwriter and reinsurance (and terms with the same or a similar meaning). The prohibitions do not apply under the RBNZ Act if an entity is a registered bank, or under the IPS Act if an entity carries on insurance business in New Zealand (which would require the entity to hold an insurance business licence). If a potential issuer wishes to use a restricted word in its name but not register as a bank or obtain an insurance business licence, an application can be made to the Reserve Bank for an authorisation or exemption.

The Reserve Bank recently undertook a public consultation on its approval of authorisations and exemptions under the RBNZ Act, and in late August 2019, it announced the outcome of that consultation. This included guidance on the interpretation of the relevant legislative provisions and a class authorisation for overseas banks (that are not registered in New Zealand) to carry on limited wholesale activities in New Zealand without the need for registration, subject to certain requirements. The class authorisation came into force on 23 September 2019.

### ***Non-bank deposit-takers***

A non-bank deposit taker (NBDT) is a person who makes a regulated offer of debt securities in New Zealand and carries on the business of borrowing and lending money, providing financial services, or both. The definition is broad, and captures entities beyond the traditional finance companies at which the regime was originally targeted. The NBDT Act requires NBDTs to be licensed by the Reserve Bank. NBDTs are subject to prudential supervision by the Reserve Bank with the relevant supervisor (trustee) tasked with monitoring an NBDT's compliance with the relevant prudential requirements. The prudential supervision of NBDTs is currently under consideration as part of a wider review of the RBNZ Act.

### **iii Offers of financial products**

New Zealand has a disclosure-based approach to the offer of financial products to the public. An offer of financial products for issue will require full disclosure to investors under Part 3 of the FMC Act, unless an exclusion applies (and limited disclosure is required for offers made in reliance on some FMC Act exclusions).

In addition, certain offers of financial products for sale (secondary sales) also require disclosure. For example, if financial products are issued (but not, *inter alia*, under a regulated offer) with a view to the original holder selling the products, and the offer for sale is made within 12 months of the original issue date, that secondary offer will require disclosure.

The FMC Act applies to any offer of financial products in New Zealand regardless of where the resulting issue or transfer occurs, or where the issuer is resident, incorporated or carries on business.

For a regulated offer of financial products, a product disclosure statement (PDS) must be prepared, and certain information relating to the offer must be contained in a publicly available register entry for the offer. The PDS must be lodged with the Registrar of Financial Service Providers, and the register entry must contain all material information not contained in the PDS. Material information means information that a reasonable person would expect to, or that would be likely to, influence persons who commonly invest in financial products in deciding whether to acquire the financial products on offer, and is specific to the particular issuer or the particular financial product. Investors to whom disclosure is required must (subject to certain exceptions) be given a PDS before an application to acquire the relevant financial products under a regulated offer is accepted.

The Regulations set out detailed requirements for the timing, form and content of initial and continuing disclosure for financial products, including limited disclosure for products offered under certain FMC Act exclusions. The content requirements for a PDS are prescriptive, and include prescribed statements and page or word limits. The Regulations impose different disclosure requirements for different types of financial products.

Under the FMC Act, there is an exclusion for offers to wholesale investors, which includes:

- a* investment businesses;
- b* people who meet specified investment activity criteria;
- c* large entities (those with net assets of at least NZ\$5 million or consolidated turnover over NZ\$5 million in each of the two most recently completed financial years);
- d* government agencies;
- e* eligible investors;
- f* persons paying a minimum of NZ\$750,000 for the financial products on offer;
- g* persons acquiring derivatives with a minimum notional value of NZ\$5 million; and
- h* *bona fide* underwriters or sub-underwriters.

Even where an exclusion applies, certain disclosure requirements may still apply.

The FMC Act also contains an exclusion for quoted financial products (QFP). This exclusion allows issuers to offer equity securities, debt securities and managed investment products of the same class as financial products that are quoted on an appropriate licensed market without a PDS. The QFP exclusion can also be used for offers of options to acquire financial products where the underlying financial products are of the same class as QFPs. The issuer must issue a 'cleansing notice' to the market (which includes a confirmation that the issuer is complying with its continuous disclosure and financial reporting obligations), as well as a document setting out the terms and conditions applicable to the financial product (commonly a short term sheet). The QFP exclusion is popular among issuers, and has quickly become the norm in the debt and equity markets.

### ***Liability***

If a PDS, any application form that accompanies that PDS or the register entry relating to a financial product omits information required by the FMC Act or the Regulations, or contains a statement that is false or misleading or is likely to mislead, and that matter is materially adverse from the point of view of an investor, there is potential civil liability under the FMC Act. If a person acquires a financial product that declines in value after defective disclosure is made, that person is treated as having suffered loss or damage because of that defective disclosure unless it is proved that the decline in value was caused by a matter other

than the relevant statement. This reverses the usual onus of proof, and means that investors do not need to show the link between the defective disclosure and the loss they have suffered to obtain an order for compensation.

Every director of the offeror at the time of the contravention will be treated as also having contravened that provision of the FMC Act, and can be ordered to pay a pecuniary penalty or compensation. A number of defences are available to that director, including if he or she can prove that he or she took all reasonable and proper steps to ensure that the entity complied with the relevant provision.

Criminal liability can also attach if the offeror knows that, or is reckless as to whether, a statement is false or misleading or is likely to mislead. In such circumstances, a director of an offeror may also commit an offence if the director knows or is reckless as to whether the statement is false or misleading or likely to mislead.

#### **iv Some other features of New Zealand's capital markets**

##### ***Regulation of derivatives***

Offers of derivatives are regulated by the FMC Act, and issuers are required to prepare and lodge a PDS in respect of a regulated offer of derivative products.

A derivatives issuer (meaning a person in the business of entering into derivatives) who makes regulated offers of derivatives is required to hold a market services licence (unless an exemption applies). In addition to the exclusions discussed above, there are exclusions under the FMC Act that apply specifically to offers of derivatives, including:

- a* offers of derivatives made by a person who is not a derivatives issuer;
- b* offers of quoted derivatives on a licensed market;
- c* offers of derivatives approved for trading on a prescribed overseas market; and
- d* offers of currency forwards by registered banks (or their subsidiaries) where settlement is, broadly, within 12 months of issue.

If a derivatives issuer makes a regulated offer of derivatives, it will also be required to ensure that a client agreement is in place with the counterparty prior to the issue of the derivative and provide confirmations to the counterparty.

##### ***Exchanges and markets***

###### *The FMC Act*

A person who wishes to operate a financial product market in New Zealand will be required to obtain a licence to operate that market from the FMA or the responsible minister under the FMC Act. NZX Limited (NZX) is currently a licensed market operator in New Zealand and is licensed to operate, inter alia, the NZX Main Board (NZSX, NZX's original equities market) and the NZX Debt Market (NZDX). Effective 1 July 2019, the NXT Market and NZX Alternative Market (for small to medium-sized businesses) were consolidated with the NZSX into a single equity board, being the NZX Main Board.

###### *NZX*

Listed issuers whose securities are quoted on one of NZX's licensed markets will be subject to the Listing Rules applicable to that market and the FMC Act. The Listing Rules set out a number of obligations for issuers, including obligations to prepare and deliver annual reports to NZX that contain certain prescribed information, and to make a preliminary

announcement to the market after the end of each financial year or half year. Listed entities must also describe their corporate governance practices in detail in their annual reports (to the extent that these are not described on its website).

In addition, listed entities must comply with the continuous disclosure requirements of the Listing Rules, and disclose price-sensitive information to the market (by means of an announcement to NZX) immediately once they become aware of the information. There are limited exceptions to this disclosure obligation.

In certain circumstances, listed entities must also release material information to the market to prevent the development or subsistence of a market for its securities based on false or misleading information.

### ***Clearing***

There are two principal settlement and clearing systems operating in the New Zealand financial markets: the NZClear system operated by the Reserve Bank (formerly known as Austraclear) and the clearing and settlement system operated by New Zealand Clearing and Depository Corporation Limited (a wholly owned subsidiary of NZX) (NZCDC). NZCDC clears and settles all trades conducted on NZX's markets.

NZClear and the NZCDC have each been declared to be a designated settlement system for the purposes of the RBNZ Act. As a result, those systems are subject to statutory protections in relation to, inter alia, the enforceability of the rules, the finality of settlements and the validity of netting in respect of those systems.

New Zealand is not a member of the G20, and has not introduced legislation to require standardised over-the-counter (OTC) derivatives contracts to be cleared through central counterparties. However, in August 2019 the Financial Markets (Derivatives Margin and Benchmarking) Reform Amendment Act 2019 (FMRA Act) was enacted. The FMRA Act amends several pieces of legislation, including the RBNZ Act, to address aspects of New Zealand law to allow compliance with the G20 margin requirements for OTC derivatives.

### ***Corporate governance***

Directors' duties in New Zealand are prescribed by legislation, in particular the Companies Act, and common law. As fiduciaries, directors owe a duty:

- a* to act honestly;
- b* to exercise care and diligence;
- c* to act in good faith in the best interests of the company and for a proper purpose;
- d* not to improperly use their position or company information; and
- e* to disclose their material personal interests and avoid conflicts of interest.

Directors have duties regarding financial and other reporting and disclosure, solvency matters and reckless trading.

The Companies Act permits directors to rely on information or advice supplied by employees, professional advisers or experts, and other directors or directors' committees, provided that a director acts in good faith, makes proper enquiries where warranted by the circumstances, has no knowledge that such reliance is unwarranted, and has reasonable grounds to believe that his or her reliance on another person was warranted. Breaches of certain directors' duties under the Companies Act attract criminal liability.

At least one director of a company incorporated in New Zealand must live in New Zealand, or in an 'enforcement country' where that director is also a director of a company

registered (not as an overseas company) in that enforcement country. Similar requirements apply to limited partnerships under the Limited Partnerships Act 2008. At present, Australia is the only country prescribed as an enforcement country.

### ***Anti-money laundering***

New Zealand's anti-money laundering regime is set out in the AMLA.

The AMLA applies to reporting entities, which include, inter alia:

- a* a financial institution (a wide definition that includes a person who participates in securities issues and provides financial services related to those issues in the ordinary course of business);
- b* a designated non-financial business or profession; and
- c* any other person or class of persons deemed to be a reporting entity under the regulations or any other enactment.

The AMLA includes customer due diligence, reporting and record-keeping requirements, and in addition requires reporting entities to develop and maintain a risk assessment and a risk-based anti-money laundering and countering financing of terrorism programme. The AMLA provides for external supervision of entities subject to the AMLA to monitor the level of risk of money laundering and the financing of terrorism involved in an entity's activities, and to ensure programmes are appropriately tailored to address those risks.

## **II THE YEAR IN REVIEW**

### **i Continued green bond issuance and the emergence of sustainability bonds**

Following the inaugural retail (regulated offer) of green bonds in New Zealand by Auckland Council (New Zealand's largest local authority) in June 2018, a number of other New Zealand issuers have successfully raised financing through such offers. For example, Argosy Property Limited raised NZ\$100 million in March 2019 in the first regulated offer of green bonds by a New Zealand corporate, and Housing New Zealand Limited raised NZ\$500 million in April 2019 through its wholesale offer of sustainability bonds.

### **ii Capital Markets 2029**

In January 2019, NZX and the FMA initiated an industry-led review of New Zealand's capital markets framework. In collaboration with EY, the industry working group delivered its 10-year vision and growth agenda to promote stronger capital markets for all New Zealanders, entitled 'Growing New Zealand's Capital Markets 2029', in September 2019. The report identified key trends in New Zealand's capital markets and set out a number of recommendations intended to, among other things, raise the level of participation and engagement, promote the use of capital markets to fund infrastructure, grow the base of companies that can access the public capital markets and offer more choice of investment for individuals.

### **iii Revised NZX Listing Rules and listing of wholesale debt**

Following substantial consultation, NZX released its revised Listing Rules on 1 January 2019, with all issuers required to have transitioned to these by 1 July 2019. Key changes effected by the revised Listing Rules included revised eligibility for listing requirements, the introduction

of the concept of constructive knowledge in respect of continuous disclosure and the introduction of tailored rules for funds to be listed. The revised Listing Rules also introduce the listing of wholesale debt, which is subject to only limited requirements. Among other things, the stated aim of these changes is to make it easier for companies to list on NZX, make it simpler and faster for listed companies to raise additional capital, and generally enhance investor protections.

#### **iv Benchmarking reforms**

In addition to the OTC reforms discussed above, the FMRA Act will introduce a voluntary licensing regime for administrators of financial benchmarks to be supervised and enforced by the FMA. The regime will be brought into force by order in council no later than 30 August 2020. Implementation of this regime is intended to ensure that a New Zealand financial benchmark can continue to be referenced within the EU when Regulation (EU) No. 2016/1011, commonly referred to as the Benchmarks Regulation, fully comes into force.

### **III OUTLOOK AND CONCLUSIONS**

The government is undertaking a review of the RBNZ Act to ensure the Reserve Bank's monetary and financial policy frameworks still provide the most efficient and effective model for New Zealand. In particular, the focus is to ensure that the RBNZ Act is fit for purpose and aligned with what the government considers will provide a strong, flexible and enduring regulatory framework that enjoys broad public and industry support. Public consultation began in November 2018, and the review is ongoing.

In August 2019, the Reserve Bank published and sought submissions on an exposure draft of the Financial Market Infrastructures Bill. The Bill will establish a new framework for regulation and supervision of operators and participants in the financial market infrastructure, being systems used for payment, clearing, settling or recording of financial transactions. Under the proposed regime, the regulators will be looking to monitor the sector with a range of information-gathering and investigative powers, with enhanced regulation in certain circumstances. It is anticipated that the Bill will be introduced to Parliament in late 2019.

# NIGERIA

*Fred Onuobia and Ayodele Ashiata Kadiri<sup>1</sup>*

## I INTRODUCTION

### i The Investments and Securities Act, 2007

The Nigerian capital market is regulated by a panoply of laws, chief among them being the Investments and Securities Act, 2007 (ISA). Divided into 18 parts, the ISA makes provision for the establishment of the Securities and Exchange Commission (SEC). The SEC is the main regulatory organ of the Nigerian capital market and has the power, inter alia, to:

- a* make rules and regulations for the market;<sup>2</sup>
- b* register and regulate securities exchanges and other self-regulatory organisations;
- c* register and regulate the issuance of securities;<sup>3</sup>
- d* intervene in the management and control of failing capital market operators;<sup>4</sup> and
- e* in appropriate circumstances, impose penalties and levies on defaulting capital market operators.

Consequently, the Securities and Exchange Commission Rules and Regulation, 2013 (SEC Rules), drawn up by the SEC pursuant to its powers, is considered the market's bible. The SEC periodically releases new rules to complement the SEC Rules.

Two other key bodies established by the ISA are the Administrative Proceedings Committee (APC) and the Investments and Securities Tribunal (IST). The APC is a committee of the SEC established as a quasi-judicial fact-finding body. Essentially, it provides the avenue for market operators against whom complaints have been made (by investors and

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2 The Securities and Exchange Commission has issued the SEC Rules, 2013 (as amended), available at [sec.gov.ng/regulation/rules-codes](http://sec.gov.ng/regulation/rules-codes).

3 The Investments and Securities Act, 2007, Section 315, defines securities as: debentures, stocks or bonds issued or proposed to be issued by a government; debentures, stocks, shares, bonds or notes issued or proposed to be issued by a body corporate; any right or option in respect of any such debentures, stocks, shares, bonds, notes; or commodities futures, contracts, options and other derivatives, and the term securities in this Act includes those securities in the category of the securities listed above, which may be transferred by means of any electronic mode approved by the SEC and which may be deposited, kept or stored with any licensed depository or custodian company as provided under this Act.

4 ISA, Section 315 defines capital market operators as 'any persons (individual or corporate) duly registered by the Commission to perform specific functions in the capital market', which covers brokers, underwriters, solicitors and their respective firms.

the SEC alike) to be heard prior to the determination of the complaint by the SEC.<sup>5</sup> It goes without saying that a decision of the APC will be regarded as a decision of the SEC, and an appeal can therefore be made to the IST.

The IST is established under the ISA to adjudicate on any question of law or dispute involving:

- a* a decision or determination of the SEC in the operation and application of the ISA, and, in particular, relating to any dispute between:
  - capital market operators;
  - capital market operators and their clients;
  - an investor and a securities exchange or capital trade point or clearing and settlement agency; or
  - capital market operators and self-regulatory organisations;
- b* the SEC and a self-regulatory organisation;
- c* a capital market operator and the SEC;
- d* an investor and the SEC;
- e* an issuer of securities and the SEC; and
- f* disputes arising from the administration, management and operation of collective investment schemes.<sup>6</sup>

Decisions of the IST are to be enforced in the same manner as a decision of the Federal High Court (FHC). Appeals arising from decisions of the IST lie at the first instance to the Court of Appeal.

## **ii The Companies and Allied Matters Act**

The Companies and Allied Matters Act (CAMA)<sup>7</sup> is secondary in its applicability to the capital market. It governs most aspects of the incorporation and operations of companies and other corporate bodies requiring incorporation or registration with the Corporate Affairs Commission (CAC).<sup>8</sup> To the extent that these companies and corporate bodies are participants in Nigeria's capital market, CAMA provisions are significant and apply also to the capital market. For instance, Parts VI and VII of the CAMA make provisions on the nature and types of shares and bonds to be issued by companies. These securities end up being offered and traded in the Nigerian capital market.

## **iii Other relevant statutes**

Undoubtedly, other sector-specific legislation has a certain degree of relevance to the capital market. Arguably, the most important is that relating to banks<sup>9</sup> (Banks and Other Financial

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5 Under an SEC circular dated 16 February 2015 on complaints management, most complaints are now to be initially lodged and resolved at trade group level or by self-regulatory organisations, such as the Nigerian Stock Exchange. Complaints not resolved at this level are to be referred to the SEC. Consequently, market operators must register as members of their respective SEC-recognised trade groups. The objective of this arrangement is to secure speedy resolution of complaints.

6 See ISA, Section 274.

7 The Companies and Allied Matters Act, Cap C20, LFN 2004.

8 The Corporate Affairs Commission is established by the CAMA, Section 1. It is Nigeria's equivalent of the UK Companies House.

9 Banks are significant issuers of securities traded in the Nigerian capital market.



Institutions Act, 1991) (as Amended), pension fund administrators<sup>10</sup> (Pension Reform Act, 2014) and the Central Bank of Nigeria (CBN)<sup>11</sup> (Central Bank of Nigeria (Establishment) Act, 2007).

#### iv Regulation of foreign investment

There is no difference in the regulatory treatment of foreign investment in the capital market as compared with the regulation of local investment in the market. Dealings in foreign exchange are regulated by both statute and the CBN through regulations, circulars and directives. A key piece of legislation is the Foreign Exchange (Monitoring and Miscellaneous Provisions) Act<sup>12</sup> (FEMM Act).<sup>13</sup> Foreign exchange (FX) transactions are also regulated by the Foreign Exchange Manual (FX Manual), which was recently revised so that it conforms with the foreign exchange practices implemented by the CBN in the past two years.

There are no regulatory restrictions on foreign investment in the capital market. Pursuant to Section 26 of the FEMM Act:

*A person, whether (a) resident in or outside Nigeria, or (b) a citizen of Nigeria or not, may deal in, invest in, acquire or dispose of, create or transfer any interest in securities and other money market instruments whether denominated in foreign currencies in Nigeria or not. A person may invest in securities traded on the Nigerian capital market or by private placement in Nigeria.*

Nevertheless, a foreign investor seeking to invest in the market must ensure that any foreign currency to be invested in the market is imported into Nigeria through an authorised dealer.<sup>14</sup> The FX Manual now permits authorised dealers to issue an electronic certificate of capital importation (eCCI) to the investor. The CBN initiated the development of the eCCI platform in 2016 to address the problems posed by the issuance of paper certificates of capital importation such as the transfer of paper certificates from one foreign investor to another or replacements of lost CCIs. The eCCI platform for the deployment of eCCIs was finalised in 2017. With the revisions to the FX Manual in 2018, eCCIs will now be issued to foreign investors purchasing Nigerian treasury bills and Nigerian government bonds,<sup>15</sup> and the CBN has introduced a master eCCI for global depositary receipts. Authorised dealers are expected to issue master eCCIs in the amount of the foreign exchange inflow to depositary banks. The eCCI guarantees 'unconditional transferability of funds, through an authorised dealer in

10 Pension fund administrators are influential investors in the market. Regulations made pursuant to the Pension Reform Act on assets that qualify for investments by pension fund administrators invariably dictate products that make their way to the capital market.

11 The CBN regulates banks and dealings in foreign exchange in the Nigerian economy.

12 The Foreign Exchange (Monitoring and Miscellaneous Provisions) Act, Cap F34, LFN 2004.

13 The Foreign Exchange Manual issued by the CBN is in furtherance of the regulatory duty imposed by the FEMM Act. The CBN also regularly issues circulars on the regulation of the use of foreign exchange in the economy. For example, the CBN, by a Circular on the 'Inclusion of some Imported Goods and Services on the List of Items not valid for Foreign Exchange in the Nigerian Foreign Exchange Markets' dated 23 June 2015, barred access to the foreign exchange market for the purchase of foreign exchange for investment in Eurobonds, foreign currency bonds and shares.

14 An authorised dealer is a bank licensed under the Banks and Other Financial Institutions Act, 1991 (as Amended) and such other specialised bank issued with a licence to deal in foreign exchange. The Foreign Exchange (Monitoring and Miscellaneous Provisions) Act, Section 41.

15 Memorandums 19 and 20 of the FX Manual.

freely convertible currency, relating to dividends or profits (net of taxes) attributable to the investment'.<sup>16</sup> Similarly, foreign exchange purchased from the Nigerian Autonomous Foreign Exchange Market<sup>17</sup> can be freely repatriated from Nigeria without any further approval. The freedom to repatriate must be exercised in accordance with the provisions of the FEMM Act and the FX Manual to avoid running foul of the forex repatriation regime.<sup>18</sup>

The SEC Rules also require portfolio investors to appoint a custodian and to file a copy of the letter of appointment of the custodian with the SEC within 10 working days of making the appointment.<sup>19</sup>

Nigerian law requires a foreign company seeking to operate in the Nigerian capital market to first incorporate and register a Nigerian company with the CAC.<sup>20</sup> Subsequently, the company must register with and obtain the relevant licences or authorisations from the SEC before it can commence operations as a capital market operator in the market.<sup>21</sup>

Similarly, a foreign company can only apply and be registered as a dealing member of the Nigerian Stock Exchange (NSE) upon registering and incorporating a separate Nigerian entity with the CAC.

## v Cross-border securities transactions

Much like foreign investments, foreign issuers can issue, sell or offer for sale or subscription securities to the public through the Nigerian capital market. Securities may be denominated in naira or any convertible foreign currency.<sup>22</sup> The SEC Rules require foreign issuers to file an application for the registration of their securities with the SEC, and the application must be accompanied by a draft prospectus.<sup>23</sup> Importantly, under new NSE Rules, foreign issuers may apply for the listing of their *sukuk* and debt securities on the NSE.

<sup>16</sup> FEMM Act, Section 15(4).

<sup>17</sup> Defined in the FEMM Act as 'a market which the authorised dealers, authorised buyers, foreign exchange end-users and the Central Bank are participants and may include other participants that the Government of the Federation may, from time to time, recognise'.

<sup>18</sup> The Nigerian Subsidiary of the South African telecommunications company, MTN, was directed by the CBN to refund the sum of US\$8.13 billion, which the CBN said was illegally repatriated from Nigeria. Fines were also imposed on several authorised dealers for forex repatriation infractions the CBN found them to have committed. See <https://guardian.ng/news/nigeria-orders-south-africas-mtn-to-refund-8-13-bln/> (accessed on 29 August 2019). Issues around the fines have now been resolved amongst the CBN, MTN and the authorised dealers.

<sup>19</sup> SEC Rules, Rule 411(e).

<sup>20</sup> CAMA, Section 54 makes it a general requirement for all foreign companies intent on carrying on business in any sector of the Nigerian economy to obtain incorporation as a separate Nigerian entity before commencing business. The CAC certificate of incorporation issued to a foreign company pursuant to this provision is one of the documents required for registration with the SEC as a capital market operator.

<sup>21</sup> SEC Rules, Rule 407. Other registration requirements include a certified true copy of the certificate of incorporation in the company's country of domicile; proof of registration with the securities regulator or any other regulatory authority in the foreign entity's country of domicile; and the shareholding structure of the foreign company.

<sup>22</sup> SEC Rules, Rule 414.

<sup>23</sup> Extensive provisions are made for the content of the draft prospectus in Rule 419 of the SEC Rules. The registration obligations placed on foreign issuers are the same as those placed on Nigerian public companies, trust companies, collective investment schemes, governments and government agencies, and supranational bodies.

Foreign issuers may, at the discretion of the SEC, be exempted from certain securities registration obligations under the SEC Rules if it is 'in the public interest and where reciprocal agreement exists between Nigeria and the country of the issuer, or the issuer's country is a member of the International Organization of Securities Commissions'.<sup>24</sup>

## vi The court system

Nigeria operates a common law system, but with a federal written Constitution<sup>25</sup> as the basic law. The Supreme Court of Nigeria sits atop the hierarchy of courts, with the Court of Appeal on the next rung. The high courts and National Industrial Court are on the next rung; these courts are referred to as superior courts of record. Of importance to the Nigerian capital market is the FHC, which has 36 divisions across the country.

The FHC has exclusive jurisdiction over matters:

- a 'arising from the operation of the Companies and Allied Matters Act or any other enactment replacing that Act or regulating the operation of companies incorporated under the Companies and Allied Matters Act';
- b 'the administration or the management and control of the federal government or any of its agencies'; and
- c 'any action or proceeding for a declaration or injunction affecting the validity of any executive or administrative action or decision by the federal government or any of its agencies'.<sup>26</sup>

Most operators in the capital market are limited liability companies incorporated under and regulated by the CAMA. It is arguable that the FHC has jurisdiction over matters that touch on the operation of these 'CAMA companies', even if such matters occur in the capital market. Points (b) and (c) above are also relevant to capital market disputes because the SEC, which is the main regulatory body of the capital market, is an agency of the federal government.<sup>27</sup>

24 SEC Rules, Rule 416.

25 The Constitution of the Federal Republic of Nigeria, 1999 (as amended).

26 Section 251 of the Constitution.

27 There is often an overlap of jurisdiction between the FHC and the IST in capital market disputes, and there have been no definitive pronouncements or general guiding principles laid down by the Supreme Court on this issue. Cases have therefore been determined individually, creating inconsistency, uncertainty and the opportunity to forum shop.

For example, in *Ajayi v. SEC* [2009] 13 NWLR Pt 1157, the FHC decision declining jurisdiction was upheld by the Court of Appeal. The case was for judicial review of an SEC decision through its Administrative Proceedings Committee. The FHC in declining jurisdiction stated that the ISA 'rested the adjudication arising from the operation of the ISA within the purview of the IST'. That jurisdiction of the IST is not of a concurrent application with the FHC (per Peter-Odili, JCA at p. 26). However, another panel of the Court of Appeal in *Christopher Okeke v. SEC* (2013) LPELR-20355 (CA) refused to follow *Ajayi v. SEC*, and decided that the FHC had jurisdiction instead. The Court in its ruling stated that the jurisdiction of the FHC granted by the Constitution 'cannot be whittled down or taken away by an ordinary Act of the National Assembly in the absence of any amendment to the provision [of the Constitution] in question' (per Saulawa, JCA at p. 28).

## vii The FMDQ Securities Exchange Plc

The FMDQ Securities Exchange Plc (FMDQ Exchange) is the largest securities exchange<sup>28</sup> in Nigeria by trading volume and focuses on debt and derivative products. The FMDQ Exchange's listing requirements are similar to those of the NSE, but it is dissimilar in its admission of commercial papers for listing. Further, unlike the NSE, the FMDQ Exchange currently operates only one quotation list. Like the NSE and in furtherance of Part XIV of the ISA, the FMDQ Exchange established its investor protection fund in 2017.

The FMDQ Exchange also has a thriving derivatives platform and plays a vibrant role in the trading of over-the-counter (OTC) FX futures.<sup>29</sup> In 2016, the FMDQ, in collaboration with the CBN, launched the naira-settled OTC FX futures. The FMDQ, following a CBN circular dated 21 April 2017, also developed the Nigerian Autonomous Foreign Exchange Rate Fixing (NAFEX), which is a fixing methodology for the settlement of certain FX derivatives in the Nigerian market.<sup>30</sup> Generally, and with the supervision of the CBN, the FMDQ is responsible for the registration and operational regulation of FX options and will spearhead the development of other risk management products and guidelines.

In the first half of 2019, the FMDQ Group (FMDQ) underwent a restructuring that birthed the first vertically integrated financial market infrastructure group in Africa made up of three entities: the FMDQ Exchange, FMDQ Depository Limited, and FMDQ Clear Limited. With the restructuring, FMDQ obtained the requisite approval of the SEC to reflect the new status upgrade of the FMDQ Securities Exchange Plc from an OTC market to a securities exchange. FMDQ Clear Limited was also registered as the first central and only clearing house in Nigeria. FMDQ Depository Limited will provide clearing, custodian and settlement services. Equity securities were not admitted for listing before the restructuring, that is, when FMDQ Securities Exchange Plc operated as a hybrid operating both as a traditional securities exchange and as an OTC platform.<sup>31</sup> However, with its new status, it appears the FMDQ Exchange will provide a platform for trading not only equities but also commodities.

## viii The NSE

A very significant player in the Nigerian capital market is the NSE.<sup>32</sup> Established in the wake of Nigeria's independence from British colonial rule, the NSE operates an automated trading

28 See <https://www.fmdqgroup.com/about/> (accessed on 29 August 2019).

29 See the Guidelines for the Operation of the Nigerian Inter-Bank Foreign Exchange Market, 2016; the OTC FX Futures Market Operational Standards, 2018 (and the appendix - OTC FX Futures Market Close-Out Methodology) and the OTC Foreign Exchange Futures Market Framework, 2019. See generally <https://www.fmdqgroup.com/markets/products/derivatives/> (accessed on 29 August 2019) for the FMDQ's publications on its derivative products (accessed on August 29, 2019)

30 By the circular, the CBN also established an investors' and exporters' window for eligible invisible transactions detailed under the miscellaneous payments of Memorandum 15 of the 2006 version of the FX Manual (Memorandum 14 of the 2017 revision). It is expected that the circular may be updated to reflect how the revisions to the FX Manual will affect derivatives in the investors' and exporters' window. The circular can be accessed at <https://www.cbn.gov.ng/Out/2017/FMD/ESTABLISHMENT%20OF%20INVESTORS%20&%20EXPORTERS%20FX%20WINDOW.pdf> (accessed on 3 September 2019).

31 The FMDQ Securities Exchange Plc (then FMDQ OTC Plc) initially operated as an OTC platform, then became FMDQ OTC Securities Exchange Plc in 2018 before the restructuring in the first half of 2019.

32 The NSE is currently a non-profit-making CAMA company limited by guarantee. However, there are plans for the demutualisation of the NSE. In this regard, the SEC released the Rules on Demutualisation

system and is, in conjunction with the Central Securities Clearing System Plc (CSCS), capable of offering electronic clearing, settlements, delivery and custodial services. Headquartered in Nigeria's commercial capital, Lagos, the NSE has 13 other branches in the country, where trading occurs simultaneously.

The NSE currently operates the Main Board, the Alternative Securities Market (ASeM), and the Premium Board, which was introduced in August 2015.<sup>33</sup> The ASeM Board is targeted at small and medium-sized enterprises, and requires fewer stringent listing requirements and relatively low capital-raising costs. Significantly, companies seeking to be listed on the ASeM must appoint a designated adviser whose role is to navigate the company through the listing process and requirements, especially its continuing obligations once listed on the ASeM. Conversely, the Premium Board is for gold standard companies that successfully meet the most stringent standards of the NSE. Importantly, all trading and listing on the NSE occurs through dealing members, which are stockbroking firms so licensed by the NSE. Investors are required to open securities accounts with the CSCS.

As mandated by the ISA,<sup>34</sup> the NSE has maintained an investor protection fund (IPF) since 2013. The IPF is administered by a board of trustees subject to the regulatory supervision of the SEC. The purpose of the IPF is for compensation of investors' losses arising from:

*the insolvency, bankruptcy or negligence of a dealing member firm of a securities exchange or capital point; and defalcation committed by a dealing member firm or any of its directors, officers, employees or representatives in relation to securities, money or any property entrusted to, or received or deemed received by the dealing member firm in the course of its business as a capital market operator.*<sup>35</sup>

Claims can be made against a dealing member, and the current maximum amount an investor can receive as compensation in a claim against a dealing member is 400,000 naira.<sup>36</sup> The SEC launched the National Investor Protection Fund (NIPF) in 2015. The rules of the NIPF were finalised and became operational in June 2017. The launch of all these funds (i.e., the IPF, the NIPF and the FMDQ investment protection fund) is in furtherance of the investor protection mandate of the 10-year Nigerian Capital Market Master Plan launched in 2015.

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of Securities Exchanges in Nigeria in the first quarter of 2015. The implementation of the demutualisation of the NSE has gathered momentum this year with the enactment of the Demutualisation of the Nigerian Stock Exchange Act, 2018. See also Section II.iv.

33 The Premium Board was officially launched by the NSE on 25 August 2015 with the three pioneer companies that successfully met the stringent listing requirements: Zenith Bank Plc, FBN Holdings Plc and Dangote Cement Plc. On 16 April 2018, the NSE migrated Access Bank Plc, Lafarge Africa Plc, Seplat Petroleum Development Company Plc and United Bank for Africa Plc to the Premium Board. MTN Nigeria Communications Plc was migrated to the Premium Board on 16 May 2019, bringing the total number of companies on the Premium Board to eight. However, Lafarge Africa Plc is currently tagged as below listing standards in line with NSE's Compliance Status Indicator Codes. See <http://www.nse.com.ng/issuers/listed-securities/listed-companies?filter=premium+board> (last accessed 29 August 2019).

34 The SEC's national investor protection fund is 5 billion naira. See ISA, Section 197.

35 ISA, Section 198.

36 This amount might be inadequate to compensate a high-net-worth investor. In relative terms, however, it is a decent sum to the average small-time investor who is more susceptible to volatility in the market and misconduct on the part of capital market operators.

## ix Other securities exchanges

The NASD provides a formal OTC trading platform for unlisted securities of public companies. Unlike the FMDQ Exchange, equity securities can be traded on the NASD platform. Securities traded on the NASD are categorised as 'NASD Blue' (shares with a history of sound financial performance), 'NASD Pink' (shares of companies that do not comply with the minimum disclosure and reporting requirements of the SEC and NASD) or 'NASD Red' (shares of companies that fail to provide NASD with information).<sup>37</sup>

There are a number of proposals to establish exchanges for commodities in addition to the Nigerian Commodity Exchange (NCX)<sup>38</sup> and the AFEX Commodities Exchange. The NCX was set up as a stock exchange in 1998 and converted into a commodity exchange in 2001. Major commodities currently being traded are agricultural produce such as cocoa, sesame seeds, palm produce and cowpeas. The NCX recently announced that it would extend the use of its platform to solid mineral-related products. The NCX was the only commodity exchange in Nigeria until 2014 when the SEC registered the first private sector commodities exchange, AFEX.<sup>39</sup> The SEC has also given its final approval for the establishment of the Lagos Commodity and Futures Exchange being promoted by the Association of Securities Dealing Houses of Nigeria to operate as a commodities and futures market.<sup>40</sup>

## II THE YEAR IN REVIEW

### i Derivatives

The derivatives regulatory space has been very active in recent years. Derivatives are largely traded on a bilateral basis between international banks and major Nigerian banks. Perhaps because a majority of the players in the space are banks and the underlying instruments for most derivatives transactions that currently occur in the market are foreign exchange ones, the main regulator has been the CBN. Last year, both the SEC and the NSE proposed different rules to guide the trading of derivatives. However, the SEC approved the NSE Rulebook of the Nigerian Stock Exchange Derivative Market on 19 August 2019 (NSE Rulebook).<sup>41</sup> While the NSE Rulebook will govern trading of derivatives on the NSE, the SEC rules (when finalised) will govern both OTC-traded derivatives and exchange-traded derivatives. In 2018, the Senate of the National Assembly passed the Companies and Allied Matters Bill (Companies Bill), which seeks to amend the CAMA. The Companies Bill includes provisions on the validity of netting arrangements in certain contracts, including derivative contracts. The Companies Bill is currently awaiting being passed by the House of Representatives and gaining the assent of the President. These regulatory, albeit incomplete, interventions in the derivatives space are indicative of the growing relevance of derivatives in the Nigerian capital market.

37 The NASD provides the rules for admission of securities on its website at <https://nasdng.com/prices-markets/otc-securities-categorization/> (accessed on 29 August 2019).

38 See <http://nigeriacommex.com/en/> (accessed on 29 August 2019).

39 See SEC publication 'A Report on Commodities Trading Ecosystem in Nigeria', available at <http://sec.gov.ng/wp-content/uploads/2018/04/Report-of-TC-on-Commodity-Ecosystem-2.pdf> (accessed on 1 October 2018).

40 See <https://www.vanguardngr.com/2019/08/report-on-commodities-trading-expected-to-spur-capital-market-economy-sec/> (accessed on 29 August 2019).

41 See <https://punchng.com/sec-approves-nse-rulebook-on-derivatives-market/> (last accessed on 29 August 2019).

## ii CBN regulation

To provide some background, prior to 2016, certain hedging products had been approved by the CBN for offer by authorised dealers to their customers. In particular, Memorandum 5 of the FX Manual permits authorised dealers to deal in FX spot, forward, futures and swap contracts. In addition to this, in 2011, the CBN released Guidelines for FX Derivatives in the Nigerian Financial Markets, which lists the approved hedging products that authorised dealers can offer to their customers as 'FX Options, Forwards (Outright and Non-Deliverable), FX Swaps and Cross-Currency Interest Rate Swaps'. The 2011 Guidelines further state that 'Authorised Dealers are to ensure that their customers are hedging trade- (visible and invisible) related foreign exchange exposures in their obligations and not speculating on the Naira'.

In 2016, as part of its response to the prevalent FX liquidity shortage in the Nigerian financial markets, the CBN issued its Revised Guidelines for the Operation of the Nigerian Inter-Bank Foreign Exchange Market (Revised Guidelines). Under the Revised Guidelines, naira-settled non-deliverable OTC FX futures (NDFs) were included in the approved hedging products that authorised dealers can offer to their customers. As with other hedging products, NDFs must be backed by trade transactions (visible and invisible) or evidenced investment.

The CBN further directed that the NDF trades were to be facilitated on the FMDQ Exchange (this was prior to the FMDQ restructuring). Generally, with the restructuring of the FMDQ, as well as the new outlook of the FMDQ Exchange, stakeholders anticipate further CBN circulars and FMDQ publications in due course to explain how the new status of the FMDQ Exchange will affect the continued implementation of these guidelines (if at all).

## iii New products

From the second half of 2017, the federal government has been pioneering the issuance of new products in the market. The first was the seven-year 100 billion naira sovereign *sukuk* bond issued in September 2017. On 18 December 2017, Nigeria issued a five-year 10.69 billion naira sovereign green bond, which is the world's first Climate Bonds Initiative certified sovereign bond. The SEC also approved and issued the rules on green bonds in the last quarter of 2018. Last year, the FMDQ, the Climate Bonds Initiative and the Financial Sector Deepening Africa began promoting a scheme, the Nigerian Green Bond Market Development Programme, targeted at driving education about and raising awareness of the implementation of green financing in Nigeria, and as a consequence, the development of the green bond market and the non-sovereign debt capital market. It was in furtherance of that scheme that Access Bank Plc (one of Nigeria's leading banks) announced the issuance of the first certified corporate green bond in Africa, raising 15 billion naira in April 2019.<sup>42</sup>

## iv Sundry matters

The demutualisation of the NSE has been accelerated following the enactment of the Demutualisation of the Nigerian Stock Exchange Act, 2018 last year. It is expected that the NSE will complete its public listing by the end of this year.<sup>43</sup> The Nigerian Insurance Commission, NAICOM, recently revised upwards the minimum capital base for insurance

42 The five-year, 15.50 per cent fixed rate and fully subscribed bond has been awarded an AA- rating by Augusto & Co, and certified by the Climate Bonds Initiative. According to stakeholders, the issuance of the corporate green bond reveals the prospects of the Nigerian green finance market.

43 See <https://af.reuters.com/article/nigeriaNews/idAFL5N22S6X3> (accessed on 30 August 2019).

companies.<sup>44</sup> While the new capital requirements will immediately apply to companies seeking to carry on insurance business in Nigeria, existing insurance and reinsurance companies are required to be compliant with the share capital requirements no later than 30 June 2020. There are likely to be a lot of capital-raising exercises (both debt and equity) in the insurance industry in the coming months as insurers seek to comply with the new requirements. In 2014, the federal government issued an executive order exempting income from certain securities exchange transactions from VAT (VAT Order). The VAT Order, which was officially gazetted and dated 30 July 2014, became effective from 25 July 2014 and was to last for a period of five years from that date. Consequently, the VAT Order ceased to be effective on 24 July 2019. According to reports by several news agencies, the federal government may extend the exemption. The SEC continues to dedicate its efforts to implementing the Capital Market Master Plan, and has announced its intention to review the Capital Market Master Plan in line with current Nigerian economic realities, and engage stakeholders on e-Dividend registration and multiple accounts regularisation to deal with the problems associated with unclaimed dividends in the Nigerian capital market.

### **III OUTLOOK AND CONCLUSIONS**

The Nigerian capital market can best be described as emerging, robust and dynamic. Current global economic challenges have no doubt had an effect on the Nigerian capital market. However, tailor-made regulations and products introduced by the SEC make the market attractive to both local and foreign investors.

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<sup>44</sup> See the Circular on Minimum Paid-Up Share Capital dated 20 May 2019 and the follow-up circulars dated 23 July 2019 (<https://www.proshareng.com/news/INSURANCE/Nigeria--New-Minimum-Paid-Up-Share-Capital-Policy-For-Insurance-And-Reinsurance-Firms/45396>), (<https://www.proshareng.com/news/INSURANCE/Clarification-on-NAICOM%E2%80%99s-May-2019-Recapitalization-Policy-%E2%80%93Mergers-and-Acquisition-Guidelines-and-/46247>) and (<https://www.proshareng.com/news/Insurance/NAICOM-%E2%80%93Insurers-to-Submit-Recapitali/46248>) all accessed on 5 September 2019.



# PORTUGAL

*José Pedro Fazenda Martins, Orlando Vogler Guiné and Soraia Ussene<sup>1</sup>*

## I INTRODUCTION

The Portuguese economy has been recovering strongly since the end of the financial crisis and the successful conclusion of the financial assistance programme, benefiting from healthy dynamics in the tourism sector and improved investment in various other sectors. The improvement of leading indicators, the expansion of industrial production, the existence of low interest rates and a declining unemployment rate have been increasingly contributing to a boost in private consumption.

The Portuguese capital markets framework is substantially in line with the European legislation, which has been responsible for increasing harmonisation within the European Union. Notwithstanding, specific domestic laws and regulations may apply to specific instruments, their form of representation and transactions. Regulations issued by the Portuguese Securities Market Commission (CMVM), the Portuguese central securities depository Interbolsa and Euronext Lisbon should also be considered, since these national regulatory authorities may condense, adapt and interpret European legislation with a certain level of discretion.

The Securities Code (enacted by Decree-Law 486/99, as amended) establishes the framework for financial instruments, offers, financial markets and financial intermediation, and has been the statute used to transpose a variety of important European directives (including any amendments thereto) into national law, such as the Transparency Directive,<sup>2</sup> the Takeover Directive,<sup>3</sup> the Settlement Directives<sup>4</sup> and the MiFID II Directive.<sup>5</sup> Other relevant statutes include the Companies Code (as enacted by Decree-Law 262/86, as amended; this governs the corporate rules on shares and bonds) and the Credit Institutions and Financial Companies Framework (enacted by Decree-Law 298/92, as amended, also heavily amended to transpose or adjust to EU legislation).

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2 Directive 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market.

3 Directive 2004/25/EC on takeover bids.

4 Directive 98/26/EC on settlement finality in payment and securities settlement systems.

5 Directive 2014/65/EU on markets in financial instruments.

A considerable number of new or revised regulatory frameworks have affected the capital markets in Portugal during 2019, including:

- a* the new Prospectus Regulation<sup>6</sup> together with Delegated Regulations (EU) 2019/980 and 2019/979, both of 14 March 2019. Among other things, key changes in this context include:
  - a prospectus summary as a new content requirement and length restrictions that will make the summary section more concise but more difficult to draft;
  - material changes to the rules relating to risk factors, including European Securities and Markets Authority guidelines, to be taken into account; and
  - the obligation for financial intermediaries to contact investors on the same day that a supplement is published;
- b* Law No. 69/2019, of 28 August, which provides for the execution in the Portuguese jurisdiction of Regulation (EU) 2017/2402 of 12 December 2017, which lays down a general framework for securitisations and creates a specific framework for simple, transparent and standardised securitisations; and
- c* the SIGI regime, approved by Decree-Law No. 19/2019, which creates and regulates real estate investment and management companies (SIGIs) and aligns practices regarding SIGIs with the best international practices on real estate transfer trusts.

In addition to the new regulatory framework of this year, note that 2019 is still a year of implementation of the regulatory framework of the previous year, since 2018 was a year marked by a considerable number of new or revised regulatory frameworks in Portugal (MiFID II, MiFIR,<sup>7</sup> Packaged Retail and Insurance-based Investment Products Regulation (PRIIPs Regulation) and Decree-Law 56/2018, which implemented MiFID II and has also modified the general framework for collective investment schemes).

Regulations, notices and instructions issued by the CMVM or the Bank of Portugal may also be relevant. Bearing in mind the banking union that is currently being implemented and EU harmonisation developments, national banking laws are largely in line with EU rules.

The Portuguese capital markets framework still has a number of specificities (increasingly fewer, in light of EU harmonisation) that should be taken into account. The securities ownership regime is one of them. Under Portuguese law, legal ownership is not set immediately at the level of the accounts opened by financial intermediaries at the local central securities depository (CSD), but rather at a second level in the chain of custody, namely at the level of the accounts opened by clients at the respective financial intermediaries. In practice, though, the system works well, and most international investors hold Portuguese securities through indirect custody chains, going through Euroclear and Clearstream or other global custodians.

Another example, with important practical implications, is that the Portuguese tender offers regime is significantly wider in scope when compared to the Takeover Directive given that, in addition to equity securities, debt securities are also comprised within its scope of application (as is the case in some other jurisdictions). This means that typical debt securities tender offers will normally be restricted to professional investors in Portugal unless a securities

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<sup>6</sup> Regulation (EU) 2017/1129 of 14 June 2017.

<sup>7</sup> Markets in Financial Instruments Regulation (No. 600/2014).

takeover prospectus (in some cases, where the bonds are listed outside Portugal, a long-form information memorandum translated into Portuguese and resembling a prospectus) is approved and disclosed.

The financial regulation system is composed of three pillars (following the same structure as the European supervisory system, and divided in accordance with the activities and matters at stake), which are supervised by three authorities:

- a* the Bank of Portugal (the country's central bank), which has a prudential function (in coordination with the European Central Bank, particularly for the largest Portuguese banks) and market conduct powers to supervise matters related to credit institutions and financial companies acting in Portugal;
- b* the CMVM, which is empowered to supervise the market conduct of financial markets, issuers of securities, and financial instruments and financial intermediaries (investment firms and credit institutions acting under MiFID II capacity; and
- c* the Portuguese Insurance and Pension Funds Authority (ASF), which supervises the national insurance system.

Finally, the Portuguese authorities may apply sanctions to entities that fail to comply with the applicable laws. In general, resulting fines depend on the type of entity and activities carried out, as well as the seriousness of a breach. A supervisory authority's decision may be contested and submitted to the decision of a special court that exclusively decides on competition, regulation and supervisory matters.

Since the financial crisis, and given the collapse of some important Portuguese economic conglomerates, the supervisory authorities have been much more active in sanctioning market players, and the above-mentioned special court on regulatory matters was set up to enhance the capacity to respond to current regulatory demands. In recent years, authorities have imposed fines on several entities, including banking board members who were accused of hiding relevant accounting information.

## II THE YEAR IN REVIEW

### i Developments affecting debt and equity offerings

#### *Tender offers*

Given the relatively small size of the Portuguese market, with a reduced number of listed companies as compared with the capital markets of larger European economies, takeover bids, voluntary or compulsory, are not very common. The most important ones during the past year are described below.

In May 2018, Chinese state-owned power company China Three Gorges (CTG) preliminarily announced a voluntary takeover bid for the remaining 76.7 per cent of EDP shares that it did not already own. Since EDP controls EDP-Renováveis (EDP-R), CTG would be required, in the event that its offer for EDP were successful, to launch a mandatory bid for EDP-R. Therefore, at the same time, CTG also announced a preliminary takeover bid for EDP-R, which in practice allowed CTG to freeze at that point the cut-off date for the six-month volume-weighted average price of EDP-R shares, which serves to test the fairness of a mandatory bid price.

Under the terms of the respective preliminary announcements:

- a* the launching of the offer over EDP was subject, among other conditions, to the approval of an amendment to EDP's by-laws to remove the existing voting cap; and
- b* in turn, the launching of the offer over EDP-R was subject, among other things, to the verification of all conditions precedent for the launching of the offer over EDP.

On 24 April 2019, the general meeting of EDP did not approve the proposal for a resolution to remove the referred voting cap existing in EDP's by-laws, while CTG has confirmed in advance its intention not to waive such condition. For this purpose, a condition precedent for the registration and subsequent launching of the offer over EDP and, consequently, over EDP-R, was not verified. In light of the above, and in accordance with a notice disclosed to the market by CMVM on 12 April 2019, the CMVM's board of directors resolved, on 30 April 2019, to refuse the requests for registration of those takeover bids, thereby extinguishing the respective administrative procedures.

### ***Debt markets***

2019 was a strong year in the debt markets for non-financial Portuguese companies, which have continued to seek recourse to the retail capital markets. Government bonds also continued to be placed under public offers, thus allowing retail investors to continue their exposure to this market segment, which had been previously restricted (as far as the primary market was concerned) to institutional investors.

Private placements (both with and without listing) continued to play an important part in the diversification of financing routes for the Portuguese economy.

In October 2019, Mota-Engil, SGPS, SA launched a public subscription offer with a total nominal value of up to €75 million combined with two public exchange offers. This was the first prospectus approved by the Portuguese regulator after the new Prospectus Regulation entered into force. Moreover, this prospectus tackled the challenges imposed by the new framework, in particular in terms of the content of the summary section and given that a supplement was later approved to increase the total amount of the public subscription offer up to €100 million. The financial intermediaries had to contact the investors on the same day that the supplement was published. This communication was made by way of a short message service, which the Portuguese regulator considered to be a suitable means to inform the investors.

Apart from the usual issuers, in June 2019 the Portuguese market witnessed two inaugural public offers: Transportes Aéreos Portugueses, SA, the Portuguese airline company, with €200 million notes due in 2023; and Sociedade Independente de Comunicação, SA in the broadcasting and contents sector. The most innovative feature of these two deals is that it was the first time that it was acknowledged that Article 501 of the Portuguese Commercial Code (PCC) was regarded as equivalent to a corporate guarantee to avoid testing the debt-to-equity ratio. In particular, Article 349(1) of the PCC states that a corporation must comply with a debt-to-equity ratio equal to or higher than 35 per cent after bond issuance. As an exception to this, Article 349(4)(c) also foresees that the ratio is not applicable in cases where special guarantees are provided in favour of noteholders to secure repayment obligations under the relevant issue, and Article 501 of the PCC regime is now deemed equivalent.

At the start of the year, and for the first time in the country's history, a Portuguese company requested admission to trading of Portuguese law-governed securities on Alternative Fixed Income Market (MARF): José de Mello Saúde, SA issued commercial paper governed by

the maximum outstanding balance of €50 million on MARE. MARE is a multilateral trading facility, and is not a regulated market in accordance with the provisions of MiFID II. This deal was followed by another issue of commercial paper governed by Portuguese law, with the maximum outstanding balance of €50 million issued by Mota-Engil, SGPS, SA. In the second semester of 2019, the first Portuguese bonds were listed on MARE: €58 million notes by Efacec Power Solutions, SGPS, SA, a Portuguese limited liability company. This was the debut issuance in the capital markets of Efacec and the second-largest trade ever made on MARE.

In this context, MARE is a very attractive market for Portuguese law-governed companies as it has a diversified base of investors and allows for additional financing possibilities.

As regards the euro medium-term note (EMTN) programmes of Portuguese issuers, these have been undergoing adjustments to MiFID II and PRIIPs Regulation language requirements in line with other EU jurisdictions, and enabling these programmes to be ready for use in the international markets once the interest rate environment changes.

### ***Liability management exercise: the PTIF BV bonds case***

An interesting case that spanned various aspects of the legal regime of public offers is that involving the retail notes issued by Portugal Telecom SGPS.

In brief, in 2012 Portugal Telecom SGPS used the Prospectus Directive<sup>8</sup> passporting mechanism to use the prospectus of its EMTN programme in Portugal in a €400 million public offering of bonds with a par value of €1,000 per bond and maturity in 2016, to be placed with and subscribed to by retail investors. This was a public offer of securities under the usual terms.

In 2014, owing to corporate and business events, the issuer launched a consent solicitation process (that is, the calling of a meeting of bondholders to consent to a set of matters), which resulted in the substitution of the original issuer with PT Portugal and the payment of a consent fee to bondholders. In addition, Oi (a company with its registered office in Brazil) became bound as the guarantor of these obligations. In light of the doubts that could arise, and in a process closely monitored by the CMVM, it was concluded that this type of proceeding did not trigger the public offer regime.

In 2015, in the context of the sale of PT Portugal by its shareholder, the then-issuer PT Portugal launched a new consent solicitation process under which it was replaced by a new issuer, PTIF BV. The proceedings included the payment of a new consent fee and the creation of a sale option for investors (put option), with Oi (the parent company of PTIF BV) remaining as the guarantor. Again, this was not a public offering.

In June 2016, Oi filed a judicial recovery procedure in Rio de Janeiro, which was admitted, and PTIF BV defaulted on the due payment at maturity. The CMVM closely monitored this situation to safeguard the interests of retail investors in Portugal and to keep them informed about the process.

In 2017, Oi launched a programme in Brazil for small creditors, which allowed for an advance payment, in a first tranche (prior to the voting and approval of the judicial recovery plan of Oi), and the payment of a second tranche (following approval of the judicial recovery plan) to creditors up to the maximum limit of 50,000 reais. The programme was replicated

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8 Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading.

in Portugal beginning in October 2017 and ending in early December 2017. In this way, thousands of creditors in Portugal (who, unlike the small creditors in Brazil, were creditors of securities issued by PTIF BV and guaranteed by Oi) could enjoy the same benefit.

As mentioned above, this was a partial advance of the outstanding amount, followed by a second additional tranche of payment, which had as counterbalance the blocking (rather than the buying) of obligations. In this way, it was concluded, once again, that the public offer regime in Portugal was not to be applied.

Following approval by creditors and the court of the judicial recovery plan in Brazil in December 2017, it has also been interesting to follow the additional steps that have been taken to consolidate this decision at the securities level, including election processes, consent solicitations and settlement processes, across various clearing systems, including the Depository Trust and Clearing Corporation, Euroclear and Clearstream and, as there were these PT international securities identification number notes involved, also Interbolsa. None of these transactions amounted to public offers.

The last developments include acknowledgment by the Portuguese courts of the decisions taken in Brazil regarding the judicial recovery plan, which was a first-time achievement in the Portuguese jurisdiction.

## **ii Developments affecting derivatives, securitisations and other structured products**

### ***Derivatives***

After the big challenge of adjusting to variation margin requirements for financial counterparties and non-financial counterparties above the clearing threshold (NFC+) and clearing requirements for certain interest rate derivatives and credit default swaps (under the European Market Infrastructure Regulation framework) in 2017, and also adjustments to tackle MiFID II challenges in 2018 that included, inter alia, obligations to trade certain classes of derivatives through trading venues and certain pre and post-transaction information requirements, Regulation (EU) 2019/834 of 20 May 2019 entered into force on 17 June 2019 with significant amendments aiming to simplify the documentary process, introducing a new counterparty category (the small financial counterparty) and reducing certain burdens, including of reporting for small non-financial counterparties, as the financial counterparty should be responsible for reporting on behalf of both itself and the NFC.

### ***Asset-backed securities***

The securitisation market has been active during the past three years, and a variety of transactions have already been completed. These included transactions listed on the regulated market of Euronext Lisbon, both retained and placed in the market (at least some tranches of the transactions), with a variety of assets or receivables being securitised, including electricity receivables and traditional banking loans (for instance, mortgage-backed loans and consumer loans – both performing and non-performing). The transaction structure is, in certain cases, becoming more complex, and we have seen again derivatives being used to hedge interest rate risks (but in the form of a cap rather than an ordinary swap).

Non-performing loans (NPLs) are still a hot topic in the Portuguese financial system, and securitisations have been playing a role in solving this, even though most of the transactions are still made in a whole loan sale format. In November 2017, Caixa Económica Montepio Geral, having been successful in disposing to investors the mezzanine and junior tranches of its rated (and without government support) NPL securitisation Évora, the senior €123 million tranche was successfully placed in the market in June 2018, and the notes

were listed in Euronext Lisbon under the first NPL listing prospectus in southern Europe. This type of structure, which is particularly complex, includes the need to incorporate in the structure a real estate asset manager company and a monitoring agent and servicing committee. Given it has been proven that it works and at competitive pricing, in 2018 and 2019 similar deals were also launched: Guincho Finance in November and Gaia Finance in May 2019. Guincho Finance was originated by Banco Santander Totta. This was the first NPL made in Portugal in compliance with the new General Data Protection Regulation.

This deal was followed by Gaia Finance originated by Caixa Económica Montepio Geral. This was the first deal under which the assignor was not the original lender, and also the first transaction compliant with the new Securitisation Regulation in Portugal.

Finally, for the first time in years, a synthetic securitisation was also launched in May 2019 by a Portuguese bank in compliance with the Capital Requirements Regulation (CRR), including the requirement that the proceeds from the notes are deposited or otherwise controlled. In respect of securitisations, and now more in relation to performing loans, the STS Regulation,<sup>9</sup> which establishes a general securitisation framework at the EU level that is already, and will continue to be, particularly relevant, and became applicable for all securitisation products from 1 January 2019 onwards. Also to be noted is Regulation (EU) 2017/2401, amending Regulation (EU) 575/2013, which will make the capital treatment of securitisations for banks and investment firms more risk-sensitive and better suited to properly reflect the specific features of simple, transparent and standardised securitisations.

### ***Covered bonds***

Covered bonds continue to play a part in the Portuguese capital markets, with some issuances on the banking side, including syndicate issuances. Pass-through covered bonds programmes have also been set up by Portuguese issuers. By the end of October 2017, the first issue of pass-through covered bonds (i.e., covered bonds that in certain events convert the redemption structure into a product more like asset-back securities) placed in the market by a Portuguese issuer had taken place.

The result of the work developed by the European Commission on a directive proposal for a common EU minimum covered bonds framework has accelerated, and on 18 April 2019, the European Parliament provisionally adopted the covered bonds harmonisation package (a directive on covered bonds that replaces the provisions of Article 52 of the UCITS Directive and a Regulation that amends Article 129 of the CRR). The proposed directive is essentially designed to set a common legal ground (not so heavily based on rules as the market feared) and to legally acknowledge existing market practices (leveraging significantly on the work done by the European Covered Bonds Council). Some of the predicted changes include, inter alia, investors' access to information regarding the cover pool, a baseline covered bonds definition (dual recourse, segregation of assets, bankruptcy remoteness, public supervision, liquidity buffer) and the use of a European Covered Bonds Label. Given that the proposed directive appears to be substantially aligned with Portuguese law and market practices, we would not expect it to materially affect the market, but we will be seeing Portuguese issuers having to adapt their covered bonds programmes to include specific adjustments regarding objective and specified triggers, namely regarding the soft bullet and pass through structures.

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<sup>9</sup> Regulation (EU) 2017/2402 laying down a general framework for securitisations and creating a specific framework for simple, transparent and standardised securitisations.

The second part of the harmonisation package (the amendments to the CRR) includes additional requirements that covered bonds have to fulfil to benefit from preferential capital treatment and foresees credit risk-related features (eligibility of cover assets, loan-to-value limits, minimum over collateralisation).

In terms of timing, according to the European Covered Bonds Council, it is unlikely that the new covered bond package will apply before 2022 as, following publication of the new covered bonds directive in the official gazette, national lawmakers will have 18 months to transpose the directive into national law. The provisions of national laws shall apply at the latest 12 months after the transposition deadline. On the other hand, CRR amendments do not have to be transposed into national law, as the CRR is directly applicable and should apply from the date the covered bonds directive is applied.

### ***Own-funds regulations and senior non-preferred instruments***

After the first Additional Tier 1 capital instruments issuance placed in the market (€500 million by Caixa Geral de Depósitos) in 2017, with a write-down (and up) feature, rather than a conversion, later that year and in 2018, banks have started to issue Tier 2 capital instruments to the market, with Banco Comercial Português, Caixa Geral de Depósitos and Novo Banco having successfully approached the market. On January 2019, Banco Comercial Português also issued successfully €400 million Additional Tier 1 capital.

The CRR<sup>10</sup>, the CRD V,<sup>11</sup> both of 20 May 2019, and BRRD<sup>12</sup> entered into force on 27 June 2019. As regards CRD V, Member States shall adopt and publish by 28 December 2020 the measures necessary to comply with CRD V, although the majority of provisions will only apply from 28 June 2021. Regarding senior non-preferred instruments, Directive (EU) 2017/2399<sup>13</sup> of 12 December 2017 was finally transposed into the Portuguese legal framework by Law No. 23/2019, and has established that claims in respect of all deposits shall benefit from a general credit privilege over the movable assets of an insolvent entity and a specific credit privilege over its immovable assets. In this respect, Portuguese issuers have been updating their programmes in terms of eligible instruments in accordance with the new CRR rules as provided by Regulation (EU) 2019/876 of 20 May 2019.

### ***MiFID II***

The MiFID II and MiFIR legislative package entered into force in 2018 and is now in an advanced stage of implementation. Whereas MiFIR was directly applicable in Portugal, MiFID II was, after months of delay in the legislative process, finally transposed into Portuguese law by means of Law 35/2018 of 20 July, which entered into force on 1 August 2018. This law has amended various legal regimes that form the basis of the organisation and functioning of Portuguese financial markets, among which is the Securities Code.

The aim of this new regulatory package was to ensure greater transparency for all market participants, while also increasing market safety, efficiency and fairness, implementing enhanced governance for trading venues, on-exchange trading of standardised derivatives, more intensive regulation of commodity derivatives and greater consolidation of market data.

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<sup>10</sup> Regulation (EU) 2019/876.

<sup>11</sup> Directive (EU) 2019/878.

<sup>12</sup> Directive (EU) 2019/879.

<sup>13</sup> See Directive (EU) 2017/2399 as regards the ranking of unsecured debt instruments in the insolvency hierarchy.



Investor protection has been stepped up through the introduction of new requirements on product governance and intervention and independent investment advice, improved pre and post-trade transparency, the extension of existing rules on structured deposits and an improvement in requirements in a variety of areas, such as the responsibilities of management bodies, cross-selling, staff remuneration, inducement and information, more extensive transaction reporting, conflicts of interest and complaints handling. For independent discretionary portfolio management and investment advice segments, for instance, this implies revisiting the fee structures and arrangements that have been in place up to now, and a global review of their procedures and documentation. Product governance has also been a very significant challenge.

### ***The PRIIPs Regulation***

According to the PRIIPs Regulation, a packaged retail and insurance-based investment product constitutes any investment where, regardless of legal form, the amount payable or repayable to the retail investor is subject to fluctuations because of exposure to reference values or to the performance of one or more assets that are not directly purchased by the retail investor.

The PRIIPs Regulation pursues the objective of increasing the transparency and comparability of investment products through the issue of a standardised short-form disclosure document – the PRIIPs key information document (KID) – thereby making it easier for retail investors to understand and compare the key features, risks and costs of different products within the PRIIPs scope.

Law 35/2018 has been the instrument used for adapting the PRIIPs Regulation to the internal legal order in Portugal. The new regime defines, inter alia:

- a* the competent supervisory authorities, depending on the nature of the investment product in question (the CMVM, the Bank of Portugal or the ASF);
- b* a prohibition on the advertising of PRIIPs without the prior approval of the competent supervisory authority;
- c* a prohibition on making the execution of deposit contracts dependent upon the acquisition of financial instruments, insurance contracts or other financial savings and investment products that do not ensure the invested capital at all times; and
- d* the obligation to notify the competent supervisory authority of the PRIIP-related KID prior to the date it will become available to the public or modified.

The PRIIPs Regulation shall be read in conjunction with Law 35/2018 and CMVM Regulation 8/2018, which applies exclusively to PRIIPs whose issuance, trading or provision of consulting services is supervised by the CMVM. This Regulation regulates the information and trading duties of PRIIPs, specifically:

- a* the information to be made available;
- b* the language and features of the KID;
- c* the content of PRIIP advertising and the prior notification of the KID;
- d* protection measures for non-professional investors; and
- e* communication and registration duties.

### iii Cases and dispute settlement

Besides derivatives litigation and a prospectus case, discussed below, we would highlight that the application of the resolution measure to Banco Espírito Santo (BES) (and to Banif) entailed a significant amount of litigation, for various reasons and involved different stakeholders, but this did not prevent the sale process of Novo Banco being concluded in October 2017. We expect to report on the outcomes of these disputes in the coming years. Nevertheless, in an important case in the United Kingdom, *Goldman Sachs International v. Novo Banco SA*, it was confirmed that litigation regarding this particular resolution measure, including regarding English law contracts, should be decided by the Portuguese courts. It was decided that it was not for the court to interfere in the exercise of resolution powers by the Bank of Portugal (the national resolution authority), and thus that there were no grounds to pursue the case in the English courts.

More recently, two legal proceedings related to the sale of Novo Banco have been judged, one initiated by a shareholder of BES and another by several holders of subordinated bonds issued by BES, before the Lisbon Administrative Court, which were aggregated and designated as pilot proceedings. In both legal proceedings the plaintiffs challenged the validity of the Resolution Measure applied to BES on the basis of alleged illegalities and unconstitutionality. On 12 March 2019, the Lisbon Administrative Court fully dismissed the claims of the plaintiffs.

#### **Highlighted case law**

As context on derivatives, banks operating in the Portuguese market have been contracting swaps with clients during the past decade as follows: under master agreements governed by Portuguese law, based on the International Swaps and Derivatives Association (ISDA) master agreement principles, but shorter and less complex; and under standard ISDA master agreements. The latter alternative has been typically adopted by larger corporations (or public sector entities, as mentioned above) with wider experience in the financial markets, while the former has been more frequently used for smaller clients and by small and medium-sized enterprises (SMEs) that are relatively less experienced in the financial markets and more tempted to sue banks when an underlying asset evolves negatively.

During the past few years, several cases involving interest rate swap agreements have been analysed and decided by the Portuguese Supreme Court of Justice (STJ), essentially those related to disputes with SMEs.

In 2013, the STJ acknowledged the validity of derivative contracts and the applicability of a swap termination because of an abnormal change in circumstances, and also highlighted the importance of securing a balanced contract.

Following this decision, in 2015, two cases proved noteworthy in clarifying a range of issues that had been extensively discussed within the legal community, as reported in this chapter in the 2016 edition. The STJ affirmed the standing of derivatives as legally valid financial instruments, recognised as such under EU and national law, and thus not qualifying swaps as gambling or betting contracts. This represented a clear contribution to the stability of the financial system.

Case law has also addressed choice of forum clauses, having decided that choice of jurisdiction based on the applicable EU civil procedure rules (notably, Regulation (EU) No. 1215/2012) prevails over Portuguese domestic law, therefore acknowledging the validity of clauses attributing jurisdiction to the courts of England.

In another judicial decision, the Lisbon Court of Appeals ruled that not only shareholders that have decided to tender their shares to a bidder in a takeover are protected by prospectus liability. Any investor, either buyer or seller, that relied on the information inserted by a bidder in a prospectus may claim for damages against the bidder.

#### **iv Relevant tax and insolvency law**

##### ***Tax considerations***

The relevant tax issues will naturally depend on the kind of transaction at stake.

In particular in respect of corporate finance-type transactions, it is important to remember that, whenever some sort of financing with links to Portugal is contemplated, certain tax contingencies must be considered. In particular, account should be taken of any withholding tax on interest payments (as a general rule, 28 per cent for natural persons and 25 per cent for legal persons), including for non-residents (i.e., individuals, companies and even financial institutions). Another important aspect is the possible application of stamp duty when some sort of financing is granted (up to 0.6 per cent of the capital, depending on the maturity) and when paying interest (4 per cent of each payment).

Through a bond issue, these taxes may not apply or may be applied to a lesser extent. Under Decree-Law No. 193/2005 of 7 November, there is an exemption from withholding tax on interest payments to be made to non-residents if the requirements and formalities therein are met, including being registered in a CSD recognised by law (such as Interbolsa). On the other hand, and since bonds are a capital market instrument, stamp duty is not applicable to bond financing or to applicable interest payments, since that would restrict the free movement of capital within the European Union. In any case, it should be borne in mind that in the case of secured financing and if no stamp duty is levied on the financing, stamp duty may be payable on the security package.

##### ***Outline of the Portuguese insolvency regime***

The Portuguese Insolvency and Companies Recovery Code, which was established under Decree-Law 53/2004, has been amended and updated regularly, and contains provisions similar to those that can be found in the insolvency regimes of most jurisdictions, aimed at tackling the usual concerns arising in insolvency cases. Besides regulating insolvency proceedings, the Code also sets forth a special recovery proceeding, the aim of which is to promote the rehabilitation of debtors facing financial difficulties but that prove to still be economically viable, by providing a moratorium on any creditor action while a recovery plan is being agreed. This special recovery proceeding constitutes a standalone urgent judicial proceeding based on out-of-court negotiations that are later confirmed by a court.

As usual, the law provides for hardening periods (which are backwards-counting periods from the insolvency proceeding and in respect of which legal contracts may be resolved or terminated with retroactive effect), which notably depend on the date of contracting and the particular circumstances under which the relevant legal contracts were entered into; this includes a 60-day hardening period in respect of security provided with the relevant financing commitment (if these are after the financing, the period is six months). Financial collateral arrangements are excluded from the scope of the Code.

There have been recent legal amendments and additional statutes to enhance the recovery prospects of viable companies, which should be analysed in the context of potential restructurings.

**v Role of exchanges, central counterparties and rating agencies**

The Target 2 Securities system has entered into force and is already applicable. For this purpose, Interbolsa published Regulation 2/2016. Interbolsa also became eligible as a securities settlement system for the purposes of the short-term European paper (STEP) and step label,<sup>14</sup> the aim of which is to enhance the market and collateral prospects for Portuguese commercial paper issuers.

**vi Other strategic considerations**

Certain negative developments in the market during the past few years underline the importance for systemic entities and listed companies to have robust compliance and risk management systems in place. Increased public pressure on official institutions has resulted in more intense scrutiny by the supervisory authorities, including the CMVM, regarding:

- a* prospectus review and approval, but there is now a relevant trend at the CMVM to focus on quicker and more predictable reviews and calendar planning;
- b* complex financial products placement and relevant documentation;
- c* rules of conduct; and
- d* corporate governance.

The internal governance arrangements of listed firms and financial institutions, and the assessment of the suitability of those who hold positions in credit institutions and corporate bodies, increasingly tend to be on the regulators' radar.

Investor activism and securities law litigation have also increased in recent years, as mentioned above. As noted above, it should always be borne in mind that in Portuguese corporate finance transactions there may be relevant tax issues to be taken into account, and the bond route may be a way to overcome the hurdles encountered.

**III OUTLOOK AND CONCLUSIONS**

The current economic environment in Portugal seems to be increasingly positive, with healthy dynamics, a current spike in the tourism sector and improved investment in various other sectors.

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<sup>14</sup> STEP programmes must fulfil certain criteria to be STEP-compliant, and therefore eligible to apply for a step label.

# RUSSIA

*Vladimir Khrenov*<sup>1</sup>

## I INTRODUCTION

### i Overview of the structure of the law

While Russian capital markets regulation has come of age after more than two decades of rapid, and at times erratic, development, it still has some way to go before it reaches maturity. The process of Russian capital markets regulation started with the dismantling of the centrally planned Soviet economic model during the last decade of the 20th century, and a search for the most suitable market-oriented substitute for a defunct legal and regulatory regime. Apart from some scant financial market concepts and terminology antecedent to the Bolshevik revolution of 1917, Russian law provided little (if any) of the frame of reference needed to jump-start market reforms. The legislative reforms of the 1990s were heavily influenced by the US model of securities regulation, which at the time was given credit for governing the most liquid and efficient capital markets in the world. Russian financial regulation has since been decoupled from the US model proper, while largely following international trends. Significant strides have been taken in recent years, with the aim of expanding the product line of financial instruments and enhancing discipline in financial markets. Some other initiatives and commitments, including those taken within the G20 process, are still work in progress.

The centrepiece of Russia's capital markets regulatory framework is the Federal Law on the Securities Market (Securities Market Act). The first version was enacted in 1996, which has since been amended more than 40 times, including most recently in 2016 (as discussed in more detail below).

The Securities Market Act:

- a* defines the scope and types of regulated market activities;
- b* establishes broad principles applicable to the various categories of regulated market participants;
- c* defines the various types of securities as well as the procedure for their issue and distribution;
- d* sets out the general rules applicable to secondary market trading activities;
- e* sets out the standards for continuous disclosure;
- f* regulates exchange trading;
- g* prohibits insider trading;
- h* defines repo transactions and derivative instruments;
- i* sets out the main principles of government regulation of the securities market; and
- j* bestows regulatory and supervisory authority on the Bank of Russia.

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There also exists an interwoven web of other laws and regulations that influence the behaviour of market participants, including:

- a* the Civil Code;
- b* the Law on Joint Stock Companies;
- c* the Law on Organised Markets;
- d* the Law on Commodity Exchanges and Exchange Trading;
- e* the Law on Central Depository;
- f* the Law on Clearing and Clearing Activities;
- g* the Law on Protection of Legal Rights and Interests of Investors in the Securities Markets;
- h* the Law on the Crackdown Upon Unlawful Use of Inside Information and Market Manipulation;
- i* the Law on Mortgage-Backed Securities;
- j* the Law on Investment Funds; and
- k* the Law on Private Pension Funds.

In addition to these, a myriad of regulations are being passed, amended, repealed and superseded by new regulations on a continual basis.

## **ii Regulation of international capital market transactions**

Russian legislators and financial regulators have long been concerned with finding an equilibrium between ensuring access to international capital markets for Russian issuers and preventing a liquidity drain to foreign markets. Measures to find this balance include, most notably, a requirement for a Bank of Russia approval of an offshore issue or trading on an organised market of equity securities by a Russian issuer. This approval for equity securities is conditional upon:

- a* the registration of the new issue of securities in Russia;
- b* the securities being listed on a Russian exchange
- c* the number of shares (or securities convertible into such shares) traded outside Russia not exceeding a prescribed threshold (varying between 5 and 25 per cent, depending on a number of factors, including local free float, Russia's strategic interests, inter-regulator agreements); and
- d* in relation to depository receipts, a restriction on the exercise of voting powers by any persons other than the security holders (i.e., foreign custodians or nominees may not vote such securities without express instruction from the holders).

Notably, however, the quantitative restrictions on the number of shares available for an offshore offering by the most liquid Russian issuers do not apply, provided that the offering meets certain additional requirements. A Bank of Russia approval is not required for an offshore issue of securities that are not shares or securities convertible into shares.

Foreign issuers are also restricted in their ability to tap into Russian capital markets, although in a different manner. Foreign issuers may issue sponsored Russian depository receipts and place them in the Russian market in accordance with Article 27.5-3 of the Securities Market Act. Alternatively, securities issued by foreign issuers may be directly eligible for trading in Russia if certain requirements, as set out in Article 51.1 of the Securities Market Act, are met.

First, securities issued by foreign issuers must be assigned a CUSIP<sup>2</sup> number and a CFI<sup>3</sup> code and recognised as securities for Russian law purposes following a specified procedure.

Second, they must be issued by a qualifying issuer, which is defined to include:

- a* a qualifying foreign sovereign issuer or its administrative subdivision or a foreign central bank;
- b* a qualifying multinational organisation;
- c* an entity incorporated in an OECD, Financial Action Task Force or MONEYVAL<sup>4</sup> Member State, or in a jurisdiction whose financial regulator has signed a cooperation agreement with the Bank of Russia; or
- d* an entity that has listed its securities on an exchange approved by the Bank of Russia.

Placement (i.e., offering in the primary market) of securities issued by foreign issuers requires registration of a prospectus by the Bank of Russia. In most cases, the prospectus must be co-signed by a local broker that also assumes liability for the contents of the prospectus. In contrast, admission of foreign securities for trading in the secondary market may be effected without the registration of a Russian prospectus if the securities are listed on an eligible foreign exchange (FX) and are given a dual listing by a Russian exchange. Any other offering of or trading in foreign securities requires specific permission from the Bank of Russia, which should generally be granted if certain criteria are met. The Securities Market Act allows admission to exchange trading of unsponsored foreign securities without the issuer's consent, provided that the securities are admitted to on-exchange trading outside the exchange's principal listing, but that the securities have been included in the primary listing of an eligible foreign stock exchange (this latter requirement may be disappplied for debt securities) and that the securities are not restricted from public offering in Russia under their governing law. To date, however, the number of foreign securities distributed or admitted to trading in Russia (including in the form of Russian depository receipts) remains insignificant.

Foreign securities that have not been admitted for distribution or public trading may be offered without a registered prospectus to qualified investors through a bilaterally negotiated secondary market transaction or through an offering on a Russian exchange restricted to qualified investors. Similarly, 'foreign financial instruments that are not recognised as securities' (for Russian law purposes) may only be offered to persons who are *ipso jure* qualified investors (various types of regulated financial institutions) or have been categorised as qualified investors by a Russian broker. This awkwardly-phrased provision, which amounts to a suitability-like selling restriction, has resulted in a caution-driven choice by most international dealers to have their cross-border derivative transactions with unregulated Russian corporate clients intermediated by a local broker. Local brokers alone may classify a client as a qualified investor. Because the term foreign financial instrument is undefined and the regulator has to date declined to provide any interpretative guidance on its definition, these burdensome structures (which increase transaction costs and may limit the throughput capacity of a local broker) tend to be used for all underlying assets involving foreign currency, securities or other benchmarks. The choice to use a local broker also

2 The Committee on Uniform Security Identification Procedures.

3 Classification of financial instrument according to ISO 10962.

4 The Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism – MONEYVAL – is a permanent monitoring body of the Council of Europe.

often stems from a lingering uncertainty over the enforceability of cross-border cash-settled derivative transactions with Russian unregulated entities under the gaming provisions of the Russian Civil Code.

The measures designed to lower the entry barriers for foreign securities into the domestic market were mirrored by changes to liberalise the outbound flow of securities trading flows. Most importantly, recognition of the status of foreign nominee holders of securities (even if by way of a phase-in approach sequentially encompassing government and corporate debt securities and equities) and the creation of a central depository are designed to streamline the infrastructure for a seamless cross-border flow of interests in securities and facilitate offshore trading in Russian securities.

### **iii Respective roles of local agencies and central banks**

Historically, the regulatory landscape represented a patchwork of rule-making and oversight jurisdictions of a number of government agencies. Over time, however, the regulatory functions came to be concentrated first within two principal agencies – the Federal Financial Markets Service (FFMS) and the Bank of Russia – and then, since 2013, at the Bank of Russia.

During the period of regulatory duopoly, which ended on 1 September 2013, the principal regulatory body for capital market activities was the FFMS. The Securities Market Act delegated a considerable amount of authority to the ‘federal executive agency for the securities market’ – the role of the FFMS for many years – in relation to both rule-making and oversight over the activities on the financial markets, except banking, insurance and audit activities. The federal executive agency for the securities market set the rules applicable to the distribution of securities, registered prospectuses for the issue of securities by non-bank issuers (except sovereign and sub-sovereign issuers), as well as taking enforcement action against delinquent issuers. With respect to regulated market participants, it set out regulatory requirements for the activities of the professional securities market, defined capital requirements, granted licences to engage in regulated activities and enforced regulatory requirements against non-compliant firms.

The Bank of Russia, for its part, determined the procedure for the issue of securities by credit organisations and registered their prospectuses. It had oversight authority over banks, including banks’ investment activities on the capital markets. It had limited rule-making jurisdiction over banks’ fiduciary asset management activities, and prescribed the rules applicable to custodian activities. Through its equity stake in principal market infrastructure projects (such as the Moscow Exchange, formerly MICEX) and its leverage as a bank regulator, the Bank of Russia had the ability indirectly to exercise considerable influence on the functioning of the market. All these factors, viewed against the backdrop of the dominant role played by banks in many sectors of the Russian capital markets, made the central bank a powerful player in the regulation and monitoring of domestic capital markets in Russia even during the period leading up to September 2013.

On 1 September 2013, however, the regulatory jurisdictions of the FFMS and the Bank of Russia were merged, the FFMS was dissolved and the Bank of Russia assumed the overall regulatory and supervisory jurisdiction across all market segments, thus becoming the single ‘mega-regulator’. To ensure continuity, core FFMS staff members were transferred to the newly formed regulatory arm of the Bank: the Financial Markets Service of the Bank of Russia.



#### iv Structure of the courts

The Russian court system comprises the Constitutional Court, courts of general jurisdiction, state commercial courts (arbitration courts) and military tribunals. As a general rule, disputes involving natural persons are adjudicated by the courts of general jurisdiction. Commercial disputes between legal entities or registered entrepreneurs are adjudicated by the arbitration courts. In addition, certain categories of disputes fall within the subject matter jurisdiction of the arbitration courts irrespective of the identity of the disputing parties: all insolvency cases, corporate disputes (including derivative lawsuits, challenges to corporate governance actions and other causes of action affecting shareholders' rights), claims against securities custodians and certain others. Given the substantial interest on the part of financial institutions to enter into complex financial transactions with high-net-worth individuals, suggestions have been made that the above list should be expanded to include financial market disputes within the exclusive subject matter jurisdiction of the arbitration courts, which are far better equipped to handle them than the courts of general jurisdiction, but this change has yet to be implemented.

There are more than 80 arbitration courts at the trial level across Russia (i.e., courts of first instance), each covering a geographically defined judicial district. These courts handle both the trial *per se* and the first level of the appeal process. The appellate division is composed of different judges of the same court. The next level of the appeal process – the cassation division – is made up of 10 federal circuit courts that have appellate jurisdiction over the decisions rendered by the appellate division of the arbitration courts within the relevant judicial circuit. Finally, the Supreme Court is the highest state court in Russia for both the courts of general jurisdiction and – since 2014 – the arbitration courts, and has ultimate (but largely discretionary) appellate jurisdiction over cassation decisions, as well as original jurisdiction over a limited number of matters.

The internal structure of the arbitration courts often accommodates the need for specialist expertise in various areas of commercial disputes. Panels specialising in corporate law, insolvency and other matters are often created within the structure of the courts. Since 2012, special financial panels have been created in a number of courts in key financial centres, including the Arbitration Court for the City of Moscow and the Federal Arbitration Court for the Moscow circuit. This was the judiciary's response to the ever-increasing complexity of recognised financial instruments that regulatory developments have spawned in the Russian capital markets.

#### v Trends reflected in decisions by the courts and other relevant authorities

The trends reflected in legislative amendments and actions by the Bank of Russia indicate a policy of promoting further integration of domestic financial markets into the international network while gradually lowering protection barriers for both inbound and outbound investments. Recognition of foreign nominees (a status long denied to foreign brokers, custodians and other nominee holders), Russia's commitment to the G20 financial regulatory reform objectives, the introduction of new concepts such as special purpose vehicles, securitisations, note issuance programmes, asset-backed securities, escrow accounts, recognition of close-out netting, further liberalisation of FX controls and large-scale amendments to the Civil Code (as discussed in the previous edition), which have been favourable to financial market transactions, are the latest manifestations of the trend. Simplification of the procedure for issuing new securities in the domestic market and the introduction of additional protections

to bondholders also represent long-awaited market-friendly measures designed to encourage companies to tap the securities markets amid diminishing liquidity in the domestic capital markets.

## **II THE YEAR IN REVIEW**

Much like the four preceding years, 2019 has been a year in which the Russian capital markets have been affected by opposite forces. On the one hand, the statutory and regulatory reforms referred to in Section I have laid the foundations for a quantum leap of market activities and a new level of complexity of financial techniques and instruments available to market participants. These developments, however, have largely been eclipsed by sanctions in the international sector affecting, *inter alia*, the ability of some of the largest players in the Russian financial and energy sectors to issue new debt and equity securities or otherwise raise capital in international financial markets. Complying with the existing sanctions, and apprehensive of more sanctions to come as a result of an escalation of geopolitical tensions regarding the situations in Ukraine and Syria, and allegations of intervention in the electoral process in other countries and of Russia's involvement in the poisoning of a former Russian military intelligence officer in the United Kingdom, most international financial institutions have sharply curtailed their dealings with Russian counterparties, thus bringing the cross-border capital market flows for new issues to a virtual halt. Predictably, this has had a knock-on effect on local market flows and liquidity, particularly in non-rouble currencies. There has been no indication so far in 2019 that the sanctions are likely to be softened or lifted in the short term. On the contrary, we have seen new sanctions introduced and a real risk of a tightening of the sanctions regime. As a result, despite some positives in the legislative and regulatory agenda, 2019 has largely been a period of doldrums in the Russian financial markets. The mid to long-term effects of the international sanctions on Russian capital markets – both local and cross-border – cannot be easily or accurately assessed at the time of writing, as much will depend on how the international geopolitical situation evolves and whether the sanctions are tightened or relaxed as a result.

### **i Developments affecting financial market transactions**

2019 has been an interesting year not so much from the standpoint of changes to the existing legislative framework but rather as a stress test for some of the principal features of a framework that has been put in place over the past few years. The financial sector is undergoing a dramatic shake-up. A combination of two factors – an economic slowdown and the resulting deterioration of the credit quality of banks' loan portfolios on the one hand, and the Bank of Russia's toughening of prudential supervision enforcement practices on the other – has resulted in a large-scale reconfiguration of the structure of the Russian banking sector. Many privately owned banks – including the largest – lost their licences and have been put into bankruptcy or have been taken over by the regulator acting through the Deposit Insurance Agency (DIA) or a newly created Foundation for the Consolidation of the Banking Sector. The recently adopted recovery and resolution regime is being applied on a large scale, pushing out private shareholders (through mandatory write-off of outstanding equity securities) and replacing them in most cases with government control. The banking business is thus being consolidated around state-owned banks.

On the positive side, the State Duma, which is the lower house of the Russian parliament, passed a whole host of changes to the Securities Market Act – the bulk of which will come

into effect in 2020 – that define new types of securities, including ever-green bonds and medium-term notes, subordinated notes that now can be offered to non-qualified investors, and preferred shares that entitle the holder to super-priority in receiving dividends in relation to other types of preferred shares and common stock. The amendments relax the requirement for prospectus registration: an exemption from registration now applies to securities offered to qualified investors and current shareholders irrespective of their number. Similarly, if a tranche of debt securities is placed within a year from the registration of a programme of issue, the placement of such tranche is exempt from the prospectus requirement; later tranches, however, can no longer rely on the shelf-registration. Amendments to the Law On mortgage-backed securities have addressed some weaknesses that, within the regime of mortgage-backed securities (MBSs) and a new type of exchange-traded and over-the-counter (OTC) MBSs that are segregated from other liabilities upon insolvency of the issuer will become available in 2020.

Changes to the Securities Market Act have also clarified certain requirements applicable to the offer of securities by foreign issuers, as well as to disclosure of information on such securities by an exchange.

New rules apply to the quality of collateral for covered bonds: loss or deterioration of collateral are treated as events of default unless disappplied pursuant to the terms and conditions of the bonds.

A new set of rules affecting class actions came into effect on 1 October 2019. It is now possible to file a class action, including an action on behalf of shareholders of a joint-stock company or other securities holders, in a court of general jurisdiction.

A more robust regime governing liability for insider trading and market manipulation came into effect on 1 May 2019 that expands the list of insiders and the scope of inside information.

The tightening of the international sanctions regime has also brought about changes to the regulatory framework. The changes to the Securities Market Act enacted in December 2018 have authorised the government to exempt issuers that have or may become subject to foreign sanctions as well as other market participants (clearing houses, central counterparties (CCPs), custodians) and insiders from certain disclosure obligations, thus shielding certain sensitive information from the public domain.

## **ii Bankruptcy**

Most statutory changes in the bankruptcy regime predate 2019. Notably, there was a major overhaul of the bankruptcy legislation in 2015. The two statutes that previously governed the bankruptcy proceedings of banks and non-banking organisations have been merged into a single statute. The new law contains detailed sets of rules applicable to bankruptcy proceedings affecting various types of economic actors, including various types of regulated financial entities such as banks, brokers, dealers, asset managers, clearing houses, insurance companies, private pension funds and some others. The new regime also includes certain bail-in measures applicable to the insolvency of banking institutions that gave rise to a large number of disputes over the past three years, including in 2019.

### iii Developments affecting derivatives, securitisations and other structured products

#### *Close-out netting*

The Russian close-out netting legislation came into effect on 11 August 2011. The recognition of close-out netting was accompanied by a number of other important measures that rewarded the industry's push for an overhaul of the regulatory framework applicable to OTC derivatives. Those measures included:

- a* an amendment to the gaming statute designed to provide a safe harbour to eligible derivative transactions;
- b* the introduction of a definition of financial derivatives to the Securities Markets Act;
- c* express recognition of a single master agreement that may govern multiple derivatives or repo transactions;
- d* amendments to the Tax Code allowing more flexibility to end-users for hedge accounting and deductibility of losses; and
- e* liberalisation of FX controls to allow foreign currency settlement under local market derivative transactions.

The Insolvency Act (Federal Law No. 127-FZ) (as amended) provides that:

*obligations arising out of contracts governed by a master agreement (single agreement) which corresponds to the model terms envisaged by [the Securities Market Act] (hereinafter – financial contracts) shall terminate in accordance with the procedure envisaged by said master agreement (single agreement) . . . Such termination shall give rise to a monetary obligation the amount of which is to be determined in accordance with the procedure envisaged by the master agreement.*

The principal reason for the delay in passing the netting legislation was mistrust on the part of some Russian authorities about the potential for abuse created by netting. That mistrust is not unjustified, as it is rooted in the recent history of bankruptcies of some Russian banks and corporate entities tainted by alleged and proven fraud and asset stripping. To address these concerns, the netting legislation has a number of built-in systems designed to ensure that the close-out mechanics are fair to the debtor's estate and have sufficient safeguards against retroactive changes to the transaction terms intended to create an out-of-the-money position for the debtor, which can then be netted against a creditor's liability.

Under the Civil Code, the model terms of a contract refer to a set of published standardised contractual provisions incorporated by reference into an agreement between the contracting parties. To be eligible for close-out netting under the Insolvency Act, the model terms must either be developed by a Russian self-regulatory organisation and approved by the Bank of Russia, or be developed by an international organisation from a list approved by the Bank of Russia. This limitation is designed to stem the uncontrolled proliferation of netting-eligible master agreements and keep the contents of such agreements in line with what the regulator recognises as legitimate market practice.

Russian agreements approved to date include the 2011 Model Terms of Financial Derivative Transactions jointly published by the National Stock Market Participants' Association (NAUFOR), the Association of Russian Banks (ARB) and the National Foreign Exchange Association (NFEA); and the master agreement for domestic repurchase transactions published by the National Stock Market Association.

Eligible international agreements include *pro forma* master agreements published by the International Swaps and Derivatives Association (ISDA) and the International Capital

Market Association (ICMA), provided, however, that certain changes are introduced through a schedule to the relevant master agreement to make it fully compliant with the Insolvency Act.

The scope of netting-eligible transactions is limited to financial contracts defined to include repos, OTC financial derivatives and 'other agreements the object of which is foreign exchange or securities'. The definition of a repo in the Securities Market Act is not dissimilar to what is generally understood to constitute a repo transaction in the international financial markets. OTC financial derivatives are defined in the Bank of Russia Regulation No. 3565-U to comprise:

- a* cash-settled or deliverable swap transactions with payouts linked to a change in the price or level of an eligible underlying asset (price of commodities, securities, interest rates, FX rates, inflation rate, credit and potentially others);
- b* put and call options (including swaptions) on an eligible underlying asset; and
- c* forward transactions for the delivery of securities, FXs or commodities with a settlement cycle of T+3 or longer, provided that the parties have expressly chosen to treat them as financial derivative transactions or cash-settled forward transactions linked to an eligible underlying asset.

Credit support arrangements such as a title-transfer credit support annex should be protected by the close-out netting regime, particularly in light of the 2015 amendments to the Securities Market Act that now recognise title transfer security arrangements.

The netting regime applies to pre-insolvency transactions (the cut-off point is defined slightly differently for certain types of debtors), thus disqualifying from close-out netting any transaction entered into after the commencement of an insolvency proceeding. One of the parties to a qualifying transaction must be a financial institution (Russian or foreign), a central bank (Russian or foreign) or a multilateral financial organisation. The Insolvency Act thus disqualifies transactions between unregulated entities and transactions with natural persons, which reflects a long-standing politically sensitive policy of discouraging derivative transactions with individuals (which, to the disappointment of sell-side institutions, does not carve out high-net-worth individuals).

In 2013, the ICMA published a netting opinion for repo transactions governed by the Global Master Repurchase Agreement. An ISDA netting opinion was published in February 2015, while the collateral opinion is still pending.

The above regime has remained largely unaffected by legislative and regulatory developments in 2019.

### ***Trade data reporting***

The trade data reporting regime underwent a major overhaul in 2016, and a new chapter on trade data repositories was added to the Securities Market Act. In furtherance of the new statutory regime, the Bank of Russia issued Directive No. 4104-U on 16 August 2016 on the types of reportable OTC transactions and the procedure for trade data reporting. The activities of a trade data repository are now licensable by, and subject to the supervision of, the Bank of Russia. Reportable transactions now include OTC repo and derivative transactions as well as certain other transactions identified by the Bank of Russia, irrespective of whether the transactions were entered into on a standalone basis or under a master agreement. (Previously, only transactions under a master agreement were reportable.)

Broadly speaking, the reporting regime is consistent with Russia's G20 obligations under the Pittsburgh Protocol, although it is worth noting that in some respects, Russia's reform at this stage is somewhat milder than the G20 parameters: specifically, because of the structure of Russia's OTC market, with relatively little volume of electronic trading, the draft regulation does not envisage real-time reporting and requires submission of new data within three business days of the reportable event. In relation to transactions between a regulated and an unregulated entity, the new regulation imposes the reporting obligation solely on the regulated entity (such as a bank, broker, dealer or asset manager). Transactions between unregulated entities become reportable if certain trading volume thresholds are exceeded.

The new regulation dispenses with the two features of the reporting regime that previously caused the most concern among market participants. The most troublesome, from the market's perspective, was the provision in the regulation that in the event of a discrepancy between the transaction documentation and the record in the repository, the latter will prevail for the purposes of calculating the close-out amount upon insolvency of a party. This requirement upped the ante tremendously for what otherwise should be a mundane operational routine. This provision was removed from the regulation in 2015, and the record in the trade registry no longer has priority over the contractual documentation. The new regulation solidified this position.

The other feature of the old regime that inconvenienced the market was that registration of a transaction with the trade data repository was a prerequisite for the transaction's eligibility for close-out netting. The principal risk associated with this requirement was that if a transaction failed to be registered with the trade repository, the rest of the trading portfolio could also be disqualified from netting because the Securities Market Act and the relevant master agreements (both the ISDA master agreement and the local market master agreements) did not provide for a mechanism for calculating the early termination amount that would distinguish between registered and unregistered transactions. Both the law and the relevant types of master agreements require that in the event of the bankruptcy of a party to a master agreement, all outstanding transactions must terminate, and the early termination amount must be calculated on the basis of the close-out values of all the thus-terminated transactions. To the relief of market participants, registration of a transaction with a trade data repository is no longer a prerequisite to netting.

### ***Credit derivatives***

A Bank of Russia regulation on the types of financial derivative instruments, as amended in 2015, now accommodates the use of credit default swaps in the domestic market. This development is in line with the publication earlier in 2015 of the credit derivatives definitions for use with the Russian industry-standard derivatives master agreement. The hard-wiring of the local credit derivatives market, however, is taking longer than the market would have wished. The finance industry appears to lack the requisite motivation to put in place the necessary infrastructure for servicing the needs of the local credit derivatives market in the form of a local determinations committee and an auction mechanism. The principal reason for this dampened enthusiasm is that the Bank of Russia, while giving informal preliminary indications that it would be inclined to approve credit derivatives as a means of offloading credit risk for capital adequacy purposes, has so far failed to take any specific steps to implement it. Without regulatory recognition as a balance sheet management tool, credit derivatives are unlikely to top the priorities list of the local banking community. Little progress has been made in 2019 to further this agenda.

### ***Structured notes***

One of the relatively few noticeable developments in financial legislation during the year in review has been the amendment to the Securities Markets Act accommodating the issuance of structured notes in the domestic market. Prior to this amendment, Russian law defined a note (a bond) as a financial instrument that entitles its holder to claim from the issuer the repayment of its face amount (and any additional sums (e.g., coupons) if so provided in the terms and conditions of the note). That definition has always been construed to preclude the terms of the notes from setting out circumstances the occurrence of which would allow the issuer to pay less than the face value of the note. The new definition introduces the notion of a structured note, which, subject to compliance with a number of requirements set forth in the Securities Markets Act as amended, links the payout under the note to the occurrence or non-occurrence of any of the events listed as an eligible underlying for a financial derivative (a change in the interest rates, exchange rates or price of commodities or securities, the occurrence of a credit event, etc.). Structured notes may be issued to qualified investors by regulated financial institutions (banks, brokers or dealers) and by special purpose vehicles. In the event that a structured note is issued by a broker, dealer or special purpose vehicle, it must be collateralised.

On 23 February 2019, a new set of rules governing registration of structured notes came into effect, filling the regulatory void that as a practical matter has been hampering the issue of structured bonds. In addition to procedural matters, the new Bank of Russia regulation addresses the substantive issues that must be laid out in offering documents, including a detailed description of redemption amount calculations.

### ***Syndicated loans***

At the end of December 2017, Russia passed a special federal law on syndicated loans that sets out the framework for creating a lenders syndicate, addresses issues pertaining to inter-creditor agreements and other governance issues within syndicates, and facilitates secondary market trading in the syndicated loan market. Notably, a recent market initiative resulted in the development of industry-standard documentation for syndicated loans (similar to the Loan Market Association standard).

### ***Standard contract documentation***

The last week of 2011 was marked by the approval by the FFMS and the publication of a new version of the model terms of a contract (a *pro forma* master agreement) for domestic derivatives transactions. The agreement is a revised version of the 2009 Model Terms of Financial Derivative Transactions jointly developed by NAUFOR, the ARB and the NFEA. The 2011 version contains amendments required by the Securities Market Act, and is netting-compliant for the purposes of the Insolvency Act. A barely retouched 2011 version of the product annexes, covering such underlyings as FX, interest rates, equities and fixed income securities, has also been published. By contrast, the credit support annex has undergone some more noticeable changes designed to ensure netting-eligibility of margin amounts.

Given that approval by the regulator of the model terms of a contract is a prerequisite for netting eligibility of the transactions governed thereby (and, accordingly, for a more favourable capital treatment for regulated entities), the local derivatives market has largely migrated from bespoke master agreements to the industry-standard form.

Since 2011, NAUFOR, the ARB and the NFEA have published the commodity definitions to be used in conjunction with the local master agreement and a set of definitions covering non-Russian equity and fixed income securities. In 2015, the credit derivatives definitions were published to complete the current set of underlying asset classes.

The Russian standard contract documentation for derivative transactions largely follows – with ISDA's permission – the architecture of the ISDA master agreement and the ISDA product definitions to ensure consistency with the international OTC derivatives market and reduce the basis documentation risk between local market and cross-border transactions.

#### iv Cases and dispute settlement

Against the backdrop of geopolitical tensions, the Russian economy during the past five years has seen unprecedented volatility in the exchange rate of its domestic currency, which has led to a dramatic shake-up of other sectors of the financial markets. The financial condition of many borrowers has been tested, and in some cases failed to withstand the economic pressures, which have pushed them into bankruptcy or forced sale. However, until early 2016 these challenges had not translated into litigation – insolvency-related or otherwise. That year, however, some of the restraints snapped and the pressures began to show. There was a dramatic widening of the shakeout of the banking sector during 2017, which has expanded further in 2019. Many privately owned banks, including the largest, have either lost their licences and are being liquidated or have been subject to recovery and resolution measures enacted during the past two to three years. Many aspects of the recovery and resolution regime are now being tested in litigation.

Some holders of Russian banks' subordinated debt have challenged the retroactivity of the new bail-in provisions embedded in the insolvency legislation. Pursuant to Article 25.1 of the Law on Banks and Banking Activity, if a bank's capital adequacy ratio falls below a specified amount or if a bank finds itself subject to a recovery and resolution procedure involving public funds (currently administered by the DIA), that bank's obligations under subordinated loans or notes automatically terminate *ipso jure* in an amount required to restore the bank's own funds to the required level of capital adequacy. Notably, Article 25.1 does not contain any express grandfathering language or provide for a transition period or expressly provide that it has retroactive effect. The Civil Code in Article 422 contains a restriction on the retroactive application of newly enacted civil law statutes affecting pre-existing contracts. However, debtors that found themselves on the receiving end of recovery and resolution measures complied with the terms of the recovery plans and notified their lenders of the termination of existing subordinated obligations. It is not surprising, therefore, that the introduction of recovery and resolution measures with DIA participation in a number of banks has resulted in disputes regarding the temporal scope of the application of the bail-in provisions initiated by subordinated creditors challenging the termination of antecedent debt on the basis of Article 25.1. In more than a dozen such disputes, all but one judgment confirmed the applicability of the new bail-in regime to existing subordinated debt. Only in *ORIMI v. Tavrichesky Bank* did the court decide that the termination was initially invalidated on the grounds of non-retroactivity of Article 25.1. The *ORIMI* decision, which was 'bucking the trend' for a while, was subsequently quashed by the cassation division for the north-western judicial circuit, which rather than returning the case to lower courts for retrial instead ruled on the merits, upholding termination of the subordinated loan by operation of Article 25.1, despite the argument of its non-retroactivity on the basis of Article 422 of the Civil Code, which the court held to be inapplicable.



Article 25.1 was held to be a mandatory provision of Russian law that is part of the insolvency regime, and as such applicable *ipso jure*, and to be a matter of public policy. Court practice also offers a number of other more technical arguments as to why Article 422 of the Civil Code does not preclude termination of antecedent subordinated debt by virtue of Article 25.1 of the Law on Banks and Banking Activity.

Finally, while none of the bail-in cases so far adjudicated in Russian courts have involved a situation where the debt was governed by foreign law, the rationale used by the courts in upholding termination (reference to public policy and insolvency) makes it unlikely that the governing law of the contract could be relied on in Russian courts to avoid the application of Article 25.1. In that regard, note that in one such dispute, a foreign holder of subordinated debt of a Russian bank filed for arbitration at the London Court for International Arbitration (LCIA) for the recognition of the debt as still enforceable and unaffected by the Russian bail-in regime. Notably, the debt was governed by Russian law and the LCIA arbitrators ruled that by virtue of an English law principle,<sup>5</sup> which provides that a discharge of a contractual debt under the bankruptcy law of any foreign country outside the United Kingdom, is not a valid discharge in England. While this principle has since been heavily criticised in England (and which is clearly a misfit in the efforts to harmonise international recovery and resolution regimes), the arbitrators have ruled that it is still good law and have declined to recognise the Russian-law effect on a subordinated loan agreement governed by English law. In the wake of this decision, in 2019 other international holders of subordinated debt instruments issued by Russian banks have successfully sought to invalidate the discharge through international arbitration.

The second line of cases adjudicated in 2017 that affect financial markets pertains to mis-selling of financial derivatives, and a dealer's duty to disclose risks when selling a financial instrument to a client as well as suitability and appropriateness. These cases followed the landmark case *Platinum Nedvizhimost LLC v. Bank of Moscow*, adjudicated in favour of the client in 2016. In that case, the court found multiple discrepancies between the stated objective of the swaps (fixing the FX and interest rate risks for the client) and their real effect, such that the client was misled into entering into the swaps – inter alia:

- a* a failure by the bank to provide adequate explanation to the client of the risks embedded in the proposed structure, including in the event of a sharp move in the rouble exchange rate;
- b* the complexity of the transaction based on a multi-layer structure of contractual documentation (master agreement, product definitions, confirmations, margin agreement) with multiple cross-references and complex terminology that required specialist expertise to understand it;
- c* a failure by the bank to analyse the nature of FX risks associated with the client's business or to suggest a more suitable financial product to address those risks; and
- d* the payout profile of the swap was skewed in favour of the bank, including as a result of posting rouble cash collateral.

All these factors were held to amount to bad faith behaviour and an abuse of rights on the part of the bank, which as a matter of Russian law renders the relevant contract void *ab initio*.

<sup>5</sup> Sometimes referred to as the *Gibbs* principle as it was first set out in the decision of the Court of Appeal in *Antony Gibbs & Sons v. La Société Industrielle et Commerciale des Métaux* (1890).

This was a case of first impression for the Russian court system in the areas of mis-selling, appropriateness and suitability. The Supreme Arbitration Court of Russia (formerly the highest commercial court in the country, which has now been disbanded and whose jurisdiction as the highest commercial court has been subsumed by the Supreme Court) previously published a draft resolution addressing some of the above issues, including the duty of a market professional to disclose to a client the economic risks embedded in an interest rate swap. The resolution was never finalised, but its main thrust was for the first time endorsed in an actual dispute by the Russian courts.

That decision initially galvanised the industry to develop standard forms and standards of risk disclosure and best practices for the dealer community in the OTC derivatives market. However, before that initiative produced any tangible results, another dispute erupted on a scale that is rarely seen in Russian courts. The Russian pipeline monopoly Transneft filed a lawsuit against the largest Russian bank, Sberbank, for the voiding of a barrier FX call option transaction. The notional amount of the transaction was set at US\$2 billion. The instrument was sold to the company as a ‘cheapener’ of the service costs of a rouble bond issued by the company. The bank claimed that selling the option with a knock-in barrier level well above the current US dollar–rouble spot rate carried little risk for the company, yet would allow it to receive an option premium for the sold call option that would reduce the effective coupon rate below the rouble bond. Soon after the transaction was entered into, however, the US dollar–rouble exchange rate broke through the barrier level and left the company with losses under the transaction in an amount of more than US\$1 billion. The company claimed that the instrument was unsuitable for its declared purposes because:

- a* it exposed the company to unlimited losses;
- b* the risk level was misrepresented by the bank;
- c* the marketing materials were contradictory and confusing; and
- d* the bank failed in its duty of good faith to explain in an ample and clear fashion the nature of the transaction and the risks involved, and to ascertain that the company properly understood the risks.

The court of first instance sided with the company and ruled that the breach of good faith obligations on the part of the dealer – and the standard of good faith is more rigorous in the context of selling complex derivative instruments – rendered the transaction void *ab initio*. The bank appealed, and the appellate court reversed the lower court decision, invoking the fact that the company is a large, sophisticated company with an in-house economics department that should have understood the risks embedded in the transaction. In the appellate court’s view, the risks were properly disclosed by the bank and the terms of the transaction were balanced and fair. The company challenged the appellate court’s decision in the cassation court. However, the dispute was settled out of court in early 2018 before the cassation court rendered its decision.

This dispute revealed the shortfalls of the fledgling regulatory framework affecting derivatives and other complex financial instruments, which at the time contained only rudimentary standards of client classification, risk disclosure, appropriateness and suitability. Such formal rules only existed in the form of self-regulatory organisation (SRO) standards developed for the securities market, yet the appellate division refused to apply them by way of legal analogy to the OTC derivatives market, thus leaving the end-user community without the requisite statutory protections. The fall-back requirement of good faith does not necessarily fill the void, largely because the courts are themselves struggling to understand

what should be the required standards of behaviour in the market. The regulator, which is best positioned to formulate the guidelines, has so far failed to devote sufficient attention to that area. The financial industry has stepped up to the plate and developed a set of standards for disclosure of risks embedded in derivative transactions. These standards were approved by leading SROs for mandatory use by broker-dealers and recommended by the Bank of Russia for use by banks.

#### **v Relevant tax and insolvency law**

For a while, one of the major impediments to the development of the derivatives markets, both domestic and cross-border, was the uncertain, and often market-unfriendly, tax regime applicable to derivative transactions. The section of the Russian Tax Code governing taxation of repo and derivative transactions underwent a significant overhaul with the aim of creating a tax environment conducive to the development of this market.

As amended, the Tax Code more clearly defines which instruments qualify for a special tax regime applicable to derivative instruments. With the exception of weather derivatives and transactions referenced to official statistical data (and, in the case of transactions with natural persons, credit derivatives), all transactions that fall within the definition of derivatives under the Securities Markets Act enjoy the special tax regime. Cash-settled derivatives are treated as derivatives in all circumstances, while deliverable transactions enjoy the same treatment if the parties made the relevant election in their accounting policies. Dealers are allowed to deduct derivatives-related losses from their overall income tax base. Non-dealers calculate their tax liabilities for derivatives-related income (or losses) separately from the rest of their activities. Importantly, the amendments have substantially liberalised the rules applicable to the treatment of hedging transactions, thus allowing the taxpayer significantly more flexibility in determining its hedging strategies.

#### **vi Role of exchanges, central counterparties and rating agencies**

The role of the stock exchange for the Russian market is paramount. In the absence of alternative trading systems (including non-exchange electronic venues such as electronic communications networks or multilateral trading facilities), the Moscow Exchange is the principal cluster of liquidity for the cash equities and fixed-income markets. The on-exchange derivatives market trades across all assets classes (except credit), and serves as the principal forward price benchmark for the relevant underlying assets and indices not only for commercial purposes but also for tax and accounting. The OTC segment is either very small relative to the exchange-traded market (e.g., derivatives on equity or fixed income securities) or offers products that are not yet offered by the exchange (e.g., interest-rate swaps or cross-currency swaps). In that sense, the exchange-traded and OTC markets are largely complementary at this time rather than competitive.

Commodity exchanges, despite the commodity-oriented structure of Russia's economy, have for a long time struggled to justify their existence. Liquidity continues to be insignificant, as most commodity producers prefer to enter into direct offtake relationships with buyers. The development of organised commodity markets was given a new thrust with the establishment of the St Petersburg International Mercantile Exchange (SPIMEX) in light of the new legislative regime designed to bring transparency to the commodity markets by compelling mandatory transaction reporting to a commodity exchange even for OTC sale contracts.

SPIMEX has quickly developed a series of indices for various groups of commodities, which have been included as commodity reference prices in the commodity annex to the Russian standard OTC derivatives documentation.

While Russia has committed to ensure CCP clearing of all standardised derivatives under the G20 Pittsburgh Protocol, it is not yet mandating central clearing of OTC derivatives. The very notion of a CCP clearing appeared for the first time in Russian law in 2012 with the adoption of the Law on Clearing. Although the Law on Clearing provides some basic protections to CCPs, all the issues that are currently discussed and grappled with by both regulators and various CCPs throughout the world will need to be refined for the Russian market (e.g., which model of segregation can be accommodated under Russian law, risk management procedures, loss mutualisation, client clearing documentation). This notwithstanding, the National Clearing Center (part of the Moscow Exchange group of companies) now provides CCP clearing for OTC interest rate swaps, FX swaps and cross-currency swaps, although the clearing volumes remain low. Once the teething problems of the trial period have been resolved, the Bank of Russia intends to make clearing of such contracts mandatory. The first phase will not include client clearing, although attempts by the financial industry to develop a client-clearing addendum to the standard OTC documentation are under way.

The role of the leading global rating agencies is fairly limited in the Russian domestic market but obviously affects Russian borrowers and issuers that have tapped the international markets. Attempts to create domestic rating agencies (including as a policy measure designed to create a counterbalance to US-based rating agencies) have so far had only limited success, but have been reinvigorated in light of the geopolitical tensions.

A national credit rating agency was established at the end of 2015, with capital of 3 billion roubles evenly divided among investors and a cap of 5 per cent on an individual ownership stake.

### **III OUTLOOK AND CONCLUSIONS**

While the legislative reforms of the past few years represent a pivotal change in the regulation of the capital markets in Russia, the success or failure of such reforms can only be judged with the passage of time. The principal litmus test of whether the decisions made were the right ones will be the sustainable growth and sophistication of the capital markets. Currently, however, the accuracy of any litmus test is compromised by the challenging geopolitical situation that Russia is in, and those tensions have shown no sign of subsiding in 2019. The new regulatory paradigm that has begun to take shape with legislative and regulatory progress, the creation of a mega-regulator and the ongoing implementation of the G20 reform measures is now facing a strong headwind in the form of political tensions. The international financial sanctions against some of the leading Russian companies and their expansion in 2019 are bound to leave an imprint on how Russian capital markets will develop in the short to medium term. Reorientation towards the Asian markets, and a search for alternative funding sources unaffected by the current sanctions regime and supplanting cross-border flows with domestic growth, require time. Meanwhile, if the current breakdown in the economic and financial integration between the Russian and the global financial markets continues, the growth prospects of the cross-border and local markets are likely to remain subdued for some time to come.

# SPAIN

*David García-Ochoa Mayor and Carlos Montoro Esteve<sup>1</sup>*

## I INTRODUCTION

### i Overview

Following a corruption scandal involving the People's Party, in June 2018 the conservative Prime Minister, Mariano Rajoy, was voted out of office after six years as a result of a no-confidence motion brought by the socialist Pedro Sánchez and supported by six other parties, among them Podemos. Nevertheless, Mr Sánchez struggled to find allies and maintain a working majority in Congress, even with the parties that had backed the no-confidence motion. Mr Sánchez called for a new general election after the 2019 General State Budget was voted down. The general election was held on 28 April 2019; Mr Sánchez won with 28.7 per cent of the vote and 123 seats, an improvement of 38 seats. However, Mr Sánchez failed to obtain sufficient support to be appointed as Prime Minister in the first vote held in July 2019. Further discussions were held but, on 18 September 2019, Mr Sánchez announced that the negotiations had been unsuccessful and that the deadlock continued, obliging him to call for a new general election to be held in November 2019. This uncertain political framework could potentially threaten investor confidence in Spain.

### ii Structure of the law

Until late 2015, the most important piece of legislation regarding the securities market in Spain was Law 24/1988, of 28 July, on the securities market (LMV), which had been amended on numerous occasions (inter alia, by Royal Decree 726/1989, of 23 June, on the governing bodies and members of stock exchange companies, *sociedad de bolsas* and collateral requirements, by Royal Decree 948/2001, of 3 August, on systems of investor indemnification, and by Royal Decree 1082/2012, of 13 July, on collective investment schemes). For reasons of coherence, the government decided to approve Royal Legislative Decree 4/2015, of 23 October, that is, the consolidated text of the Securities Market Act (TRLMV).

The TRLMV contains the principles governing all securities markets in Spain, and is the law into which most of the EU directives on securities markets have been incorporated. As such, capital market regulations in Spain are significantly aligned with those of other EU countries. The TRLMV establishes which securities are tradable and the way they should be represented (in particular, by book entries and how book entries should be made).

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In June 2017, the TRLMV was slightly amended pursuant to Royal Decree 11/2017, of 23 June, on urgent measures on financial matters, to clarify the definition of the financial instruments that will not be considered as non-complex.

In recent years, the government has enacted several royal decree-laws to implement into Spanish law the provisions of MiFID II,<sup>2</sup> amending the TRLMV accordingly. First, Royal Decree-Law 21/2017, of 29 December, amended the regulation of multilateral trading facilities, introduced the concept of organised trading facilities (i.e., alternative regulated markets with fewer requirements for operation than multilateral trading facilities) and also set out the rules of operation for algorithmic-generated orders. Royal Decree-Law 14/2018, of 28 September, then continued with the implementation of MiFID II into Spanish law, amending the TRLMV to, among other things:

- a* adapt the list of financial instruments to the list of financial instruments established in Section C of Annex I of MiFID II;
- b* incorporate the wording of Articles 2 and 3 of MiFID II by regulating cases of non-application of the TRLMV (e.g., the provision of services exclusively to the parent companies, subsidiaries or other subsidiaries of the parent companies); or
- c* extend the application of specific principles to structured deposits marketing and advice.

Subsequently, Royal Decree 1464/2018, of 21 December, completed the transposition of MiFID II into Spanish law, completing the regulatory development of the TRLMV and amending Royal Decree 217/2008. Another important amendment came with Royal Decree-Law 19/2018, of 23 November, on payment services and other urgent measures of a financial nature, whose ninth final provision amended the TRLMV to, among other things, clarify the concepts of inside information and relevant information.

Another important piece of legislation is Royal Decree 878/2015, of 2 October, on clearing, settlement and registry of negotiable securities, on the legal regime of central securities depositories and central counterparties, and transparency requirements of issuers of securities trading in an official secondary market. It amended Law 41/1999, of 12 November, on clearing and settlement of securities systems, which transposed into Spanish law Directive 98/26/EC of the European Parliament and of the Council, of 19 May 1998, on settlement finality in payment and securities settlement systems. Royal Decree 878/2015 was also slightly amended by Royal Decree 1464/2018 to include organised trading facilities in the references to multilateral trading facilities made in this Royal Decree.

In addition, on 30 June 2017, Regulation No. 2017/1129 of the European Parliament and of the Council on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market was published. Apart from repealing Directive 2003/71/EC, Regulation 2017/1129 constitutes an advance towards the consummation of the Capital Market Union, which aims at making markets work more efficiently and offering investors and savers new opportunities to put their capital to work. Regulation 2017/1129 entered into force on 20 July 2017 and is generally applicable from 21 July 2019. The main amendments introduced by Regulation 2017/1129 are set out in Section II.

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2 Directive 2014/65/EU of 15 May 2014, on the markets in financial instruments.

### iii Structure of the courts

The commercial courts are the specialist first instance courts generally entrusted with hearing civil claims lodged with regard to corporate and insolvency law. Other matters (inter alia, those related to civil liability arising from inadequate commercialisation and placement of financial instruments) are normally heard by general first instance courts.

### iv Regulatory authorities

The most important regulatory authority in the Spanish capital markets is the National Securities Market Commission (CNMV). However, the Bank of Spain (in respect of the public debt market), the Ministry of Economy and Competitiveness (regarding certain approvals and the imposition of penalties) and the departments of economy of some autonomous regions also have certain supervisory powers.

The CNMV is an entity with its own legal personality separate from that of the central government or the autonomous regions. The CNMV is governed by a board of directors made up of a chair and a vice chair (both appointed by the Council of Ministers), the Director General of the Treasury and Financial Policy, the Deputy Governor of the Bank of Spain, and three other directors appointed by the Minister of Economy and Competitiveness.

The main functions of the CNMV are to supervise and inspect the securities markets and the activity of all individuals or legal entities related thereto, as well as to impose any penalties for infringements of securities market legislation. It must ensure the transparency and efficiency of the securities markets, protect investors and disseminate any information that may be necessary for these purposes. Likewise, when so empowered by law on a case-by-case basis, it can also issue circulars containing mandatory rules for the implementation and enforcement of the regulations issued by the Council of Ministers or the Minister of Economy and Competitiveness.

The Bank of Spain has two main functions. As a member of the European System of Central Banks, it is in charge of defining and implementing the Eurosystem's monetary policy, carrying out foreign exchange transactions consistent with the provisions of Article 219 of the Treaty on the Functioning of the European Union, and holding and managing Spain's official currency reserves. Second, as a national central bank, the Bank of Spain is responsible for managing the market for public debt represented by book entries and for issuing circulars that develop regulations governing that market (among other matters).

## II THE YEAR IN REVIEW

### i Developments affecting debt and equity offerings

#### *Regulation 2017/1129*

As mentioned in Section I, the main amendments introduced by Regulation 2017/1129, which generally applies as from 21 July 2019, are the following:

- a* the reduction of the maximum amount of the offering (in a 12-month period) excluded from the scope of application from a limit of €5 million to €1 million. In any case, Member States are allowed to increase this limit up to €8 million;
- b* the increase from 10 to 20 per cent of the threshold of the exception for the admission of securities already admitted in the same market, and a broadening of the scope of the exception to securities that are fungible with securities already admitted to trading;

- c the addition of an exception to the offer and admission of non-equity securities issued by credit institutions involving total aggregated consideration of less than €75 million, provided that these securities are not subordinated, convertible or exchangeable and do not give the right to subscribe for or acquire other types of securities and are not linked to a derivative instrument; and
- d the limitation of the exemption to admit shares resulting from conversion or exchange of other securities to 20 per cent.

### ***Current initial public offering and takeover activity***

Initial public offering and takeover activity in Spain has reactivated in recent years. Among others, Italian motorway operator Atlantia and Spanish construction group ACS reached a deal to combine forces to take over Spain's Abertis. Likewise, the Swedish private equity firms EQT, Miles Capital and Corporación Financiera Alba combined forces to lead a takeover bid for Parques Reunidos, a Madrid-based attractions operator. The joint venture company (Piolin BidCo) obtained a controlling stake in the company, since Miles Capital and Corporación Financiera Alba together already owned over 44 per cent of Parques Reunidos, and the joint venture company secured an additional 5.91 per cent stake after reaching a deal with two of the company's shareholders.

Relatedly, Thailand's Minor hotel group acquired 47.76 per cent of NH Hotels Group, bringing its total stake to 94.14 per cent, and Russian billionaire Mikhail Fridman, through his investment fund LetterOne, won control of Spanish retailer DIA after a lengthy takeover bid.

### ***Reform of the clearing, settlement and registry system of securities transactions***

Royal Decree 878/2015, of 2 October, on clearing, settlement and registry of negotiable securities, on the legal regime of central securities depositories and central counterparties, and transparency requirements of issuers of securities trading in an official secondary market, has implemented the changes advanced in Law 32/2011, of 4 October.

The reform of the Spanish clearing, settlement and registry system of securities transactions was implemented in two subsequent phases.

The first phase, which was completed in April 2016 pursuant to the provisions of Royal Decree 878/2015, included the central counterparty (CCP) implementation and migration of the equity settlement system to the new platform, ARCO.

The second and definitive phase (which was implemented in September 2017) included the Spanish system's connection to T2S,<sup>3</sup> and the transfer of fixed-income securities to the ARCO platform, which entailed the unification of the registry and settlement approach for both equities and fixed-income instruments. Furthermore, as a result of the connection to T2S, the settlement process is now performed in accordance with the procedures and time periods established by T2S.

Although the market framework will not experience any modifications in relation to the trading platforms as a consequence of the reform, it will nevertheless imply some changes to trading members' systems, including some modifications to the communication protocols

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3 T2S (TARGET2-Securities) is a securities settlement entity that offers centralised delivery-versus-payment settlement in central bank money in all European securities markets.



of the trades to the trading platform to add new optional information on the clearing side. It also may be necessary to put controls in place regarding the activity between trading and clearing members.

## **ii Developments affecting derivatives, securitisations and other structured products**

### ***Securitisations legal regime***

No further developments affecting securitisation and other structured products have been enacted since 28 December 2017, when (the Securitisation Regulation<sup>4</sup> and the related CRR Amending Regulation<sup>5</sup> were published in the Official Journal of the European Union. These Regulations represent the most material reform of securitisation regulation in the European Union for many years. The main new elements that were introduced aimed at:

- a* harmonising existing rules on due diligence, risk retention, disclosure and credit-granting, which will uniformly apply to all securitisations, securitising entities and all types of EU-regulated institutional investors;
- b* creating a new framework for simple, transparent and standardised long-term securitisations and asset-backed commercial paper programmes; and
- c* implementing the revised Basel securitisation framework.

On a related note, on 12 December 2018, the European Banking Authority published its final guidelines on the harmonised interpretation of the criteria for securitisations to be eligible as simple, transparent and standardised on a cross-sectoral basis throughout the EU. The guidelines apply from 15 May 2019.

## **iii Cases and dispute settlement**

On 6 June 2017, and after some critical days when depositors were said to be withdrawing €2 billion a day and its stock market value had halved, Banco Popular was declared to be failing or likely to fail by the European Central Bank. The Single Resolution Board (SRB), a key element of the Banking Union and its Single Resolution Mechanism (the mission of which is to ensure the orderly resolution of failing banks, with as little effect as possible on the real economy of EU countries), acted swiftly after this communication. In the exercise of its powers, the SRB agreed to declare Banco Popular's resolution and approved all the measures to be applied to the credit institution.

The resolution mechanism adopted by the SRB established that the resolution instrument to be applied to Banco Popular was the sale of its business by means of a transfer of shares, subsequent to the write-down and conversion of the relevant capital instruments determined by the loss absorption needed to meet the resolution objectives. For that purpose, the Fund for Orderly Bank Restructuring had to begin an open tender process to sell the entity. Upon conclusion of the process, the offer submitted by Banco Santander was the only one to fulfil the requirements for acceptance. The SRB decided to accept the offer, given the effects a possible insolvency proceeding could have on the continuity of the entity's critical functions. After all these actions, it was agreed to transfer all the shares comprising Banco

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4 Regulation (EU) 2017/2402.

5 Regulation (EU) 2017/2401.

Popular's share capital issued as a result of the conversion of Tier 2 capital instruments in exchange for €1. This transfer was performed on behalf and in the name of the shareholders without the need to obtain their consent as per Article 25.7 of Law 11/2015.

In July 2019, Banco Santander communicated that the integration of Banco Popular and its branches was successfully completed. The integration process involved the technological migration of almost 1,600 Banco Popular branches across Spain, fully migrating more than three million active customers to Banco Santander's platform, who can now enjoy use of Santander ATMs around the globe without charges or fees. As part of the integration, Banco Popular branches were rebranded, becoming Santander branches (i.e., Banco Popular ceased to exist commercially).

#### **iv Relevant tax and insolvency law**

Non-resident taxpayers are subject to non-resident income tax (NRIT) on Spanish-source income, and must generally declare and pay NRIT during the first 20 days of April, July, October and January: in these cases, NRIT is paid on income obtained during the calendar quarter immediately preceding these payment periods.

Spanish-source income would include, inter alia:

- a* interest paid by a Spanish-resident taxpayer or with respect to financing used in Spain;
- b* income triggered by the disposal of bonds issued by Spanish-resident persons;
- c* dividends distributed by Spanish-resident entities; and
- d* capital gains on the disposal of shares and units issued by Spanish-resident entities or undertakings for collective investment (UCIs).

Income deemed to be obtained in Spain is generally subject to NRIT at a rate of 19 per cent for entities or individuals resident in an EU or EEA Member State that has an effective exchange of tax information in relation to Spain; and 24 per cent for NRIT taxpayers who are not resident in an EU or EEA Member State that has an effective exchange of tax information in relation to Spain.

In addition, a reduced tax rate of 19 per cent is applied to dividends, interest and capital gains deriving from the sale of assets. Each income is subject to taxation separately on a gross basis (with certain exceptions, no expenses are deductible, except for entities or individuals resident in an EU Member State under specific conditions). Normally, a withholding tax generally equal to the non-resident's final tax liability is levied on interest, dividends and capital gains on UCIs, in which case the taxpayer does not need to file an NRIT return with the Spanish tax authorities to declare and assess the NRIT liability.

A brief overview of the Spanish taxation applicable to non-resident investors is provided below. Note that this refers to individuals or entities not resident in Spain for tax purposes, and not acting through a permanent establishment located in Spain.

#### ***Capital gains on transfer of interests in Spanish corporations or undertakings for collective investment***

In general, capital gains obtained in Spain by a non-resident taxpayer from the transfer of interests in Spanish corporations or UCIs will be taxed under NRIT at a rate of 19 per cent. No withholding tax is levied on capital gains, except for those related to an investment in a Spanish UCI.

Domestic legislation provides for an exemption from tax for the benefit of residents of countries that have entered into a convention for the avoidance of double taxation (CDT)

with Spain, and that includes an exchange-of-information clause in the case of transfers of shares of Spanish companies or reimbursements of units in a UCI that are carried out in a Spanish official secondary securities market.

In addition, EU residents are entitled to an exemption on capital gains obtained upon disposal of shares, provided that the following conditions are met:

- a* most of the value of the assets of the company to which the shares belong does not derive (directly or indirectly) from real estate located in Spain;
- b* in the case of a non-resident individual, he or she has not held a direct or indirect interest of at least 25 per cent in the relevant Spanish company's capital or net equity during the 12 months preceding the transfer;
- c* in the case of non-resident entities, the transfer fulfils the requirements of Article 21 of the Corporate Income Tax Law (which are highly complex and must be analysed case by case); and
- d* the capital gain is not obtained through a tax haven jurisdiction or a permanent establishment located in a country or jurisdiction that is not an EU Member State.

Finally, most CDTs provide for an exemption from capital gains tax, except when the assets are allocated to a Spanish permanent establishment or when the assets are Spanish real estate (also generally including for this purpose any capital gains from the transfer of Spanish land-rich companies, with some exceptions). In some cases, when the assets consist of shares in a Spanish-resident entity, the exemption is conditional on the fact that the holding is below significant participation thresholds (below 15 or 25 per cent).

### ***Interest and dividends***

In general, interest and dividends obtained in Spain by a non-resident taxpayer will be taxed under NRIT at a rate of 19 per cent, and will be subject to withholding tax on account of NRIT.

Domestic rules provide certain tax exemptions on income obtained by non-residents (e.g., income derived from Spanish public debt or listed preference participations and debt instruments meeting certain requirements, or interest accrued on non-residents' bank accounts). In particular, in the case of preference participations and debt securities issued under the first additional provision of Law 10/2014, of 26 June (which can be issued not only by banks or listed companies, but also by any Spanish corporation, provided the securities are listed in a regulated market, a multilateral trading facility (MTF) or an organised market, among other requirements), non-resident taxpayers will not be subject to taxation or withholding in Spain.

In addition, EU residents are entitled to an exemption on interest obtained in Spain, provided that interest is not obtained through a tax haven jurisdiction or a permanent establishment located in Spain or in a country or jurisdiction that is not an EU Member State (the EU lender interest exemption).

Regarding dividends, under the provision implementing in Spain the Parent-Subsidiary Directive (i.e., Article 21 of the Corporate Income Tax Law), no Spanish withholding taxes should be levied on the dividends distributed by a Spanish subsidiary to its EU parent company (and EEA parent companies under additional specific conditions) to the extent that, in brief:

- a* the EU parent company maintains a direct holding in the capital of the Spanish subsidiary of at least 5 per cent (or the acquisition basis of the interest exceeds €20 million) without interruption during the year prior to the date on which the distributed profit is due;

- b the EU parent company is incorporated under the laws of an EU Member State (other than a tax haven jurisdiction) and is subject to corporate income tax in a Member State, without the possibility of being exempt; and
- c the distributed dividends do not derive from the subsidiary's liquidation.

The implementation of the Parent-Subsidiary Directive in Spain includes an anti-abuse provision, by virtue of which the withholding tax exemption will not be applicable when the majority of the voting rights of the EU parent company are held directly or indirectly by individuals or entities not resident in the European Union, except when the EU parent company evidences that it has been incorporated and operates for valid economic and substantive business reasons. The EU Parent-Subsidiary exemption may also apply to parent companies resident in an EEA Member State that has ratified an effective exchange of tax information agreement with Spain under similar conditions.

However, it remains unclear how the Spanish tax authorities will construe the judgments handed down by the Court of Justice of the European Union (CJEU) on 26 February 2019 in *T Denmark and Y Denmark v. the Danish Ministry of Taxation*<sup>6</sup> and in *N Luxembourg 1, X Denmark A/S, C Denmark I and Z Denmark ApS v. the Danish Ministry of Taxation*<sup>7</sup> (together, the Danish cases) when applying any domestic NRIT exemptions and, in particular, the EU Lender and the Parent-Subsidiary Directives. Although none of these provisions includes a beneficial owner test and there is no legal definition of beneficial ownership in Spain (and no clear guidelines or resolutions outlining the contours of this international tax concept have been issued by Spanish tax authorities and courts), based on the views of the CJEU, the possibility that the Spanish tax authorities may attempt to apply the general anti-abuse provision to situations in which the recipient of Spanish-sourced income lacks the 'right to use and enjoy' that income, or when it acts on a back-to-back basis or does not bear (or bears little) economic risk in connection with the specific investment, cannot be ruled out. Proper monitoring of the evolution of this topic should be carried out in all EU jurisdictions in coming years.

Finally, non-residents who are resident in a country that has entered into a CDT with Spain will be entitled to apply the reduced tax rates or exemption provided in the relevant CDT (CDTs usually establish rates ranging from zero to 15 per cent on interest and dividends) if they are the beneficial owners of such income.

### ***Insolvency law***

The most important piece of Spanish legislation on this matter is Law 22/2003, of 9 July, on insolvency, which has been amended on a number of occasions in the past few years to facilitate the refinancing processes undertaken by Spanish companies and their general recapitalisation.

One of the main particularities of this Law is that, in the case of issuers of securities or derivative instruments traded in an official secondary market, the insolvency trustee will either be a CNMV staff expert or a person designated by the CNMV to fulfil certain requirements (basically, an economist or an auditor with a certain specialisation and experience, a Big Four firm or an audit company).

<sup>6</sup> Joined cases C-116/16 and C-117/16.

<sup>7</sup> Joined cases C-115/16, C-118/16, C-119/16 and C-299/16.

## v Role of exchanges and central counterparties

### *Secondary markets and multilateral trading facilities*

Under Spanish law, in the area of securities markets, an initial and basic distinction is made between primary and secondary markets. In the primary market (also known as the issuance market), issuers put into circulation (i.e., issue) securities, which are subscribed by investors, either directly or through financial intermediaries. In the secondary markets, previously issued securities are traded. Secondary markets offer liquidity to those securities that have already been issued in the primary market and facilitate their subscription, since the existence of the secondary markets allows investors to sell the relevant securities in an uncomplicated manner.

The official secondary markets are also known as regulated markets and mainly include:

- a* the stock exchanges;
- b* the market for public debt represented by book entries;
- c* futures and options and other derivative markets, notwithstanding the underlying assets (either financial or non-financial); and
- d* the AIAF<sup>8</sup> fixed income market.

There are currently four stock exchanges in Spain, all subject to the supervision of the CNMV. These are established in Madrid, Barcelona, Bilbao and Valencia; there is also the SIBE, which is the interconnection system between stock exchanges. Only those securities previously admitted to listing on at least two of the Spanish stock exchanges are traded on the SIBE, provided that the prior authorisation of the CNMV is obtained.

In addition to the official secondary markets, multilateral trading facilities (MTFs) are increasingly relevant. An MTF is a multilateral system operated by an investment firm or a market operator that brings together multiple third-party buying and selling interests in financial instruments – in the system and in accordance with non-discretionary rules – in a way that results in an agreement in accordance with the TRLMV. Examples of Spanish MTFs are:

- a* the Mercado Alternativo Bursátil, the alternative stock market, implemented in 2006 as a less-regulated market for SICAVs (open-ended collective investment companies) and stocks with small market capitalisation; and
- b* the Mercado Alternativo de Renta Fija, the alternative fixed-income market, implemented in 2013 as an alternative source of funding for medium-sized companies with positive business prospects and usually unlisted shares.

Spain's third trading environment concerns systematic internalisers (SIs). SIs are investment services firms and credit institutions that execute, through the regulated market or a multilateral trading system, on their own account, client orders for shares listed on regulated markets in an organised, frequent and systematic way. SI transactions are subject to compliance with specific requirements on the transparency and size of transactions.

8 AIAF Mercado de Renta Fija SA is the reference market for corporate debt or private fixed income integrated into Spanish stock exchanges and markets.

## CCPs

In the past, the only Spanish markets that provided CCP services were the futures and options market, with the former Spanish Financial Futures and Options Exchange (MEFF) acting as both an official secondary market and as a CCP. After the amendments to the LMV introduced by Law 44/2002, it was made possible to incorporate CCP companies to provide a counterparty to one or more securities traded in the different securities markets.

Given the need to separate trading and clearing activities pursuant to the European Market Infrastructure Regulation, the clearing activity carried out by MEFF is now carried out by BME Clearing, the first and only CCP incorporated to date in Spain. In this regard, BME Clearing's activities, currently covering financial derivatives, public debt repos and electricity derivatives, will extend to cash markets (equities and fixed income) in the context of the reform of the clearing and settlement activities in Spain referred to above.

The clearing activity is carried out through a 'subjective novation', whereby the CCP intervenes as a party to the contracts traded in the relevant market (as purchaser in relation to the selling party and as seller in relation to the purchasing party), guaranteeing full compliance with the relevant contract.

In June 2018, the European Securities and Markets Authority (ESMA) published an opinion addressed to competent authorities responsible for CCP supervision (in Spain, the CNMV), which sets out how CCPs in the European Union should consider in their internal risk models the liquidity risk posed by all entities towards which the CCP has a liquidity exposure, such as liquidity providers. The opinion outlines the assessment of the liquidity risk posed by liquidity providers regardless of whether they are a clearing member. ESMA clarifies that CCPs should include, when measuring their liquidity needs, the default of their top two clearing members in all their capacities in relation to the CCP, in addition to assessing in their stress testing scenarios all entities towards which the CCP has a liquidity exposure.

## vi Other strategic considerations

### *Structural reforms: credit institutions*

The new institutional and legal framework for the Spanish banking system is in its final stages of implementation under a process that commenced in 2012, expanded in 2013 and is likely to continue for the next few years.

One notable reform was Royal Decree 84/2015, of 13 February, implementing Law 10/2014, of 26 June, on the organisation, supervision and solvency of credit institutions, whose purpose is to continue adapting the Spanish legal system to the new provisions of CRD IV<sup>9</sup> and CRR,<sup>10</sup> as well as the new provisions included in Council Regulation (EU) No. 1024/2013<sup>11</sup> with regard to the Single Supervisory Mechanism.

9 Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms.

10 Regulation (EU) No. 575/2013 on prudential requirements for credit institutions and investment firms.

11 Regulation conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions.

### **III OUTLOOK AND CONCLUSIONS**

It seems that volatility in the markets will continue. Indeed, it appears that any political compromise or measure (irrespective of the Prime Minister) will be tainted by the fact that its implementation or enactment would depend on a coalition of parties. Tensions between the Spanish and Catalan governments are also not expected to cease in the short to medium term. These political challenges occur in a weak labour market: structural unemployment, especially youth employment, is still high despite the recovery experienced in recent years, and in the EU field, Brexit still raises questions as to how the euro and the European market will be affected.

# SWITZERLAND

*François M Bianchi, Daniel Bono, Andrea Giger and Till Spillmann<sup>1</sup>*

## I INTRODUCTION

For a better understanding of the Swiss capital market, it is worth highlighting that Switzerland is neither a member of the European Union (EU) nor the European Economic Area (EEA). Consequently, the EU prospectus rules and other EU or EEA capital markets rules and regulations are not applicable in Switzerland. Since Swiss capital market participants largely depend on free and unrestricted access to the European (capital) markets, Switzerland regularly adapts its legislation to EU equivalence requirements to facilitate market access. As part of Switzerland's efforts to meet EU-equivalent standards, it is in the process of implementing a comprehensive reform package fundamentally changing the Swiss financial market regulatory framework, which is expected to enter into force by 1 January 2020. One of the aims of the new rules is the regulatory harmonisation with the relevant EU rules (MiFID II,<sup>2</sup> MiFIR,<sup>3</sup> the Prospectus Directive,<sup>4</sup> the PRIIPs Regulation)<sup>5</sup> with adjustments made to reflect the specific Swiss circumstances.

The Swiss initial public offering (IPO) market in 2019 was not as strong as in 2018, with four IPOs during the first three quarters of 2019 on the SIX Swiss Exchange Ltd with an aggregate issue volume of approximately 2.3 billion Swiss francs and a total market capitalisation of 34.99 billion Swiss francs. The Swiss debt market is also active, particularly with respect to bonds and structured notes issues. According to the SIX website, as at September 2019 a total of 3,618 bonds were listed on SIX (of which 1,146 were Swiss bonds denominated in Swiss francs, 638 were foreign bonds denominated in Swiss francs and 1,834 bonds were not denominated in Swiss francs). Further, there exists an active market for unlisted bonds or notes and privately placed debt securities.

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2 Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments.

3 Regulation (EU) No. 600/2014 on markets in financial instruments.

4 Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading.

5 Regulation (EU) No. 1286/2014 on key information documents for packaged retail and insurance-based investment products (PRIIPs).



**i Structure of the law**

The relevant Swiss capital market legislation governing the primary and secondary securities markets includes:

- a* the Swiss Code of Obligations governing the prospectus requirements for the public offering of equity and debt securities;
- b* the Federal Act on Financial Market Infrastructures and Market Conduct in Securities and Derivatives Trading (FMIA) governing the organisation and operation of financial market infrastructures, and the conduct of financial market participants in securities and derivatives trading;
- c* the Ordinance on Financial Market Infrastructures and Market Conduct in Securities and Derivatives Trading (FMIO) implementing the provisions of the FMIA;
- d* the Ordinance of the Swiss Financial Market Supervisory Authority on Financial Market Infrastructures and Market Conduct in Securities and Derivatives Trading (FMIO-FINMA) implementing the provisions of the FMIA;
- e* the Federal Act on the Swiss Financial Market Supervisory Authority stipulating provisions regarding supervision of the financial markets by the Swiss Financial Market Supervisory Authority (FINMA);
- f* the Ordinance of the Takeover Board on Public Takeover Offers providing rules on the requirements for public takeover offers;
- g* the Regulations of the Takeover Board, stipulating regulations governing the organisation of the Takeover Board;
- h* the listing rules and all other rules, directives, circulars, prospectus schemes of SIX Swiss Exchange Ltd governing the listing and trading in securities on the SIX Swiss Exchange and laying down the principles for maintaining listings of equity and debt securities on the SIX Swiss Exchange;
- i* the Guideline for Notes issued by Foreign Borrowers dated 1 September 2001 of the Swiss Bankers' Association;
- j* the Federal Act on Collective Investment Schemes (CISA) governing the issue of structured products;
- k* the Federal Ordinance on Collective Investment Schemes implementing the provisions of the CISA;
- l* the Federal Act on Intermediated Securities governing the custody, transfer and related issues of securities held with regulated custodians;
- m* the Federal Act on Banks and Savings Banks;
- n* the Federal Ordinance on Banks and Savings Banks;
- o* the Federal Act on Combating Money Laundering and Terrorist Financing and the corresponding implementing ordinances; and
- p* the Federal Act on Stock Exchanges and Securities Trading (SESTA) and the corresponding implementing ordinances.

**ii Stock exchange regulation**

The principal stock exchange for the listing and trading of equity and debt securities, structured products, derivatives and other securities in Switzerland is the SIX Swiss Exchange in Zurich. It has adopted – based on the principle of self-regulation – a comprehensive set of its own regulations, directives and notices governing, inter alia, the requirements for admission to

trading and listing and disclosure requirements. The second Swiss stock exchange is the BX Swiss, in Berne, which is comparatively small and mainly focuses on domestic issuers. Since 2018, BX Swiss is a wholly owned subsidiary of the Börse Stuttgart GmbH.

### **iii Structure of the courts**

In principle, the Swiss court system is based on a three-tier hierarchy: the first-instance cantonal courts (which apply both cantonal and federal law), the second-instance cantonal appellate courts and the Federal Supreme Court (the highest judicial authority in Switzerland). As an exception to the principle of double instance at cantonal level, there are certain specific matters that are brought directly before an inferior federal court (e.g., the Federal Administrative Court or the Federal Criminal Court) and other matters that can be directly decided by the exclusive first cantonal instance. Some cantons have established a commercial court as a sole cantonal instance competent for certain disputes relating to commercial matters. Judgments of the first-instance cantonal courts are generally subject to appeal to the second-instance cantonal appellate courts, and judgments of an inferior federal court, the second-instance cantonal courts or the sole cantonal instance courts are subject to appeal to the Federal Supreme Court, if certain conditions are met. No special courts with jurisdiction over securities-related actions exist in Switzerland.

### **iv Regulatory bodies**

FINMA is an independent regulatory body monitoring developments at financial institutions under its supervision and the financial market in Switzerland. FINMA has statutory authority to supervise securities exchanges, licensed banks, insurance companies, securities dealers and collective investment schemes. It authorises their operations to engage in financial market activity, and ensures that the supervised institutions comply with the requisite laws, regulations and ordinances and maintain their licensing requirements. FINMA has certain limited powers to enforce the provisions of the FMIA and to proceed with and take administrative measures against any failure to disclose shareholdings, insider trading and market manipulation. As a general rule, decisions of FINMA may be challenged at the Federal Administrative Court, the decisions of which may be appealed at the Federal Supreme Court. The prosecution of insider trading and market manipulation is the responsibility of Switzerland's attorney general.

The SIX Swiss Exchange is a self-regulated organisation whose investigative bodies supervise and enforce compliance with its rules, regulations and directives. Any appeals against a sanction decision made by a SIX Exchange regulation or disputes between the SIX Swiss Exchange and any listed company concerning the listing, delisting or trading of securities on SIX are filed with the Sanctions Commission or the Independent Appeals Board and can subsequently be submitted to the Board of Arbitration.

The Swiss Takeover Board enacts rules on public takeover offers and public share buybacks, and supervises compliance with those rules. Decisions of the Takeover Board may be challenged before FINMA and, finally, the Federal Administrative Court.

In contrast to other jurisdictions (e.g., the United States, the EU and the EEA), in principle there is currently no requirement for a prospectus to be filed with, or approved in advance by, a regulatory authority in connection with the offering of equity or debt securities in, from or into Switzerland. This constitutes a major advantage for Swiss securities offerings with respect to time to market. However, with the contemplated implementation of the new prospectus regime (as discussed further in Section II.i), a requirement for *ex ante* approval of prospectuses, including in the case of secondary public offerings, will be introduced.

## II THE YEAR IN REVIEW

### i Developments affecting debt and equity offerings

Of the numerous developments affecting debt and equity offerings in Switzerland, the following are of particular interest.

#### *Swiss Federal Financial Services Act to enter into force*

On 15 June 2018, Parliament adopted the Swiss Federal Financial Services Act (FinSA). The final version of the Swiss Federal Financial Services Ordinance (FinSO), implementing the FinSA and specifying several details on how the new prospectus regime principles will be implemented, is expected in November 2019. The FinSA is expected to enter into force together with the FinSO on 1 January 2020 with a transitional period of two years. However, new public offerings and admissions to trading will need to comply with the new prospectus regime six months after a review body (as defined below) is admitted by FINMA.

The FinSA will set out cross-sector rules for the provision of financial services, introduce a comprehensive and harmonised prospectus regime to meet EU equivalence requirements while reflecting specific Swiss circumstances, and will be applicable to all public offerings of financial instruments and all securities to be admitted to trading on a trading platform in Switzerland.

With regard to the offering of equity and debt securities, fundamental innovations of the Swiss capital markets regulation include:

- a* the requirement for approval for all offering and listing prospectuses by a new regulatory body (review body) that is licensed and supervised by FINMA, irrespective of whether the securities are admitted to trading on a Swiss trading platform;
- b* an obligation to publish a prospectus not only for primary but also for secondary public offerings of securities in Switzerland;
- c* the codification of the private placement exemption and other exemptions to publish a prospectus in line with accepted Swiss standards and the EU Prospectus Directive;<sup>6</sup> and
- d* the requirement to prepare a basis information document in the case of offerings of financial instruments other than shares (or comparable equity securities) or debt instruments without derivative character to retail investors containing all necessary information to enable a client to make a decision about its investment, presented in an easily comprehensible way and designed to make financial instruments easier to compare.

While, in principle, the review body would have to approve a prospectus prior to a public offering or an admission of securities to trading on a Swiss trading platform, a prospectus for certain debt securities (e.g., bonds) can be approved after its publication, provided certain requirements are met. By preserving the advantage of the current approval process for listing prospectuses in the Swiss debt capital markets, Switzerland continues to ensure attractive time-to-market conditions for issuers of debt instruments.

Another significant change brought in by the FinSA is that prospectuses prepared under foreign legislation may be approved by the review body if they are prepared according

<sup>6</sup> Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading.

to international standards established by international organisations of securities regulators and the disclosure and ongoing reporting duties are equivalent to the requirements set forth in the FinSA.

### ***Swiss Federal Financial Institutions Act to enter into force***

On 15 June 2018, parliament adopted the Swiss Federal Financial Institutions Act (FinIA). The final version of the Swiss Federal Financial Institutions Ordinance (FinIO) implementing the FinIA is expected in November 2019. The FinIA and the FinIO are expected to enter into force together with the FinSA and FinSO on 1 January 2020 with a transition period of two years. The FinIA and the FinIO essentially harmonise the authorisation rules for financial service providers and will, for the first time in Switzerland, subject independent portfolio managers and trustees to licensing requirements and continuous prudential supervision.

### ***SESTA***

Simultaneously with the enactment of the FinSA and the FinIA, the SESTA and the corresponding implementing ordinances will cease to exist.

### ***CISA***

The entry into force of the FinSA and FinIA will lead to important changes to the CISA. It is particularly noteworthy that certain regulatory requirements introduced in 2013 as part of the CISA Revision 2013 will already be amended or abolished. For example, the requirement to appoint a Swiss representative and a Swiss paying agent for foreign collective investment schemes distributed to qualified investors in or into Switzerland will no longer exist (some exceptions apply). Another important change consists of the abolition of the CISA distributor licence in its current form.

The scope of the CISA will be substantially reduced as a result of the entry into force of the FinSA and FinIA: in essence, the CISA will continue to contain the product level requirements for Swiss collective investment schemes and for foreign collective investment schemes offered to investors in Switzerland, whereas in contrast, the licence requirements for fund management companies and asset managers of collective investment schemes will be incorporated in the FinIA, and the fund industry specific point of sale duties of the CISA will be replaced by the new cross-sectoral code of conduct duties of the FinSA.

Under the revised CISA, distributors of collective investment schemes will no longer be subject to a licensing requirement, regardless of whether they distribute collective investment schemes exclusively to non-qualified or (also) to qualified investors.

### ***FINMA guidelines regarding initial coin offerings***

To provide increased legal certainty regarding regulatory matters and streamline the procedure for obtaining negative clearance regarding certain regulatory aspects of initial coin offerings (ICOs), FINMA published ICO guidelines in February 2018.

In August 2019, based on guidance issued by the Financial Action Task Force (FATF) on virtual asset service providers in June 2019, FINMA published guidance on the application of Swiss anti-money laundering rules to financial services providers supervised by FINMA in the area of blockchain technology (FINMA Guidance 02/2019). The FINMA standard is one of the most stringent in the world as, unlike the FATF standard, it does not include an exception for unregulated wallets. If information about the sender and recipient cannot

be transmitted reliably in the respective payment system, FINMA-supervised institutions are not permitted to receive tokens from customers of other institutions or to send tokens to such customers.

In September 2019, FINMA published a supplement to its ICO guidelines outlining the treatment of stable coins under Swiss supervisory laws, noting that since mid-2018 an increasing number of ICOs and other tokenisation projects are based around the creation of stable coins. The aim of stable coins is typically to minimise value fluctuations of payment tokens such as bitcoin by backing the tokens with assets such as fiat currencies, commodities, real estate or securities. In this context, FINMA has confirmed that its treatment of stable coins under supervisory laws follows the existing approach for blockchain-based tokens, focusing on substance over form and that, in ruling on concrete projects, it will follow the 'same risks, same rules' principle. The stable coin supplement includes specific remarks on possible categories of stable coins (currencies, commodities, real estate and securities) for indicative purposes and sets out supplemental minimum requirements for enquiries concerning stable coins.

In its press release regarding the stable coins ICO guidelines supplement, FINMA also confirmed that the Libra Association had asked FINMA for an assessment of how it would classify the Libra project under Swiss supervisory law and provided an indicative classification under Swiss supervisory law. FINMA noted, inter alia, that the Libra project as currently envisaged would require a payment system licence under the FMIA and that, given the planned international scope of the project, an internationally coordinated approach would be required.

## **ii Developments affecting derivatives, securitisations and other structured products**

FinSA stipulates that structured products may only be offered to private clients (absent an asset management agreement) into, in or from Switzerland if they are issued, guaranteed or secured in an equivalent manner by a Swiss bank, insurance company securities house or insurance company, or a pertinent foreign institution subject to equivalent standards of supervision.

## **iii Cases and dispute settlement**

Lawsuits involving breaches of securities law are not common in Switzerland. In 2019, no relevant decisions were published in the area of Swiss capital market law.

## **iv Relevant tax and insolvency law**

### ***Corporate tax reform***

Switzerland has been undergoing major corporate tax reforms. The third corporate tax reform package proposed by the Swiss Federal Council intended to abolish certain tax advantages for holding, domiciliary and mixed companies pursuant to an agreement with the EU as well as implementing tax advantages deemed to be in line with EU rules.

The third corporate tax reform package hit a political roadblock when voters rejected it in a referendum in February 2017, with an unexpectedly high proportion of 59.1 per cent of the popular vote. While the Federal Council has announced its intention to propose a new reform package as soon as possible, the referendum added a lot of uncertainty, in part because it is unclear whether a new package will be in place within the time frame agreed with the EU.

In the meantime, the Federal Council has proposed a well-balanced new reform package and submitted it to the Swiss Federal Parliament. On 28 September 2018, the Swiss Federal Parliament adopted Tax Proposal 17 with a clear majority.

On 19 May 2019, Swiss voters approved the reform package with 66.4 per cent of the popular vote in a referendum (combined with more than 2 billion Swiss francs of additional funding for Switzerland's statutory pension system, AHV/AVS). The aim of the reform package is to create an internationally compliant, competitive tax system for companies by abolishing existing tax privileges for companies that operate predominantly internationally (subject to phase-in) and introducing replacement measures including a general reduction of tax rates, a Patent Box, an R&D super-deduction, a step-up upon migration of companies or activities to Switzerland for tax purposes and the option for cantons to introduce a notional interest deduction.

Detailed draft regulations are expected to be issued by the Swiss Federal Tax Administration by year-end 2019. In order for the new rules to come into effect on 1 January 2020, Swiss cantons must pass amendments to the cantonal tax laws.

### ***Withholding tax reform***

Another troubled Swiss tax reform project relates to withholding tax. Currently, a Swiss issuer of bonds must deduct withholding tax at a rate of 35 per cent from interest, and certain other payments made to investors inside and outside Switzerland (debtor-based regime).

Because it may be difficult for investors outside Switzerland to reclaim Swiss withholding tax, the current system makes it impracticable for Swiss issuers to directly access investors outside Switzerland. This has had a material adverse effect on the Swiss capital markets for decades. To address this issue, the Federal Council published draft legislation in December 2014 to, among other things, replace the current debtor-based regime with a paying agent-based regime for Swiss withholding tax, whereby a withholding would be required only for Swiss investors. The Federal Council withdrew the draft legislation in June 2015 and mandated the Federal Finance Department to appoint a group of experts to prepare a proposal for reform of the Swiss withholding tax system. Because of a popular initiative to enshrine banking secrecy in the Swiss Constitution, this project was put on hold in 2015 pending the results of the referendum. To facilitate compliance by banks with the tougher capital requirements under Basel III prior to the reform of the Swiss withholding tax system, the Federal Council has exempted contingent capital instruments and bail-in bonds from withholding tax until 2021.

On 9 January 2018, its sponsors withdrew the banking secrecy initiative. Following this withdrawal, the Federal Council and the group of experts have recommenced the withholding tax reform project. Implementation of the reform is expected to take about two years.

### **v Role of exchanges, central counterparties and rating agencies**

Financial market infrastructures (FMIs) in Switzerland include stock exchanges and other trading venues, central counterparties (CCPs), central securities depositories (CSDs), trade repositories and payment systems. FMIs require authorisation from FINMA before they can commence operations. Stock exchanges and trading venues must establish their own independent regulatory and monitoring organisations appropriate to their activities under FINMA supervision. CCPs shall require deposits of collateral in the form of initial margins, variation margins and default fund contributions from all trading participants to enable them to settle transactions in an orderly way. Furthermore, CCPs must have adequate capital and

diversify their risk appropriately, and must separate their own assets, receivables and liabilities from the collateral, receivables and liabilities of its participants. CSDs must ensure the proper and lawful custody, recording and transfer of securities, and that the number of securities deposited with them equals the number of securities credited to their clients.

### **III OUTLOOK AND CONCLUSIONS**

The continuing comprehensive reform of the Swiss financial market regulatory framework will usher in a new era of securities regulation and is essential for aligning Swiss regulations to the EU equivalence standards to preserve access to the European financial markets. In particular, the introduction of a new harmonised prospectus regime aiming to establish a level playing field with corresponding EU prospectus regulations is an important step towards ensuring that Switzerland's capital markets environment remains attractive and keeps up with international standards. While parts of the new regulation will be in line with well-established Swiss market practice (e.g., the content of prospectus and private placement exemptions), other areas will require special attention from market participants and advisers.

# THAILAND

*Patcharaporn Pootranon, Veerakorn Samranweth and Natcharee Apichotsuratsamee<sup>1</sup>*

## I INTRODUCTION

The broad framework of capital markets in Thailand is governed by the Securities and Exchange Act BE 2535 (1992), under which the Securities and Exchange Commission of Thailand (SEC) was established. The SEC is empowered to introduce policies for the development and supervision of the securities markets and related activities, including governing the offering of securities, and the governance of issuing companies and securities businesses in Thailand. The SEC's organisation extends to the Capital Market Supervisory Board and the Office of the Securities and Exchange Commission (SEC Office), a regulatory body established by the Securities and Exchange Act that supervises securities businesses on their day-to-day operations, public offerings and business takeovers, as well as implementing policies, inspecting licensed or approved companies and individuals, and developing financial products.

The Securities and Exchange Act also established the Stock Exchange of Thailand (SET), which is the principal stock exchange in Thailand, consisting of securities companies that are SET members. The SET is responsible for, among other things, processing all listing applications, ensuring that disclosure requirements for listed companies are fulfilled and monitoring all trading activities in connection with listed securities. In 2019, the composition of the board of directors of the SET was amended, and an appointment procedure was specified under the Securities and Exchange Act that will induce transparency regarding the composition of the board of directors of the SET.

A public limited company must comply with the Public Limited Companies Act BE 2535 (1992) (PLCA), which governs corporate matters and the relationships between the issuing company, its directors, executives and shareholders.

There are several other laws and regulations that specifically govern certain types of financial transactions: for example, derivatives transactions are governed by the Derivatives Act BE 2546 (2003), and trusts are governed by the Trust for Transactions in Capital Markets Act BE 2550 (2007).

Another regulatory body involved in the country's financial system is the Bank of Thailand (BOT), which is the country's central bank, whose main goals are:

- a* promoting Thailand's monetary stability;
- b* formulating and implementing monetary policies as specified by the Monetary Policy Committee by way of, inter alia, mobilising deposits;

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- c* determining the interest rate for loans to financial institutions;
- d* trading foreign currencies and exchanging them for future cash flow;
- e* borrowing foreign currencies to maintain monetary stability;
- f* trading securities as necessary and exchanging them for future cash flow;
- g* controlling the money supply in the country's financial system; and
- h* borrowing or lending securities with or without returns.

The BOT also provides banking facilities to the government in terms of being a depository for the Ministry of Finance (MOF), and acts as the government's custodian of deposits, securities and other valuables. Its roles include acting as the government's representative in trading gold and currencies, and as the registrar of the government's bond transactions in terms of purchasing and selling government bonds and paying principal and interest to bondholders.

The role of the BOT as regards financial institutions includes supervision and examination of institutions' financial status and performance, and their risk management systems, with the aim of promoting financial stability. When necessary, the BOT is the lender of last resort for financial institutions. Thailand's payment systems, including the electronic clearing system, are supported and administered by the BOT to ensure safety and efficiency.

Another main function of the BOT is to manage Thailand's foreign exchange rate under the foreign exchange system and assets in the currency reserve according to the Currency Act BE 2501 (1958), and to control the foreign exchange under the Exchange Control Act BE 2485 (1942).

## II THE YEAR IN REVIEW

### i Developments affecting debt and equity offerings

#### *Equity*

Only a public limited company can offer shares to the public. A public offering of shares requires approval from the SEC Office, and the filing of a registration statement and submission of a draft prospectus to the SEC Office before conducting the offering. The appointment of a financial adviser is also required to undertake the application for approval and the filing of a registration statement and a prospectus. As for the solicitation, advising and offering of the securities, the issuing company of the equity type (i.e., shares and warrants to buy shares) is required to appoint an underwriter, who must comply with the selling restrictions under the relevant regulations issued under the Securities and Exchange Act. In respect of the offering, the SEC aims to protect investors by, among other things, granting approvals based on certain criteria. Mainly, shareholders' rights must be protected, and shareholders must be treated fairly. The board of directors and executives must have a system of checks and balances under which a clear and fair structure is in place, and there must be no conflict of interest between the company and its directors, executives or major shareholders (otherwise, there shall be a valid mechanism to cope with any conflict of interest). Any disclosures must be sufficient, and financial statements must be prepared in accordance with the relevant accounting standards.

In terms of regulations regarding an offering, there are certain measures to avoid going through the process of requesting an approval from the SEC Office and to be exempted from filing a registration statement and draft prospectus with the SEC Office; for example, issuing the rights offering to the shareholders of the issuing company proportionately to the shareholding, or private placement of shares to:

- a* no more than 50 persons in a 12-month period;
- b* any person with an aggregate value not exceeding 20 million baht in a 12-month period, using the offering price as a basis for calculation; or
- c* an institutional investor (as defined in Clause 2(4) of Notification of the Securities and Exchange Commission No. KorChor 17/2551 on the definitions in the issuing and offering of securities regulations).

The number of investors referred to in (a) or the aggregate value of the offering referred to in (b) shall exclude the value of any offer made to the institutional investor referred to in (c), regardless of whether the offering is made simultaneously or at a different time (private placement (PP)). However, the SEC has tightened its control over the issuance of PP shares of a listed company by imposing an approval process prior to the sale of PP shares. Deemed approval for PP shares issued by a listed company is granted only in the case of offering the PP shares at the market price (a discount of not more than 10 per cent may be granted if necessary, subject to the discretion of the board of directors, provided that this is in the best interests of the listed company).

Furthermore, effective from 1 April 2018, with respect to the offering of shares to the cornerstone investors in an initial public offering (IPO), there is a regulation governing the offering and allotment of shares to the cornerstone investors whereby the offering is made during the period between the submission of applications for approval by, and the registration of statements and a prospectus with, the Office of SEC until the shares have commenced trading on the SET, in which case the following are required:

- a* the offering must be approved by the shareholders' meeting of the issuer, and the board of directors shall be authorised to offer and allocate portions of shares to the cornerstone investors, which must be separate portions from the newly issued shares to be offered to the public;
- b* a cornerstone investor shall have the following characteristics:
  - he or she will be an institutional investor;
  - he or she will not be a person related to the issuer;<sup>2</sup>
  - he or she will not be a patron of the issuer;<sup>3</sup> and
  - he or she will not be an underwriter for the offering;
- c* the total amount of the newly issued shares offered to the public, and the portions offered to cornerstone investors and the portions offered by the existing shareholders of the issuer (selling shareholders), shall not be below 5,000 million baht; and
- d* the price of shares prescribed in the relevant cornerstone investment agreements shall be identical to the IPO price shown in the final prospectus. In addition, the names of the cornerstone investors and the approximate number of shares to be purchased by each cornerstone investor must be specified in the registration statements.

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2 Includes directors, executives and major shareholders of the issuer.

3 Includes customers or suppliers of the issuer.

### ***Offering of offshore shares***

The SEC Office provides an option for an offshore company to offer its shares to investors in Thailand and be traded on the SET, subject to the SEC Office's approval and the filing of a registration statement in the prescribed form and a prospectus with the SEC Office that must become effective prior to commencing the offering. The main regulations with which the offshore company must comply are divided into the following:

- a* for a dual listing, the Capital Market Supervisory Board Notification No. TorChor 14/2558 on rules on the offering of securities issued by an offshore company that has or will have its shares listed on one or more offshore exchanges; and
- b* for an offshore company not having its shares listed on any offshore exchange, the Capital Market Supervisory Board Notification No. TorChor 3/2558 shall be applied.

There are certain exemptions from obtaining an approval from, and filing a registration statement in the prescribed form and prospectus with, the SEC Office, such as when the offering of shares is made to:

- a* no more than 50 persons in a 12-month period;
- b* any entity with an aggregate value not exceeding 20 million baht in a 12-month period, using the offering price as a basis for calculation; or
- c* an institutional investor (as defined in Clause 2(4) of Notification of the Securities and Exchange Commission No. KorChor 17/2551 on the definitions in the issuing and offering of securities regulations.

The number of investors referred to in (a) or the aggregate value of the offering referred to in (b) shall exclude the value of any offer made to the institutional investors referred to in (c), regardless of whether the offering is made simultaneously or at different times. In addition, an offshore company that offers the shares under these exemptions must submit the result of the sale after the offering to the SEC.

### ***Debt***

The Thai debt market is relatively small compared to the market for bank loans and equity. Nonetheless, it is active and developing with various types of debt instruments available. Debt securities mainly comprise bonds (issued by the government, state agencies or state-owned enterprises) and debentures (issued by private companies). Corporate debentures may be issued by both public limited companies and limited companies.<sup>4</sup> Other varieties of debt securities include convertible debentures, derivatives debentures (including exchangeable debentures), Basel III subordinated debentures, securitised debentures, perpetual debentures and foreign debentures. While a wide range of issue types are possible, typical corporate domestic issues are plain vanilla debentures with fixed-rate coupons and bullet repayment at maturity.

The MOF and the SEC Office are the main authorities with key roles in formulating policy and regulating the Thai bond markets. The MOF is responsible for national fiscal policy and the management of public debt, which relates directly to the structure of government bonds. Tax laws are one of the key mechanisms used by the MOF to influence Thai bond

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<sup>4</sup> In Thailand, a public limited company is a company incorporated under the Public Limited Companies Act BE 2535 (1992), with the aim of offering its shares to the public, while a limited company is incorporated under the Civil and Commercial Code, and its shares are privately owned and restricted to being offered to the public (unless it has been converted to a public limited company).

markets. The SEC Office is the regulator of the capital markets, supervising the offering of securities and regulating those carrying on securities businesses, such as underwriters and financial advisers. The Thai Bond Market Association (Thai BMA) was established with the objective of creating a basic system of trading debt securities among traders in the secondary market, providing information regarding market data to investors and encouraging market development. The Thai BMA promotes and supports the studying of and research into debt securities, and establishes debt market standards.

An offer of debentures on a public offering basis requires approval from the SEC Office and can obtain a shelf approval for a period of two years, including the filing of a registration statement and draft prospectus with the SEC Office that must become effective before an offer can be made.

A private placement<sup>5</sup> of debentures is granted a deemed approval from the SEC Office provided that the issuer registers transfer restrictions with the SEC Office. An offering of debentures on a private placement basis, which includes an offering to foreign investors, does not require a filing of registration statements and prospectus to the SEC Office (except if the offering is made to Thai institutional investors, in which case registration statements and a prospectus are still required to be filed with the SEC Office). The current regulations regarding the issuance and offer of plain vanilla debentures no longer provide any exemption of deemed approval for offering debentures to high-net-worth investors<sup>6</sup> (i.e., the offering of debentures to high-net-worth investors requires approval from the SEC Office) where the period of the SEC Office's consideration for granting approval in such case will be shorter than the period in the case of a general public offering.

### ***Investment unit***

Alternative types of investments other than equity and debt instruments can be offered in Thailand (i.e., the investment unit of a mutual fund, where its establishment and management are subject to SEC approval and are under its supervision). Types of mutual funds vary depending on their choice of investments: for example, securities, real estate or infrastructure.

Under the Securities and Exchange Act, a mutual fund is incorporated as a juristic person under the Securities and Exchange Act. The mutual fund shall be established (by raising funds and registering the fund with the SEC Office) and managed by the securities company obtaining a mutual fund management licence from the MOF under the recommendation of the SEC Office (asset manager), and the management of the mutual fund by the asset manager will be supervised by a registered fund representative registered with the SEC Office.

In 2019, the Securities and Exchange Act was amended, imposing additional duties on asset managers. Prior to the amendment, the Securities and Exchange Act required asset

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5 A private placement in this context means an offering to not more than 10 investors in any four-month period, an offering to creditors in a debt restructuring and an offering made with a waiver from the SEC Office.

6 High-net-worth investor means, in the case of an individual, that individual has total net assets exceeding 50 million baht, excluding his or her regular residences, or annual income exceeding 4 million baht, or investments in securities or derivatives exceeding 10 million baht (or exceeding 20 million baht if the investment is aggregated with the deposit); or, in the case of a juristic person, that person has shareholders' equity exceeding 100 million baht or investments in securities or derivatives exceeding 20 million baht (or exceeding 40 million baht if the investment is aggregated with the deposit), the thresholds being considered from the latest audited financial statements of the juristic person.

managers to comply with the fund scheme and conditions between asset managers and unitholders (which are signed by a mutual fund supervisor). However, the amendment to the Act additionally imposes a fiduciary duty on asset managers in the management of a mutual fund: that is, in managing a mutual fund, an asset manager must proceed with loyalty and care to preserve the interests of all unitholders, using his or her knowledge and competence as a professional. If the asset manager breaches his or her fiduciary duty, he or she will be liable to a fine not exceeding 500,000 baht and a further fine not exceeding 10,000 baht for each day on which the offence occurs. In cases where such offence of an asset manager is the result of an order or an act of any person, or a failure to order or act in accordance with the duties of directors, managers or any persons responsible for the operation of such asset manager (collectively, responsible persons), such person shall be liable to imprisonment for a term not exceeding two years or a fine not exceeding 500,000 baht, or both.

The asset manager must also have a policy on the prevention of conflicts of interest in managing a mutual fund, as well as monitoring and overseeing acts that may cause conflicts of interest, unfair characteristics or acts that cause unitholders to lose the interest that they should receive. Failure to provide such policy by an asset manager may subject the asset manager to criminal liability in addition to the responsible persons.

Furthermore, the amendment prescribes unitholder meeting requirements, such as a quorum, and the voting terms to be complied with by the asset manager.

For foreign fund units to be offered in Thailand, generally neither offerings of units nor soliciting for the purchase of units has a private placement regime comparable to that for offerings of equity or debt, and a securities licence to operate fund management will be required. However, there is a channel for foreign collective investment scheme (CIS) operators to offer CIS units in Thailand. In summary, only the following eligible CIS operators can make an offering in Thailand: CIS established in certain countries (i.e., Association of Southeast Asian Nations countries or Asia Pacific Economic Cooperation countries), or foreign exchange trade funds established under foreign laws<sup>7</sup> and regulated by members of the International Organization of Securities Commissions (IOSCO).

### ***Services relating to offshore products to investors***

Despite the limitations on the offering of offshore capital market products to investors in Thailand, there are channels for Thai investors to invest in offshore capital market products. Apart from investing in units of mutual funds registered under the Securities and Exchange Act and having a scheme to invest outside Thailand, Thai investors are able to invest in offshore capital market products through licensed securities businesses<sup>8</sup> that are permitted to offer services in relation to investment in offshore capital market products (i.e., securities or derivatives denominated in a foreign currency), provided that the offshore capital market

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7 An exchange trade fund shall have objectives to create returns for its holders in direct correlation with the changes of the following underlying: price of gold, index having components as crude oil in whole or in part, commodity index, or index of basket of securities acceptable to a foreign exchange that is a member of the World Federation of Exchanges (WFE), that index having components as the securities listed in the foreign exchange that is the WFE member in whole, or debt instruments in the organised market

8 Currently, there are four main types of licences for conducting a securities business under the Securities and Exchange Act: for a broker, dealer or underwriter of securities, investment advisory, mutual fund management, private fund management, securities lending and borrowing, and venture capital fund management; for a broker, dealer or underwriter of debt instruments, investment advisory and securities lending and borrowing; for a broker, dealer or underwriter of units, investment advisory, mutual fund

products have characteristics and conditions similar to what can be issued and offered in Thailand (e.g., units of mutual funds, plain vanilla debentures), are under the supervision of a recognised regulator<sup>9</sup> and are offered in countries where a recognised regulator is situated. Most importantly, offshore issuers or offerors shall not conduct any public distribution of capital market products in Thailand (e.g., have public roadshow activities with investors in Thailand).

## ii Digital assets control

Cryptocurrencies and digital tokens have been used globally by corporates as tools for raising funds, specifically by fintech companies. Until recently there were no Thai laws or regulations governing these activities. However, the actions of one company have led to an important change.

A Thai fintech company successfully raised funds from the public in a very short time. The Cabinet of Thailand was concerned that activities of this kind could potentially affect the nation's financial stability, the economic system and the general public. On 10 May 2018, the Royal Enactment on Digital Assets Business BE 2561 (2018) (REDA) was introduced to set out a framework for fundraising via the offering of digital tokens. Furthermore, the aim of the REDA is to regulate businesses undertaking digital asset-related activities.

### *Assets regulated by the REDA*

The purpose of the REDA is to regulate two types of digital assets: cryptocurrencies and digital tokens. Cryptocurrencies are defined as electronic data to be used as a means of exchange for products, services, or other rights (e.g., bitcoins or ripples), while a digital token is an electronic data unit that enables the holder to participate in an investment in any project or business under an agreement between the holder and the issuing company. The public offering of digital tokens is commonly known as an initial coin offering (ICO).

### *Overview of ICOs*

An ICO is permitted by issuers that are companies incorporated under the laws of Thailand. Prior to the offering, an issuer is required to obtain approval from the SEC Office. The issuer must also prepare a registration statement and a draft prospectus, which must comply with the minimum contents that are required by, and must be filed with, the SEC Office.

The registration statement and draft prospectus must, as a minimum, include the following:

- a* a factsheet showing an overview of the issuer and the digital tokens to be offered;
- b* information about the issuer (including the use of proceeds);
- c* the business plan of the issuer;
- d* information about the digital tokens to be offered, including any special characteristics and risks;

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management, private fund management or venture capital fund management; and for a broker, dealer or underwriter of units. Other types of licences, apart from the four main licences, are investment advisory, securities lending and borrowing, and venture capital.

9 Recognised regulators are members of IOSCO, which must also be Signatory A members of the Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information; countries that are party to the Organisation for Economic Co-operation and Development; or countries within the Association of Southeast Asian Nations Economic Community).

- e information about the offering; and
- f the required certification, namely the execution of signatures as follows:
  - if the issuer is not a listed company, all directors, the chief executive officer (CEO) and the chief financial officer (CFO) of the issuer; or
  - if the issuer is a listed company, the authorised director or directors, or the CEO, as authorised by the authorised director or directors.<sup>10</sup>

If the registration statement and prospectus for digital tokens contain false statements or fail to disclose material facts that should have been stated therein, the issuer and the authorised directors who placed their signatures therein shall be required to jointly compensate the persons who purchase the digital tokens.<sup>11</sup> The rights to claim for compensation shall have a limitation period of one year from the date on which the fact that the registration statement and prospectus contained false information became known or should have been known, but not exceeding two years from the effective date of the registration statement and draft prospectus. In addition, there is criminal liability for false statements or failure to disclose material facts in the registration statement and prospectus of digital tokens. Sanctions that may be imposed on an issuer, directors and management in charge of a company are imprisonment for a term not exceeding five years, or a fine not exceeding twice the value of the offering, or both.

Under the Notification of the Securities and Exchange Commission No. KorJor 15/2561 Re: the Offering and Sale of Digital Tokens to the Public, issued under the REDA, digital tokens can only be offered to a limited group of qualified investors.<sup>12</sup> Retail investors are permitted to invest in digital tokens, subject to a threshold of 300,000 baht for each offering.<sup>13</sup>

The SEC Office will consider granting approval only for digital tokens that meet its requirements (i.e., they must be investment tokens or utility tokens only, and the business plan relating to them and the mechanism for exercising rights under them by the holders through a 'smart contract' must be enforceable and must not exploit investors). The offering of the digital tokens must be done through a business operator known as an ICO portal, which has a role similar to that of a financial adviser in a conventional shares public offering.

The eligibility criteria for a business to act as an ICO portal business include, inter alia:

- a being a company established under the laws of Thailand;
- b having registered capital of at least 5 million baht;
- c not having directors or executives with prohibited characteristics;

10 If the authorised director is not the CEO or the CFO, the signature of the CEO or the CFO shall be required as well.

11 The liability for damages shall be equivalent to the difference between the amount that the person who exercises the right to claim compensation has paid for purchasing the digital tokens and the price that should have been paid had the disclosure of information been correctly made as specified by the SEC Office. The interest at the maximum average rate payable for a fixed deposit of one year or more from at least four commercial banks specified by the SEC Office shall be added to the difference.

12 Institutional investors, ultra-high-net-worth investors, private equity funds or venture capital funds (qualified investors).

13 In the event of an offering to an investor that is not a qualified investor (retail investors), each retail investor can purchase digital tokens under each offering not exceeding 300,000 baht, and the maximum amount of the digital tokens to retail investors in each offering shall not exceed the higher of an amount equivalent to four times the issuer's shareholders' equity and 70 per cent of the amount of the offering.

- d* establishing issuer due diligence and product screening systems;
- e* examining issuers' business plans and the source codes of smart contracts;
- f* conducting know your customer (KYC) and customer due diligence (CDD); and
- g* providing suitability tests for retail investors.

After the completion of an offering, issuers of digital tokens shall be subject to the requirements of continuous disclosure. They are required to prepare and submit reports to the SEC Office with regard to their financial condition, business operations or any other information that may affect the rights and interests of digital token holders, making investments or the price or value of the digital tokens.

### ***Overview of private placement of digital tokens***

Recently, the SEC issued regulations to apply the private placement concept to digital token offerings, in which a deemed approval is granted from the SEC Office, and the offeror is therefore exempted from filing a registration statement and draft prospectus with the SEC Office.

Under Notification of the Securities and Exchange Commission No. GorJor 12/2562 Re: Private Placement Offering of Digital Tokens, the private placement of digital tokens means:

- a* the offering of digital tokens to an institutional investor or ultra-high-net-worth investor (as defined in Notification of the Securities and Exchange Commission No. Kor Jor. 4/2560 re: the Definition of Institutional Investor, Ultra-high Net Worth Investor and High Net Worth Investor), or venture capital or private equity (as defined in Notification of the Securities and Exchange Commission No. Kor Jor. 15/2561 Re: the Offering and Sale of Digital Tokens to the Public);
- b* the offering of digital tokens to no more than 50 investors in a 12-month period, provided that the investor must be a person related to an issuer of the digital tokens; or
- c* an aggregate value of the offering not exceeding 20 million baht in a 12-month period, using the offering price as a basis for calculation.

The number of investors referred to in (b) shall include the investors who receive the digital tokens by ways other than offering. The number of investors referred to in (b) or the aggregate value of the offering referred to in (c) shall exclude the value of any offer made to the institutional investors referred to in (a), regardless of whether the offering is made simultaneously or at a different time from the private placement.

The private placement of digital tokens must be made through the digital tokens offering portal approved by the SEC. In addition, if the private placement is not simultaneously made with the public offering of such digital tokens, the offeror must ensure that the purchaser in the private placement shall not be able to transfer any digital tokens before the public offering of such digital tokens, unless the transfer is made within the private placement regime.

### ***Digital assets business operators***

Another purpose of the REDA is to regulate business operators who are intermediaries for digital assets that are classified into three types: digital asset exchanges, digital asset brokers and digital asset dealers. Entities that intend to operate a digital asset business must be Thai companies and licensed by the Minister of Finance upon the recommendation of the SEC. In undertaking digital asset businesses, operators shall comply with the rules, conditions



and procedures set out by the SEC, which include having adequate sources of capital to cover business operations and other risks, segregating client assets from their own assets, and conducting KYC and CDD.

### ***Services relating to offshore investment in digital assets***

Furthermore, since 2018, the SEC has allowed licensed business operators to offer services to Thai investors in relation to offshore digital assets, provided that the offshore digital assets are offered in a country where a regulator is a member of IOSCO and a Signatory A member of the Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information. In addition, offshore issuers or offerors shall not demonstrate an intention to offer digital assets in Thailand. In the case of offshore investment in an ICO, there are requirements that the digital asset must be offered to retail investors in such country, a client that is a retail investor<sup>14</sup> must pass an examination regarding the risk of investment in the ICO, and the digital asset business operator must monitor clients' investment portion to be appropriated.

### ***Traceable transactions and anti-money laundering***

In addition, to preserve the integrity of markets by ensuring that transactions relating to digital assets are traceable, cryptocurrencies that are acceptable to issuers of digital tokens or business operators must be obtained from, or deposited with, business operators regulated under the REDA only.<sup>15</sup> Furthermore, business operators and ICO portals are subject to the Anti-Money Laundering Act<sup>16</sup> to prevent the exploitation of digital assets as a channel for money laundering.

### ***Other significant issues under the REDA***

Similar to the Securities and Exchange Act, the REDA prescribes offences of unfair trading relating to the purchase, sale or exchange of digital assets taking place in a digital asset exchange such as false dissemination, insider trading, front running and market manipulation.

## **iii Cases and dispute settlement**

### ***Judicial systems***

Thailand has a three-tier judicial system consisting of the courts of first instance, the Court of Appeal and the Supreme Court.

Several options for dispute settlement are available. One is the traditional court, which is the fundamental justice system available for all. A second option is out-of-court arbitration,<sup>17</sup> which is agreement-based (Thailand has used the UNCITRAL Model Law on International Commercial Arbitration as a model for its arbitration system). The use of arbitration for

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14 A retail investor in this context means an investor that is not an institutional investor (as defined in Notification of the Securities and Exchange Commission No. Kor Jor. 4/2560 Re: Determination of the Definitions of Institutional Investor, Ultra-high Net Worth Investor and High Net Worth Investor), or venture capital or private equity (as defined in The Notification of the Securities and Exchange Commission No. Kor Jor. 15/2561 re: Offer for Sale of Digital Tokens to the Public).

15 Section 9 of the REDA.

16 Section 7 of the REDA.

17 The Arbitration Act BE 2545 (2002). However, in-court arbitration is also available in Thailand and is provided for in the Civil Procedure Code, although its use is much less frequent.

private dispute resolution is increasing due to it being a faster and more relaxed process than the traditional court system in terms of the choice of language used during the process (to be agreed by the parties) and the venue.

The role of the court will be limited if there is an arbitration agreement in existence. If a claim is brought to court, the defendant can request that the court dismiss the claim based on the arbitration clause in the relevant agreement. Upon the court having completed an inquiry and having found no grounds for rendering the arbitration agreement void, unenforceable or impossible to perform, the court will issue an order striking the case.

### ***Enforcement of judgments***

Aside from the traditional enforcement of court judgments, an arbitration award can be enforced by the court upon request.

Currently, there is no provision for the enforcement of a foreign court judgment because Thailand is not a party to any relevant treaty under which the country would be bound to recognise and enforce a foreign court judgment.

On the other hand, foreign arbitration awards are recognised and may be enforced in Thai courts of competent jurisdiction because Thailand is a party to the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York, 10 June 1958), also known as the New York Convention. Since the Thai legal system is dualistic, treaties do not automatically come into force until they have been enacted as domestic laws. The Arbitration Act provides for the recognition and enforcement of foreign arbitration awards. For the commencement of legal proceedings in Thai courts without first presenting a dispute to arbitration despite an arbitration clause, Thai courts will issue an order striking the case, provided that the conditions specified in Section 14 of the Arbitration Act are complied with, namely that the party against whom the legal proceedings are commenced files a motion requesting the court to issue an order striking the case with the competent court, so that the parties may proceed with the arbitral proceedings. Upon the court having completed its inquiry and finding no grounds for rendering an arbitration agreement void or unenforceable or impossible to perform, the court will issue an order striking the case. The enforceability of an arbitration award is subject to challenge, and may be refused in Thai courts if one of the grounds for refusing enforcement as specified in the Arbitration Act applies or where enforcing the award would be contrary to public policy or the good morals of the people of Thailand.

## **iv Relevant tax and insolvency law**

### ***Taxation of dividends***

Dividends in respect of ordinary shares are subject to Thai withholding tax at a rate of 10 per cent, whether paid to non-resident corporate holders or to non-resident individual holders.

### ***Taxation of capital gains***

Gains realised by an individual holder, either resident or non-resident, from a sale of ordinary shares on the SET are exempt from Thai personal income tax and withholding tax. Gains realised by a non-resident corporate holder from the sale or other disposition of ordinary shares outside Thailand, in connection with which payment is made neither from nor within Thailand and where neither the purchaser nor the seller resides or does business in Thailand, are not subject to Thai withholding tax. A non-resident corporate holder will be subject to

Thai withholding tax of 15 per cent on gains realised from any sale or other disposition of ordinary shares in Thailand (including a sale on the SET) in connection with which payment is made from or within Thailand unless the holder is entitled to an exemption under an applicable tax treaty. Gains realised by a non-resident individual holder from the sale or other disposition of ordinary shares outside Thailand, in connection with which payment is made neither from nor within Thailand and where neither the purchaser nor the seller resides or does business in Thailand, are not subject to Thai withholding tax. Gains realised by a non-resident individual holder from a sale of ordinary shares on the SET are exempt from Thai personal income tax and withholding tax. Unless exempt under an applicable tax treaty, gains realised by a non-resident individual holder from a sale or other disposition of ordinary shares made other than on the SET, and for which payment is made from or within Thailand, are subject to Thai withholding tax at a rate of 15 per cent. Any payment of withholding tax is creditable against the Thai personal income tax payable if a non-resident individual files a personal income tax return in Thailand reporting gains realised from the sale of ordinary shares.

For Thai withholding tax purposes, the value of gains realised is equal to the difference between the sale price of the shares and the amount paid by the shareholder for the shares (as justifiably established by the shareholder). This determination is made on a share-by-share basis. In the foregoing instances where withholding tax applies, a purchaser of ordinary shares (or in the case of a sale on the SET, a broker executing a sale on behalf of a purchaser) is required under Thai law to withhold the applicable amount of Thai withholding tax from the sale price and make payment thereof to the relevant Thai tax authority.

### ***Taxation of digital assets***

With respect to the withholding tax applicable to digital assets, gains realised by a holder on a sale of digital assets shall be subject to Thai withholding tax at a rate of 15 per cent in all cases. In addition, there is no exemption similar to that applied in the case of a sale of shares on the SET by individuals. Furthermore, benefits from holding digital assets (e.g., profit-sharing from holding digital tokens) shall be subject to Thai withholding tax at a rate of 15 per cent, which is higher than the 10 per cent rate applicable in the case of dividends from shares paid to individuals or foreign companies.

### ***Stamp duty***

Generally, stamp duty of 0.1 per cent, or a fraction thereof, on the paid-up value of shares or the selling price of the shares – whichever is the higher – is payable within 15 days of the date of execution of a share transfer instrument in Thailand, or within 30 days of the date the share transfer instrument is brought into Thailand if executed outside Thailand. No stamp duty is payable on a transfer of shares as long as Thailand Securities Depository Company Limited (TSD) acts as the company's share registrar.

### ***Insolvency (including set-off and netting)***

The Bankruptcy Act BE 2483 (1940) provides for substantive and procedural provisions governing bankruptcy and rehabilitation matters in Thailand. Further to the Bankruptcy Act, bankruptcy and rehabilitation procedural matters are stipulated in the Establishment of and Procedures for the Bankruptcy Court Act BE 2542 (1999) and the Regulations for Bankruptcy Cases BE 2549 (2006). Insolvency is mainly tested by whether a debtor's indebtedness is greater than his or her assets.

Section 102 of the Bankruptcy Act allows for insolvency set-off and netting, provided that if a creditor that is entitled to claim for repayment of its debt is indebted to the debtor when the court issues the order placing the asset under receivership, even if the grounds for the debt of the two parties are not the same, or are subject to conditions or terms, the debts may be offset against each other, unless the creditor's right of claim against the debtor accrued after the order of receivership of the asset. In rehabilitation proceedings, under Section 90/33 of the Bankruptcy Act, if the creditor who is entitled to apply for the repayment of debt for rehabilitation is indebted to the debtor at the time of issuance of the rehabilitation order, the creditor may exercise the right of set-off, unless the creditor acquires the claim against the debtor after the court issues a rehabilitation order.

#### **v Role of exchanges, central counterparties and rating agencies**

While the primary responsibility for the regulation of new securities issues has shifted to the SEC,<sup>18</sup> the SET continues to operate the stock exchange and is responsible for listing application approvals once the SEC registration, prospectus and related requirements have been met for Thai public offerings.

#### ***TSD***

TSD acts as a securities depository, dividend-paying agent, transfer agent and registrar for Thai listed companies, and Thailand Clearing House Company Ltd acts as a clearing house. Securities companies, commercial banks, finance companies, life and non-life insurance companies, financial institutions established by specific legislation and other persons as prescribed by the TSD may become members of the TSD for depository services.

#### ***Thailand Clearing House Company Ltd***

All settlements and the clearance of transactions effected on the SET must be handled by Thailand Clearing House Company Ltd on the third business day following the day of the contract date. Companies offset sales and purchases of each member, and only the net balance of securities and cash delivered or received by each member through the company is credited.

#### ***Rating agencies***

To issue new bonds with the purpose of selling them to the general public, the SEC requires that the credit of each bond be rated by approved rating agencies (this is not the case for private placements, for which a credit rating is not necessary). Currently, the rating agencies approved by the SEC are TRIS Rating Co, Limited and Fitch Ratings (Thailand) Limited.

### **III OUTLOOK AND CONCLUSIONS**

The amendment to the Civil Procedure Code, which effectively allows class action proceedings in Thailand, was promulgated on 8 April 2015 and took effect on 4 December 2015. The main purpose of allowing class action proceedings in Thailand is to allow for individuals, especially those who do not have the means to bring a claim by themselves or those whose amount of damage would not be worth the time, cost and effort to pursue through a case independently, to join as part of the same class to commence legal proceedings and

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18 [www.set.or.th](http://www.set.or.th).

receive shared compensation. The amendment defines class to mean a group of persons having identical rights arising from common issues of fact and law, and possessing identical characteristics that are specific to the class, even if there is variation in the types of damage suffered by each person. Those suffering damage arising from the Securities and Exchange Act can bring a class action to court. Possible class action claims under the Securities and Exchange Act can be claims relating to disclosure arising from information included in a prospectus at the IPO stage, or periodic and episodic disclosure: for example, disclosure of annual financial status.

# TURKEY

*Ömer Çollak, Ökkeş Şahan and Nazlı Tönük Çapan<sup>1</sup>*

## I INTRODUCTION

### i Overview of securities law

Although securities markets in Turkey have a long history, the recognition of securities as a separate area of law is relatively new. After the nasty experiences and substantial losses incurred by so many following the unregulated securities offerings in the 1980s, the Capital Markets Law No. 2499 (Former CML) was introduced in July 1981. The Capital Markets Board (CMB), the Turkish capital markets regulatory and supervisory authority, was incorporated and endowed with all necessary powers under the Former CML. Since its incorporation, the CMB has undertaken a leading role and, while conducting its regulatory and supervisory role, has also supported the improvement of the markets and the innovation and introduction of new capital market instruments.

At the end of 2012, the Former CML was replaced by the new Capital Markets Law No. 6362 (CML), which was enacted in the Official Gazette dated 30 December 2012. The main goal of the CML is to harmonise Turkish capital markets legislation with European Union (EU) norms and with the provisions of the new Turkish Commercial Code No. 6102. While transparency, accountability, proportionality and consistency have been regarded as key structuring principles, the general preamble of the law states that the CML is only a 'market regulating text'. Furthermore, although the provisions seem detailed, generally the CML is a framework law and, accordingly, secondary legislation has been prepared and published by the CMB with the aim of providing more detailed provisions pertaining to specific capital markets instruments, transactions and entities conducting capital markets activities.

According to Article 4 of the Former CML, all capital market instruments to be issued or offered to the public were required to be registered with the CMB. Now, instead of registration, an offering document approval system has been adopted. The practical outcome of this change is the shortening and simplifying of the application procedure to the CMB during offering activities. However, approval of the information included in the offering document provides no guarantee that it is true, and accurate or relevant instruments are recommended by the CMB. The CML has also introduced a validity period of 12 months for the prospectus, so unless there is an addition or amendment, it would be sufficient for issuers to conduct offerings based on the underlying prospectus without obtaining additional CMB approval, which will be advantageous for market participants in terms of time and costs. For issuances excluding a public offering, an issuance certificate will need to be prepared by issuers and approved by the CMB.

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The CMB offering rules that are applicable depend on the types of securities offered. As a general rule, however, while it is mandatory to prepare offering circular-type disclosure documents for public offerings, it is not mandatory for private placements or offerings targeting qualified institutional investors. For the issuance of capital market instruments without a public offering process, the new law requires an issuance certificate, which must be approved by the CMB, to be prepared by the issuer.

Article 10 of the CML regulates the liability applicable for offering documents, preparation of which is mandatory and subject to CMB approval. Pursuant to Article 10 of the CML, issuers are responsible for a fair reflection of the facts in the information contained in the documents. However, as Article 10 clearly spells out, an intermediary institution, those conducting the public offering, guarantors (if any) or board members of the issuer not acting with due diligence can be held responsible for the part of the loss that cannot be indemnified by the issuers; thus, their liability is a secondary one and would be based on their negligence.

In an effort to enlarge the scope of services provided to investors in line with EU regulations, capital market instruments are redefined under the CML as securities, derivative instruments (which include leverage transactions), investment contracts and any other instrument to be determined as a capital market instrument by the CMB.

Provision of all capital market activities in Turkey is subject to CMB licensing requirements; however, foreign intermediary institutions can provide intermediary services to Turkish issuers for cross-border offerings and to Turkish investors on a reverse enquiry basis.

Corporate governance rules have been regulated by the CML, and the CMB is authorised to oblige public companies, depending on their qualifications, to comply partially or wholly with these rules, to determine principles and procedures thereto, to take decisions and to initiate lawsuits in cases of non-compliance.

Another innovation is the introduction of squeeze-out and appraisal right mechanisms into the CML. In a publicly held company, if the voting rights reach or surpass the ratio determined by the CMB as a result of a share purchase offer or any other cause, the majority shareholders will be entitled to squeeze out the minority shareholders. In such cases, the minority shareholders will also be entitled to sell their shares to the majority. In addition, shareholders opposing general assembly decisions regarding material transactions, such as a merger or material asset transfer, will have the right to sell their shares to the company and exit. The company will have to purchase the shares in an amount equal to the average amount of the weighted average price determined within the 30 days prior to the public announcement of such a material transaction.

Compared with the Former CML, the CML enlarges the scope of the supervision of the CMB. In addition to the capital market offences defined in the CML, which include insider trading, transaction and information-based market manipulation, unapproved offerings, unlicensed capital market activities, embezzlement and repurchase agreements without having underlying assets, there is the new concept of market abuse actions. Market abuse actions can be described as activities disrupting the trustworthy, transparent and stable functioning of the stock exchange and other organised markets that cannot be justified on any reasonable economic or financial grounds.

Pursuant to Article 115 of the CML, the implementation of a legal investigation because of a violation of the CML is conditional upon a written application submitted to the Public Prosecutor's Office by the CMB. In the event that a public prosecution has been filed with the trial court, a copy of the bill of indictment shall be notified to the CMB.

Apart from capital market offences, the CML regulates the administrative, pecuniary sanctions of the CMB. Accordingly, the CMB has the authority to impose administrative fines for violations of the regulations, standards and forms, or of the general and special decisions it issues. Administrative fines imposed by the CMB may be challenged in Turkey's administrative courts. The new law has significantly increased the upper limit of administrative fines for general violations to 478,846 Turkish lira for 2019 (subject to annual reevaluation by the CMB) as a deterrent to these kinds of offences. For transactions that disturb market conditions, however, the CMB can impose administrative fines of up to 958,581 Turkish lira (for 2019, subject to annual reevaluation by the CMB) depending on the case.

The CMB's primary activities take place before the criminal courts in relation to capital market offences. However, the CMB also has a role before the civil courts, mostly seeking, *inter alia*, interim injunctions in cases of unapproved offerings, the annulment of transactions realised by unlicensed entities or with the aim of embezzlement, and the annulment of board resolutions taken under the registered capital system.

Since the incorporation of special tribunals is forbidden by the Constitution of Turkey, all securities law-related proceedings are held before the courts of general jurisdiction, and the CML authorises the Supreme Council of Judges and Prosecutors to delegate capital markets crimes to criminal courts of first instance. There are practically only a few court precedents to consider, in either criminal or civil cases, as the culture of securities law is a relatively new area for the entire legal community and for Turkish society as a whole.

Intermediary activities in Turkey, including marketing activities, can only be conducted by intermediary institutions with licences granted by the CMB. Conduct against this rule constitutes a criminal offence as defined in the CML.

Foreign investment banks that are party to international sales of Turkish securities do not have legal standing before the CMB as authorised intermediary institutions. In deals where international and domestic offerings are realised concurrently, investment banks and international investors are treated as ordinary investors participating in a public offering realised in Turkey. In offerings made directly abroad, the CMB is not interested in to whom or by whom those securities are being offered.

The CMB has begun to request and review international offering circulars with the intention of protecting participants in domestic offerings. The CMB checks whether there is a contradiction between the international offering circular and the Turkish prospectus, and whether any material information is included in the international offering circular that is missing from the domestic prospectus. However, the CMB does not request or review international offering circulars in offerings of bonds issued by a Turkish issuer.

According to Decree Law No. 32, Turkish residents are free to conduct cross-border securities transactions (in the primary or secondary market) provided that these transactions are realised through a Turkish intermediary institution; however, these transactions should be realised on a reverse-enquiry basis, which means that foreign investment banks should abstain from conducting any intermediary activity in Turkey, including marketing.

On a separate note, the Central Bank of the Republic of Turkey, established in 1930, aims to achieve price stability and financial stability and to determine the exchange rate regime. The Central Bank also manages the gold and foreign exchange reserves.



## II THE YEAR IN REVIEW

The CMB continues to profit from the flexibility and the greater role of the secondary legislation that was encompassed through the enactment of the CML at the end of 2012 to align the Turkish capital markets with international standards and to cope with the needs of the Turkish market.

To this end, the CMB has adopted various amendments to communiqués on subjects ranging from corporate governance to tender offers to establish robust, well-functioning capital markets. In 2016, all market participants familiarised themselves with the execution of the new legislation, and the market seems to be making significant progress since then given the changes made in certain legislation from time to time by the CMB to meet market participants' needs and to assert Turkish capital markets as a viable option for both local and international investors.

### i Developments affecting debt and equity offerings

#### *Equity offerings*

In August 2008, an initiative was launched under the leadership of the CMB and the Istanbul Stock Exchange (now Borsa Istanbul) with a view to asserting Turkey as a viable option in the minds of international capital market investors, which was followed by studies on new capital market legislation.

Within the framework of this initiative, the CMB has also started revising its public offering regulations with the aim of deregulating public offerings as much as possible, stimulating innovation among market participants and decreasing the cost of unnecessary regulatory formalities. To this end, in 2017, the CMB published a major change regarding the sales periods and allocations percentages to attract Turkish companies to go public in Turkey rather than considering foreign exchanges. In parallel with the CMB's approach, Borsa Istanbul also introduced certain amendments to listing principles in the Borsa Istanbul Listing Directive with the aim of easing public offerings and boosting capital market activities in Turkey. Even though such changes have been made to the legislation by the regulators, the fate and success of Turkish initial public offerings (IPOs) remains inevitably tied to broader macroeconomic conditions, timing and investor sentiment.

In light of the new legislation studies, the CMB issued the Communiqué on Prospectuses and Issuance Certificates No. II-5.1, the Communiqué on Sale of Capital Market Instruments No. II-5.2 and the Share Communiqué No. VII-128.1 (New Regulations). The changes regulated under Share Communiqué No. VII-128.1, which reflect the CMB's decision dated 12 February 2013 issued regarding the transition period, can be summarised as follows.

#### *Principles to be followed prior to an IPO of shares*

The significant principles to be followed prior to an IPO are as follows:

- a In the paid or issued capital of the company making an IPO, except for the funds allowed by the legislation, there should be no funds that have been created by way of equalising assets to market value within the past two years.
- b If the fund to be collected upon capital increase is higher than the share capital of the company, and if this fund will be used in the payment of debts arising from non-cash asset transfers to related parties or companies, the capital increase will be considered as a material transaction. In this case, before the approved prospectus is submitted to the issuer, the shareholders must be granted an exit right.

- c* If the market value, which shall be calculated based on the public offering price of the shares to be offered to the public (except for the over-allotment option), is below 20 million Turkish lira, or between 20 million and 40 million Turkish lira, then either all the unsold shares, or all the unsold shares up to 20 million and half the unsold shares exceeding 20 million Turkish lira, are required to be underwritten by the intermediary institutions facilitating the public offering at their public offering price. Accordingly, the underwriting agreement is required to be sent to the CMB prior to the approval of the prospectus by the CMB. If the market value of the shares to be offered is over 40 million Turkish lira, there will be no such underwriting obligation. The intermediary institutions facilitating the public offering are not allowed to sell the shares that have been included in their portfolio through this method at a price lower than the public offering price within six months of the date the shares begin to be traded on the stock exchange.
- d* The earliest date to commence the public offering is the third day following the announcement date of the pricing report and the prospectus.
- e* The legally required percentage designated for allocation of the nominal value of shares in public offerings to domestic investors is 20 per cent (10 per cent to domestic institutional investors and 10 per cent to domestic individual investors), unlike the provisions in effect prior to the amendment dated 1 December 2017 to the Communiqué on Sale of Capital Market Instruments No. II-5.2 whereby issuers had to allocate at least 30 per cent of the nominal value of the shares to domestic investors (20 per cent to domestic institutional investors and 10 per cent to domestic individual investors). The CMB is also authorised to decrease the allocation percentages to zero or increase them to one time more by taking into consideration the market price of shares to be offered, the market conditions and an issuer's request on similar grounds.
- f* Revising an offering price downwards is possible through a public disclosure announcement without requiring any prospectus amendment. If the offering price is to be revised prior to initiation of the sales or book-building period, the public offering may not start until the second day following the date of the public disclosure, at the earliest. If the offering price is to be revised within the sales or book-building period, at least two business days shall be added to the relevant public offering period.

#### *Listing requirements*

The Borsa Istanbul Listing Directive previously required companies aiming to be listed on the BIST Star Market to have:

- a* a net profit according to the audited annual financial statements of the past two years; and
- b* an equity to capital ratio of 0.75 per cent for BIST Star Market Group 1, and of 1 per cent for BIST Star Market Group 2 in their most recent audited financial statements.

The amendments now in force enable companies that cannot satisfy the above two requirements to be listed on the BIST Star Market if the following less strict requirements are met:

- a* there should be an operating profit in the audited financial statements for the most recent annual or relevant interim period;
- b* the equity should be positive in the most recent audited annual financial statements (if negative, the application shall be made only to BIST Star Market Group 1);

- c* the equity to capital ratio should meet the threshold required for the BIST Star Market (the usual requirements for calculating the required ratio have been eased by allowing the proceeds to be obtained from the offering and the nominal value of the newly issued shares to be added to the equity amount in the most recent audited financial statement. Therefore, a company is able to include the new funds from the offering in its equity to capital calculations);
- d* the public offering must consist of primary shares with or without secondary shares (there must be an issuance of new shares); and
- e* other requirements to be listed on the BIST Star Market should be met.

If the above requirements are satisfied, Borsa Istanbul may decide for the shares to be listed on BIST Star Market, taking into account the projections that a company will present to Borsa Istanbul regarding its activities, existing financings and the use of offering proceeds.

*Principles to be followed after an IPO of shares*

The following are some of the key principles to be followed after an initial offering:

- a* As of the approval date of the prospectus for the shares offered to the public, shareholders holding 10 per cent and more of the shares in the current capital of the company or, regardless of the share percentage, all shareholders having control over the management of the company, shall not sell their shares on the stock exchange at a price lower than the public offering price for a period of one year from the date on which the shares began trading on the stock exchange. All those who will purchase shares through a private over-the-counter transaction from the shareholders shall also be subject to the aforementioned restrictions. However, the company's shares that have been purchased by the shareholders (investors) after the shares began trading on the stock exchange are not regarded within the scope of this restriction. For venture capital corporations that have purchased shares in a company that is making an IPO prior to the offering, the one-year term commences on the last date that the venture capital corporations purchased those shares.
- b* If the market value of the shares, which is calculated based on the public offering price (the floor price in cases of book building by way of a price range), is below 40 million Turkish lira, shares corresponding to 25 per cent of the nominal value of the shares offered to the public shall be made ready to be sold by way of restricting shareholders' rights to purchase new shares. In this case, the company must have adopted the registered capital system, and the necessary relevant information must be included in its prospectus.
- c* The intermediary institution facilitating the public offering, and having prepared a pricing report, is required to prepare at least two analysis reports within a year of the trading date of shares on the stock exchange. The reports must be announced on the Public Disclosure Platform and on the intermediary institution's website.

*Capital increase through rights issues by companies whose shares are traded on the stock exchange*

Share Communiqué No. VII-128.1 requires shareholders to be granted an exit right before the approved prospectus is submitted to the issuer if the fund to be collected upon capital increase is higher than the share capital of the company, and if this fund will be used in the payment of debts owed to related parties because of non-cash asset transfers. For cases of capital increases in cash, this Communiqué also obliges companies whose shares are traded

on the stock exchange to prepare a report on the purposes for which the funds shall be used. Accordingly, this report should be adopted by the board of directors of the relevant company, must be sent thereafter to the CMB with the application for approval of the prospectus, and must be announced to the public in the same manner as the prospectus. In addition, following completion of the capital increase, a report must be prepared regarding whether the funds received are being used in accordance with the principles set forth in the report and prospectus. This report must also be disclosed and announced on the company's website and on the Public Disclosure Platform operated by Borsa Istanbul.

#### *Capital increase of publicly held companies through bonus issues*

According to Share Communiqué No. VII-128.1, without prejudice to the legal obligations relating to capital increases, applications made by companies whose shares are traded on the stock exchange for capital increases through internal sources, excluding the profit for the relevant financial year, which will result in the stock exchange price of the adjusted share being reduced to less than two Turkish lira (calculated on the average of the weighted average prices made on the stock exchange within the 30 days prior to the announcement of the capital increase to the public), shall not be put into operation by the CMB.

The share capital may not be increased from internal sources unless the lowest of the accumulated losses – according to the latest financial statements that have been prepared pursuant to the legal records of the publicly held company and the regulations of the CMB, and have been announced to the public accordingly – is not covered by setting off against internal sources, or a resolution by the board of directors in relation to the recovery of such losses has been given to the CMB. However, this will not be applicable to the gains (1) of real estate sales, (2) of participation sales that are awaited in the equity capital to be added to the capital, and (3) for the funds that are not allowed to be used in the set-off of the losses from previous years as per the legislation.

#### ***Debt offerings***

As reported in earlier editions of *The International Capital Markets Law Review*, a substantial number of debt offerings in the form of Eurobonds and Turkish lira local bonds have been made by Turkish banks and corporates, particularly in the past three years, targeting international and Turkish investors, respectively. This can be attributed to the sound economic conditions in Turkey, and to certain actions undertaken by the regulatory authorities to stimulate and facilitate debt offerings.

Following the enactment of the CML, on 7 June 2013, the Communiqué on the Principles Regarding Board Registration and Sale of Debt Securities Series: II, No. 22 with the CMB was replaced by the Communiqué on Debt Instruments No. VII-128.8.

According to the Communiqué on Debt Instruments, the authority to set these limits is now held by the CMB. Currently, the issuance limit for listed companies has been decreased to the value of shareholders' equity multiplied by five, whereas the limit for non-listed companies has been decreased to shareholders' equity multiplied by three. The Communiqué on Debt Instruments introduced a detailed table of the financial statements that will be reviewed by the CMB on the application date.

Notwithstanding the foregoing, the limit for financial institutions with a long-term investment grade has been increased by 100 per cent and is set as the total equity multiplied by 10 for listed companies and the shareholders' equity multiplied by six for non-listed

companies. The investment grading has to be granted by at least one rating agency qualifying as an '[institution] established in Turkey and certified by the CMB, or international rating agencies that are accepted by the CMB, to operate as [a] rating agency in Turkey'.

Pursuant to the Communiqué on Debt Instruments, debt instruments issued in Turkey are required to be registered with the Central Registry Agency (CRA). With the changes on 18 February 2017 to the Communiqué on Debt Instruments, debt instruments issued outside Turkey are no longer required to be registered with the CRA. However, the required information about the amount, issue date, International Securities Identification Number, interest commencement date, maturity date, interest rate, name of the custodian, currency of the bonds and the country of issuance must be submitted to the CRA within three business days of the issuance. Any changes to this information should be reported to the CRA within three business days of the date of change.

The new Communiqué indicates that debt instruments issued by all issuers, including banks and corporations, can be repurchased by the issuers in the secondary markets. In such cases, the issuer has three alternatives: it can retain, resell or cancel the bonds – all before the maturity date. Each of these are options, and do not constitute an obligation on the issuer (including cancelling the bonds). Note that retaining the bonds on the balance sheet would raise some questions under Turkish law as to the termination or cancellation of the debt as a result of the same issuer becoming the debtor and creditor (for the same debt), therefore issuers tend to prefer to opt to resell or cancel.

The new Communiqué also envisages early redemption at the request of the issuer or the investor. For bond issuances in Turkey, the rules and principles governing early redemption must be provided in the prospectus or in other relevant issuance documents. The relevant rules and principles may be freely determined between the issuer and the investors for issuances abroad, notwithstanding the legislation of the country where the issuance takes place.

Decisions of the Banking Regulation and Supervision Authority (BRSA) also affect the ability of banks to issue debt instruments. Historically, banks were not allowed to issue debt instruments because of the BRSA's negative approach, taking the needs of the Turkish Treasury into consideration; however, BRSA Decision No. 3665 dated 6 May 2010 allows banks to issue foreign currency debt instruments provided they sell to individual and institutional investors residing outside Turkey. These debt instruments are subject to general issuance limits determined by the Council of Ministers. BRSA Decision No. 3875 dated 30 September 2010 also allowed banks to issue Turkish lira-denominated debt instruments, subject to issuance limits that are different from the general issuance limits determined under the new Communiqué.

## **ii Developments affecting derivatives, securitisations and other structured products**

### ***Covered bonds***

Turkish covered bonds are defined as capital markets instruments and referred to as covered securities or covered bonds in the legislation. Published on 21 January 2014 by the CMB, and amended on 5 September 2014, 20 October 2015 and 11 November 2018, the Communiqué on Covered Bonds No. III-59.1 replaced the two communiqués on mortgage-covered bonds and asset-covered bonds, creating a single framework for both debt securities.

Covered bonds may be issued by housing finance institutions or mortgage finance institutions. The nominal value of the covered bonds in circulation or trading at any given time and issued by non-mortgage finance institutions must not exceed 10 per cent of the

total assets of the issuer. If the issuer is a mortgage finance institution, the nominal value of the covered bonds in circulation or trading at any given time should not exceed five times the equity of the issuer.

Issuers are required to apply to the CMB for approval to issue covered bonds, and if the covered bonds are to be offered to the public in Turkey, the CMB must also approve the related prospectus and provide the required issuance certificate. If the issuer is a bank, the consent of the banking authority must be obtained as well. Covered bonds are required to be listed if they are offered to the public. When giving approval, the CMB may ask for a third-party guarantee (e.g., by a bank) or insurance cover for the cover pool. It may also require that covered bonds are sold to qualified investors only, and require custody of the cover pool with a Turkish bank or mortgage finance institution.

Apart from the assets that the CMB may further determine, the following meet the eligibility criteria to form the pool of cover assets:

- a* receivables of banks and finance corporations arising from housing finance that have been secured by mortgage (or another type of eligible collateral that is approved by the CMB);
- b* receivables arising from financial lease agreements entered into for housing finance;
- c* mortgage-secured receivables (or commercial loans) of banks, financial leasing companies and finance corporations;
- d* receivables arising from the placement of house sale contracts by the Housing Development Administration of Turkey, TOKİ (but note that this cover asset qualifies only if the issuance is made by a mortgage finance institution);
- e* up to 15 per cent of the net current value of the cover pool may comprise certain approved substitute assets, which include cash, certificates of liquidity issued by the Turkish Central Bank, Turkish government bonds, Turkish Treasury lease certificates (i.e., *sukuk*), securities guaranteed by the Turkish Treasury within the framework of Law No. 4749 on Public Financing and Debt Management, securities issued by or with the guarantee of the central administrations and central banks of OECD countries, or other assets that the CMB may approve and disclose to the public; and
- f* listed derivatives or derivative contracts entered into with eligible swap counterparties to hedge currency or interest risk to meet the total liabilities or maturity mismatch between the covered bonds and cover pool.

### ***Lease certificates***

After conducting extensive studies and research to tailor a capital markets instrument in line with Islamic rules (*shariah* law), the CMB issued the Communiqué on the Principles regarding Lease Certificates and Asset Lease Companies in April 2010. The aim of this Communiqué was to fulfil the preferences of investors who have Islamic sensitivities to interest-bearing instruments; *sukuk* is the Arabic term used for financial certificates structured for their compliance with Islamic rules. Following the enactment of the Communiqué on the Principles regarding Lease Certificates and Asset Lease Companies, which focused only on the *ijara sukuk* structure, the CMB continued its study to diversify Islamic instruments in Turkey and accordingly introduced other types of *sukuk* with the Communiqué on Lease Certificates No. III-61.1 (*Sukuk Communiqué*) in June 2013.

According to the Sukuk Communiqué, lease certificates can be based upon a sale and leaseback structure (*ijara*), a management agreement (*wakala*), a sale and purchase (*murabaha* or *salam*), a partnership (*mudaraba* or *musharaka*) or a construction agreement (*istisna*), or on any combination thereof.

Lease certificates may be issued through an onshore special purpose vehicle, which is known as an asset lease company (ALC). An ALC can be incorporated in the form of a joint-stock company only by the entities listed in the Sukuk Communiqué, including Turkish banks and eligible intermediary institutions. Assets or rights subject to lease certificates can be movable or immovable property, intangible assets or rights over such assets. The ALC's only activity would be issuing lease certificates. Under the Sukuk Communiqué, the holders of lease certificates will be entitled to revenues generated by the underlying assets or rights, and the sale proceeds if such assets are sold in accordance with the Sukuk Communiqué, *pro rata* their share in the total number of certificates.

The Sukuk Communiqué requires lease certificates to be in electronically registered form, whereby the attached interests are recorded with the CRA in Turkey for both onshore and offshore issuances. The CMB has discretion to exempt certificates from this requirement if they are to be issued abroad.

Law No. 7159 providing certain exceptions to the issuance of lease certificates that are qualified as Additional Tier 1 and Tier 2 capital, under which participation banks are fund users, was published on 28 December 2018. As per the CML, non-recourse structures are impermissible, meaning that if the obligor of the underlying transactions does not fulfil its payment obligations towards the ALC, then the board of directors of the ALC is required to protect the interest of the certificate holders, including by selling the assets underlying the lease certificate and distributing the sale proceeds to the certificate holders. While this requirement aims to significantly protect the lease certificate holders, in the meantime it was restricting or eliminating the possibility of subordinated lease certificate issuances by ALCs, as such requirement was not in line with the requirements of banking legislation relating to Additional Tier 1 and Tier 2 issuances, and thus participation banks have tended to issue their Tier 2 certificates via offshore special purpose vehicles. However, with the recently introduced change on 28 December 2018 lease certificate issuances, which are qualified as Additional Tier 1 and Tier 2 capital, and where participation banks are funds users (i.e., obligors) in such issuances, they will be exempt from the obligation to use the underlying rights and assets to repay the lease certificate holders.

The same can be applied for most securities; lease certificates may be sold through a public offering, or without a public offering as a private placement or sale to qualified investors. The main difference between a public offering and a sale without public offering is the obligation to prepare an offering prospectus, which is not applicable to a sale without a public offering.

After the issuance of legislation on lease certificates, changes were made to Turkey's tax regulations to remove some of the barriers and to stimulate the issuance of lease certificates. These changes include exempting asset transfers from notary and land registry charges, prepared documents from stamp duty taxes and income derived from asset transfers from income taxes. Additionally, the Turkish Council of Ministers, with Decree 2011/1854 dated 29 June 2011, determined that withholding tax based on the maturities of lease certificate interest payments is the same as conventional notes.

### iii Cases and dispute resolution

The courts of Turkey will not enforce a judgment obtained in a court in a country other than Turkey unless:

- a* there is in effect a treaty between Turkey and the other country providing for reciprocal enforcement of court judgments, or a multilateral treaty to which Turkey and the country where the judgment is rendered are party;
- b* there is a provision in the laws of the other country that provides for the enforcement of judgments of the Turkish courts; or
- c* there is *de facto* enforcement in the other country of judgments rendered by Turkish courts.

For instance, there is no treaty between the United States and Turkey or the United Kingdom and Turkey providing for reciprocal enforcement of judgments. There is also no provision in the laws of the United Kingdom or the United States permitting the enforcement of judgments rendered by Turkish courts. Further, there is no *de facto* reciprocity between Turkey and the individual states in the United States, except that courts of New York have rendered at least one judgment in the past confirming *de facto* reciprocity between Turkey and New York State. In 2005, the Supreme Court of the State of New York decided that a judgment of the First Commercial Court of the Republic of Turkey may be enforced in New York State. Turkish courts have also rendered at least one judgment in the past confirming *de facto* reciprocity between Turkey and the United Kingdom. However, since *de facto* reciprocity is decided by the relevant Turkish court for each individual case to determine the up-to-date situation with respect to the enforcement, there is uncertainty as to the enforceability of court judgments obtained in the United States or the United Kingdom by Turkish courts.

In addition, Turkish courts will not enforce any judgment obtained in a court established in another country if:

- a* the defendant was not duly summoned or represented or the defendant's fundamental procedural rights were not observed, and the defendant brings an objection before the Turkish court against the request for enforcement on either of these grounds;
- b* the judgment in question was rendered with respect to a matter within the exclusive jurisdiction of Turkish courts;
- c* the judgment is incompatible with a judgment of a court in Turkey between the same parties and relating to the same issues or, as the case may be, with an earlier foreign judgment on the same issue and enforceable in Turkey;
- d* the judgment is clearly against the public policy rules of Turkey;
- e* the judgment is not final and binding with no further recourse for appeal or similar revision process under the laws of the country where the judgment has been rendered; or
- f* the judgment was rendered by a foreign court that treated itself as competent even though it had no actual relationship with the parties or the subject matter at hand, and the defendant brings an objection before the Turkish court against the request for enforcement on this ground.

### iv Relevant tax and insolvency law

#### *Taxation*

There are two regimes for the taxation of securities in Turkey:

- a* the declaration regime: this is the primary regime whereby taxes are declared by taxpayers in their annual tax return; and



- b* the provisional regime: this is a provisional regime that, although introduced as a temporary measure that was initially set to conclude at the end of 2015, has now been extended until the end of 2020.

Income tax is covered by the declaration regime. Capital gains and interest income derived mainly from listed securities are covered by the provisional regime.

Under the provisional regime, taxation is carried out through withholding, mainly by brokerage houses, banks and custody banks. The capital gains derived for a listing of equities on the stock exchange falls under the provisional system and will be subject to a zero per cent rate of withholding tax.

Debt instruments issued by Turkish-resident companies abroad, such as Eurobonds, are subject to the declaration regime. Non-resident investors are only exempt from the declaration regime until the end of 2020. Interest income is subject to withholding tax under the provisional regime at a rate that ranges from zero per cent to 10 per cent, depending on the debt instrument's maturity. Eurobonds with a maturity of three years or more are subject to withholding tax at a rate of zero per cent.

Debt instruments issued by companies resident in Turkey are subject to withholding tax under the provisional regime. The capital gains and the interest income derived from debt securities issued in Turkey by both resident and non-resident companies are subject to withholding tax at a rate of zero per cent.

In addition to the aforementioned withholding tax, any capital gains derived from listing will be subject to corporate tax at a rate of 20 per cent (22 per cent for 2019 and 2020). Certain exemptions can apply to the corporate tax due. For example, there is a 75 per cent capital gains tax exemption applicable provided that:

- a* the shares are held for more than two years;
- b* the seller does not engage in securities trading;
- c* the proceeds are collected within two years of the sale year; and
- d* the exempted amount is kept in a special reserve account for five years and is not distributed to shareholders.

Finally, the transfer of shares is exempt from VAT and the documentation related to listing is exempt from stamp tax.

### ***Insolvency***

In the event that the bonds or notes are unsecured obligations of the issuer through a pledge, the bonds or notes rank and will rank *pari passu*, without any preference among themselves, with all other outstanding unprivileged and unsecured obligations of the relevant issuer through a pledge in the event of insolvency.

Regarding the restructuring of bonds, a new and limited set of rules has recently been introduced through the Borsa Istanbul Listing Directive to allow an increase in the trading volume of defaulted bonds under the Watch List Market of Borsa Istanbul. This has forced Borsa Istanbul to allow an amendment to the conditions of the bonds, and trading of both existing and new or restructured bonds on the Watch List Market. The new rules provide that an issuer restructures its defaulted bond on condition that it publicly discloses (prior to maturity) confirmation of its financial difficulty to repay the principal amount and discloses approval of the restructuring terms by bondholders holding a minimum of 50 per cent of the

issuance. There is not any specific restructuring concept in the event of a default of a coupon payment, and we understand that the restructuring terms are very much limited in scope, mostly on extension of maturity.

In addition, Law No. 7186, which packages together several and diverse measures mainly in the banking, tax and capital markets laws, was published on 19 July 2019, and the long-awaited change related to the easing of the proof of debt instrument holders' right to claim was introduced by way of the addition of a new provision to Article 31 of the CML. With this change, the registry document provided by the CRA to bondholders is now treated as a document that could immediately and permanently remove any objection in debt collection proceedings that could be made by the issuer (debtor) as to the right to receivables or the existence of the debt under the bonds. The amendment clearly counts such document among the proof documents referred to in Article 68 of the Turkish Enforcement and Bankruptcy Law that serve the permanent removal of an issuer's objection and allows a bondholder (creditor) to immediately proceed with debt collection proceedings and seizure of the assets of the issuer, if needed. This amendment provides relief to bondholders by eliminating the need to initiate a full-fledged lawsuit to annul an issuer's objections, which would trigger a lengthy debt collection process risk in the case of default of issuers.

## **v Role of exchanges, central counterparties and rating agencies**

### ***Borsa Istanbul***

The establishment of Borsa Istanbul was envisaged in the CML, as the successor to the Istanbul Stock Exchange and other securities exchanges in Turkey, for the purposes of creating a single platform. Borsa Istanbul is currently the only active stock exchange in Turkey and is located in Istanbul. It operates four main markets, namely the equity market, the debt instruments market, the precious metals and diamonds market, and the derivatives markets.

The equity market currently consists of the following market segments:

- a* the Star Market;
- b* the Collective Investment Products and Structured Products Market;
- c* the Main Market;
- d* the Emerging Companies Market;
- e* the Pre-Market Trading Platform;
- f* the Watch List Market; and
- g* the Equity Market for Qualified Investors.

In addition to these seven market segments, an official auction transaction may be conducted on the equity market when necessary, allowing the trading of stocks by courts, executive offices and other official entities in a separate market.

There is one other market, the Primary Market, on which shares in companies being publicly offered and listed for the first time on Borsa Istanbul and any additional shares offered following rights offerings of companies listed on Borsa Istanbul are traded.

In addition to these markets, there are two common transaction structures that are conducted on the equity market. Block trades of listed stocks are conducted as specifically regulated wholesale transactions, and preemption rights during rights issues (granting the right to subscribe for newly issued shares) are traded separately as preemption right transactions.

Borsa Istanbul has announced a new market structure for the Borsa Istanbul Equity Market and amendments to the trading principles on this market on 2 October 2019. The new market structure is expected to increase the motivation of both retail and institutional

investors to trade on the secondary market, and encourage issuers to put more effort into expanding the depth and liquidity of the secondary market for their shares. Under the new rules, company shares traded on the Star Market and the Main Market of the Equity Market and having a similar size, liquidity and depth will now be traded in the same group, and grouping criteria have been set. Under the new market structure, two groups will be organised under the Star Market and Main Market, namely Group 1 and Group 2, and there will be different trading principles applicable to each group. The new structure and trading principles of the Equity Market, together with upcoming amendments to the Borsa Istanbul Equity Market Directive and the Listing Directive, will become effective on 4 November 2019, while the CMB regulation on ABCD share grouping will be repealed as of such date. In addition to grouping under the Star Market and Main Market, the Collective Investment Products and Structured Products Market will be renamed as the Structured Products and Fund Market, and shares trading on this market (real estate investment companies, venture capital investment companies and securities investment companies) will be taken off said market and traded in the relevant group on the relevant market.

### ***Central counterparties***

The CMB may require central clearing institutions to be a central counterparty (CCP) as of markets or capital market instruments whereby they undertake the duty to complete clearing by acting as seller against buyer and buyer against seller. Exchanges or other organised market places may also apply to the CMB to initiate the practice of the CCP for the traded capital market instruments.

The financial liability of clearing institutions with regard to clearing transactions, in which they undertake the duty to act as CCP, shall be determined within the limits to be established and in the framework of the guarantee to be taken from their members as well as other collateral.

Central clearing institutions that are to provide CCP services must have and must maintain an adequate level of capital in line with the financial risks they have undertaken in the related capital market instruments (and other risks), and must establish and maintain a data processing infrastructure as well as internal control, risk management and internal audit systems. The internal audit units of these institutions are obliged to control the reliability and adequacy of their risk management and data processing infrastructures at six-month intervals, as a minimum, and to notify the CMB of the results. The CMB may decide the related control be made more frequently and require an independent audit to be conducted with regard to the above-mentioned issues. Furthermore, the CMB is authorised to require the financial adequacy of the institution that is to provide CCP services to be assessed with methods it would specify, including stress tests, and to request a credit rating to be assigned in cases where it deems it necessary.

To maintain financial stability, the CMB may impose additional obligations, including capital requirements on institutions of systemic importance and their members.

In principle, guarantees taken by an institution that is to provide CCP services and the assets of account holders shall be monitored separately from the assets of the institution. The institution providing CCP services shall not use these guarantees or assets for purposes other than those they were deposited for, with the exception of transactions with regard to the execution of clearing. The institution that is to provide CCP services shall take all necessary measures to comply with these requirements.

Institutions that are to provide CCP services are not obliged to make separate contracts with the parties in each transaction.

As per a CMB resolution dated 19 June 2017, İstanbul Takas ve Saklama Bankası AŞ will act as the CCP for transactions effectuated in the Equity Market of Borsa Istanbul.

### ***Rating agencies***

As per the relevant legislation, rating services in capital markets consist of providing credit ratings for corporations and sovereign ratings, and providing ratings in relation to the compliance of corporations with corporate governance principles. The rating agencies incorporated in Turkey and duly authorised by the CMB and international rating companies that are authorised by the CMB can provide rating activities in Turkey. Sovereign rating services must also be provided in compliance with the relevant legislation of the CMB.

### **vi Other strategic considerations**

Based on the latest trends in capital markets, there are signs that the outlook is due to improve, with numerous legislative changes, which will contribute to the growth of Turkish debt and equity markets. Depending on the macroeconomic conditions and Turkey's adoptive approach to such conditions, capital markets in Turkey are not likely to fall short of expectations in the coming year.

## **III OUTLOOK AND CONCLUSIONS**

Turkish securities law has been evolving as a separate area of practice, in parallel to the inflow of funds into the Turkish economy through capital markets and the development of a corporate governance culture.

During the past few years, Turkey has solved most of its structural problems and achieved stable economic growth rates. This sound economic growth has pushed regulators to prepare new legislation, issue stimulating regulations and revoke regulatory impediments confronting entrepreneurs. Turkey's EU accession negotiations are another reason for the implementation of regulatory changes: to align the country's regulatory environment with the EU acquis. These circumstances have created a fast-changing environment bearing substantial risks that would be difficult to calculate and live with, and also provide the opportunity to set precedents and shape the implementation of the law.

The newly introduced CML, and secondary regulations aiming to remove bureaucratic impediments and unnecessary regulatory burdens or restrictions, are signs of progress realised in securities law. Although there has been a recent slowdown in Turkish offerings, capital markets experts expect that remarkable initiatives through legislative changes will encourage Turkish companies to tap into debt and equity offerings and support growth in the Turkish capital markets.

# UNITED ARAB EMIRATES

*Gregory J Mayew and Silvia A Pretorius<sup>1</sup>*

## I INTRODUCTION

The United Arab Emirates (UAE) was established in 1971 and comprises the seven emirates of Abu Dhabi, Ajman, Dubai, Fujairah, Ras Al Khaimah, Sharjah and Umm Al Quwain. Abu Dhabi is the capital and the site of a number of federal ministries, the Central Bank of the United Arab Emirates (Central Bank) and other government institutions and agencies.

Under the UAE Constitution, each of the emirates retains substantial control over the conduct of government affairs within the emirate. With some exceptions, regulation of capital markets is generally a matter of UAE federal law.<sup>2</sup>

The legal system in the UAE (which includes federal laws and individual emirate laws, such as those of the emirate of Dubai) is still developing. UAE law does not recognise the doctrine of binding judicial precedent. In the absence of such a doctrine, the results of one court case do not necessarily offer a reliable basis for predicting the outcome of a subsequent case involving similar facts. Consequently, the UAE legal system may generally be regarded as offering less predictability than more developed legal systems.

In contrast, the Dubai International Financial Centre (DIFC) was established as a financial free zone with its own body of laws and regulations, which are largely separate from the UAE legal system. It also has its own courts. The DIFC laws and rules of court are largely based on English common law and the procedural rules currently in place in England and Wales.

In February 2013, the creation of a new financial free zone in the emirate of Abu Dhabi was announced (Federal Decree No. 15 of 2013) and the Abu Dhabi Global Market (ADGM) was then established pursuant to Abu Dhabi Law No. 4 of 2013. Commercial rules and regulations have been enacted by the ADGM Board of Directors as from March 2015, followed by publication of the Financial Services Regulatory Authority Rules, which establish the legislative and regulatory framework for financial services in the ADGM. The ADGM began issuing licences to non-financial services entities in May 2015, and to accept and approve financial services licence applications in October 2015.

The UAE Constitution provides for a federal court system, but permits each constituent emirate to opt out of this and maintain an independent court system. The emirates of Sharjah, Ajman, Fujairah and Umm Al Quwain have joined the federal court system. The emirates of Abu Dhabi (since 2006), Dubai and Ras Al Khaimah each maintain a separate court system. The UAE capital markets are young and still developing. There are currently three securities

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1 Gregory J Mayew is a partner and Silvia A Pretorius is a senior associate at Afridi & Angell.

2 The most notable exception is the Dubai International Financial Centre (DIFC) – see footnote 3.

exchanges, all of which are less than 20 years old: the Abu Dhabi Securities Exchange (ADX), the Dubai Financial Market (DFM) and NASDAQ Dubai. In addition, the UAE is home to the Dubai Multi Commodities Centre and the Dubai Mercantile Exchange Limited. The creation of a second market, in which shares in private joint-stock companies would be eligible for trading, was launched in 2014.

Regulation of securities and financial markets in the UAE is a potential source of confusion to investors and financial institutions. Generally speaking, there are two regulatory schemes: the UAE federal regulatory scheme, and the scheme applicable in the DIFC (and to a lesser extent, the ADGM). With regard to the laws and regulations affecting capital markets, the DIFC and the ADGM are effectively different jurisdictions altogether, with rules and regulations that differ significantly from the UAE federal regulatory scheme.<sup>3</sup> A detailed discussion of the DIFC and the ADGM schemes is beyond the scope of this chapter, which deals primarily with the UAE federal scheme.

Historically, the regulation of securities trading and transactions involving investment products was the domain of the Central Bank. The Central Bank is entrusted with the issuance and management of the country's currency, and regulation of the banking and financial sectors. A government agency, its capital is fully owned by the federal government and it has its headquarters in Abu Dhabi. The Central Bank acts as the UAE's central bank and regulatory authority, directing monetary, credit and banking policy for the entire country (other than inside the DIFC). The individual emirates do not have separate corresponding institutions. The Central Bank is also empowered to set the exchange rate of the dirham against major foreign currencies.

The Emirates Securities and Commodities Authority (SCA) was created in 2000. Until 2009, the SCA generally limited its regulatory oversight to publicly listed UAE companies and the public securities exchanges in the UAE. In recent years, the regulatory responsibility of the SCA has expanded considerably, and it is now the primary regulator of capital markets under the UAE federal scheme. The shift in regulatory responsibility over foreign securities from the Central Bank to the SCA has occurred gradually over time pursuant to an unpublished memorandum of understanding between the Central Bank and the SCA. The general public is informed of regulatory developments as and when the SCA publishes new regulations. In addition, the SCA has adopted regulatory procedures and practices, some of which are not published.

In June 2013, Morgan Stanley Capital International (MSCI), which maintains the most widely used equity index in the world, upgraded the status of the UAE capital markets from frontier to emerging market. This promotion became effective in May 2014 with the changes to the indexes. At that time, MSCI added nine UAE companies to its benchmark emerging markets index for the first time. Subsequent to the decision to upgrade the UAE markets, and in an attempt to meet listing conditions under MSCI indexes going forward

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<sup>3</sup> The DIFC is often a source of confusion to international investors who are not familiar with the UAE. It is a financial free zone established in the emirate of Dubai. It should not be confused with the emirate of Dubai itself. As noted above, the DIFC has its own laws and regulations, which differ considerably from the laws and regulations applicable to capital markets and securities transactions outside the DIFC. The DIFC regulatory scheme applies only within the DIFC. The UAE federal regulatory scheme applies everywhere in the UAE (i.e., in all seven emirates) except the DIFC. The DIFC has its own regulator, the Dubai Financial Services Authority (DFSA).

(which requires, in addition to other conditions, that listing conditions include permitting foreign ownership at acceptable rates), a number of companies listed on the ADX and the DFM decided to raise the percentage of foreign ownership.

## II THE YEAR IN REVIEW

### i Developments affecting debt and equity offerings

One prominent development is the issuance of the SCA Board of Directors' Chairman Decision No. (9/RM) of 2016 Concerning the Regulations as to Mutual Funds (New Fund Regulations), which replaces SCA Board Resolution No. 37 of 2012 Concerning the Rules of Investment Funds, as amended, and which became effective on 31 July 2016.

The New Fund Regulations continue to ensure that:

- a* the oversight of the licensing, regulation and marketing of investment funds in the UAE remains with the SCA, which also carries out oversight and prudential supervision tasks pertinent to the financial position of mutual funds established and licensed in accordance with the provisions of these Regulations;
- b* SCA approval is required for the establishment of a local investment fund, which is any investment fund established in the UAE, excluding the free zones, and licensed by the SCA;
- c* SCA approval is required for the marketing and promotion of foreign funds to investors in the UAE. The New Fund Regulations define a foreign fund as 'a mutual fund established outside the UAE, in a free zone, or in a financial free zone within the UAE'; and
- d* the marketing of a foreign fund to investors in the UAE requires the appointment of a UAE-licensed local promoter.

The New Fund Regulations do not apply to:

- a* the accumulation of funds for the purposes of investment in a joint bank account, concluding group insurance contracts, or participation in social security, employee incentive programmes or investment plans associated with insurance contracts, unless such investments or collected money are directed from such plans to mutual funds; or
- b* funds established by federal or local government agencies, the companies fully owned by any of them or the foreign funds promoted to one of such entities. In addition, the New Fund Regulations specifically do not apply in the case of reverse solicitation.

While the New Fund Regulations provide that no foreign fund may be offered, marketed, advertised or distributed within the UAE prior to obtaining approval of the promotion from the SCA and appointing a local promoter, they do not specify who is eligible to be a local promoter, what the obligations of the local promoter are or the minimum subscription per single investor. The New Fund Regulations provide that the term of the SCA approval shall be one year, and may be renewed with an application submitted to the SCA at least one month before expiry thereof. The SCA shall have the right to reject the application for renewal as required by the public interest.

The New Fund Regulations apply to both private and public placements. However, a distinction is made between public funds (either open-ended or close-ended funds established in the UAE that target all investors) and private funds (either open-ended or close-ended funds established in the UAE that target qualified investors).

An application for the licensing of a public open-ended mutual fund must be submitted by its founders or a corporate entity licensed by the SCA to practise the activity of establishing and managing such a fund in the UAE. The New Fund Regulations provide that a prospectus, with supporting documents, and a key investor information document must be submitted. It is prohibited to announce the start of initial procedures to obtain a licence for a fund, announce its licensing, subscribe in its units, promote it, distribute any promotional materials or announce any information in relation to the fund prior to obtaining the approval of the SCA for the licensing and announcement. The term of the licence for the fund shall be one year, and it may be renewed.

Similarly to public open-ended funds, the scope of investment in public close-ended funds includes tradable securities (stocks, bonds and cash instruments) and high-liquid non-tradable securities, financial derivatives on tradable securities to control the level of risks set forth in the prospectus or for hedging in an amount not greater than the total net asset value subject to disclosure thereof, declared indexes and bank deposits to ensure liquidity with a maximum maturity of 12 months with licensed banks, subject to determining the investment ratio.

Public close-ended mutual funds have the following investment restrictions:

- a* the ratio of investment in securities issued by one entity may not exceed 10 per cent of the net value of the fund's assets or 10 per cent of the issued capital (whichever is less);
- b* the ratio of investment in unlisted securities may not exceed 10 per cent of the fund's net asset value;
- c* the ratio of investment may not exceed 20 per cent of the fund's net asset value in securities listed in a foreign market, provided that the market is subject to a regulator similar to the SCA;
- d* investment in financial derivatives is subject to a limit of no more than 1 per cent of the fund's net asset value;
- e* investment in another mutual fund is not permitted unless it is consistent with the investment policy of the fund and in a manner that serves the interests of unit holders; and
- f* engaging in foreign exchange operations is permitted only when they are incidental and with the objective of managing its investments.

The New Fund Regulations make provision for various types of mutual funds, including a master fund (a public mutual fund or part of a group of funds affiliated to an umbrella fund, provided the master fund meets certain criteria), a feeder fund (a public mutual fund or part of a group of funds affiliated to an umbrella fund excluded from investing in tradable securities and from some other investments as determined by the SCA, and that invests at least 85 per cent of its assets in the units of a public master fund or a public foreign fund) and an umbrella fund.

In January 2017, the SCA issued Chairman of the SCA Board of Directors' Decision No. 3/RM of 2017 Concerning the Regulation of Promotion and Introduction (Promotion Regulations). These Regulations appear to supplement but not necessarily replace those sections of the New Fund Regulations that relate to promoting foreign funds, as the Promotion Regulations do not stipulate that they replace the New Fund Regulations either fully or in part. While the Promotion Regulations reconfirm that any marketing of interests in foreign funds to investors in the UAE requires that such interests be registered with the SCA, they also reiterate that reverse solicitations set out in the New Fund Regulations still



apply. The Promotion Regulations also specify a further exemption whereby a foreign fund need not be marketed by way of a private offering in the UAE by an SCA-licensed promoter if offered to a qualified investor. A qualified investor is:

- a* an investor capable of managing its investments by itself and on its own accord, such as:
  - the federal government and local governments, government institutions and authorities, or the companies fully owned by any of the aforementioned;
  - international bodies and organisations;
  - a person licensed to engage in a commercial business in the UAE, provided that one of the purposes of its business is investment; or
  - a natural person with an annual income of no less than 1 million UAE dirhams, or with his or her net equity, with the exception of his or her main residence, valued at 5 million UAE dirhams and declaring that he or she has the adequate knowledge and experience – whether solely or through a financial consultant – to assess the offering documents, the advantages and the risks associated with or arising from the investment; and
- b* represented by an investment manager licensed by the SCA.

In addition to foreign funds, the SCA has assumed oversight responsibilities in relation to the marketing of most types of foreign securities in the UAE. Specifically, it has regulatory oversight with regard to matters pertaining to plain vanilla (non-listed foreign) security products, while the Central Bank still retains oversight authority with regard to sophisticated products such as credit-linked notes. Various new SCA regulations relating to funds have been enacted between 2016 and 2019:

- a* Chairman of the Authority's Board of Directors' Decision No. 10/RM of 2016 Concerning the Fees of Mutual Funds, outlining the fees payable to the SCA in respect of application fees and licence renewals for public and private mutual funds;
- b* Administrative Decision No. 49/RT of 2016 Concerned the Exchange-Traded Fund (ETF), regulating the incorporation and prospectus requirements for ETFs;
- c* Administrative Decision No. 52/RT of 2016 Concerning the Controls of Cash Investment Fund (CIF), regulating the investments permissible for CIFs;
- d* Administrative Decision No. 1/RT of 2017 Concerning Real Estate Investment Fund Controls;
- e* Administrative Decision No. 2/RT of 2017 Concerning Private Equity Fund Controls, which has introduced rules relating to the obligations of both general and limited partners and places restrictions on the investments a private ownership fund can make. This means that a fund must invest the majority of its monies in purchasing:
  - shares in limited liability, joint partnership, joint venture or private shareholding companies; or
  - securities of public shareholding companies that are intending to commence conversion into private shareholding companies or before the commencement of the liquidation process;
- f* Administrative Decision No. 3/RT of 2017 Concerning The Venture Capital Fund Controls;
- g* Chairman of the Authority's Board of Directors' Decision No. 4/RM of 2017 Concerning the Regulation of the Activity of Administrative Services for Investment Funds;
- h* Administrative Decision No. 57/RT of 2017 Concerning the Adjustment of Positions Mechanisms for Mutual Funds;

- i* Administrative Decision No. 58/RT of 2017 Concerning the Adjustment of Positions Mechanisms for Promotion and Introduction Activities;
- j* Administrative Decision No. 123/RT of 2017 Concerning the Regulatory Controls for Financial Activities and Services;
- k* Decision of the Chairman of the SCA Board of Directors No. 32/RM of 2017 Concerning the Regulation for General and Limited Partnership Funds;
- l* Decision of the Chairman of the SCA Board of Directors No. 5/RM of 2018 Concerning the Imposition of Sanctions;
- m* Decision of the Chairman of the SCA Board of Directors No. 12/RM of 2018 Concerning the XBRL;
- n* Chairman of the SCA Board of Directors' Decision No. 18/RM of 2018 Concerning the Regulations as to Licensing Credit Rating Agencies;
- o* Chairman of the SCA Board of Directors' Decision No. 19/RM of 2018 Concerning the Regulation of the Central Depository Activity;
- p* Chairman of the SCA Board of Directors' Decision No. 20/RM of 2018 Concerning the Issuing and Offering of Islamic Securities;
- q* Chairman of the SCA Board of Directors' Decision No. 20/RM of 2018 Concerning the Offering or Issuance of Islamic Securities; and
- r* Chairman of the SCA Board of Directors' Decision No. 8/TM of 2019 on the Mechanism of Investment Funds.

In addition to regulations relating to investment funds, the SCA has been active on a number of other fronts. Recently, it issued a series of regulations governing market making, securities lending and borrowing, short selling and liquidity,<sup>4</sup> as well as central clearing, cross-border securities trading, and efficiency and appropriateness controls for licensed companies and accredited persons in the securities industry.<sup>5</sup>

Market making is defined in these regulations as the activity of providing continuous prices for the purchase and sale of certain securities to increase the liquidity of securities in accordance with market-maker regulations.

The practice of market making requires a licence from the SCA. An applicant for a licence must be a corporate person with paid capital of at least 30 million UAE dirhams (or the equivalent) meeting any of the following criteria:

- a* a company established in UAE with at least 51 per cent UAE ownership or the nationality of one of the Gulf Cooperation Council (GCC) states. One of its purposes must be to practise market making;

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4 See SCA Board of Directors' Decision No. 46 of 2012 Concerning the Regulations as to Market Makers, as amended by Chairman of the SCA Board of Directors' Decision No. 26 of 2014, SCA Board of Directors' Decision No. 47 of 2012 Concerning the Regulations as to Lending and Borrowing Securities, SCA Board of Directors' Decision No. 48 of 2012 Concerning the Regulations as to Short Selling of Securities and SCA Board Decision No. 49 of 2012 Concerning Regulations as to Liquidity Provision.

5 See SCA Board Decision No. 11 of 2015, Concerning the Regulations of Clearing Operations in Commodities Markets, Chairman of the SCA Board of Directors' Decision No. 22/RM of 2016 Concerning the Regulation of the Central Clearing Party Business, Administrative Decision No. 34/RT of 2016 Concerning the Regulatory Controls for Financial Activities and Services, Administrative Decision No. 49/RT of 2016 Concerning the Concerning the Exchange-Traded Fund and Administrative Decision No. 52/RT of 2016 Concerning the Controls of Cash Investment Fund.

- b* a company established in the UAE and licensed by the SCA to operate in the field of securities, in which case the applicant shall be subject to the controls issued by the SCA concerning the prevention of conflicts between activities; or
- c* a commercial bank or investment company licensed by the UAE Central Bank, or a branch of a foreign bank, provided that the parent bank is licensed to practise this activity, and subject to obtaining the approval of the UAE Central Bank in any of these cases.

Any investor is permitted to lend securities owned by that investor, but the borrowing of securities, unless otherwise approved by the SCA, is permissible only when carried out by a licensed market maker practising market making or by the clearing department of an exchange in the case of a failure to deliver sold securities on the settlement date.

Licensed market makers are permitted to engage in short selling. Each exchange has the power to determine the securities eligible for short sales provided that short selling is not permitted until one month after a company's initial listing. In addition, short selling is not permitted for a subscription in capital increase shares or in covered warrants. More generally, each exchange has the power to create its own rules governing short selling procedures provided that these rules are subject to SCA approval.

Duly licensed market makers are also permitted to act as liquidity providers by entering into agreements with issuers of listed securities provided that the liquidity provider cannot at any time own more than 5 per cent of the listed securities. All liquidity provision agreements must be disclosed to the SCA, and the exchange on which the securities are listed and the exchange in turn shall disclose the agreement to the public.

The regulations address separating clearing and settlement functions, transferring securities ownership and depositories, and further permit the incorporation of companies, independent from securities exchanges, to handle clearing transactions under a licence from the SCA.

The regulations for central clearing houses provide that clearing transactions are no longer executed on securities exchanges. The regulations also regulate clearing transactions and redistribute the tasks carried out on the exchanges.

In June 2013, the SCA issued Board Resolution No. 38 of 2013 Concerning the Trading of Rights Issue for Capital Increases. A rights issue can be listed and traded subject to the provisions of this Resolution. A rights issue is defined therein as a financial instrument representing rights that are granted to a company's shareholders to have priority to subscribe for shares in that company's capital increase.

In January 2014, the SCA issued Board of Director's Decision No. 1 of 2014 Concerning the Regulations on Investment Management, which became effective on 28 February 2014. This Decision defines investment management as the management of securities portfolios for the account of third parties or the management of mutual funds.

With limited exceptions (the promotion of financial portfolios owned by federal and local government entities), any entity wishing to carry on or promote investment management activities in the UAE must obtain a licence from the SCA. Applicants must meet strict eligibility criteria, and must have a paid-up capital of no less than 5 million UAE dirhams and a bank guarantee of 1 million UAE dirhams. There are also conditions to be met relating to technical and administrative staff, the entity's premises, required electronic and software programs, internal control systems and an operational guide for risk management systems.

In April 2014, the SCA issued two new regulations: Board of Directors' Decision No. 16 of 2014 Concerning the Regulation of Sukuk (Sukuk Regulations) and Board of Directors' Decision No. 17 of 2014 Concerning the Regulations of Debt Securities (Debt Securities Regulations).

*Sukuk* are defined as tradable financial instruments of equal value that represent a share of ownership of an asset or a group of assets, and that are issued in accordance with *shariah* law.

Retail *sukuk* may only be issued in the UAE through public subscription, and approval must be obtained from the SCA before issuing or listing any *sukuk* on the market in accordance with the provisions of the Sukuk Regulations. Excluded from the provisions of these Regulations are government *sukuk*, and *sukuk* that will not be offered through public subscription or listed on the market. A condition for the principal listing of retail *sukuk* is that the applicant must be established in the UAE and outside a financial free zone.

Other issues covered under the Sukuk Regulations include the procedures and documents required for approval by the SCA of primary and joint listings of sukuk, the establishment of an SCA sukuk register, as well as trading, clearance and settlement of sukuk, and suspension and cancellation of listings.

The Debt Securities Regulations replace SCA Board Resolution No. 94/R of 2005 Concerning the Listing of Debt Securities. Debt securities are defined as tradable financial instruments of equal value evidencing or creating indebtedness on the issuer, whether secured or unsecured. The Debt Securities Regulations state that with the exception of government corporate bonds, no corporate bond shall be issued and offered for public subscription in the UAE without first obtaining the SCA's approval. The corporate bonds must also be listed on the market. To be listed, debt securities must satisfy the following conditions:

- a* they must comply with the provisions of the Commercial Companies Law and with the issuer's constitutional documents;
- b* unless the SCA decides otherwise, the aggregate value of all debt securities to be listed must be at least 10 million UAE dirhams, or the equivalent thereof in a foreign currency that is acceptable to the SCA and the market; and
- c* where the debt securities sought to be listed are secured debt securities, a trustee must be appointed to represent the interests of the holders of those debt securities, and that trustee must have the right of access to any information relating to the assets.

The Debt Securities Regulations provide that the general assembly must approve the issuance of corporate bonds if the issuer is a joint-stock company, and that a subscription announcement must be prepared and presented according to the format approved by the SCA.

The Debt Securities Regulations also require non-government issuers to obtain SCA approval before publishing any document or making any announcement inside the UAE relating to the listing of corporate bonds. The documents or announcement must clearly indicate that SCA approval was granted for publication. This requirement is also applicable to *sukuk*.

Both the Sukuk Regulations and the Debt Securities Regulations provide that neither the SCA nor the markets shall have any responsibility for any information (lists, financial statements, financial data, information, reports or any other documents) presented by the applicant or issuer.

The SCA issued Board of Directors' Decision No. 27 of 2014 on the Regulation of Securities Brokerage in July 2014. The Regulation classifies brokerage firms into those that engage in trading only while the clearance and settlement operations are conducted through clearance members, and those that engage in trading clearance and settlement operations for their clients.

Some of the features of the new Regulation include the new classification of brokerage firms, new capital requirements (3 million UAE dirhams with respect to a brokerage company (trading member) and 10 million UAE dirhams for a brokerage company (trading and clearing member)), and increases in the value of bank guarantee requirements. Under the new Regulation, no company shall engage in a brokerage activity without a licence from the SCA and registration in the SCA Register for brokers.

In July 2014, the SCA also introduced controls for brokerage firms trading for their clients in foreign markets whereby a brokerage firm may trade for its clients in the foreign markets in the normal way of trading, or using accounts, only after obtaining the approval of the SCA.<sup>6</sup>

SCA Board of Directors' Decision No. 10 of 2014 Concerning the Regulation of Listing and Trading of Shares of Private Joint Stock Companies provides the conditions under which private joint-stock companies would be able to list their shares on the market, including the requirement that the capital be paid in full, that the audited budget be issued for the last two fiscal years and that the company facilitates the trading of its shares through brokerage companies licensed by the SCA. Private joint-stock companies that are listed on the market shall be exempt from the Corporate Governance Regulations, Ministerial Resolution No. 370 of 2009 Concerning the Share Register of Private Joint-Stock Companies and SCA Board of Directors' Decision No. 3/R of 2000 concerning the Regulations as to Disclosure and Transparency.

The much-anticipated new UAE Commercial Companies Law (Federal Law No. 2 of 2015) was issued on 1 April 2015 and came into force on 1 July 2015. The provisions relating to corporate governance were significantly enhanced. Some of the most significant amendments relate to public companies and capital markets. The minimum free float permitted in an initial public offering (IPO) was reduced from 55 to 30 per cent, with the maximum proportion that can be floated decreased from 80 to 70 per cent. The share price can now be determined by way of a book-building process, and shares can be issued at a premium. Pursuant to the Commercial Companies Law, the concerned authorities have introduced subordinated legislation in a number of areas, including the Corporate Governance Regulations as noted below, and regulations on IPOs and book-building.<sup>7</sup> The concerned authorities have also been authorised to introduce legislation regarding the rules on the formation and qualification of *shariah* boards, the creation of different classes of shares and their rights. For public joint-stock companies, the minimum share capital requirement of 10 million UAE dirhams has been increased to 30 million UAE dirhams. The concept of authorised (but not issued) share capital has been introduced. Public offers of subscription to shares are expressly prohibited without SCA consent.

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6 See SCA Administrative Decision No. 86/RT of 2014 Concerning the Controls of Trading by Brokerage Firms for their Clients in Foreign Markets.

7 See SCA Chairman Resolution No. 6/TM of 2019, amending SCA Board Resolution No. 11/RM of 2016 On the Regulations for Issuing and Offering Shares of Public Joint Stock Companies.

The Commercial Companies Law prohibits any company, other than a public joint-stock company, from offering any securities in an IPO. In all cases, no company or natural or corporate person, incorporated or registered anywhere in the world, may publish any advertisements in the UAE that include a call for an IPO in securities prior to obtaining the approval of the SCA. This prohibition has also been introduced by the SCA.<sup>8</sup>

A company may now issue shares to a strategic partner (i.e., an investor from an industry sector related to the company's own) through a capital increase on terms approved by a special resolution of the shareholders without needing to comply with preemption rights.

In September 2018, the SCA issued SCA Chairman Decision No. (28/Chairman) of 2018 Approving the Fintech Regulatory Framework (Fintech Regulatory Sandbox Guidelines). A fintech regulatory sandbox is a process-based framework that allows entities to test innovative products, services, solutions and business models under a relaxed regulatory environment, but within a defined space and duration.

The Commercial Companies Law has introduced the concept of investment funds incorporated as a separate legal personality in the form of common investment companies, and the concept that a public shareholding company may buy back a portion of its own shares to resell them. SCA Board of Directors' Decision No. 40 of 2015 set out the conditions and procedures for companies to do so, which include the following:

- a* at least two financial years must have elapsed since the establishment of the listed public shareholding company on the financial market;
- b* the company must have issued two audited balance sheets approved by its general assembly;
- c* at least one year must have elapsed since the last selling transaction of shares previously bought back (if any);
- d* approval of the general assembly of the company under a special resolution on the buy-back for resale transactions;
- e* the buy-back may not exceed 10 per cent of the shares representing the company's paid-up capital; and
- f* the company may not execute the buy-back transaction until after six months have elapsed since the last issuance of any securities in a public offer.

Pursuant to the Commercial Companies Law, the SCA issued Resolution No. 7/RM in April 2016, which sets out new corporate governance rules and corporate discipline standards for public joint-stock companies (Corporate Governance Regulations), which replaced the existing resolutions and regulations.<sup>9</sup> The Corporate Governance Regulations apply to all listed UAE companies, their board members, managers, chairs and auditors to whom the provisions of the Commercial Companies Law apply. As an exception, Chapter Two (which covers the corporate governance rules) will not apply to banks, finance companies, financial investment companies, and money exchange and financial brokerage firms that are subject to the supervision of the Central Bank.

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8 See SCA Board of Directors' Decision No. 18 of 2015 Amending Certain Articles of the Regulations as to Disclosure and Transparency.

9 See SCA Board Resolution No. 16 of 2013 Concerning the Amendment of the Regulations on Disclosure and Transparency, which amended certain articles of SCA Resolution No. 3/R of 2000 Concerning the Regulations as to Disclosure and Transparency.

The Corporate Governance Regulations now provide clear rules in relation to calling a general assembly. Unless approved by 95 per cent of the shareholders, a board can no longer call a general assembly with fewer than 30 days' notice. Immediate disclosure must be made to shareholders pursuant to a detailed notice to the market and on the website of the company directly after the conclusion of the board meeting declaring its resolutions and the date of the general assembly's meeting.

The standards to be observed with regard to participation in the meetings of boards of directors via modern technology (such as videoconferencing) are now comprehensively covered in the Corporate Governance Regulations.

Under these Regulations, listed companies are now required to maintain special and comprehensive registers of conflicts of interest, insiders and related parties. The Regulations also require listed companies to include a provision in their articles of association that provides for a minimum representation of women on their board of not less than 20 per cent. Companies that do not satisfy this requirement will need to disclose the reason for this in their annual governance reports.

On 11 March 2019, the SCA, the Dubai Financial Services Authority (DFSA) of the DIFC and the Financial Services Regulatory Authority (FSRA) of the ADGM issued a joint press release announcing the enactment of legislation enabling the implementation of a passporting scheme to facilitate the UAE-wide promotion of domestic funds. Historically, the existence of three different regulatory regimes in the UAE has been an impediment to the growth of the market for funds since a fund approved by a particular regulator was only eligible for promotion within the relevant jurisdiction and not throughout the UAE. The passporting regime aims to change this. The DFSA and ADGM have published amendments to the relevant rules and regulations implementing the passporting regime. The SCA's regulations have not yet been published. The passporting regime applies to both private and public domestic funds. It does not apply to foreign funds promoted in the UAE. Foreign funds and other types of securities promoted in the UAE remain subject to the applicable rules of the jurisdiction in which they are promoted.

## **ii Developments affecting derivatives, securitisations and other structured products**

Derivative products have been marketed and sold in the UAE for many years. There have been some recent changes to the rules and regulations affecting these products to expand the investment options available to customers in the markets with the issuance of SCA Board of Directors' Decision No. 22 /RM of 2018 Concerning the Regulation of Derivatives Contracts (Derivatives Contracts Regulations).

Pursuant to the Derivatives Contracts Regulations, derivative contracts are financial contracts of a specific value determined by the contracting parties. These types of contracts derive their value from that of the underlying securities (defined to be local securities and foreign securities, or local or foreign index subject matter of a derivatives contract, and are dependent on the change of value of such securities) and are dependent on the change of value of such securities. The Derivatives Contracts Regulations also classify structured derivatives contracts as 'derivatives contracts structured on the local securities or indicators issued in accordance with the market's conditions and rules, derivatives contracts structured on foreign securities, issued in accordance with the market's conditions and rules upon obtaining the SCA's consent, and derivatives contracts structured on local securities or indicators, issued in accordance with the conditions and rules of the foreign market upon obtaining the SCA's

consent'. Customers who deal in over-the-counter derivatives contracts on local securities or indicators are required to settle and clear the trading of these contracts through a central clearing party.

The Derivatives Contracts Regulations address the obligations of the markets in the UAE. In addition to other obligations set forth in the law that established the SCA and its regulations, these include the following:

- a* to continuously disclose and update the securities involved in the structured derivatives contracts in the market;
- b* to continuously disclose the types and specifications of the structured derivatives contracts in the market in accordance with its rules, as well as any updates or amendments thereto, provided that they may not enter into force in the event there are pending unsettled structured derivatives contracts;
- c* not deregister any security involved, in cases where pending or unsettled structured derivatives contracts, which include these involving securities, exist in the market;
- d* announce the working days, the hours dedicated to trading in the structured derivatives contracts therein, and the opening and closing times;
- e* settle all transactions through a central clearing party;
- f* specify the number of structured financial derivatives contracts in the series of contracts. The market should also specify the securities involved, the month of contract settlement, the month of contracting and the expiry date of the contract that may be registered with the market. The market may enforce limits for each structured derivatives contract or for all contracts;
- g* specify the initial margin of the transactions of structured derivatives contracts therewith. The market should also set the conditions and rules governing the structured derivatives contracts therewith, rules of trading and listing thereof on the market, and the rules and conditions of licensing practice of the tasks of the derivatives member, and the rules of licence renewal as well as the obligations of the derivatives member, provided that the rules, as well any update or change thereto, are approved by the SCA before they enter into force; and
- h* abide by the provisions related to structured derivatives contracts that are compatible with the principles of Islamic *shariah*.

Securitisation transactions are extremely rare in the UAE as the existing legal and regulatory environment is not well suited to structuring such transactions. There have been no significant recent developments.

### **iii Cases and dispute settlement**

As has already been noted, the capital markets in the UAE are young and developing. The UAE has only had emerging market status since 2012/2013. It is not a common law jurisdiction, and the doctrine of binding judicial precedent is not followed. To date, there is an absence of significant court cases regarding securities law matters, and there have been no significant recent developments.

### **iv Relevant tax and insolvency law**

With limited exceptions, the UAE is (as a matter of practice) a tax-free jurisdiction. There is no federal income tax law, nor are there any federal taxes on income. There is no personal income tax.



Corporate income tax statutes have been enacted in most of the emirates (all of which predate the formation of the UAE in 1971) but they are not implemented.<sup>10</sup> Instead, corporate taxes are collected with respect to branches of foreign banks (at the emirate level) and courier companies (at the federal level). Further, taxes are imposed at the emirate level on the holders of petroleum concessions at rates specifically negotiated in the relevant concession agreements. Taxes are imposed by certain emirates on some goods and services (including, for example, sales of alcoholic beverages, hotels, restaurant bills and residential leases).

The UAE Ministry of Finance issued Federal Decree-Law No. 8 of 2017 (VAT Law) and launched a dedicated website for the Federal Tax Authority. The VAT Law introduced a new 5 per cent VAT starting in January 2018. The Law is based on the common principles agreed by all GCC countries in the GCC VAT framework agreement. It sets the general rules for implementation of the new tax, and includes some details on the goods and services that are subject to VAT and those that will receive special treatment. Full details of the scope of VAT implementation were revealed in the VAT Law's executive regulations, UAE Cabinet Decision No. 52 of 2017, which outlines supply of goods and services in all cases, including supply in special cases, supply of more than one component and exemptions related to legal supply. The regulations also define mandatory tax registration, optional tax registration, registrations that are liable to exceptions, tax grouping and deregistration.

Separately, the Ministry of Finance has announced that it is still studying reforms to the corporate tax regime, that the tax rate is under study and that businesses will be given at least one year to prepare for any changes. As there are still many stages to go through before the laws are enacted, there is still no firm timeline for implementation of the corporate tax legislation.

The economic slowdown that affected the UAE following the global financial crisis highlighted the inadequacy of the bankruptcy and insolvency law. The new Bankruptcy Law of the UAE was enacted on 20 September 2016 as Decree-Law No. 9 of 2016 and came into effect on 31 December 2016. The new Bankruptcy Law replaces and repeals the previous legislation on the subject: Book 5 of the UAE Federal Law No. 18 of 1993 promulgating the Code of Commercial Practice. Perhaps the most important new feature of the new Bankruptcy Law is the introduction of a regime that allows for protection and reorganisation of distressed businesses. It will be interesting to see how the new Law is implemented in practice and whether debtors make use of its provisions. Nevertheless, the introduction of an insolvency regime that offers protection and encourages restructuring to enable troubled businesses to survive what would otherwise have been a bankruptcy situation is welcome, and is a milestone development in the UAE's business law landscape.

In addition to the new Bankruptcy Law, the Commercial Companies Law contains provisions for the dissolution of a company. The Penal Code of the UAE (contained in Federal Law No. 3 of 1987) also contains criminal sanctions for bankrupts.

The Commercial Companies Law provides for the dissolution of a company in certain prescribed circumstances, including where the losses to a company amount to half of its capital. All debts of the company become due and owing upon the company's dissolution. If the company's assets are not sufficient to meet all the debts, then the liquidator is required

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10 Each emirate, except for Umm Al Quwain, has an income tax decree. The income tax decrees of the emirates of Fujairah (1966), Sharjah (1968), Ajman (1968), Dubai (1969) and Ras Al Khaimah (1969) are based on, and broadly similar to, the Emirate of Abu Dhabi Income Tax Decree of 1965.

to make proportional payment of those debts, without prejudice to the rights of preferred creditors. Every debt arising from acts of liquidation must be paid out of the company's assets in priority over other debts.

There have been reports in the past few years that the UAE is working on a personal insolvency law. However, at the time of writing, the time frame for realisation of this law cannot be predicted.

#### **v Role of exchanges, central counterparties and rating agencies**

The SCA is responsible for the regulatory oversight of the ADX and the DFM.<sup>11</sup> In addition to the rules and regulations of the SCA, each exchange has its own rules and regulations.

The ADX and the DFM each have a clearing, settlement, depository and registry departments that operate a clearing, settlement and depository system (CSD) and are responsible for the clearing and settlement of transactions executed on the exchange. Each exchange follows a multilateral netting system under which transactions are cleared and settled on a net basis by brokers. After the clearing of transactions by the exchange, the transfer of securities ownership is made through the electronic book-entry system operated by that exchange.

To buy or sell securities listed on the ADX or the DFM, an investor must apply for and be granted an identification number, called an investor number (IN), by the relevant exchange. The issuance of an IN triggers the creation of an investor account for the custody of shares traded on the exchange (custody account). The IN identifies the investor's account in the CSD. In addition to the custody account, every investor must have at least one trading account with a licensed broker.

All shares traded on the ADX and the DFM are in dematerialised (electronic) form. Ownership of shares is reflected in a computerised credit entry in the investor account.

All trading is done through licensed brokers. An investor must have at least one trading account with a licensed broker but can have accounts with multiple brokers. To open an account with a broker, an investor has to enter into a customer agreement with the broker. The investor must also give the broker a power of attorney authorising the broker to execute any written share transfer form on behalf of the investor in relation to any trades executed on the applicable exchange by the broker. The broker will process buy or sell orders from the investor upon receipt of instructions in the manner specified in the customer agreement.

To sell listed securities, investors must transfer the securities from their custody account to their trading account with a broker. Upon receiving a sell order, the broker will record the order on the electronic trading system. The system matches buy and sell orders of a particular stock based on the price and quantity requirements. The cash settlement is done among brokers through the designated settlement bank. Once the trade is executed, the investor will be notified of confirmation of the deal, and the transfer of share ownership occurs electronically by debits and credits to the custody accounts of the seller and buyer.

As a legal matter, the transfer of securities occurs by way of contractual assignment. At the time sellers of securities transfer the securities from their custody account to their trading account with a broker, the obligation to settle transfers to the broker. However, the seller

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11 NASDAQ Dubai is not regulated by the SCA but by the DFSA, and is part of the separate regulatory regime applicable in the DIFC. As already noted, the regulatory scheme applicable in the DIFC is beyond the scope of this chapter.

is still at risk until payment is actually received. Every broker is required to submit a bank guarantee of at least 10 million UAE dirhams, and the seller may draw upon this guarantee if payment is not received.

Although the ADX and the DFM each operates a CSD, neither acts as a central counterparty in the sense that neither legally guarantees the completion of transactions on the exchange. The economic risk of clearing and settlement is intended to be addressed by the bank guarantees required by each accredited broker and the trading limits imposed on the brokers.

There are no UAE-based rating agencies. Some UAE issuers have securities rated by international rating agencies such as Moody's and Standard & Poor's.

In May 2018, the SCA issued Chairman of the SCA Board of Directors' Decision No. (18/RM) of 2018 Concerning the Licensing of Credit Rating Agencies. Pursuant to these regulations, the SCA is now regulating credit rating agencies in the UAE. A credit rating agency may only be carried out in the UAE subject to obtaining a licence from the SCA.

#### **vi Other strategic considerations**

Under the current law, all companies incorporated in the UAE must have majority UAE ownership. In addition, the authorities impose additional restrictions on the ownership of some publicly traded companies. As a result of these restrictions, the demand from foreign investors for shares in certain publicly traded companies may, at times, exceed the number of shares permitted to be sold to foreign nationals. Many UAE banks will hold shares in publicly traded companies on behalf of clients through custodial arrangements. A riskier strategy for an investor is to use an unregulated individual holding UAE nationality as a proxy to hold shares on the investor's behalf.

It is possible to register a security interest over listed securities with the relevant exchange. In practice, however, the registration fees charged by the ADX and the DFM are often deemed to be prohibitively expensive by investors and secured parties, who sometimes opt for the cheaper but far riskier alternative (from the perspective of the secured party) of an unregistered contractual pledge.

### **III OUTLOOK AND CONCLUSIONS**

The pace of legislative and regulatory change in the UAE has generally been slow. Predictions about future developments are difficult to make. At the current time, there is speculation that the government could liberalise laws regarding foreign ownership of businesses in certain yet-to-be-identified sectors. VAT was introduced in 2018 at a rate of 5 per cent, and some commentators believe this rate may be increased in the coming years. More generally, taxation is an area that could see changes in the future. While the UAE has historically been a tax-free haven, the implementation of corporate income tax in the future is a possibility. A new Commercial Companies Law was enacted in 2015 and, at the time of writing, there is speculation that further amendments may be forthcoming in the near future.

While still in its nascent stage, the cryptocurrency market is gaining ground in the UAE. According to the website CoinSchedule, the UAE ranked seventh (tied with Germany) in the world for crypto token sales in 2019 for the period from 1 January 2019 to 8 September 2019. It is anticipated that the cryptocurrency market in the UAE will continue to grow.

# UNITED KINGDOM

*Anna Delgado, Tim Morris, Thomas Picton, Paul Miller and Jonathan Walsh<sup>1</sup>*

## I INTRODUCTION

### i Prudential Regulation Authority

For many years, the United Kingdom's regulation of financial markets and of providers of financial services was in the hands of a statutory body known as the Financial Services Authority (FSA). However, in the wake of the financial crisis of 2008, the responsibility for prudential supervision of systemically important banks and other providers of financial services was transferred to the Bank of England in its capacity as the Prudential Regulation Authority (PRA). Currently, the PRA is responsible for the prudential regulation and supervision of around 1,500 UK banks, building societies, credit unions, insurers and major investment firms.

### ii Financial Conduct Authority

UK banks and other providers of financial services that do not fall within the scope of the PRA for the purposes of prudential regulation and supervision are prudentially regulated and supervised by the successor to the FSA, the Financial Conduct Authority (FCA). The FCA is also responsible for regulating and policing the conduct of all firms carrying on regulated activities in the financial services sector in the United Kingdom (UK), whether those firms are prudentially regulated and supervised by the FCA or the PRA. Therefore, PRA-regulated firms are *de facto* dual-regulated firms: by the PRA for prudential regulation and by the FCA for conduct purposes.

### *Financial services legislation*

There are two major pieces of primary legislation that govern much of the activity in financial services in the UK: the Financial Services and Markets Act 2000 (FSMA) and the Banking Act 2009 (Banking Act). Much of the detail of financial services regulation in the UK is found in the Rulebook of the PRA and the FCA Handbook, which contain legally binding rules made by the PRA and the FCA, respectively, under powers granted to them by the FSMA.

In addition, much of the legislation in this area originates at the EU level and either has direct effect in the UK (and other EU Member States) without the need for any domestic

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implementing legislation, such as the Prospectus Regulation,<sup>2</sup> the Market Abuse Regulation<sup>3</sup> and the Capital Requirements Regulation,<sup>4</sup> or is given effect in the UK by provisions of the FSMA, the Banking Act, the PRA Rulebook or the FCA Handbook, such as the Transparency Directive,<sup>5</sup> the Markets in Financial Instruments Directive<sup>6</sup> (MiFID II) or the Bank Recovery and Resolution Directive.<sup>7</sup>

## II THE YEAR IN REVIEW

### i Brexit

Casting its shadow over everything in the capital markets, and elsewhere, has been the UK's decision to leave the European Union (EU). While there have been many predictions of what might happen upon exit, there have been rather fewer concrete steps that enable predictions to be made with any accuracy.

On 29 March 2017, the UK gave notice under Article 50 of the Treaty on the European Union of its intention to exit the EU, setting the exit date as 29 March 2019 and starting a process of negotiations with the EU regarding the terms of the exit and the framework of the future trading relationship between the remaining EU Member States and the UK. This original exit date has subsequently been postponed three times and is currently scheduled for 31 January 2020. A withdrawal agreement and political declaration on the future relationship between the UK and the EU was endorsed by a decision of the European Council on 17 October 2019. Among other things, the agreement provides that, although the UK will formally exit the EU on exit day, it will continue to apply EU law in such a way that it produces in the UK the same legal effects as those it produces within the EU (subject as otherwise provided in the agreement). By the same token, EU Member States will continue to treat the UK as a Member State during the transition period (subject as otherwise provided in the agreement). This transition period is scheduled to last until 31 December 2020.

However, the UK parliament has so far failed to approve the withdrawal agreement and political declaration, leaving open the very real possibility that the UK will leave the EU on exit day without any withdrawal agreement and without any transition period coming into effect. To guard against this possibility, the UK has enacted legislation in the form of the EU (Withdrawal) Act 2018 (EUWA) and several hundred pieces of secondary legislation made under the EUWA which, among other things, is intended to convert the *acquis* – the body

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2 Regulation (EU) 2017/1129 of the European Parliament and of the Council of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market.

3 Regulation (EU) No. 596/2016 of the European Parliament and of the Council of 16 April 2014 on market abuse.

4 Regulation (EU) No. 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms.

5 Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market.

6 Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments.

7 Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms.

of European legislation – into UK law at the moment of the UK's exit from the EU so that, to the greatest practical extent, the same rules and laws will apply in the UK on the day after exit as on the day before.

In addition, this legislation provides, so far as the UK is concerned, for the responsibilities of EU bodies to be reassigned to UK authorities (the Bank of England (PRA) and the FCA) and for the creation of a temporary permissions regime (TPR), which will allow firms within the European Economic Area (EEA) that have lost their passporting rights on the UK's exit from the EU to continue operating in the UK for a time-limited period after the UK has left the EU; and provide those firms wishing to maintain their UK business permanently with sufficient time to apply for full authorisation from UK regulators.

It also provides that prospectuses approved by a competent authority in another Member State of the EU and passported into the UK before exit day will be grandfathered for use in the UK until their validity expires.

## **ii Benchmark reform and LIBOR transition**

One unexpected consequence of the financial crisis of 2008 was the highlighting of both the critical importance and fragility of the major interest rate benchmarks, particularly the Interbank Offered Rates (IBORs). Following a major review, the Financial Stability Board recommended in 2014 developing alternative, nearly risk-free reference rates (RFRs).

In a speech on 27 July 2017, Andrew Bailey, the Chief Executive of the FCA, gave this process considerable momentum by questioning the future of the London Interbank Offered Rate (LIBOR) and announcing that the FCA had secured agreement from panel banks for sustaining LIBOR until the end of 2021 but that, beyond this date, the FCA would no longer use its powers to sustain LIBOR by persuading or obliging panel banks to continue to provide submissions.

Since this speech, there has been a dramatic increase in the efforts of authorities and market participants around the world to develop RFR-based benchmarks that suit market participants' requirements as well as or better than IBORs, to develop provisions for new contracts that are suitable for the new RFRs and to develop robust fallback provisions that deal more satisfactorily with a primary benchmark ceasing to be available for any reason either completely or for a prolonged period.

In the past year this has led to things such as the following:

- a* the almost complete cessation of new public issues of floating rate debt securities referencing sterling LIBOR maturing beyond the end of 2021;
- b* a significant volume, both in terms of number and value, of new public issues of floating rate debt securities referencing the Sterling Overnight Index Average benchmark (as the preferred alternative RFR for use instead of sterling LIBOR identified by the Working Group on Sterling Risk-Free Reference Rates sponsored by the Bank of England) or the Secured Overnight Financing Rate benchmark (as the preferred alternative RFR for use instead of US dollar LIBOR identified by the US Working Group, the Alternative Reference Rates Committee (ARRC), sponsored by the Federal Reserve Bank of New York);
- c* the working group on euro risk-free rates (sponsored by the European Central Bank) announcing that the Euro Overnight Index Average (EONIA) will, with effect from 2 October 2019, be recalibrated as the euro short-term rate (€STR) plus a fixed spread

- of 0.085 per cent (8.5 basis points) for a transition period covering the time from the first publication date of the €STR on 2 October 2019 until 3 January 2022, on which date EONIA will be discontinued;
- d* the European Money Markets Institute announcing that it has been granted authorisation under the Benchmarks Regulation<sup>8</sup> for the administration of the Euro-zone Interbank Offered Rate (EURIBOR) by moving to a new hybrid calculation methodology, that it intends to transition panel banks from the current EURIBOR methodology to the new hybrid methodology by the end of 2019, and that as a result of the new methodology, it does not contemplate a cessation of EURIBOR comparable to LIBOR;
  - e* the ARRC publishing recommended contractual fallback language for US dollar LIBOR-denominated floating rate debt securities; and
  - f* the first consent solicitations starting to appear in the market whose purpose is to transition outstanding issues of floating rate debt securities referencing LIBOR to instead reference one of the alternative RFRs and to insert more robust fallback language in the issue documentation.

### **iii The new Prospectus Regulation**

The new Prospectus Regulation<sup>9</sup> has applied in full in all Member States since 21 July 2019. From that date it has repealed and replaced the Prospectus Directive regime (which was given effect in the UK by Part 6 of the Financial Services and Markets Act 2000 and the FCA's Prospectus Rules). As a result, much of Part 6 of the FSMA has been repealed, and the FCA has replaced its Prospectus Rules with new Prospectus Regulation Rules.

The new Prospectus Regulation regime represents an evolutionary rather than revolutionary change from the previous Prospectus Directive regime. Most of the landscape of the Prospectus Regulation regime is familiar territory to anyone used to working under the Prospectus Directive regime. The principal differences can be summarised as follows.

#### ***Wholesale versus retail***

Under the Prospectus Directive regime debt securities with a minimum denomination of at least €100,000 or equivalent (wholesale securities) were subject to a somewhat less onerous regime than debt securities with a lower denomination (retail securities). Under the Prospectus Regulation, this less onerous regime has not only been maintained, but extended to non-equity securities that are to be traded only on a regulated market, or a specific segment of one, and to which only qualified investors have access for trading purposes. Both the Luxembourg and London stock exchanges have already established such market segments.

#### ***Summaries: exemptions extended***

The Prospectus Regulation has abolished the requirement for a base prospectus to include a summary. However, the final terms for each individual issue under the programme described in the base prospectus must have a summary of the issue annexed to it, although there is an exemption for issues of wholesale securities or securities admitted to trading on a qualified

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8 Regulation (EU) 2016/1011 of the European Parliament and of the Council of 8 June 2016 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds.

9 Regulation (EU) 2017/1129.

investors only market segment. Under the Prospectus Directive regime, the only common situation where a summary was not required for a prospectus was where the prospectus related to wholesale securities. The Prospectus Regulation extends this exemption to any prospectus that relates to the admission to trading of non-equity securities on a qualified investors only market segment.

### ***Summaries: prescriptive format***

The Prospectus Regulation has abolished the highly prescriptive requirements of the Prospectus Directive regime for the format and content of prospectus summaries. However, it has replaced these requirements with new highly prescriptive requirements for format and content. The Prospectus Regulation regime requires that a summary must not exceed seven sides of A4 paper, subject to extension in certain limited circumstances, and that it must be made up of four sections, (a) to (d):

- a* Section (a) is largely made up of health warnings;
- b* Section (b) must describe the issuer, its principal activities, its major shareholders and its key managers, a selection of historical key financial information presented in a prescribed format for each financial year covered by the prospectus and any subsequent interim financial period (accompanied by comparative data), and the most material risk factors specific to the issuer;
- c* Section (c) must describe the main features of the securities and, if there is a guarantee, the nature and scope of the guarantee, as well as a description of the guarantor (including similar information to that required in relation to the issuer) and the most material risk factors specific to the securities (and, if there is a guarantee, the guarantor); and
- d* Section (d) must describe the general terms of the offer or the admission to trading, including the total expenses and the expenses charged to the investor, and the reasons for the offer.

The overall number of risk factors that can be included in the summary (risks relating to the issuer, the guarantor (if there is one) and the securities) is limited to 15.

### ***Incorporation by reference***

The Prospectus Regulation somewhat extends the range of information that can be incorporated by reference in a prospectus. However, it retains the requirement that such information must have been published prior to or simultaneously with the prospectus, although it is sufficient that the information is published electronically, and it is no longer necessary that it be approved by or filed with any competent authority. Most significantly, all regulated information, not just filings under the prospectus or transparency regimes, is now capable of being incorporated by reference. Furthermore, historic annual and interim financial information and audit reports, wherever published and for whatever reason, are now capable of incorporation by reference.

### ***Risk factors***

The Prospectus Regulation regime requires risk factors to be presented in a limited number of categories depending on their nature and, in each category, in order of priority according to the issuer's assessment of their magnitude and potential negative impact. There is also much new emphasis on risk factors being material and specific and corroborated either by other



parts of the prospectus or by the surrounding circumstances. It remains to be seen whether this will have much effect in practice beyond intensifying the discussions between issuers and competent authorities over the drafting of risk factor sections.

### ***Registration documents***

The Prospectus Regulation has introduced a new feature into the prospectus regime: the universal registration document. This is a registration document drawn up by an issuer that already has securities admitted to trading on a regulated market or a multilateral trading facility in a Member State and that is designed to enable an issuer to fast track the approval of its prospectuses, and to avoid duplication of filings under the prospectus regime and the transparency regime. However, it is doubtful that in practice this innovation will have much impact. Nevertheless, it is worth noting that under the new regime it is possible to passport registration documents (including universal registration documents) in certain circumstances.

### ***Financial intermediaries***

The Prospectus Regulation imposes new obligations on financial intermediaries through which securities are purchased or subscribed:

- a* to inform investors of the possibility of a supplement being published; where and when it would be published; and that the financial intermediary would assist them in exercising their rights to withdraw acceptances; and
- b* to contact investors on the day when any supplement is published.

This may require many financial intermediaries to introduce new compliance procedures and also to ensure that they are promptly notified by an issuer when it publishes any supplement.

### ***Advertisements***

When it comes to advertisements concerning prospectuses, little has changed except the definition (in the Prospectus Regulation) of what constitutes an advertisement. While under the Prospectus Directive regime an advertisement has to be an announcement, under the Prospectus Regulation regime a communication is sufficient. This suggests a wider category, including such things as bilateral conversations, to which it may not be straightforward to apply the Prospectus Regulation regime's advertisement requirements.

### ***Profit estimates and forecasts***

Under the Prospectus Regulation regime, if an issuer has published a profit forecast or a profit estimate (which is still outstanding and valid):

- a* in the case of non-equity securities, inclusion of that profit forecast or profit estimate in the prospectus is voluntary;
- b* in the case of equity securities, that profit forecast or profit estimate must be included in the prospectus; and
- c* in all cases, the Prospectus Directive's requirement to include an accompanying accountant's or auditor's report is removed.

This last point is particularly significant for a number of medium-term note issuers that publish preliminary annual results that fall within the definition of a profit estimate. Unless they are willing to pay for an accountant's or auditor's report (and the accountant or auditor is willing

to provide one), such issuers have under the Prospectus Directive regime found themselves effectively unable to use their programmes from the date of publication of the preliminary results until the full annual results are published and incorporated in the programme base prospectus. This problem should no longer arise under the Prospectus Regulation regime.

Finally, while the Prospectus Regulation has repealed the Prospectus Directive and all regulations made under it, it provides that prospectuses approved in accordance with the national laws transposing the Prospectus Directive before 21 July 2019 shall continue to be governed by that national law until the end of their validity, or until 21 July 2020, whichever occurs first.

#### **iv Sustainable finance**

In December 2015, governments from around the world adopted the Paris Agreement on climate change, and in the same year the UN adopted its 2030 Agenda for Sustainable Development, which has at its core 17 sustainable development goals. Following on from this, in 2016 the European Commission appointed a High-Level Expert Group on sustainable finance, which on 31 January 2018 published its final report offering a comprehensive vision on how to build a sustainable finance strategy for the EU. Building upon the report of the Group, on 8 March 2018 the European Commission published its Action Plan on Financing Sustainable Growth, unveiling its strategy for a financial system that supports the EU's climate and sustainable development agenda. The Action Plan is part of broader efforts to connect finance with the specific needs of the European and global economy for the benefit of the planet and society.

Following the publication of the Action Plan, the Commission established the Technical Working Group on Sustainable Finance, and on 18 June 2019 it published reports and guidelines relating to its four key deliverables:

- a* EU Taxonomy for sustainable activities;
- b* EU Green Bond Standard;
- c* EU Climate Benchmarks and Benchmarks' ESG<sup>10</sup> Disclosures; and
- d* guidelines on the disclosure of environmental and social information.

In parallel, in May 2018, the Commission adopted the following package of legislative proposals:

- a* the Taxonomy Regulation: Proposal<sup>11</sup> for a regulation on the establishment of a framework to facilitate sustainable investment, which introduces an EU-wide taxonomy of environmentally sustainable activities. This envisages that the taxonomy will be rolled out progressively over time. It has been designed to identify a broader spectrum of sustainable activities than only assets, and it includes a roadmap for the taxonomy to be finalised, step by step, through a series of delegated acts scheduled for publication between 2019 and 31 December 2022;
- b* the Disclosure Regulation: a proposal<sup>12</sup> for a regulation on disclosures relating to sustainable investments and sustainability risks, which imposes new transparency and disclosure requirements on firms that receive a mandate from their clients or beneficiaries to take investment decisions on their behalf;

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<sup>10</sup> Environmental, social and governance.

<sup>11</sup> COM(2018) 353.

<sup>12</sup> COM(2018) 354.

- c* the Low Carbon Benchmark Regulation amending the Benchmarks Regulation to introduce two new categories of benchmarks – low carbon benchmarks and positive carbon impact benchmarks – has now been approved by the Council and is awaiting publication in the OJ; and
- d* the Delegated Regulation: a delegated regulation that amends delegated regulations made under the MiFID II Directive, and a delegated regulation that amends delegated regulations made under the Insurance Distribution Directive,<sup>13</sup> which together will amend the product governance regime to require investment firms and insurance distributors to ask their clients about their preferences concerning ESG, and then to take them into account when advising their clients.

All of these Commission proposals are still going through the EU legislative process. In March and April 2019, the European Parliament announced it had reached agreed positions on all of these measures, and the Council is in the process of adopting positions on them.

In parallel with this action at an EU level, on 2 July 2019, the UK government published its Green Finance Strategy, which aims to align private sector financial flows with clean, environmentally sustainable and resilient growth, supported by government action, and strengthen the competitiveness of the UK financial sector.

Major elements of this Strategy include:

- a* setting out the government's expectation for all listed companies and large asset owners to disclose in line with the Financial Stability Board's taskforce on climate-related financial disclosure (TCFD) recommendations by 2022;
- b* consulting in 2019 on TCFD guidance for pension schemes with a view to putting it on a statutory footing during 2020;
- c* establishing a joint taskforce with UK regulators that will examine the most effective way to approach disclosure, including exploring the appropriateness of mandatory reporting; and
- d* clarifying the responsibilities of the PRA, the FCA and the Financial Policy Committee regarding the climate change commitments in the Paris Agreement when carrying out their duties.

The government says it will publish an interim report by the end of 2020, including progress on the implementation of the TCFD recommendations, and it will formally review progress against the objectives of the Strategy by 2022.

## **v The new Securitisation Regulation**

The main development in the securitisation market has been the final agreed text from the European Parliament of the regulations dealing with capital treatment and permissible structures for securitisation transactions. What is referred to as the Securitisation Regulation was issued in two parts:

- a* Regulation (EU) 2017/2401, amending the regulations dealing with prudential requirements for credit institutions and investment firms, essentially amending the capital requirements regulations; and
- b* the much-awaited (and discussed) Regulation (EU) 2017/2402 of 12 December 2017 introducing (and laying down) a general framework for securitisation and creating a

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13 (EU) 2016/97.

new category of securitisations to be known as simple, transparent and standardised (STS). Securitisations that satisfy the criteria for STS will attract favourable capital treatment for institutional investors.

The new regulations comprise a significant number of criteria to be complied with by those seeking to have their transactions accepted as STS, and applies to originators, sponsors, original lenders and securitisation special purpose entities. There are detailed requirements dealing with both asset-backed commercial paper (ABCP) programmes and transactions, and non-ABCP (i.e., term asset-backed securities). The due diligence requirements are extensive, as are the new reporting requirements to ensure that the transparency conditions are met. A number of the key provisions provide for the supplement to the basic text of the regulations of regulatory technical standards or implementing technical standards to be submitted by the European Securities and Markets Authority or the European Banking Authority, such as those relating to notification, risk retention and homogeneity (in relation to underlying securitisation exposures). New bodies will also participate in the STS process, such as the Securitisation Repositories (to store all the information to be required to be supplied as part of the STS accreditation) and third-party verification agencies, to assist parties with the substantial compliance process envisaged by the new regime. Notwithstanding the fact that the STS regime has applied since January 2019, there is still a great deal of detail to be fully understood. Accordingly, a number of transactions are already being structured in anticipation of the new compliance. Since the UK is still a party to these arrangements, at least until 31 October 2019, many UK deals are also being structured to take account of these new rules using the transitional arrangements set out in the regulations. How Brexit will affect these transactions is as yet uncertain.

## **vi Tax**

HM Treasury and HMRC have been leading discussions with advisers around potential changes to the UK tax regime for securitisation vehicles to ensure that the UK regime for them remains competitive and appropriately focused. Any change is still some way off, however.

The Finance Act 2018 extended the exemption from withholding tax on payments of interest made on quoted Eurobonds to cover debt admitted to trading on a multilateral trading facility (MTF) operated by an EEA-regulated stock exchange. An MTF is defined as a multilateral system, operated by an investment firm or a market operator, that brings together multiple third-party buying and selling interests in financial instruments – in the system and in accordance with non-discretionary rules – in a way that results in a contract in accordance with Title II of MiFID II. This extension has notably brought within the ambit of the quoted Eurobond exemption the London Stock Exchange's International Securities Market and the Vienna Stock Exchange's Dritte Markt.

There is a further exemption from withholding tax on interest that applies to qualifying private placements (QPP). Some complex interplay between those QPP rules and the new double tax treaties with Jersey, Guernsey and the Isle of Man had meant that there was some uncertainty as to whether entities in those jurisdictions could benefit from the QPP exemption. It has now been clarified that they are not able to do so.

### **III OUTLOOK AND CONCLUSIONS**

Looming large over everything in the UK in the coming months will be the process of Brexit and its impact on all aspects of the UK economy. In the event that the UK exits the EU on 31 January 2020 on the basis of the withdrawal agreement and political declaration agreed on 17 October 2018, then a transition period will come into effect lasting from exit day until 31 December 2020 (or maybe later) during which the UK will continue to apply EU law in such a way that it produces in the UK the same legal effects as those it produces within the EU (subject as otherwise provided in the agreement). EU Member States will continue to treat the UK as a Member State (subject as otherwise provided in the agreement). For most practical purposes in the international capital market this will manifest itself as a preservation of the status quo until (at least) the end of the transition period.

On the other hand, if the UK and the EU fail to reach an agreement on the terms of the UK's withdrawal from the EU with the result that the transition period never comes into effect then it is likely that on 31 January 2020 the UK will exit the EU and simply become a third country as far as EU legislation is concerned. To prepare for this eventuality, HM Treasury plans to use powers in the EUWA to ensure that the UK continues to have a functioning financial services regulatory regime.

The functions of the EUWA that convert into UK domestic law the existing body of directly applicable EU law (this body of law is referred to as retained EU law) and give ministers powers to prevent, remedy or mitigate any failure of EU law to operate effectively, or any other deficiency in retained EU law are referred to by the UK government as 'onshoring'. These functions are largely given effect through secondary legislation (known as statutory instruments (SIs)) which is not intended to make policy changes other than to reflect the UK's new position outside the EU and to smooth the transition to this situation.

As part of the onshoring process, the government also plans to delegate powers to the UK's financial services regulators (the Bank of England, the PRA and the FCA) to address deficiencies in the regulators' rulebooks arising as a result of exit, and to the EU Binding Technical Standards that will become part of UK law.

To this end, HM Treasury has issued the Financial Regulators' Powers (Technical Standards etc.) (Amendment etc.) (EU Exit) Regulations 2018. Part 2 of the Regulations delegates the Treasury's powers under Section 8 of the EUWA to the FCA, the PRA, the Bank of England and the Payment Systems Regulator. Part 3 of the Regulations amends the Financial Services and Markets Act 2000 and the Financial Services (Banking Reform) Act 2013 to provide for the way in which the regulators are to exercise the legislative functions of EU bodies that may be transferred to them under the EUWA.

The government has also issued the EEA Passport Rights (Amendment, etc., and Transitional Provisions) (EU Exit) Regulations 2018. These Regulations will, in a no deal scenario, repeal the mechanism under which the UK participates in the EU passporting system and replace it with what HM Treasury calls the TPR (see Section II.i), which will allow EEA firms that have lost their passporting rights on the UK's exit from the EU to continue operating in the UK for a time-limited period after the UK has left the EU; and provide those firms wishing to maintain their UK business on a permanent basis with sufficient time to apply for full authorisation from UK regulators.

Finally a number of SIs establish the financial services contracts regime (FSCR), which will operate alongside the TPR to ensure existing contractual obligations not covered by the TPR can continue to be met.

The FSCR will be relevant where EEA firms that carry on a regulated activity in the UK via the passporting regime fail to notify the FCA that they wish to enter the TPR, or are unsuccessful in securing authorisation at the end of it, but still have regulated business in the UK to run off. Its purpose is solely to allow EEA firms to run off existing UK contracts and conduct an orderly exit from the UK market. EEA firms within this regime will not be able to write new UK business.

# UNITED STATES

*Mark Walsh and Michael Hyatte<sup>1</sup>*

## I INTRODUCTION

Regulation of the capital markets in the United States is principally conducted by federal government agencies, particularly the Securities and Exchange Commission (SEC).

The Securities Act of 1933 (Securities Act) requires that all offers and sales of securities in the United States be made either pursuant to an effective registration statement or an explicit exemption from registration. Any class of securities listed on a US exchange must be registered under the Securities Exchange Act of 1934 (Exchange Act), and the issuer of the relevant class is required to file annual and other reports with the SEC. Exchange Act registration and reporting also apply to unlisted equity securities, including securities of companies traded and organised outside the United States, held by a sufficiently large population of US record-holders. Companies with securities registered under the Exchange Act are also subject to the SEC's rules on ownership reporting and tender offers.

The perspective of the SEC statutes is that persons making investment decisions in regulated transactions should have complete and reliable information. The detailed disclosure requirements that apply to such transactions are found in the rules promulgated by the SEC under the securities laws.

In addition to the SEC, other federal and state regulators and self-regulatory organisations, such as the Financial Industry Regulatory Authority, have important roles in the oversight of the securities activities of banks, insurers and broker-dealers, in particular. Finally, the Commodity Futures Trading Commission (CFTC) continues to adopt and propose important rules relevant to the securities industry and the capital markets.

Although the SEC proposes and adopts rules under the federal securities laws every year, particularly wide-ranging rule changes were adopted in recent years as a result of the financial crisis, including those mandated by the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd–Frank Act). The thrust of the Dodd–Frank Act, which sought to increase investor protection through substantive market regulation, was somewhat at odds with the SEC's previous efforts to reduce the regulatory burden on issuers, and many argue that the Dodd–Frank Act reforms have gone so far as to have had a chilling effect on the capital markets. Reflecting these concerns, the administration of President Trump has rolled

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back some, and announced plans to further roll back other, Dodd–Frank Act reforms. While the deregulatory stance of the Trump administration is clear, so far the changes relevant to the capital markets and the US financial system have been limited.

This chapter summarises some of the more important rule changes and proposals during the past year, and important litigation, tax and other developments likely to be of interest to capital markets practitioners outside the United States.

## II THE YEAR IN REVIEW

The SEC, Congress and various administrations have long wrestled with the challenge of updating the requirements of the Securities Act, the Exchange Act and other federal securities laws to keep pace with changes in market practice and technology. There has also been the ever-present challenge of simplifying disclosure to ensure an appropriate balance between the quantity and quality of the information furnished to investors. Each of these challenges was addressed again in 2019 in the SEC rule changes and proposals discussed below. In addition, the SEC has continued to provide guidance to the market both in relation to areas of focus and the interpretation of its existing rules and regulations.

### i Developments affecting debt and equity offerings

On 6 December 2018, SEC Chairman Jay Clayton outlined the SEC's priorities for the year ahead.<sup>2</sup> He also referred to the SEC's recently published four-year strategic plan.<sup>3</sup> Under the heading 'Significant Initiatives for 2019', Chairman Clayton has identified several more immediate priorities. As well as identifying key market risks, these include completing the SEC's work on standard of conduct rules for investment professionals; facilitating capital formation and access to investment opportunities for retail investors, including by streamlining, harmonising and improving the 'patchwork' of securities offering exemptions currently in place; assessing the continued need for quarterly reporting by domestic reporting companies, and other efforts to encourage long-term investment; and addressing investor protection concerns in relation to distributed ledger technology, digital assets and initial coin offerings. Over the past year, the SEC has made tangible progress in relation to most of these issues.

#### *Addressing Brexit, LIBOR, cybersecurity and other risks in SEC filings*

In his December 2018 remarks, SEC Chairman Clayton identified three market risks the SEC staff was monitoring: Brexit, LIBOR and cybersecurity.

##### *Brexit*

Chairman Clayton has indicated that he had requested that SEC staff focus on the disclosures companies are making about Brexit, having noted considerable variations of disclosures, even within the same industry. Having directed the staff to monitor whether Brexit-related information and material risks are being effectively communicated to investors, he indicated he would like to see fewer generic disclosures and more thoughtful and appropriately detailed

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2 SEC Rulemaking Over the Past Year, the Road Ahead and Challenges Posed by Brexit, LIBOR Transition and Cybersecurity Risk, available at <https://www.sec.gov/news/speech-clayton-120618>.

3 SEC Strategic Plan Fiscal Years 2018-2022, available at [https://www.sec.gov/files/SEC\\_Strategic\\_Plan\\_FY18-FY22\\_FINAL\\_0.pdf](https://www.sec.gov/files/SEC_Strategic_Plan_FY18-FY22_FINAL_0.pdf).



disclosures about how management are considering Brexit and its potential impacts on companies and their operations. The SEC continues to work with its domestic and non-US counterparts to identify and plan for potential Brexit-related impacts.

### *LIBOR*

Chairman Clayton referred to the significant risks faced by many market participants in how to manage the transition from LIBOR to a new rate (such as SOFR, the recommended alternative rate for US dollar LIBOR), particularly with respect to those existing contracts that will still be outstanding when LIBOR is phased out in 2021. In terms of the documents governing LIBOR-based instruments, questions to be addressed include whether fallback language exists and, if it exists, whether it will work correctly in such a situation. If not, will consents be needed to amend the documentation, bearing in mind that consents can be difficult and expensive to obtain?

Chairman Clayton's remarks were expanded upon by the SEC staff in a 12 July 2019 staff statement on LIBOR transition.<sup>4</sup> Beyond the implications for registrants on their existing contracts, the statement noted the potential impact on their businesses more broadly, such as on strategy, products, processes and information systems. It suggested that 'prudent risk management may necessitate the establishment of a task force to assess the impact of financial, operational, legal, regulatory, technology, and other risks'.<sup>5</sup> Supplementing these broader remarks, various divisions of the SEC's staff set out more specific guidance for affected market participants, with the Division of Corporation Finance encouraging companies to consider the following guidance in deciding what disclosures are relevant and appropriate:

- a* since the evaluation and mitigation of risks related to the expected discontinuation of LIBOR may span several reporting periods, reporting companies should consider disclosing the status of company efforts to date and the significant matters yet to be addressed;
- b* when a company identifies a material exposure to LIBOR but does not yet know or cannot yet reasonably estimate the expected impact, it should consider disclosing the uncertainty; and
- c* disclosures that allow investors to see this issue through the eyes of management are likely to be the most useful for investors, which may entail sharing information used by management and the board in assessing and monitoring how the transition from LIBOR to an alternative reference rate may affect a company. This could include qualitative disclosures and, when material, quantitative disclosures, such as the notional value of contracts referencing LIBOR and extending past 2021.

The Division noted that LIBOR risks were being highlighted most by larger companies in the real estate, banking and insurance industries, but recommended increased focus on the issue by other registrants as well.

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<sup>4</sup> 'SEC Staff Statement on LIBOR Transition', available at <https://www.sec.gov/news/public-statement/libor-transitions> (LIBOR Policy Statement).

<sup>5</sup> LIBOR Policy Statement at page 3.

### *Cybersecurity*

Chairman Clayton noted that investors are entitled to be informed about the material cybersecurity risks and incidents affecting the companies in which they invest, and referred to the extensive interpretative guidance published by the SEC earlier in 2018.<sup>6</sup> The SEC's seriousness of purpose in relation to this issue was made clear in its 24 July 2019 US\$100 million settlement with Facebook (the largest penalty ever imposed by the SEC in a disclosure-related case) in relation to the inadequacy of its risk factor disclosure concerning data losses and related failings in disclosure controls and procedures mandated under the Exchange Act. Although Facebook had a generic risk factor about data that 'may' be improperly accessed, it had access to enough information to know that was more than a theoretical possibility. As the SEC stated: 'Public companies must identify and consider the material risks to their business and have procedures designed to make disclosures that are accurate in all material respects, including not continuing to describe a risk as hypothetical when it has in fact happened'.<sup>7</sup>

### *Risk identification and categorisation*

On 8 August 2019, the SEC proposed amendments to Regulation S-K of relevance to foreign private issuers filing on Forms F-1, F-3 and F-4 (the Securities Act forms used by them in connection with most capital raisings).<sup>8</sup> The proposed amendments would require:

- a* summary risk factor disclosures if the risk factor section exceeds 15 pages, with the summary to consist of a bullet point list summarising the principal risk factors, to appear at the front of the registration statement under an appropriate heading;
- b* disclosure of the material rather than the most significant risks facing the company to encourage companies to disclose the risks to which a reasonable investor would attach importance in making investment decisions; and
- c* organisation of risk factors under relevant headings (already a common practice) and, if a company discloses generic risks that could apply to any company or offering (which continues to be discouraged), they will be required to appear at the end of the risk factor section under the caption 'General Risk Factors'.

The overall effect would be to align US risk factor disclosures more closely with recent changes in Europe under the EU Prospectus Regulation, which became effective in July 2019.

Partly because Form 20-F (the Exchange Act form for annual reporting by foreign private issuers) has for some time been already aligned with the IOSCO requirements for disclosure in cross-border security offerings, the SEC has not proposed corresponding amendments to Form 20-F. However, it has solicited comment from market participants as to whether such further amendments (as well as amendments to business and legal proceedings disclosure) would be appropriate.

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6 'Commission Statement and Guidance on Public Company Cybersecurity Disclosures' available at <https://www.sec.gov/rules/interp/2018/33-10459.pdf>.

7 'Facebook to Pay \$100 Million for Misleading Investors About the Risks It Faced from Misuse of User Data' available at <https://www.sec.gov/news/press-release/2019-140>.

8 'Modernisation of Regulation S-K Items 101, 103, and 105' available at <https://www.sec.gov/rules/proposed/2019/33-10668.pdf>.

### ***Modernisation and simplification of existing disclosure requirements***

On 20 March 2019, the SEC adopted rule amendments to modernise and simplify Securities Act and Exchange Act disclosure requirements applicable to both domestic and foreign private issuers<sup>9</sup>. The amendments, which are reflected in Regulation S-K and various SEC forms (including Form 20-F), implemented several of the recommendations in the SEC staff's Report on Modernisation and Simplification of Regulation S-K,<sup>10</sup> which was submitted to Congress in November 2016.

Among the more noteworthy amendments are the following:

#### *Reducing the burden on filing exhibits*

The SEC amended Regulation S-K and related SEC forms (including Form 20-F) to allow registrants to:

- a* redact confidential information from material contracts without having to first submit a confidential treatment request to the SEC, so long as such information is not material and would be likely to cause competitive harm to the registrant if publicly disclosed;
- b* omit immaterial schedules and attachments from all exhibits; and
- c* omit personally identifiable information.

SEC examiners may question omissions from exhibits and request a company's justification for a claim. It also limits to newly reporting registrants the requirement to file material contracts that were entered into within two years of the applicable registration statement or report.

#### *Streamlining management discussion and analysis disclosure by excluding discussion of the earliest year of the financials*

The SEC amended Regulation S-K and related SEC forms (including Form 20-F) to allow registrants, when financial statements included in a filing cover three years, to eliminate management discussion and analysis (MD&A) discussion of the earliest year if such discussion was already included in any other of the registrant's prior filings on EDGAR. Where the discussion of the earliest year is omitted, there must be a cross-reference to the prior filing in which the discussion may be found. The amendments add an instruction that emphasises that registrants have discretion to use any form of MD&A presentation that would enhance investors understanding (and are not limited to using year-to-year comparisons).

#### *Offering-related amendments*

The SEC has adopted amendments to Regulation S-K and related SEC forms (including Forms F-1, F-3 and F-4) to streamline the information required on a prospectus cover page by explicitly allowing registrants to state that the offering price will be determined by a particular method or formula that is more fully explained in the prospectus (with a cross-reference to such disclosure) and exclude the portion of the legend relating to state law for offerings that are not prohibited by state blue-sky laws.

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<sup>9</sup> 'FAST ACT Modernisation and Simplification of Regulation S-K' is available at <https://www.sec.gov/rules/final/2019/33-1061.8.pdf>.

<sup>10</sup> The FAST Act Report is available at <https://www.sec.gov/reports/sec-fast-act-report-2016.pdf>.

*Other significant amendments*

- a* the amendments clarify that a description of property is required only to the extent physical properties are material to the registrant and may be provided on a collective basis, if appropriate. However, this clarification does not apply to companies in the mining, real estate and oil and gas industries.
- b* the amendments require that a brief description of the registrant's registered capital stock, debt securities, warrants, rights, American depositary receipts (ADRs) and other securities must be filed as an exhibit to Form 10-K or Form 20-F rather than limiting this disclosure to registration statements (as is currently the case). The required descriptions may be incorporated by reference to other hyperlinked filings;
- c* the amendments require the disclosure of trading symbols for each class of the registrant's registered securities on the cover pages of the SEC forms specified, including Form 20-F; and
- d* the amendments require registrants to tag all – rather than some as currently required – of the data on the cover pages of the SEC forms specified, including Form 20-F, using Inline XBRL.

Most of the amendments to the rules are now effective, except for the cover page data tagging requirements (which are subject to a three-year phase-in). Taken together with the rule amendments adopted by the SEC in August 2018,<sup>11</sup> which eliminated numerous redundant or obsolete disclosure requirements, these latest amendments represent an important step in the SEC's efforts to improve its disclosure framework.

***SEC concept release on securities offering exemptions***

Although foreign private issuers and other registrants routinely register public offerings of securities with the SEC, many still prefer to access the US capital markets on the basis of available exemptions from SEC registration requirements. Many non-US readers will be familiar with Rule 144A and Regulation S, but the broader exempt offering framework, and the interplay between the various exemptions, is complex and less well understood.

On 18 June 2019, the SEC published a concept release soliciting public comment on 'possible ways to simplify, harmonize, and improve the exempt offering framework to promote capital formation and expand investment opportunities while maintaining appropriate investor protections'.<sup>12</sup> Although the concept release does not propose specific rule changes, input provided to the SEC by industry participants will likely play a significant role in shaping future proposed rulemaking.

The SEC's concept release covers seven broad themes as follows:

*The exempt offering framework*

The SEC wants to determine if the exempt offering framework, as a whole, is consistent, accessible and effective for both companies and investors, or whether the SEC should consider changes to simplify, improve or harmonise the exempt offering framework.

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11 'Disclosure Update and Simplification', available at <https://www.sec.gov/rules/final/2018/33-10532.pdf>.

12 'Concept Release on Harmonization of Securities Offering Exemptions' available at <https://www.sec.gov/rules/concept/2019/33-10649.pdf>.

### *The capital raising exemptions within the framework*

The SEC is considering whether there should be any changes to improve, harmonise or streamline any of the capital raising exemptions, specifically the private placement exemption and Rule 506 of Regulation D, Regulation A, Rule 504 of Regulation D, the intrastate offering exemptions and Regulation Crowdfunding.

### *Potential gaps in the framework*

The SEC is seeking to determine if there are gaps in the SEC's framework that make it difficult, especially for smaller companies, to rely on an exemption from registration to raise capital at key stages of their business cycle.

### *Investor limitations*

The SEC wishes to determine whether the limitations on persons eligible to invest in certain exempt offerings, or the amount they can invest, provide an appropriate level of investor protection (i.e., whether the current levels of investor protection are insufficient, appropriate or excessive) or pose an undue obstacle to capital formation or investor access to investment opportunities, including a discussion of the persons and companies that fall within the accredited investor definition. Historically, the SEC has given little consideration to investors' opportunity costs in its rulemaking deliberations.

### *Integration*

The SEC wants to determine if it can and should do more to allow companies to transition more easily from one exempt offering to another and, ultimately, to a registered public offering.

### *Pooled investments funds*

The SEC wants to determine whether it should facilitate capital formation in exempt offerings through pooled investment funds, including interval funds and other closed-end funds, and whether retail investors should be allowed greater exposure to growth-stage companies through pooled investment funds in light of the advantages and risks of investing through such funds.

### *Secondary trading*

The SEC wishes to determine whether it should revise its rules governing exemptions for resales of securities to facilitate capital formation and to promote investor protection by improving secondary market liquidity.

The concept release reviews the existing securities law framework for each of these topics and follows with a series of questions. The number (138 in total) and tenor of the questions, ranging from very open-ended, broad questions to very specific questions, suggest that the SEC is conducting a very thorough, fundamental inspection of the overall framework. The deadline for comments to the SEC in relation to the concept release was 24 September 2019.

### ***Other SEC initiatives relevant to debt and equity markets***

The SEC and its staff routinely adopt more targeted rule changes of relevance to issuers and underwriters and also provide guidance to the market as to the manner in which it interprets its existing rules and regulations. Notable recent examples include the following:

#### *Testing-the-waters communications*

On 26 September 2019, the SEC adopted a new Rule 163B that permits issuers (or any person authorised to act on their behalf) to gauge market interest in a possible initial public offering or other registered securities offering through discussions with specified institutional investors prior to, or following, the filing of a registration statement with the SEC. The new rule extends the SEC's 'test-the-waters' accommodation made available to emerging growth companies following the enactment of the JOBS Act. The new rule extends to permitted oral and written communications made to persons reasonably believed to be qualified institutional buyers within the meaning of Rule 144A or institutions that are accredited investors within the meaning of Regulation D. There are no SEC filing or legending requirements triggered by use of the Rule.

#### *Framework for analysis of digital assets*

On 3 April 2019, the SEC's new Strategic Hub for Innovation and Financial Technology released its much-anticipated guidance to assist market participants in their assessment of whether a distribution of digital assets amounts to an offering of securities required to be registered under the Securities Act.<sup>13</sup> The framework is based on an amalgamation of sources, including federal court decisions, SEC enforcement activities, public statements and speeches. It amounts to an interpretation of the US Supreme Court's longstanding *Howey* test for finding an investment contract cognisable as a security under the SEC statutes. The test is whether there is an investment of money in a common enterprise with a reasonable expectation of profits to be derived by the efforts of others.<sup>14</sup> Simultaneously with the publication of the framework, the SEC's Division of Corporation Finance issued a no-action letter to TurnKey Jet, Inc enabling it to offer and sell its tokens without registration under the Securities Act.

#### *Effectiveness of Inline XBRL requirements*

On 20 August 2019, the SEC published guidance in the form of compliance and disclosure interpretations to clarify the new Inline XBRL requirements.<sup>15</sup> Foreign private issuers will be required to comply with the Inline XBRL requirements based on their filer status and basis of accounting. For a foreign private issuer that prepares its financial statements in accordance with US GAAP, the phase-in of the Inline XBRL requirements is determined based on its filer status. Large accelerated filers, including foreign private issuers that prepare their financial statements in accordance with US GAAP, will be required to comply with Inline XBRL for financial statements for fiscal periods ending on or after 15 June 2019. Accelerated filers,

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13 'Framework for 'Investment Contract' Analysis of Digital Assets' available at <https://www.sec.gov/corpfin/framework-investment-contract-analysis-digitalassets>.

14 *SEC v. W J Howey Co*, 328 U.S. 293 (1946).

15 Interactive Data, Compliance – Disclosure Interpretations, available at <https://www.sec.gov/corpfin/interactive-data-cdi>.

including foreign private issuers, that prepare their financial statements in accordance with US GAAP will be required to comply with Inline XBRL for financial statements for fiscal periods ending on or after 15 June 2020. All other filers, including foreign private issuers that prepare their financial statements in accordance with IFRS, will be required to comply with Inline XBRL for financial statements for fiscal periods ending on or after 15 June 2021. The guidance also clarified that Form 20-F filers will be required to comply with Inline XBRL beginning with the first filing on a form for which Inline XBRL is required for a fiscal period ending on or after the applicable compliance date.

## **ii Developments affecting derivatives, securitisations and other structured products**

In recent years, US regulatory changes in relation to derivatives, securitisations and other structured products have been focused on rule changes mandated by the Dodd-Frank Act, including Section 619, commonly known as the Volcker Rule. During 2019, the SEC and such other regulatory authorities have continued to both implement and refine these rules, and have proposed additional rule changes for consideration.

### ***Interagency amendment of the Volcker Rule***

In September 2019, the SEC, the CFTC, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Federal Reserve Board approved amendments to the Volcker Rule.<sup>16</sup> The Rule restricts banks from engaging in proprietary trading and from owning hedge funds and private equity funds. Distinguishing between what qualifies as proprietary trading and what does not has proven to be extremely difficult. In addition, banks that do relatively little trading have been required to go through substantial compliance exercises to ensure that activities that have long been regarded as traditional banking activities do not violate the Volcker Rule.

Among other things, the final Rule will:

- a* tailor the Rule's compliance requirements based on the size of a firm's trading assets and liabilities, with the most stringent requirements applied to banking entities with the most trading activity;
- b* clarify that banking entities that trade within internal risk limits set under the conditions in the final Rule are engaged in permissible market making or underwriting activity;
- c* streamline the criteria that apply when a banking entity seeks to rely on the hedging exemption from the proprietary trading prohibition;
- d* limit the impact of the rule on the foreign activities of foreign banking organisations; and
- e* simplify the trading activity information that banking entities are required to provide to the agencies.

The final Rule is scheduled to become effective from 1 January 2020.

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<sup>16</sup> 'Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds', available at <https://www.fdic.gov/news/board/2019/2019-08-20-notice-dis-a-fr.pdf>.

***SEC adopts requirements for security-based swap dealers and major security-based swap participants and amends capital and segregation requirements for broker-dealers***

On 21 June 2019, the SEC took another significant step towards establishing the regulatory regime for security-based swaps dealers by adopting a package of measures under the Dodd-Frank Act.<sup>17</sup> These and other rules previously adopted by the SEC are designed to enhance the risk mitigation practices of firms that stand at the centre of the security-based swap market, thereby protecting their counterparties and reducing risk to the market as a whole.

The rules address four key areas:

- a* they establish minimum capital requirements for security-based swap dealers and major security-based swap participants for which there is not a prudential regulator non-bank security-based swap dealers (SBSDs) and major security-based swap participants (MSBSPs). They also increase the minimum net capital requirements for broker-dealers that use internal models to compute net capital (ANC broker-dealers). In addition, they establish capital requirements tailored to security-based swaps and swaps for broker-dealers that are not registered as an SBSD or MSBSP to the extent they trade these instruments;
- b* they establish margin requirements for non-bank SBSDs and MSBSPs with respect to non-cleared security-based swaps;
- c* they establish segregation requirements for SBSDs and stand-alone broker-dealers for cleared and non-cleared security-based swaps; and
- d* they amend the SEC's existing cross-border rule to provide a means to request substituted compliance with respect to the capital and margin requirements for foreign SBSDs and MSBSPs, and provide guidance discussing how the SEC will evaluate requests for substituted compliance.

***SEC proposes to align margin requirements for security futures with requirements for similar financial products***

On 3 July 2019, the SEC proposed to align the minimum margin required on security futures with other similar financial products.<sup>18</sup> The proposal, made jointly with the CFTC, would set the minimum margin requirement for security futures at 15 per cent of the current market value of each security future.

In 2002, the SEC and CFTC adopted rules establishing margin requirements for unhedged security futures products at 20 per cent. In light of lower margin requirements that have been established for comparable financial products and the resulting asymmetry, the SEC and CFTC have determined that it is appropriate to reexamine the minimum margin required for security futures.

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17 'Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital and Segregation Requirements for Broker-Dealers', available at <https://www.sec.gov/rules/final/2019/34-86175.pdf>.

18 'Customer Margin Rules Relating To Security Futures', available at <https://www.sec.gov/rules/proposed/2019/34-86304.pdf>.



***SEC proposes actions to improve the cross-border application of security-based swap requirements***

On 10 May 2019, the SEC proposed a package of rule amendments and interpretive guidance to improve the framework for regulating cross-border security-based swap transactions and market participants.<sup>19</sup>

The proposals are intended to improve the regulatory framework by pragmatically addressing implementation issues and efficiency concerns, and in some cases further harmonising the regulatory regime governing security-based swaps administered by the SEC with the regulatory regime governing swaps administered by the CFTC.

The proposing release addresses four key areas:

- a* the use of transactions that have been arranged, negotiated, or executed by personnel located in the US as a trigger for regulating security-based swaps and market participants;
- b* the requirement that non-US resident security-based swap dealers and major security-based swap participants certify and provide an opinion of counsel that the SEC can access their books and records and conduct onsite inspections and examinations;
- c* the cross-border application of statutory disqualification provisions; and
- d* the questionnaires or employment applications that security-based swap dealers and major security-based swap participants must maintain with regard to their foreign associated persons.

**iii Bankruptcy and other US cases of relevance to the capital markets**

During 2019, US federal courts have rendered judgments in relation to several cases of interest to capital markets practitioners, some of which are discussed below. Very often the issue in question has been the extraterritorial application of US laws and the jurisdictional reach of US courts.

***US Supreme Court denies certiorari in Stoyas v. Toshiba Corporation***<sup>20</sup>

After the Supreme Court's 2010 decision in *Morrison v. National Australia Bank*,<sup>21</sup> US courts have typically held that foreign issuers whose securities are traded in the US via ADRs or American depositary shares (ADSs) cannot be sued under Section 10(b) of the Securities Exchange Act and Rule 10b-5 by purchasers or sellers of a company's stock traded abroad, but can be sued by buyers or sellers of ADRs<sup>22</sup> if the suit is based on a purchase or sale on a US exchange or that otherwise takes place in the US (such as an over-the-counter (OTC) trade or private placement in which the parties commit to the trade within the US). However, those cases have typically addressed sponsored ADR facilities, in which there could be no question of the issuer's involvement. In 2016, the decision of the US District Court in *Stoyas* was the first to expressly rule on how *Morrison* applies to unsponsored ADR facilities. The *Stoyas* court held that a foreign issuer's lack of involvement in the unsponsored facility means it cannot be sued for statements it made to the markets overseas. On appeal, in 2018, the

<sup>19</sup> 'Proposed Rule Amendments and Guidance Addressing Cross-Border Application of Certain Security-Based Swap Requirements', available <https://www.sec.gov/rules/proposed/2019/34-85823.pdf>

<sup>20</sup> *Stoyas v. Toshiba Corp*, 191 F.Supp.3d 1080 (C.D. Cal. 2016) (*Stoyas I*), rev'd, 896 F.3d 933 (9th Cir. 2018).

<sup>21</sup> *Morrison v. Nat'l Australia Bank Ltd*, 561 U.S. 247 (2010).

<sup>22</sup> ADR and ADS are used interchangeably here, despite the distinct role of the two instruments in trading.

Ninth Circuit reversed, holding that an issuer can be sued by purchasers of ADRs through an unsponsored facility, although it left open some questions.<sup>23</sup> Toshiba petitioned the Supreme Court to hear the case, which it declined to do.

After *Morrison* held that Section 10(b) applies only to transactions in the United States, most of the decisions on the territorial application of Section 10(b) have focused on where off-exchange transactions take place. For example, the Southern District of New York, in *Satyam Computer Services Ltd Securities Litigation*, held that Section 10(b) did not cover the exercise of employee stock options to buy NYSE-listed ADSs in an Indian corporation because the terms of the options (as written by the company) deemed them to be exercised only when notice was received in India.<sup>24</sup> The fact that the company did not consent to options on its ADSs being transacted in the United States, regardless of the listing of the underlying security, was thus important in *Satyam*, but the court was still addressing securities with which the company was involved. By contrast, the Second Circuit's decision in *ParkCentral Global Hub Ltd v. Porsche Automobile Holdings* found that US trading alone was not sufficient if the company had no connection to the security – but *ParkCentral* involved swaps, not ADRs, and an unusual fact pattern in which the defendant was not the issuer but a potential acquirer.<sup>25</sup>

*Stoyas* presented the question squarely: the defendant, Toshiba, has only stock listed on the Tokyo and Nagoya exchanges and ADRs traded on US OTC markets – specifically, OTC Link – pursuant to an unsponsored ADR facility set up without the involvement of the company; it did not list or trade any securities in the United States.<sup>26</sup> The plaintiffs in *Stoyas* argued that it was enough that the issuer had complied with Rule 12g3-2's disclosure requirements (an exemption from Exchange Act registration) 'and never objected to the sale of its securities in the United States'.<sup>27</sup> The Ninth Circuit described the unsponsored ADR issuance as 'without Toshiba's 'formal participation' and possibly without its acquiescence'.<sup>28</sup>

The District Court concluded that an OTC market is not a US exchange for purposes of *Morrison's* rule that securities traded on US exchanges are covered, given that the Exchange Act treats national securities exchanges and OTC markets as distinct.<sup>29</sup> The District Court further concluded that 'Plaintiffs have not argued or pled that Defendant was involved in th[e ADS] transactions in any way . . . nowhere in *Morrison* did the Court state that US securities laws could be applied to a foreign company that only listed its securities on foreign exchanges but whose stocks are purchased by an American depository bank on a foreign exchange and then resold as a different kind of security (an ADR) in the United States'.<sup>30</sup>

On appeal, the Ninth Circuit disagreed on both points. First, as to *Morrison's* reference to Section 10(b) covering domestic exchanges,<sup>31</sup> the Ninth Circuit declined to decide whether OTC Link is a domestic exchange, but disagreed with the District Court that only national securities exchanges, as defined in the Exchange Act, qualify under *Morrison*. Second, the

23 *Stoyas v. Toshiba Corp*, 896 F.3d 933 (9th Cir. 2018) (*Stoyas II*).

24 *Satyam Computer Servs Ltd Secs Litig*, 915 F. Supp. 2d 450, 474-75 (S.D.N.Y. 2013).

25 *ParkCentral Global Hub Ltd v. Porsche Automobile Holdings SE*, 763 F.3d 198, 215-16 (2d Cir. 2014).

26 *Stoyas I*, 191 F. Supp.3d at 1084 n. 1, 1089, 1091 (noting that the depository bank had to purchase the stock on a foreign exchange); *Stoyas II*, 896 F.3d at 939.

27 *Stoyas I*, 191 F. Supp.3d at 1093.

28 *Stoyas II*, 896 F.3d at 941.

29 *Stoyas I*, 191 F. Supp.3d at 1090-91.

30 *Stoyas I*, 191 F. Supp.3d at 1094.

31 *Morrison*, 561 U.S. at 267.

Ninth Circuit criticised the Second Circuit's reasoning in *ParkCentral* and concluded that the Exchange Act covers any ADR transaction in the United States regardless of whether the facility is sponsored.<sup>32</sup> However, that was not the end, because the Ninth Circuit concluded that a claim could be stated only if there were sufficient facts pleaded to show a sufficient connection between the issuer and the transaction – a requirement that may in practice insulate some issuers who had no involvement in an unsponsored ADR facility.<sup>33</sup> The Ninth Circuit sent the case back to let the plaintiffs plead more facts on this point.<sup>34</sup> It did not, however, suggest that investors other than ADR purchasers could ever sue.

On 14 January 2019, the Supreme Court invited the Solicitor General to file an amicus brief in the *Stoyas* case to express the views of the United States.<sup>35</sup> The Solicitor General submitted the *amicus* brief in May 2019, urging the Supreme Court to deny *certiorari*. In its brief, the Solicitor General argued that the Ninth Circuit's holding in *Stoyas* was correct because the Section 10(b) claim at issue originated from a domestic transaction under *Morrison*.<sup>36</sup> Therefore, in the Solicitor General's opinion, *Stoyas* did not represent 'an impermissible extraterritorial application of Section 10(b)' because neither party disputed that the purchases of the unsponsored ADRs took place in the United States.<sup>37</sup> The Solicitor General also agreed with the Ninth Circuit, however, that the case should be remanded to allow for factual development. On 24 June 2019, the Supreme Court denied *certiorari* in the *Stoyas* case, allowing the Ninth Circuit's decision to stand and the case to be remanded for further development of the facts.<sup>38</sup> Accordingly, unless and until there are further decisions on the question, issuers of stock that is traded through ADR facilities in the United States, even if unsponsored, should consider the possibility that they will face liability to US purchasers of those ADRs.

***Second Circuit rules that presumption against extraterritoriality and international comity principles do not limit recovery of fraudulent transfer***

In February 2019, in *In re Picard*,<sup>39</sup> the Second Circuit addressed the question of whether the presumption against extraterritoriality or international comity principles limit a trustee's ability to recover property under Bankruptcy Code Section 550(a)(2) from a foreign subsequent transferee. In this case, the trustee sought to avoid an initial asset transfer made by a US debtor as an intentional fraudulent conveyance, and recover the asset from a foreign transferee that received the asset from a foreign initial transferee. The Second Circuit concluded

32 *Stoyas II*, 896 F.3d at 950.

33 *Stoyas II*, 896 F.3d at 951.

34 *Id.*

35 *Toshiba Corp v. Automotive Industries Pension Trust Fund, et al*, 2019 U.S. LEXIS 680 (2019).

36 Brief for the United States as *Amicus Curiae* on Petition for a Writ of *Certiorari* to the United States Court of Appeals for the Ninth Circuit, *Toshiba Corp v. Automotive Industries Pension Trust Fund, et al*, 2019 U.S. LEXIS 680 (2019) (No. 18-496), 2019 U.S. S. Ct. Briefs LEXIS 1836, \*15 (US Brief).

37 US Brief, 2019 U.S. S. Ct. Briefs LEXIS at \*22.

38 *Toshiba Corp v. Automotive Industries Pension Trust Fund, et al*, 2019 U.S. LEXIS 4259 (2019).

39 *In re Picard*, 917 F.3d 85 (2d Cir. 2019), petition for cert. filed sub nom. *HSBC Holdings PLC v. Irving H Picard* (U.S. 30 August 2019) (No. 19-277).

that neither doctrine precludes the trustee from recovering against the subsequent transferee. This decision provides guidance for the lower courts, which have been split on the extent to which the Bankruptcy Code's avoidance and recovery provisions apply extraterritorially.<sup>40</sup>

In *Picard*, the trustee administering the liquidation of Bernard L. Madoff Investment Securities LLC (Madoff Securities) commenced actions to avoid payments made by Madoff Securities to non-US investment funds as intentional fraudulent transfers, and recover the subsequently transferred payments from the funds' non-US investors under Bankruptcy Code Section 550(a)(2).<sup>41</sup> In a prior decision in the *Madoff* liquidation, the District Court held that the presumption against extraterritoriality would prevent a trustee from recovering property under Section 550(a)(2) if the transaction was determined to be a foreign transaction, and that international comity principles similarly limited the scope of Section 550(a)(2).<sup>42</sup> On remand, the Bankruptcy Court concluded that the factors relevant to determining whether the transactions were domestic or foreign were the locations from which the transfers were sent and the location or residence of the initial and subsequent transferee.<sup>43</sup> The Bankruptcy Court then made a factual determination that certain transactions between foreign initial transferees and foreign subsequent transferees did not have a nexus to the US, and dismissed the trustee's recovery actions under the presumption against extraterritoriality.

Rather than focusing on the domestic or foreign nature of the subsequent transfer between the fund and its investors, the Second Circuit focused on the initial transfer that was the subject of the fraudulent transfer claim, and concluded that the regulatory focus of the Bankruptcy Code's avoidance and recovery provisions was the transfer of property that depleted the estate. As a result, the Court held that the US debtor's fraudulent transfer of property from the US was a domestic activity, and therefore the presumption against extraterritoriality did not prohibit the trustee from recovering the fraudulent property under Section 550(a), regardless of the location of any initial or subsequent transfer.

With respect to principles of international comity, the Court considered whether, as a matter of statutory interpretation, a court should presume that Congress intended to limit the application of US law on a given set of facts out of respect for foreign sovereigns. The Court determined that the US has a compelling interest in allowing a US estate to recover fraudulently transferred property to assure its creditors will receive a fair share of the estate's property in a bankruptcy. The Court acknowledged that when a debtor in the US courts is also in liquidation proceedings in a foreign court, the foreign jurisdiction has at least some interest in adjudicating property disputes. However, in this case Madoff Securities was not subject to a parallel proceeding in a foreign jurisdiction. The Court determined that the fact that certain transferees were subject to foreign liquidation proceedings did not present a compelling interest to prevent the US estate from recovering fraudulently

40 See, e.g., *La Monica v. CEVA Group PLC (In re CIL Ltd)*, 582 B.R. 46 (Bankr. S.D.N.Y. 2018) (concluding that fraudulent transfer and recovery provisions cannot apply extraterritorially to foreign transactions); *Weisfelner v. Blavatnik (In re Lyondell Chem Co)*, 543 B.R. 127 (Bankr. S.D.N.Y. 2016) (concluding that Congress did intend to extend the scope of the Bankruptcy Code's avoidance powers to recover assets transferred abroad).

41 To the extent that a transfer is avoided, Section 550(a)(1) enables the trustee to recover the transferred property from the debtor's initial transferee, and Section 550(a)(2) permits a trustee to recover property from any subsequent transferee.

42 *Sec Inv'r Prot Corp v. Bernard L. Madoff Inv Sec LLC*, 513 B.R. 222 (S.D.N.Y. 2014), as supplemented by 2014 WL 3778155 (S.D.N.Y. July 28, 2014).

43 *Sec Inv'r Prot Corp v. Bernard L. Madoff Inv Sec LLC*, 2016 WL 6900689 (Bankr. S.D.N.Y. Nov. 22, 2016).

transferred property. The Second Circuit determined that the Bankruptcy Code provided no indication that trustees seeking to recover property in US proceedings should defer to a foreign transferee's liquidation proceeding, particularly where Section 550(a)(2) permits a trustee to recover fraudulently transferred assets from even remote subsequent transferees.

The Court did emphasise that the allegation that the initial transfer was an intentional fraudulent transfer was relevant to its decision, as were the facts that the debtor was a domestic entity and that the alleged fraudulent transfer occurred when property was transferred from US bank accounts. The Court noted that it was not expressing an opinion as to whether the regulatory focus of Section 550(a) would similarly be the initial transfer if it did not involve an intentional fraudulent transfer, or whether the residence of the debtor or the location of the transfer, standing alone, would support a finding that the transfer was domestic in nature. The Court further noted that whether the US adjudication would conflict with a foreign adjudication may depend on different facts in different cases. As a result, the Court left open the possibility that the extraterritoriality and international comity analysis could vary under different factual circumstances.

### ***Bankruptcy court extends application of safe harbours in Chapter 15 proceedings***

In December 2018, the Bankruptcy Court for the Southern District of New York held in *In re Fairfield Sentry Limited* that the Bankruptcy Code safe harbours for qualified financial contracts apply to actions brought by a foreign representative in a Chapter 15 case seeking to avoid foreign transfers under foreign insolvency laws.<sup>44</sup> This decision further highlights the complexities regarding how avoidance laws and safe harbours may apply when non-US parties or non-US assets are involved.

In a Chapter 15 case under the Bankruptcy Code, a debtor or its representative seeks to have a foreign insolvency or restructuring proceeding recognised by the a US bankruptcy court, which enables the foreign debtor to, among other things, protect and administer assets located in the United States and seek certain relief from the US court under the Bankruptcy Code.<sup>45</sup> Notably, a foreign representative is not permitted to pursue preference or fraudulent conveyance actions under Sections 544, 547, 548 or 550 in a Chapter 15 case.<sup>46</sup>

In *Fairfield Sentry*, foreign representatives acting as liquidators of investment funds subject to liquidation proceedings in the British Virgin Islands (BVI) commenced a Chapter 15 proceeding in the United States, and sought to recover redemption payments made to US clients under the avoidance provisions of the BVI's Insolvency Act. The redemption payments were settlement payments made in connection with securities contracts, and the defendants took the position that such payments could not be avoided under Bankruptcy Code Section 546(e)'s safe harbour.<sup>47</sup> The liquidators argued that the Bankruptcy Code's safe harbours did not apply extraterritorially, and therefore did not apply to an action brought by a foreign

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44 *In re Fairfield Sentry Limited*, 596 B.R. 275 (Bankr. S.D.N.Y. 2018).

45 See 11 U.S.C. §§ 1501 -1532.

46 See 11 U.S.C. § 1521(a)(7) (listing certain relief that may be granted to a debtor upon recognition of a foreign proceeding, including 'granting any additional relief that may be available to a trustee, except for relief available under sections 552, 544, 545, 547, 548, 550, and 724(a)').

47 Section 546(e) of the Bankruptcy Code prohibits a debtor or bankruptcy trustee from avoiding margin payments or settlement payments, or transfers in connection with a securities contract, commodity contract, or forward contract, in each case 'made by or to (or for the benefit of)' a qualified entity. For purposes of Section 546(e), a qualified entity may be a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant or securities clearing agency.

representative under foreign law to recover foreign asset transfers. The Bankruptcy Court determined that the extraterritoriality issue was not relevant, because Bankruptcy Code Section 561(d) specifically provides that a foreign representative or US bankruptcy court cannot interfere with a non-debtor counterparty's enforcement of closeout rights under a qualified protected contract, regardless of whether the collateral is within or outside of the United States; and the safe harbours limit avoidance powers in a Chapter 15 case to the same extent as in a Chapter 7 or Chapter 11 case.<sup>48</sup>

The liquidators argued that, because Section 546(e) would not apply if the proceeding was a Chapter 7 or Chapter 11 case due to the presumption against extraterritoriality, the safe harbour could not apply to the transfers as issue, which involved a foreign debtor, foreign law and transfers occurring outside of the United States. The Court rejected this argument, and concluded that Section 561(d) extends the safe harbours for qualified protected contracts in the context of a Chapter 15 case, regardless of whether the collateral was located within or outside of the United States. Because the Bankruptcy Code would not permit a foreign representative to bring an avoidance action under Sections 544, 547, 548 or 550, the Court determined that Section 561(d) necessarily refers and applies to avoidance actions brought under non-US law. As such, if the defendants were able to establish that the subject transactions were entitled to protection under Section 546(e),<sup>49</sup> the Bankruptcy Code would prevent the foreign representative from avoiding the transfers under foreign law in the Chapter 15 case.

#### **iv US tax law changes of relevance to the capital markets**

During 2019, there have been several developments in US tax law of relevance to capital markets practitioners.

##### ***FATCA guidance on gross proceeds withholding and foreign pass-through payments***

In December 2018, the US Treasury Department (Treasury) and the US Internal Revenue Service (IRS) issued proposed regulations providing guidance with respect to Sections 1471 through 1474 of the US Internal Revenue Code (Code), commonly referred to as FATCA).<sup>50</sup> The preamble to the proposed regulations states that taxpayers may generally rely on the rules therein until final regulations are issued.

Generally, FATCA requires US and non-US withholding agents (including foreign financial institutions (FFIs)) to identify who their payees are and the FATCA status of those payees. US withholding agents must withhold tax on certain payments (including gross proceeds received with respect to certain sales or other dispositions) to FFIs that do not agree to report certain information to the US regarding their US accounts and on certain payments to non-financial foreign entities that do not provide information about their substantial US owners to withholding agents. Withholding is also required with respect to foreign pass-through payments, a term that was largely undefined in previous IRS guidance. The US has entered into intergovernmental agreements with many non-US governments that have the effect of minimising the impact of FATCA on the financial institutions located in those countries.

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<sup>48</sup> 11 U.S.C. § 561(d).

<sup>49</sup> The parties did not dispute that the redemption payments fell within the scope of transactions covered by Section 546(e), but the Bankruptcy Court determined that it had inadequate evidence to determine whether either the transferor or transferee was a qualified entity under the safe harbour, particularly in light of the Supreme Court's ruling in *Merit Management*.

<sup>50</sup> Reg-132881-17 (13 December 2018).

The proposed regulations make a number of changes with respect to the FATCA regime. Significantly, because the IRS has now determined that withholding on gross proceeds is no longer necessary in light of current global compliance with FATCA, the proposed regulations remove this requirement.

Furthermore, the proposed regulations further extend the time for withholding on foreign pass-through payments. Withholding on a foreign pass-through payment will not be required before the date that is two years after the date of publication of final regulations defining the term foreign pass-through payment. The preamble reiterates that the IRS still considers such withholding to serve an important purpose, but requests comments on alternative approaches that might serve the same compliance objectives.

### ***Removal of US tax impediments to credit support from foreign subsidiaries***

Foreign subsidiaries of a US parent issuer have not historically provided credit support for the parent's debt because doing so could subject the foreign subsidiary's earnings to US tax. Section 956 of the Code deems a US parent to receive a distribution from its controlled foreign corporation (CFC) that provides credit enhancement for the parent's debt, such as guarantees or pledges. These tax consequences led to a market practice that US issuers of debt securities did not provide guarantees or security from their foreign subsidiaries, domestic holding companies that solely own foreign subsidiaries or any domestic subsidiaries of their foreign subsidiaries; and limited pledges of equity interests in their foreign subsidiaries to 65 per cent of the voting equities in their first-tier foreign subsidiaries or in such domestic holding companies of foreign subsidiaries.

This deemed distribution for credit support reflected how a US parent was taxed on actual repatriations of earnings of its foreign subsidiaries. However, the tax treatment of actual distributions changed in 2017. The Tax Cuts and Jobs Act created a deduction for actual distributions by certain foreign corporate subsidiaries to their 10 per cent US corporate shareholders under Section 245A of the Code. The deduction, however, did not extend to earnings deemed distributed by the foreign subsidiary providing credit support.

In May 2019, the IRS and Treasury published final regulations to harmonise the taxation of deemed repatriations by CFCs from credit support to their US corporate shareholders with the taxation of actual repatriations.<sup>51</sup> The new regulations reduce the amount of the deemed distribution to the extent the US corporate shareholder could deduct it under Section 245A if the deemed distribution were an actual distribution. In many circumstances, the deemed distribution under Section 956 can be reduced to zero.

While the new regulations address many cases where credit support from foreign subsidiaries raised tax issues, circumstances remain where such credit support may still raise issues. The new regulations only apply to US corporate issuers, so the treatment of non-corporate US issuers, such as real estate investment trusts or regulated investment companies, remains unchanged. A US partnership, such as a limited liability company, domestic private equity fund partnership or family investment partnership, may benefit from the new regulations if its beneficial owners are all corporate US shareholders. However, it will not benefit from the regulations to the extent its beneficial owners include non-corporate US entities. Section 245A also includes exceptions denying a deduction for actual distributions of a foreign subsidiary, which also apply despite the regulations. One exception requires a

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51 84 Fed. Reg. 23716 (23 May 2019).

foreign subsidiary's stock to be held for more than 365 days in a two-year period for the subsidiary's actual distributions to be deductible.<sup>52</sup> Therefore, credit support from a recently acquired foreign subsidiary may still raise tax issues. Issues may also arise if income of the foreign subsidiary is deemed to be effectively connected with a US trade or business, or if the foreign subsidiary's dividends to its US parent were deductible under foreign tax law.

The new regulations apply to taxable years of a CFC beginning on or after 22 July 2019. However, the new regulations may be applied to taxable years beginning after 31 December 2017 if the US parent and certain of its affiliates apply the regulations for the taxable years of each of their CFCs beginning after 31 December 2017.

### ***Proposed and final global intangible low-taxed income regulations***

In June 2019, Treasury and the IRS issued proposed regulations<sup>53</sup> and final regulations<sup>54</sup> with respect to global intangible low-taxed income (GILTI) under Section 951A of the Code.

Section 951A of the Code generally requires that a US shareholder of any CFC must include in gross income in the current taxable year its share of the CFC's GILTI. The amount of a US shareholder's GILTI inclusion generally reflects the sum, across all of its CFCs, of certain CFC income, offset by the sum of certain CFC losses, in excess of a 10 per cent return on a tangible asset investment (with the return reduced by certain interest expenses).

Significantly, the proposed regulations provide for a new election pursuant to which taxpayers can exclude certain high-taxed income from GILTI. High-taxed income is gross income subject to foreign income tax at an effective rate that is greater than 90 per cent of the US corporate rate (i.e., 18.9 per cent under the current US corporate rate of 21 per cent).

The proposed regulations also address the treatment of domestic partnerships for purposes of determining amounts included in the gross income of their partners under Section 951A with respect to CFCs owned by the partnership.

The final regulations provide guidance relating to the determination of a US shareholder's *pro rata* share of a CFC's Subpart F income and GILTI to be included in the shareholder's gross income, as well as certain reporting requirements relating to inclusions of Subpart F income and GILTI. The final regulations also include anti-abuse provisions that were included in earlier proposed regulations. In addition, the final regulations adopt an aggregate approach for purposes of determining the amount of GILTI to be included in the gross income of the partners of a domestic partnership with respect to CFCs owned by the partnership.

### ***Proposed passive foreign investment companies regulations***

Treasury and the IRS issued proposed regulations in July 2019 providing guidance with respect to passive foreign investment companies (PFICs).<sup>55</sup> Specifically, the proposed regulations contain rules governing:

- a* the attribution of PFIC stock owned through partnerships;
- b* the look-through rules that apply to 25 per cent-owned corporations and the special look-through rules for 25 per cent-owned domestic corporations;
- c* the PFIC insurance rules; and
- d* the standards used to determine whether a PFIC satisfies the income and asset tests.

52 Sections 245A(1)(A) and 246(c)(5) of the Code.

53 Reg-101828-19 (21 June 2019).

54 Treasury Decision 9866 (21 June 2019).

55 84 Fed. Reg. 33120 (11 July 2019).



The proposed regulations clarify that the application of the attribution rules under Section 1298 of the Code to a tiered-ownership structure should be applied from the top down. The top down approach starts with a United States person that is a shareholder and determines what stock is owned at each lower tier on a proportionate basis. This approach is limited in its application to attribution through partnerships.

With respect to the look-through rules, the IRS proposed regulations that provide that where a tested foreign corporation does not own at least 25 per cent of the value of a partnership, such corporation's distributive share of income from the partnership will be treated as *per se* passive. Furthermore, the proposed regulations provide that dividends paid by a 25 per cent or greater subsidiary would be eliminated from income by the tested foreign corporation when applying the general look-through rule only if the subsidiary accumulated the earnings while it was a 25 per cent subsidiary of the tested foreign corporation.

The PFIC rules include an exception from those rules for certain qualifying insurance corporations (QICs) engaged in the active conduct of an insurance business. The proposed regulations provide standards for determining whether a foreign insurance company is a QIC and whether a QIC is engaged in the active conduct of an insurance business, including a proposal that would deny the insurance exception to companies that pay significant fees to outside service providers for underwriting and asset management.

The proposed regulations also provide guidance as to which Subpart F exceptions under Section 954 of the Code would apply for purposes of excluding income from passive income when determining if a foreign corporation is a PFIC.

The proposed regulations will apply to tax years of shareholders that begin on or after the date the final regulations are published in the Federal Register. However, prior to finalisation, the insurance rules may be relied upon for tax years beginning after 31 December 2017, and the remaining provisions may be relied upon for all open tax years.

### III OUTLOOK AND CONCLUSIONS

The US capital markets continue to attract existing and first-time issuers of debt and equity securities, notwithstanding the continued rapid evolution of markets in Europe, Asia and elsewhere. The prospect of SEC, Department of Justice and other US regulatory oversight, although certainly a concern for many foreign private issuers, remains outweighed by the depth and liquidity of US institutional and retail markets. This is perhaps particularly the case for initial public offerings of equity by sector-specific industries, such as life sciences and technology companies, and by issuers of non-investment grade debt securities, where US investor participation is often viewed as integral to the success of a proposed transaction, but it also remains a key for the generally larger SEC registrants of long standing for whom a diversified global investor base is important. The overall thrust of current US regulatory developments appears likely to remain focused for the moment on easing the burdens associated with accessing these markets. At the same time, the SEC has expressed its intent to continue to regulate strictly capital raising initiatives, in respect of which it has well-known concerns.

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He built his experience and practice as international legal counsel in several international investment banks, and joined De Pardieu Brocas Maffei as a partner in 2002. He is a member of the International Bar Association.

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Reflecting his wide range of experience, Michael regularly counsels on the Securities Act of 1933, the Securities Exchange Act of 1934, the Trust Indenture Act of 1939 and the Sarbanes-Oxley Act.

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Mr Khrenov advises some of the largest sell-side and buy-side clients – both Russian and international – on all aspects of the derivatives and structured products markets and transactions involving Russian law aspects or parties. He advised the National Settlement Depository in relation to setting up an OTC trade data repository. He also advised the Moscow Exchange on the pilot project of central counterparty clearing of single currency and cross-currency interest rate swaps.

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Frank regularly holds conferences on securitisation and other capital markets topics in Luxembourg and abroad. He is a member of the securitisation working group of ALFI (the Association of the Luxembourg Fund Industry) and the securitisation working group and the financial markets committee of the ABBL (the Luxembourg Bankers' association). Frank is also a member of the Islamic finance working group of Luxembourg for Finance (Luxembourg's agency for the development of the Luxembourg financial centre) and has recently joined the Haut Comité de la Place Financière (a committee set up by the Ministry of Finance aiming to modernise Luxembourg's financial sector legislation).

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Fred Onuobia is the managing partner of G Elias & Co. He holds a master of law degree from University College London. His areas of practice include securities, banking and project finance law. He is recognised as a leading lawyer by *IFLR1000*, *Chambers Global* and *The Legal 500*. Fred Onuobia has advised on major equity offerings, bond offerings and securitisations, including an offering that was listed simultaneously on stock exchanges in three countries, a 3 trillion naira bond programme (the largest bond programme in Nigeria) and a residential mortgage-backed securitisation.

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Paul specialises in securities law and capital markets regulation. He advises clients on the full spectrum of debt and equity transactions, including securitisation, structured products, covered bonds, IPOs, placements and buy backs of securities, exchange offers, listing applications and ongoing obligations deriving from such listings. He further covers capital market-related regulatory aspects, such as derivatives regulation. Prior to joining Allen & Overy, Paul worked in the credit and rate markets department at JP Morgan in London.

Paul also advises Luxembourg insurers and intermediaries on insurance regulatory matters.

He regularly holds conferences on various capital market and regulatory topics in Luxembourg and abroad. Paul is a member of the Securities Committee of the Luxembourg Bankers' Association (ABBL). He is also a member of a number of working groups of the ABBL. Paul is also a member of the group of experts of the association of Luxembourg insurers and reinsurers (the ACA), focusing on the application of EMIR to Luxembourg life insurance companies.

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Arnaud Pince specialises in banking and financial regulations, in particular licensing of regulated entities, asset management regulations (distribution of investment funds, setting up of portfolio management companies and professional funds such as French real estate investment funds (OPCIs)), Fintech regulations and anti-money laundering legislation matters.

He is involved in particular in the process for obtaining regulatory approvals and in its international development (e.g., passport procedures, consumer regulations).

Arnaud Pince has also developed expertise in the approval procedures of credit institutions and investment firms and in the prudential regulations applicable to these institutions (Basel III, CRD IV, UCITS IV and AIFM). He is a regular interlocutor on the Prudential Control and Resolution Authority and the French Financial Markets Authority regarding these regulatory matters.

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Mr Şahan practises in capital markets, acting for issuers and underwriters in equity, debt and equity-linked instruments in international public offerings, Eurobond offerings and private placements. He has also significant experience in listed company mergers and acquisitions in various sectors, including financial institutions and in retail and telecommunications, acting for private equity firms and strategic investors. He has unique experience and a deep understanding of the various types of disputes arising among various market participants such as investors, shareholders, listed companies, investment institutions, independent audit companies and other capital market participants.

He holds the following licences: capital market activities (advanced level), derivative instruments, real estate appraiser, credit rating specialist, corporate governance rating specialist and independent auditing in capital markets.

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Gunter A Schwandt specialises in capital markets, mergers and acquisitions (M&A), structured finance, secured transactions, cross-border lending and real estate finance. Gunter is an expert in highly complex public issuances and securitisations and has developed in-depth expertise in CKDs (development capital certificates) and FIBRAs (the Mexican equivalent of US real estate investment trusts), advising sponsors and underwriters alike.

To date he has advised the sponsors in the structuring and launch of seven CKD funds placed on the Mexican Stock Market, focused on the real estate industry and the energy and infrastructure sectors, as well as on four FIBRA transactions, focused on the retail and hotel industries. On the corporate M&A side, Gunter advised MetLife in the sale of its Mexican pension fund business to Principal Financial Group and Pemex in the sale of its 50 per cent stake in Gasoductos de Chihuahua to IEnova for US\$1.325 billion.

Gunter also advised Grupo Salinas in its joint venture with Televisa in Iusacell, the later unwinding of that joint venture and the ultimate sale of Iusacell to AT&T for US\$2.5 billion. Gunter spent a year working at international law firm Mayer Brown LLP in Chicago. He graduated as an attorney (with honours) from the Universidad Iberoamericana. He later received his LLM (with honours) from the Northwestern University School of Law and a certificate in business administration from the Kellogg School of Management.

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During his professional career to date, he has established a sound professional reputation and has gained considerable recognition in the market of PRC legal services. He was awarded the '30 under 30' legal professional elite by ranking agency LEGALBAND in 2016, 'China Top 10 Lawyers – New Economy' in 2018 and 'China Top-10 Lawyers – Financial Technology' in 2019. He was also especially recommended in the capital market field by *The Legal 500* in 2018.



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During the past decade, Till has built remarkable expertise in advising private equity firms and corporate organisations on M&A transactions, including public to private transactions and subsequent corporate reorganisation topics. Till regularly advises underwriters and issuers on all aspects of capital market transactions, with a focus on equity capital market transactions, such as initial public offerings and rights offerings. Till's practice also includes advising lenders, borrowers and private equity sponsors on complex financing transactions, in particular acquisition, leveraged, syndicated and real estate financing transactions.

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He regularly publishes articles on banking and finance issues and represents Luxembourg on the advisory board of the *Capital Markets Law Journal* (published by Oxford University Press).

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Jonathan Walsh is a securitisation partner at Ashurst LLP. Jonathan has over 30 years' experience advising on all types of securitisation transactions and structures and in relation to a wide variety of asset classes. Clients include originators (bank and non-bank), credit enhancement providers, rating agencies and servicers. Jonathan has advised on term, conduit and warehousing facilities in relation to rated, unrated, listed and unlisted, asset backed loans, asset backed participation structures, master trusts and risk retention financings. He also regularly provides advice and comments on regulatory developments affecting securitisation structures.

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Mark Walsh co-heads Sidley's capital markets group in the EMEA region. He is qualified to practise New York, English and Hong Kong law. He joined the firm in New York in 1986, and moved to Hong Kong in 1994 to help establish an office for the firm there, and then to London, where he has been resident since 1999.

Mark advises public and private sector clients. He has worked with governments and other sovereign and quasi-sovereign clients, as well as with companies from a broad range of industries, including banking, insurance and other financial services; oil, gas and petrochemicals; pharmaceuticals and life sciences; automotive; paper and forest products; telecommunications, media and technology; real estate; and food services and distribution.

Strong leadership in advising clients has earned Mark acknowledgement from numerous industry publications, including *Chambers UK* and *Chambers Global*. He is regularly listed as a 'Leading Lawyer' in *IFLR1000* and was recently listed in *Best Lawyers 2020* for capital markets law.

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Akihiro Wani has almost 30 years' experience in the capital markets arena and is widely renowned as an expert in the banking sector. He has acted for major financial institutions on financial regulations and cutting-edge derivatives transactions, has advised on the establishment of head and branch offices of financial institutions, and has acted on various matters involving cross-border financial trading, securities, insurance and general corporate transactions. Mr Wani is a professor at Sophia University Law School, a counsel for the International Swaps and Derivatives Association in Japan and a financial expert at the P.R.I.M.E. Finance Foundation.

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