Spring 2020

IFLR

INTERNATIONAL FINANCIAL LAW REVIEW

Stop, start

It's been a difficult beginning for China's new foreign investment law

Barbados debt restructuring

Is SOFR alone enough for the US?

Merits of dual class shares

France's PACTE law for digital assets

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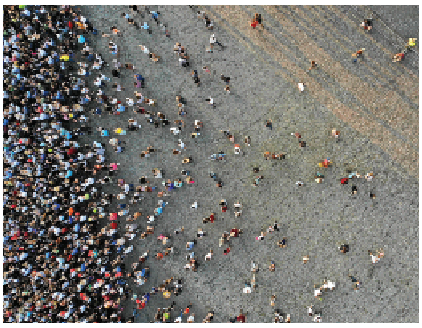

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"Don't wait until 2021. The sooner we get rid of the poll of banks, the better"

American Financial Exchange CEO Richard Sandor defends the Libor transition on page 16

EDITORIAL

Deep breaths

What a start to the year it's been. To think that at the end of 2019 – which was really not as long ago as it feels – Brexit and the US-China trade war were expected to be the two biggest stories of 2020, seems quite strange now.

It hasn't quite worked out like that. It's been more than a month since Britain Brexited and it's barely been discussed – though that will be coming later in the year, rest assured. Instead coronavirus has taken up most people's energy. As IFLR goes to press, economic growth is expected to slow, global shares have taken a major beating and travel bans are coming thick and fast. With this in mind, this issue's cover story on page 18 looks at China's much anticipated foreign investment law, which was finally implemented on January 1.

It's not all bad news though. Other highlights of the issue include a head-to-head on the merits of multiple benchmark rates (page 16) and an in-depth analysis of Barbados' recent sovereign debt restructuring (page 24) – including the innovative natural disaster clause, which is a potential game-changer in protecting island nations against climate change.

The lawyers who helped the government of the Bahamas on constructing one of the world's first central bank digital currencies explain how it works on page 43, and this quarter's special focus, from page 54 onwards, is on fintech in Europe – plus much, much more. And as always, it's all online first, at iflr.com

Enjoy the issue,

Lizzie Meager
Managing editor

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ONLY ONLINE

EMEA Brexit-driven governing law threats fail to materialise

English law has remained the top choice for financial contracts despite earlier concerns about its ongoing popularity due to Brexit uncertainty. However, one company has changed its approach. IFLR spoke to Swiss pharma giant Roche about its decision to switch from English law to Swiss

ASIA EM bonds struggle with international standards

Indian debt capital market participants say that as the market grows, more attention must be paid to due diligence, covenants, transparency and documentation gaps – which is especially important as the market grows and certain deals get rushed through

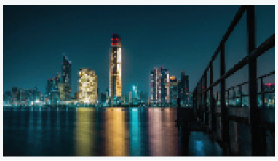
AMERICAS: Crypto community has questions for SEC's 'safe harbor'

The February proposal by Hester Peirce was at first welcomed, but market participants have since raised a number of concerns. The proposal would give digital token projects three years to demonstrate that the tokens they issue are not securities, and therefore should not be subject to the SEC's securities regulations

EMEA Interview with EU bank regulation head Nathalie Berger

The European Commission's head of bank regulation and supervision spoke with IFLR about her thoughts on Basel III implementation, the Capital Market Union, and the EU's taxonomy on sustainable finance. The regulator shared her insights ahead of what's sure to be an eventful 2020

EMEA Lack of bank buy-in restricts UAE fintech



While regulators in Abu Dhabi have launched a successful sandbox and the Dubai International Financial Centre fintech hive has launched an investment accelerator programme, momentum is reportedly being stifled by other industry players

QUOTES
OF THE QUARTER

"So far the banks appear to see more value in publishing their intent to collaborate with fintech startups than actually collaborating with them"

Co-founder of payment service provider Bridg Moussa Beidas has some feedback for conventional banks

"We have created a regulatory catch-22...the laws cannot be ignored, but neither can we, as securities regulators, ignore the conundrum our laws create"

SEC commissioner Hester Peirce admits that US policy has not created the most welcoming environment for crypto innovation when unveiling her safe harbor proposal in February

"The courts have probably done more to confuse the issue than to clarify it"

Goodwin Procter counsel David Bernstein discusses the complexity of US insider trading rules, on page 35

"A banking crisis is exactly the moment that an index based on credit transactions would lose its credibility and usefulness as a benchmark"

Honorary senior visiting fellow at Cass Business School Laurence Mutkin argues that SOFR alone is enough as a replacement for Libor, on page 16

"It is impossible to dream that investors will come here when our institutions are destroyed"

Libertad y Progreso executive director Aldo Abram is concerned about Argentina's reputation on the world stage

ASIA PACIFIC

China's default woes

Corporate bond defaults in China are expected to reach record highs in 2020, and it seems that things can only get worse before they get better. There are, however, reasons for optimism, and experts remain hopeful that this is the path towards a healthier market overall.

Rather than lending a hand to struggling corporates every time they need a lifeline, Chinese regulators are becoming more tolerant of defaults, and actually allowing them to happen. This is seen as positive by investors, especially foreign participants who want to see a deepening of the fixed income markets in the country.

According to the latest research by S&P Global, defaults exceeded $14.2 billion in 2019. With $200 billion of bonds set to mature in the next two years, the repayment pressure is on. The US/China trade war has only added fuel to the fire, and most sectors are expected to see growth levels slow.

Recent defaults include the Inner Mongolia government-owned Hohhot Economic and Technological Development Zone Investment Development Group, as well as Chinese state-owned commodities company Tewoo Group. As state-owned entities are often supported by governments to avoid defaults, who are themselves also on shaky ground, this is a worrying trend.

On the regulatory side, China has introduced measures to improve the oversight and scrutiny of credit rating agencies whose credibility has been called into question in recent years amid corporate fraud and corruption scandals. These stricter rules detail the responsibilities of credit rating agencies and ban a number of activities, including soliciting bribes and providing consulting services to bond issuers.

Despite concerns, it is worth remembering that China's onshore bond market is one of the world's largest. Through its inclusion in a number of global bond benchmarks – albeit only government debt for now – it continues to attract significant interest from foreign investors. The question investors are now asking is whether the Chinese government will allow further defaults as the country continues to open up its financial and capital markets, allowing the market to do its job, or whether it will continue to do what it has done in the past: propping up companies that in a truly free market, should be allowed to fail.

AMERICAS

The southern belle

In late 2018 Brazil's new political regime was not everyone's idea of a good thing, but it gave hope to many pragmatists in the country. It was a similar story elsewhere on the continent: in Argentina, Macri's government appeared on the verge of solving the country's economic woes, and in Venezuela it seemed possible that an insurgent opposition from Juan Guiado could topple the incumbent dictator, with the backing of the US and much of the world. Chile, Colombia and Peru all felt firm and on the cusp of political, economic and legal stability.

Fast-forward to the present day, and the continent couldn't look more different. Protests have been nonstop in Chile and Colombia; Peru's congress was dissolved after a number of key resignations left the government in tatters; and the return of Peronism in Argentina, spearheaded by the resurgent Cristina Kirchner, has left the economy on the brink of despair. One exception is Brazil, which appears – at least from an economic perspective – to be thriving under the direction of finance minister Paulo Guedes. President Bolsonaro's policies continue to divide, however, and protests wouldn't come as too much of a shock to anyone.

Without stability, it's hard to plan ahead. It's fair to say that an incredibly leftwing government that does not believe in capitalism will not have the best interests of a country's capital markets in mind. Issuing bonds in a country that does not have a trustworthy framework in place to ensure the process will be smooth is not an attractive proposition. Trying to attract foreign investment into a country in dire need of economic stimulus is a nigh-on impossible task if Macri-installed foreign currency restrictions remain in place.

Elsewhere, Argentina is a country in dire need of a strong regulatory framework and some level-headed economic guidance if it is to reach the heights of its potential, but with projections of between 30 and 40% inflation in 2020 – and the IMF once again knocking on the door – this doesn't seem all that likely.

In Chile, Colombia and Peru, with so much uncertainty rocking the political environment, it's a similar concern. Following years of turmoil, the right-wing Duque administration in Colombia gave some hope that the country would be able to propel itself into prosperity. Instead, 2019 saw thousands take to the streets to oppose Duque's stance on peace, corruption and economics. This is hardly an environment that will foster confidence in financial markets. And in Chile – for so long the posterchild of economic prosperity in the region – it's a similar story, albeit for different reasons.

The effective failure of Mercosur, the trade bloc established in 1991, highlights a greater need for the continent to work together to establish peace, regulatory control and stability.

Rejuvenating the nearly two-decade old trade bloc, or creating a new one more in line with the EU, could be the kickstart that the often-forgotten continent needs to get back on track. Brazil and Argentina, for example, have an invisible but strong tie that links the two together in many ways. Their governments and institutions should be more prepared to work together.

A united South America working towards a common goal could bring prosperity to the whole region, but divided, unstable and unpredictable as it is, it looks like there will be many more years as tumultuous as 2019 ahead for the region.

EUROPE, MIDDLE EAST & AFRICA

What on earth happens next?

Britain's flag has finally been removed from the EU and the implementation period has begun – with the two remaining aligned at least until the end of the year. In this time, greenfield thinking is desperately needed as, at present, whatever happens next in the negotiations is anyone's guess. Even those who are doing the actual negotiating are not that enlightened on what the future might hold for the relationship.

Brexit has been discussed for so long now that, frankly, once the exit actually happened, many people barely even noticed. However, as the year goes on, there's no doubt that the continued negotiations will make their way back into the headlines – whether either side likes it or not.

The British government's line is that it will pursue a deal similar to that with Australia and Canada, while the EU is putting forward proposals for closer alignment – in particular on competition policy and environmental/labour standards. Meanwhile Britain has made it clear that it will not accept supervision from the EU as part of a post-Brexit free trade deal.

The firing shot for what could be frosty divorce proceedings came from the UK's new Brexit negotiator, David Frost, during a speech to diplomats in Brussels in February. He made clear that the UK prioritises sovereignty – which translates to the country being able to set its own standards and regulations without being immediately denied access to the single market. This is in line with rhetoric from Conservative minister and long-time Brexit campaigner Michael Gove, who made it clear during a speech to industry representatives that trade friction is likely and that companies need to prepare for that reality.

The UK's new immigration plans – which spell the end of free movement and the start of a points-based system – are also a concern. The intention is to appeal to and attract talent the world over, but a salary threshold of £25,600 ($33,000) could end up shutting out younger talent, particularly in key industries such as tech. For many years, entrepreneurs have flocked to London to allow their businesses to thrive – a recent example is fintech company TransferWise, which has two Estonian co-founders.

Whatever certain politicians may say, free movement was a notable perk of EU membership. It allowed London to build and maintain its reputation as a finance hub, while benefiting from even more business opportunities by being part of the largest economy in the world. London's financial regulators have also benefited from the amount of soft power the EU gave them when legislating. UK representatives have been credited for their work on key post-crisis legislation such as Mifid II and the Capital Markets Union.

The financial industry has, of course, made its desires clear – from enhancing the role of Parliament and HM Treasury in coordinating public policy objectives with the regulators, to reflecting the need to maintain and enhance the UK's financial services ecosystem in a global context.

UK financial services may survive the shock, but if the prospect of a cliff-edge returns in 2021 – as is looking increasingly likely – it's not going to be easy.

Read this and much more online at iflr.com

OFF THE RECORD

"There's more about fish in the withdrawal agreement than finance"

A bank's policy specialist is not too optimistic about the UK government's Brexit priorities

"Our quants are using 20% of their time to onboard Libor transition work. It's a big loss for the industry"

A derivatives head at a major London bank is unsure of the point of the Libor transition

"M&A is impossible if you can't actually go to the country"

An in-house M&A lawyer is realistic when asked about the impact of the coronavirus on deal flows, on page 18

"It's pretty inevitable we'll be back on a cliff-edge come December"

A private practice banking partner does not hold out much hope for progress in Brexit negotiations throughout 2020

"To be honest it's not been downloaded by many people at all"

A trading compliance source at a UK bank sees an issue with Mifid II's best execution reports

"It's not that simple because, ultimately, the local banks are good"

An anonymous Brazil-based source has some idea why foreign banks have been slow to enter the market

Asia Pacific: In the shadows of the coronavirus

By Karry Lai, Asia reporter

Coronavirus has almost completely shut down parts of Asia in Q1

NEWS ANALYSIS

After an extended Lunar New Year break due to the coronavirus, Chinese markets reopened in the first week of February. Despite an injection of $242 billion from the People's Bank of China to ensure liquidity in the banking system, Chinese shares suffered a major drop. Although market confidence levels improved in January after the US and China signed their phase one trade deal, things aren't looking so rosy for the next few months as the latter continues to battle coronavirus across the country.

From retail and travel to transportation and manufacturing, all sectors of the economy are feeling the knock-on effects. Further policy initiatives can be expected to help industries suffering the most heavily.

In a move expected to provide more depth to the Indian derivatives market, the Reserve Bank of India (RBI) has relaxed limits on over-the-counter currency derivative transactions. Both residents and non-residents can now participate in foreign exchange hedging for transactions up to $10 million without the need to evidence underlying exposure. This comes after a recommendation from the task force on offshore rupee markets for the RBI to relax restrictions limiting participation in currency derivatives.

Hong Kong SAR's Securities and Futures Commission and the Hong Kong Monetary Authority will be launching a survey mid-2020 to assess product selling risks. It will examine the risks involved in the sale of non-exchange traded investment products by licensed operations and registered institutions that are licensed or registered for either type one or type four regulated activity. Type one licences involve dealing in securities, while type four licences involve advising on securities. Intermediaries will be expected to complete the questionnaire in the first quarter of 2021.

China's Banking and Insurance Regulatory Commission has fixed the minimum net capital for commercial lenders' wealth management subsidiaries at RMB500 million ($71 million) and 40% of the subsidiaries' net assets. Compared to a risk coefficient of zero percent for cash, bank deposits, interbank placements and fixed income securities, non-standard debt-based assets will range from 1.5 to three percent, and net capital of these subsidiaries should be 100% of the risk capital. The move aims to encourage banks' subsidiaries to invest in high-grade assets and sets higher risk coefficients for investment in non-standard assets.

The Hong Kong Stock Exchange is considering reviewing the listing regime for debt issues to professional investors only. Under chapter 37 of the listing rules, a streamlined listing process for debt issues is available to professional investors. In order to balance the need to safeguard investors while maintaining an effective listing platform for the jurisdiction's bond market, a number of recommendations are being considered. These include raising the existing issuer's minimum net assets requirement from HK$100 million ($12.7 million) to $1 billion and introducing a minimum issuance size of $100 million, as well as further listing rule amendments to enhance the regulatory oversight of issuers and guarantors' continuing obligations.

Elsewhere, Japan's Financial Services Agency is revising its stewardship code to include environmental, social and governance (ESG) factors. Under the revised code, institutional investors will need to engage with investee companies to outline how they will integrate ESG into their investment strategies. While ambitious, the revised code is only voluntary and won't be binding on member companies. However, those adopting it will be able to demonstrate their commitment towards ESG efforts and will be better prepared for future regulation.

Meanwhile, Bursa Malaysia has changed its listing requirements to include anti-corruption measures to enhance the quality and integrity of listed issuers. The measures are in line with the country's National Anti-Corruption Plan 2019-2023 and will be effective from June 1 2020. Listed issuers will be required to establish policies to prevent corrupt practices, including appropriate measures for whistleblowing, and a policy assessment every three years.

Europe, Middle East & Africa: A rough start

By Jimmie Franklin, EMEA reporter

2020 has already been a bumpy ride

It finally happened. After more than three years, Britain finally made its formal exit from the European Union on January 31. However – as anyone beyond the British government will admit – this is just the start. While both Brussels and Downing Street talk tough, financial services has taken a more pragmatic approach. In February, the City-sponsored International Regulatory Strategy Group (IRSG) released a new report outlining proposed changes to the UK's financial regulatory architecture post-Brexit. Its suggestions include a formal role for international financial standards within the UK's regulatory architecture, consolidating financial regulation to improve accessibility and compliance costs, and strengthening the scrutiny of regulators and HM Treasury by establishing a new, appropriately mandated, staffed and resourced cross-parliamentary committee.

The new UK government's honeymoon period appeared to come to an abrupt end when Prime Minister Boris Johnson's choice of chancellor, Sajid Javid, resigned in mid-February. You might think the financial industry would be sad to see a friend in a high place go – Javid once worked at both JPMorgan and Deutsche Bank – but his replacement Rishi Sunak is another former financier, having worked at Goldman Sachs before becoming a hedge fund manager.

In late January IFLR sat down with the EU Commission's bank regulation head Nathalie Berger (go to iflr.com to read the full interview) to discuss what will be an eventful year for the 27 remaining member states. The policymaker discussed the EU's taxonomy on sustainable finance and progress made on Basel III implementation, among various other initiatives. She quoted President Ursula Von Der Leyen's summer 2019 commitment to multilateralism, adding that for her, this meant properly implementing Basel III.

Elsewhere in EU regulation, an in-house lawyer speaking at IFLR's European In-house Counsel Summit in early February said that he thinks 100% GDPR compliance is practically impossible. It's clear that two years in, companies are still struggling to get to grips with the radical cultural shift needed. Companies have gone from storing large amounts of data without much thought to fielding right-to-be-forgotten requests and facing down potentially astronomical fines. Yet legal teams are unlikely to see any climbdown. Though there has been a delay in the adoption of an EU-wide regulation on e-privacy, jurisdictions beyond Europe are strengthening their data privacy laws: policymakers formally implemented the California Consumer Privacy Act (CCPA) in January.

In the Middle East many are getting excited about fintech, with a burgeoning industry developing in the UAE, Jordan and Saudi Arabia. Dubai International Financial Centre's FinTech Hive revealed the launch of a new funding accelerator programme for fintech startups in the region, as well as Africa and South Asia in January. However, market participants have warned that there is still a lack of buy-in from conventional financial institutions, saying that the impact of fintech on the broader banking industry has so far been minimal. Read the full story at iflr.com.

In Africa, news has been less than positive to start 2020. South Africa, the continent's most industrialised economy, is in the grips of an economic slowdown. In February, Moody's Investors Service cut its 2020 economic growth forecast for South Africa to 0.7%. The economy has not expanded by more than two percent annually since 2013, with neither the central bank nor the National Treasury estimating that it will reach that level by 2022. A slowdown in China has also had an impact on the continent. The hope is that the Agreement Establishing the African Continental Free Trade Agreement (AfCFTA), which entered into force on May 30 last year for 24 of the 54 countries, will bring more optimism.

Americas: Drawing the battle lines

By John Crabb, Americas editor

The US 2020 elections are only just getting started

November's election is shaping up to be the most hotly anticipated in US history, but we are yet to see who the incumbent's Democratic opposition will be. At the time of writing, it's between Bernie Sanders and Joe Biden, with all other remaining candidates struggling on Super Tuesday. A potential Sanders/Warren ticket could certainly prove interesting for financial markets.

The US's relationship with China remains unstable, but it has shown signs of improvement. Midway through January the two countries signed an agreement, known as the phase one trade deal, which is said to be the first in a number of pacts that look to remove tensions between the two economies. Key areas – such as the theft of intellectual property and spending imbalances – were addressed, but much more needs to be included in latter increments. The latest round of changes to the rules that govern the Committee on Foreign Investment in the United States also came into force since IFLR's last edition, bolstering an already robust set of controls on foreign investment into certain US sectors.

As the day of reckoning for Libor nears, government agencies around the world are ramping up their efforts to ensure chosen replacements are ready. The story is no different in the US, where the private sector Alternative Reference Rates Committee (ARRC) has introduced several measures in recent months to ensure that the secured overnight financing rate (SOFR) is both ready and robust come end-2021. The ARRC has released various consultations on issues such as: spread adjustment methodologies for cash products referencing USD Libor; swaptions based on USD Libor that could be affected by the discounting change for cleared derivatives from the use of the Effective Federal Funds Rate (EFFR) to SOFR; and, released final recommendations for new interdealer cross-currency basis swaps that use SOFR and overnight risk-free rates (RFRs) recommended by national working groups in other jurisdictions.

Elsewhere, government-sponsored enterprises Fannie Mae and Freddie Mac announced that by the end of the year they will cease to accept adjustable-rate mortgages based on Libor: an important step in the transition to SOFR. Both also announced intentions to implement ARRC-recommended fallback language to existing contracts.

Late last year the Commodity Futures Trading Commission (CFTC) proposed new cross-border swaps proposals, relaxing existing rules on US firms' overseas derivatives dealing. If implemented, the rules will replace a stricter Obama-era proposal that critics believe could damage US companies doing business abroad.

In February, SEC commissioner Hester Peirce released long awaited 'safe harbor' proposals that set out how the agency will regulate part of the crypto markets in the US, to heavily mixed reviews.

Meanwhile the lacklustre initial public offering (IPO) of mattress company Casper is indicative of a wider trend in the US equities market encapsulated by the excessive valuation of shared working space company WeWork. Casper eventually listed in February at a significantly lower value than it had once commanded. In a pre-IPO regulatory filing the company announced it had cut its target share price to between \$12 and \$13 from \$17 to \$19, valuing itself at around \$500 million. That's around \$200 million less than just a week before. Read the full story on iflr.com.

With so much going on in the US, it can be easy to forget about all the other countries of the Americas. On January 29 President Trump signed the USMCA agreement, which sets new trade rules between the US, Mexico and Canada, to replace the North American Free Trade Agreement. The new deal has been drafted to favour US citizens far more than previous iterations.

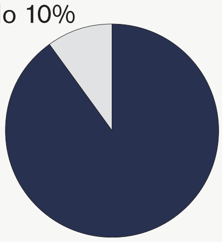
The new Argentine Peronist government has had time to settle in but has not taken much action yet. The economy it has inherited sits perilously close to default, and the IMF arrived in February for the latest rounds of negotiations. The entire financial sector is in wait-and-see mode to see how the latest sovereign debt restructuring, scheduled to close by the end of March, will transpire.

Removing barriers

In-house counsel, industry groups and private practice lawyers are unanimous in their view that the promoter concept is losing relevance and needs to change to encourage Indian companies to go public

By Karry Lai, Asia reporter

Should Indian regulators revamp the promoter concept to encourage Indian companies to go public?



The concept of a promoter – essentially, someone who is connected to the business from the start – has been around for a long time in India, and is relatively common practice for the large numbers of family-run businesses operating in the country. The closest equivalent in international practices is a controlling shareholder – though a promoter is not necessarily a majority shareholder. They are most often company founders who continue to have control over decision-making processes.

Yet the growing burden of responsibilities and liabilities of promoters are taking their toll on companies that want to grow. Many digital-era Indian companies want to go public but are feeling the brunt of the archaic concept, especially when promoters' contributions are required for listings.

There are many perks to going public: it allows businesses to expand quickly by giving them access to funds from more investors, enabling growth, as well as the improved brand recognition in the local market. Yet some promoters are not willing to take on the increased liabilities that are placed on their shoulders in the IPO process, such as meeting a 20% promoter ownership threshold.

All of this led IFLR to poll market participants on whether the concept should be phased out to encourage more companies to go public.

Overburdened with liabilities

For the Securities and Exchange Board of India (Sebi), the challenge is to align the concept of a promoter with that of a controlling shareholder. The idea of a promoter is rooted deeply in the minds of retail investors and regulators in India.

The idea of segregation of ownership versus management is more developed in other parts of the world, such as the US. "In India, promoter obligations and definitions kept on expanding," says Vishal Yaduvanshi, partner at IndusLaw.

For instance, a promoter includes not only a person in control of the company, but also anyone named as such in the annual report, regardless of their ability to exercise any influence. Additionally, the promoter takes civil and criminal liability over the entire prospectus; not only on their own disclosures.

"The regulator's idea was to protect public funds – as the promoter has fiduciary duties to the business, ensuring that the public funds invested in a business are prioritised before the promoter's interests – but this remains an Indian concept," says the head of legal for India at an international bank.

Looking at the wider APAC region, India is not a complete outlier. Other jurisdictions use promoters, but they are not known by this term. In Singapore, China and South Korea, there are similar constructs where additional liabilities are placed on large shareholders. For instance, the Singapore Exchange has a moratorium period on executive directors holding more than five percent of shares to dispose of or transfer them for six months after a company goes public. In South Korea, there are lock-in requirements for large shareholders. In China, there is a mandatory lock-in period of three years for large shareholders.

As it stands, Indian law permits a person identified as a promoter to stop being identified as such. However, while the condition is fairly pegged to changes in control of such

METHODOLOGY
IFLR publishes its quarterly poll question on iflr.com and Linkedin group page iflr.com/LinkedIn. Throughout the quarter, IFLR's editorial team gathers the responses and interviews selected respondents.

It's important that successful, fast-growing companies can access the public market

a person, such as a reduction in shareholding and relinquishment of executive positions, the law still requires such changes to be approved by the board and the shareholders. "This may lead to a farcical situation where a person who has lost control over the entity may still be identified as a promoter, and continue to assume promoter liability," says Yaduvanshi.

Changing the definition of a promoter to be linked only to exercise of control is the low-hanging fruit that could make the proposition more viable for new-age issuers.

Major barrier for tech startups

According to Rameesh Kailasam, CEO at IndiaTech.org, tech startups and technology companies may sit in multiple pillars today. One is the software or hardware-based companies that make money by selling either licences or products, such as Microsoft. Their chances of profitability are considered high. Another is those that offer business-to-business back-office and logistics-based support, like Salesforce. The biggest category, though, is consumer internet-based goods and services, whereby companies act as aggregators or marketplaces, or in social media and the gaming space, such as Facebook.

"The third category is fast-growing from a customer acquisition or userbase standpoint, though revenues and profitability may be some way away," says Kailasam. "These are typically heavily founder-driven, and they need to be supported with mechanisms such as the ability to list and differentiated voting rights."

He continues: "Listing remains a concern for founders due to minimum thresholds of 20% promoter requirements. That would mean most founders in unicorns would end up with diluted stakes."

Poll respondents generally feel that these new-age companies need to be treated differently, and that any regulatory changes in this space would greatly enable listings – as well as providing exit options for the investor community. "Since market and customer acquisition may be a constant feature, while these companies may have become profitable in the early market they started in, they cannot afford to relax and slow profitability, as another new entrant may have taken over that market," says Kailasam.

He continues: "Most of the founders of emerging unicorns in India want to list in India only, and do not want to be creating holding company structures abroad for the sake of an overseas listing. That's because in most cases, India is the company's target market. So listing norms need to be more appropriately formulated for this emerging sector."

Gradual shift

Indian market participants – including regulators – have come a long way already. Companies are increasingly disclosed as 'professionally managed', 'no-promoter companies', or with a private equity (PE) fund performing a promoter's duties, according to Lakha Nair, senior vice president at Axis Capital. "In the old days, there were disclosures ranging up to multiple levels to identify one single person who was the ultimate promoter. The revised regulations now provide for an objective test for disclosure on this front," she says.

"Initially for PE fund-led companies, the industry has had to grapple with appropriate levels of disclosure, however it has been streamlined in the new regulations," says Nair. "The shift to accept professionally-managed companies to list was a gradual one, with the primary comfort being that there is no single shareholder holding more than 25% of shares. These companies are typically audited by one of the Big Four, and have an adequate corporate governance system."

According to Avijit Banerjee, CEO and managing director at Argon Capital Advisors, while a lot of family businesses in India that are predominantly owned by promoters may have been very successful, what may have taken a backseat are elements such as cultural ethos, professionalism, transparency and corporate governance standards.

Regulators have also looked to shift control away from promoters by diluting their shareholding. "The change in increasing public shareholding requirements from 25% to 35% in July 2019 is a welcome step because not only does it increase free float and limit promoters' rights in the company, it also enhances liquidity," says Banerjee.

Looking ahead

Although a shift away from the promoter concept is seen as necessary, for now it remains an important part of the Indian corporate regulatory framework. The concept will continue to evolve, especially as some still view it as an important and helpful way to maintain checks and balances."People still want the promoter concept because they like to see behind the corporate veil – to see an actual person responsible for the actions of the company," says Nair. "There's continuity in terms of succession, and promoters are generally vision-makers, providing direction."

Yaduvanshi adds: "The cult of promoter-driven companies which dominated the Indian corporate sector in the past, along with the evolution of corporate governance mechanisms that place a huge number of obligations on the promoter, has led to reliance on the concept."

Looking into the future, a heightened focus on the responsibilities and liabilities on the board of directors and executives should help to allay such concerns and shift India towards international practices.

Americas

NAME	COUNTRY	MOVED FROM	MOVED TO	PRACTICE AREA
Helen Naves	Brazil	Trench Rossi & Watanabe Advogados	Demarest Advogados	Banking and finance
Marc Stalder	Brazil	Koury Lopes Advogados	Demarest Advogados	Real estate
Toby Allan	Canada	Dentons	McCarthy Tétrault	Corporate and M&A
Hartley Lefton	Canada	Dentons	McCarthy Tétrault	Financial services regulatory
Zygmunt Brett	El Salvador	Arias	BLP	Banking and finance
Antonella Imbers	El Salvador	Arias	BLP	Corporate and M&A
Mariana Nochez	El Salvador	Arias	BLP	Corporate and M&A
Laura E. Appleby	United States	Chapman and Cutler	Drinker Biddle & Reath	Restructuring and insolvency
Mercedes Tunstall	United States	Pillsbury Winthrop Shaw Pittman	Loeb & Loeb	Regulatory
Jaeyong So	United States	Debevoise & Plimpton	Winstead	Aviation
Jaesuk Yoo	United States	Debevoise & Plimpton	Winstead	Aviation

AMERICAS

In Chile, Clyde & Co launched an office after forming an association with Grasty Quintana Majlis.

LatAm firm ECIJA expanded into Mexico after merging with local outfit Chacón & Rodríguez.

In the US, there has been a reasonably high amount of activity with mergers, office openings and an exit.

David Boles

Dentons merged with two national firms; Indianapolis' Bingham Greenebaum Doll and Pittsburgh's Cohen & Grigsby. Duane Morris merged with New York firm Satterlee Stephens, growing its presence in the city by 60%. Meanwhile large regional firms Troutman Sanders and Pepper Hamilton confirmed that the two will merge as of April 2020.

Meanwhile Ashurst launched its third US branch in Los Angeles. Shearman & Sterling launched in Dallas – its third branch in Texas – after recruiting six partners including three from Jones Day. Perkins Coie also expanded in Texas, opening in Austin with hires

Debby Lim

from Vinson & Elkins and Wilson Sonsini.

Mishcon de Reya closed its New York branch – its sole US office – 10 years after opening. King & Wood Mallesons picked up the office's last few lawyers.

ASIA-PACIFIC

In Hong Kong SAR, PRC firm DeHeng Law Offices opened in cooperation with local firm Chungs Lawyers.

In India, Vishnu Mehra & Co

Finella Fogarty

entered into alliance with Malaysian firm Malek Paulian & Gan (MPG).

In Singapore, restructuring and insolvency boutique Nair & Co merged with PK Wong & Associates to form a full-service firm, PK Wong & Nair.

Other notable Singapore news saw Taylor Wessing end its eight-year alliance with local firm RHTLaw.

EUROPE, MIDDLE EAST AND AFRICA

A new entry to the Belgium market this year will be Reed Smith, with the firm set to open it first new office in continental Europe since 2015 in Brussels.

Helen Naves

In the Baltics, the Levin law firm alliance secured a replacement for its former Lithuania member, Dominas Levin, which merged with Walless last year. Local firm Wint combined with Glikman Akin Levin and Latvia's Kronbergs Cukste Levin to reestablish a pan-Baltic alliance.

In German firm news, Lawyers On Demand (LOD) launched its second office, adding a base in Dusseldorf. Meanwhile a new entry to the market is Japanese firm Nishimura & Asahi which launched its first European offices in Frankfurt and Düsseldorf.

Asia Pacific

NAME	COUNTRY	MOVED FROM	MOVED TO	PRACTICE AREA
Michael Maxwell	Australia	Clayton Utz	HFW - Holman Fenwick Willan	Regulatory
Jian Zhang	China	Commerce & Finance Law Offices	Shihui Partners	Capital markets
Jeremy Lightfoot	Hong Kong SAR	Campbells	Carey Olsen	Restructuring and insolvency
Angela Cui	Hong Kong SAR	King & Wood Mallesons	Han Kun Law Offices	Corporate and M&A, Private equity
Matthew Wong	Hong Kong SAR	Locke Lord	HFW - Holman Fenwick Willan	Capital markets, Corporate and M&A
Jason Kuo	Hong Kong SAR	Paul Hastings	King & Wood Mallesons	Capital markets
Khin Voong	Hong Kong SAR	King & Wood Mallesons	Watson Farley & Williams	Banking and finance
Anuj Prasad	India	Shardul Amarchand Mangaldas & Co	Cyril Amarchand Mangaldas	Corporate and M&A
Varun Sehgal	India	Shardul Amarchand Mangaldas & Co	Cyril Amarchand Mangaldas	Corporate and M&A
Kaushik Mukherjee	India	Shardul Amarchand Mangaldas	In house	Capital markets
Manish Gupta	India	Link Legal India Law Services	IndusLaw	Corporate and M&A
Rashi Saraf	India	Cyril Amarchand Mangaldas	IndusLaw	Corporate and M&A
Shafaq Uraizee Sapre	India	Lakshmikumaran and Sridharan	J Sagar Associates	Corporate and M&A
Abir Dey	India	Cyril Amarchand Mangaldas	L&L Partners Law Offices	Banking and finance
Navin Syiem	India	IndusLaw	L&L Partners Law Offices	Corporate and M&A
Ashwin Mathew	India	Mansukhlal Hiralal & Co	Lakshmikumaran & Sridharan	Corporate and M&A
Debby Lim	Singapore	Shook Lin & Bok	BlackOak	Restructuring and insolvency
Maria Tan Pedersen	Singapore	Jones Day	Dechert	Capital markets, Corporate and M&A, Project development
David Kuo	Singapore	Milbank	DLA Piper	Corporate and M&A
Jonathan Crandall	Singapore	Clifford Chance	Duane Morris Selvam	Capital markets
Joel Shen	Singapore	Stephenson Harwood	DWF	Corporate and M&A
Parthiv Rishi	Singapore	Linklaters	Sidley Austin	Corporate and M&A
Jae-Hyon Ahn	South Korea	Orrick Herrington & Sutcliffe	Baker McKenzie	Project development

In Ireland, Dentons announced it would be launching in Dublin after hiring corporate partner Eavan Saunders from William Fry as country managing partner, and banking and finance partner Peter O'Brien from Matheson.

In Italy, US firm Squire Patton Boggs opened a Milan branch after recruiting a team from Curtis Mallet-Prevost.

There were several notable developments in Russia. Castrén & Snellman announced it will close its Moscow and St Petersburg offices. The Finnish firm's Russian teams, which comprise 10 lawyers including one partner across the two offices, will join local firm Capital Legal Services. Meanwhile Nazali Legal and Tax Services opened an office in Moscow led by partner Altinay Sheralieva.

Anuj Prasad

In Spain, DAC Beachcroft added 20 lawyers to its Madrid office through a combination with local firm Asjusa.

In the UK, Finnish firm Borenius opened a representative office in London.

Read this and much more online at iflr.com

PEOPLE AND FIRMS

Europe, Middle East & Africa

NAME	COUNTRY	MOVED FROM	MOVED TO	PRACTICE AREA
Christian Sauer	France	Franklin	Bryan Cave Leighton Paisner	M&A
Alison Goldthorp	Germany	Addleshaw Goddard	Norton Rose Fulbright	Restructuring and insolvency
Regina Rath	Germany	Simmons & Simmons	Norton Rose Fulbright	Restructuring and insolvency
Naeem Hirani	Kenya	Hirani Law	Oraro & Co Advocates	Corporate and M&A, Private equity
Marcel Enrich	Spain	Baker McKenzie	Pérez-Llorca	M&A
Alastair Goldrein	UK	Shearman & Sterling	Dechert	Restructuring and insolvency
Justin Cornelius	UK	Bryan Cave Leighton Paisner	Goodwin	Investment funds
Sam Newhouse	UK	Freshfields Bruckhaus Deringer	Latham & Watkins	M&A
Matthew Daffurn	UK	Linklaters	Locke Lord	Project development, Project finance
Matthew Dunlap	UK	Latham & Watkins	Morrison & Foerster	Banking, Capital markets: Debt
Sarah Fitzpatrick	UK	Bryan Cave Leighton Paisner	Norton Rose Fulbright	Project development
Rachel Orton	UK	Squire Patton Boggs	Addleshaw Goddard	Real estate
Stuart Blythe	UK	CMS Cameron McKenna Nabarro Olswang	Baker Botts	Corporate and M&A
James Salford	UK	Addleshaw Goddard	Bird & Bird	Banking and finance
Tim Davison	UK	Baker Botts	Brown Rudnick	Corporate and M&A
Neil Foster	UK	Baker Botts	Brown Rudnick	Corporate and M&A
Sarah Melaney	UK	Baker Botts	Brown Rudnick	Corporate and M&A
David Boles	UK	Latham & Watkins	Cooley	Capital markets
Solomon Noh	UK	Shearman & Sterling	Dechert	Banking and finance, Restructuring and insolvency
James Grimwood	UK	CMS Cameron McKenna Nabarro Olswang	Goodwin Procter	Private equity
Colin Chang	UK	White & Case	Linklaters	Capital markets
Meredith Campanale	UK	White & Case	Mayer Brown	Banking and finance
Kirsti Massie	UK	White & Case	Mayer Brown	Banking and finance
Finella Fogarty	UK	DWF	RPC	Restructuring and insolvency
Peter Newman	UK	Milbank	Skadden Arps Slate Meagher & Flom	Banking and finance
Stephen Ball	UK	KPMG	Squire Patton Boggs	Private equity

IFLR 1000

This quarter's global lateral hire summary was compiled by the IFLR1000 – the guide to the world's leading financial law firms. The IFLR1000 provides daily updates on lateral hires, major law firm news and the latest deals via its Deal Data service.

Q: Is SOFR alone enough for the US industry as a Libor replacement?

Laurence Mutkin, honorary senior visiting fellow at Cass Business School

YES

As time marches on toward the likely demise of Libor at end-2021 (if not before), many people are waking up to the significant challenges surrounding the transition to the rate's successor. In the US the successor rate, chosen by a private sector group, the Alternative Reference Rates Committee (ARRC) under the auspices of the Federal Reserve, is an average of overnight rates secured on US government collateral: the secured overnight financing rate (SOFR).

At first glance, SOFR looks less suitable than Libor to be the bedrock reference rate for the great spectrum of interest rates in the US economy – from derivatives contracts to floating-rate notes, corporate loans to retail unsecured and secured lending.

SOFR is a lending rate secured against the strongest possible collateral – which is less relevant to most real economy transactions, because they involve credit risk. It is also an overnight rate, which makes it more volatile than a term rate like three-month Libor and creates difficulties in the calculation and payment of interest, because the term interest cost of SOFR can be known only in retrospect.

Some market participants have suggested that it would be better to have multiple rates fulfilling different roles, given SOFR's limited scope. But the benefits of moving to SOFR, whose credibility and integrity as a financial benchmark come from being rooted in a massively deep and liquid market, and which complies with the principles for financial benchmarks promulgated by Iosco, far outweigh all of these drawbacks – which are, in reality, smaller than they may seem. Unsurprisingly, the ARRC has been working to address them, as set out in its paced transition plan.

Wholesale and derivatives markets constitute far and away the majority of Libor-referencing contracts. These are surprisingly easy to transition, because they tend to be: defined by standardised contracts; traded on only a few venues; overseen by the same regulators; and between highly sophisticated entities, which have the technology in place to handle real-time calculations of margin and interest, and to deal with the fallback mechanisms being put in place to permit a transition from Libor to SOFR-referencing contracts.

Things get trickier as one moves towards cash and retail markets. One knotty problem is that while Libor reflects credit risk, SOFR doesn't. That means that in a banking crisis – where banks' cost of borrowing rises – the rates at which they lend, if tied to SOFR, will – perversely – fall (because in a crisis, US Treasury collateral becomes more sought after).

To address this issue, 10 large US regional banks have proposed the creation of a dynamic credit spread index to combine with SOFR, to create a benchmark lending rate which incorporates changing credit conditions. Both the ARRC and several international regulators have been cool to the idea. A fundamental drawback is that a banking crisis is practically defined as "when credit transactions become difficult to do". This means that a banking crisis is exactly the moment that an index based on credit transactions would lose its credibility and usefulness as a benchmark.

It's also worth remembering that the behaviour of Libor during the last financial crisis certainly didn't do the job of protecting the banking system. The likely truth is that no benchmark index can. That's why capital requirements and many other regulations were introduced.

Indeed, it may be that allowing a credit component in a benchmark for bank lending actually increases risk and moral hazard by making banks think they are better protected from banking crises.

But what about incumbency and familiarity? Obviously, Libor's incumbency developed over time: before 1986 it did not exist. Prior to that, the discount rate was commonly quoted. People will get used to SOFR, but the Fed could do two things to help the transition. Its review of the conduct of monetary policy, currently underway, is the obvious vehicle.

The Fed should start officially targeting SOFR, rather than the Fed funds rate (the present targeted rate), for three reasons. Firstly: the Fed's intervention tools are secured borrowing and lending, which affect SOFR directly, whereas Fed funds, being unsecured, is something the Fed cannot directly influence: which makes it a strange thing to target.

Secondly, SOFR reflects a much larger and more significant market (over $800 billion per day) than Fed funds (less than $80 billion per day). The Fed's target should be the main event, not the sideshow.

Thirdly, by adopting SOFR as its target rate, the Fed would give a great boost to public knowledge and acceptance of SOFR as a benchmark.

Another thing which might help the swifter adoption of SOFR could be to change its name to something people can understand – or at least know how to pronounce. How about 'US Secured Funds'?

"At first glance, SOFR looks less suitable than Libor to be the bedrock reference rate"

Is it problematic to divide liquidity between different rates?

Richard Sandor, lecturer in law and economics at the University of Chicago Law School and chairman and CEO of the American Financial Exchange

NO

Economics teaches that it's best to have choices. So instead of asking which benchmark will replace scandal-ridden Libor, a better question is which benchmarks will replace it.

Libor can no longer be in the mix. Don't wait until 2021. The sooner we get rid of the poll of banks, the better. The post-Libor landscape offers a world of better options for lenders, including multiple benchmarks, transparency, efficiency, lower costs, and greater innovation.

Having multiple benchmarks will enhance market efficiency and drive down transaction costs. In the US, we are seeing growing adoption of the Federal Reserve's secured overnight financing rate, or SOFR, which is derived from borrowing and lending activity using treasuries as collateral.

An additional rate is Ameribor, short for American interbank offered rate, which is based on overnight unsecured lending on the American Financial Exchange (AFX). Both benchmarks are transparent and regulated and offer capital market participants a choice of secured, in SOFR's case, and unsecured, in Ameribor's case, options.

Multiple rates will also lead to greater innovation. AFX connects borrowers and lenders across the US, creating, for the first time, a national market for unsecured lending. AFX now has its data on the blockchain, a first-of-its-kind initiative to provide greater transparency to market participants, regulators and academics.

Unlike other markets that only provide time, quantity and price transaction information, AFX now has records with additional data fields related to each transaction. This additional data includes: the entire order book at the time of each transaction; geographical region of the counterparties to each transaction; and detailed counterparty information such as credit rating, type of institution and detailed financial metrics for each counterparty.

The world after Libor will provide many more options to lending institutions than before. One size need not fit all. A choice of multiple benchmarks will make the lending market more like other markets, all of which have a plethora of benchmarks – like the commodity markets (with three different kinds of wheat for bread, cookies and pasta), oil (Brent, WTI, Dubai) and equity markets, where there are more indices than stocks (S&P 500, Dow Jones Industrial Average, Nasdaq, the Russell 2000, EAFE, and many more).

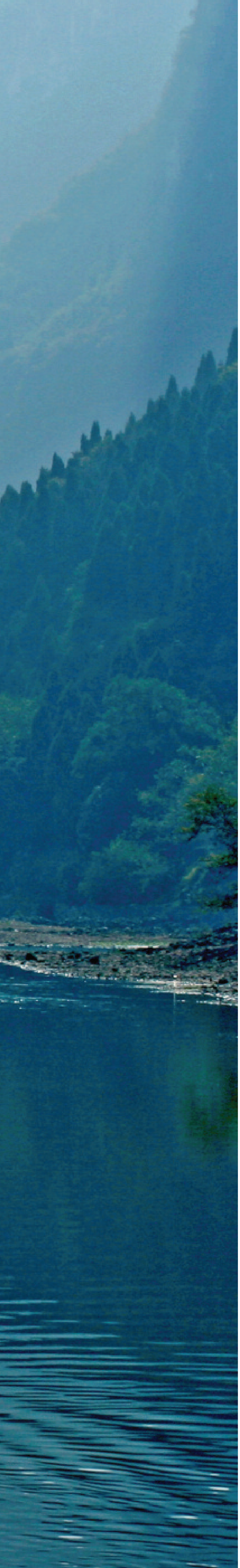
Bankers and capital markets participants need not fear a Libor sunset in 2021.

"The world after Libor will provide many more options to lending institutions than before"

There's still time to prepare. But there is also a lot of work to be done. It is critical that financial players pay very close attention to, and start reviewing their loan documents in advance of, the transition.

Lenders need to begin redrafting their commercial and industrial loan documents to replace Libor with one or more alternative benchmark reference rates. Similarly, derivatives dealers and the International Swap and Derivatives Association need to alter their master service agreements and short-form trade confirmations to replace Libor with one or more alternative benchmark reference rates aligned with Iosco benchmarks.

Choice is good and will allow capital market participants access to a truly representative American rate. All will benefit from increased transparency as benchmarks reflect financing activity in real time. The lending markets will be more diverse, and market efficiency will increase. It's up to you.



COVER STORY

Stop, start

The success of China's highly anticipated foreign investment law has been overshadowed

By John Crabb, Jimmie Franklin, Karry Lai

When China's new foreign investment law was first drafted back in 2015, the excitement was palpable. Foreign banks have long been able to operate in China, but most have struggled to gain ground over their domestic competitors. This hugely important legislation looked like that could finally change; that everyone could participate in the most remarkable growth story of this lifetime, if they wanted to.

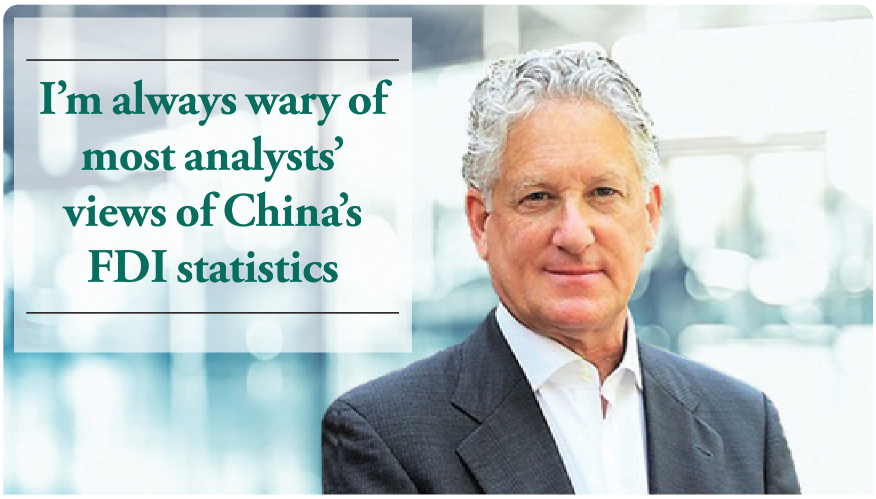
Fast-forward five years and it's a very different story. The details of the law were not revealed until November 2019 – making feedback difficult, to say the least – and a series of unfortunate events, from rapidly-escalating trade tensions with the US to the coronavirus – have overshadowed the grand unveil on January 1.

"Few clients have been moving into mainland China, due in part to the local authorities taking up considerable management time and costs," says UK-based Akin Gump M&A and antitrust partner Davina Garrod.

In-house lawyers agree. "Chinese M&A is down by all metrics, for a couple of reasons," says an M&A lawyer at a UK bank. "More recently, the coronavirus is absolutely going to have an effect on doing business in China. M&A is impossible if you can't actually go to the country."

Article 3 of the new regulation commits China to the basic state policy of encouraging foreign investors to enter the market. It reads: "The State shall implement policies on high-level investment liberalization [sic] and convenience, establish and improve the mechanism to promote foreign investment, and create a stable, transparent, foreseeable and level-playing market environment." While promising, the new commitments are also vague, and could see acquisitions remain a challenge for international investors.

The new law emphasises equal national treatment for foreign investors. They will also be granted equal protections, as stated in Article 5: "The State shall protect foreign investors' investment, earnings and other legitimate rights and interests within the territory of China in accordance with the law."



European companies' wariness about entering the Chinese market is reflected in a dip in Chinese investment into Europe. Research by Baker McKenzie shows a fall in Chinese investment into Europe of 40% (comparative to North America at 27%) in 2019. This was the lowest level since 2010, and down 83% from the 2017 peak of $107 billion. Perhaps reflective of the trade war, Europe received more than twice the amount of investment ($13.4 billion) than North America ($5.5 billion).

Baker McKenzie partner Peter Lu says: "The current nature of the relationship between China and the US has resulted in many Chinese corporations directing their investment to the domestic market instead." This has led to increased competition; inevitably many corporations want to be the strongest player on their home turf.

As well as boosting the local economy, this strategy provides an opportunity for Chinese companies to compete domestically before they tackle the European market – which can be highly crowded and competitive. Given the option to expand abroad or strengthen their position at home, Lu says that many would now choose the latter, and in doing so gain invaluable experience within their home territories and boost their chances of success in Europe at a later date. "This is a shrewd decision, as you have to learn to walk before you can run," says Lu.

"The Chinese government wants inbound portfolio investment, and will continue to open avenues to encourage this," says Rory Green, economist at TS Lombard. "There is also the question of relative attractiveness. Trade war uncertainty and the issues surrounding the coronavirus have led to it being a less attractive place for market participants to invest."

Trade wars: Finding a culprit

Hate him or love him, it is hard to deny the impact that the election of Donald Trump as president has had on the relationship between the US and China. In the years following his first imposition of tariffs on China, the swift retaliation, and the significant ramping up of the regulatory regime in place to protect US technology and national security, tensions have escalated to never-before-seen levels.

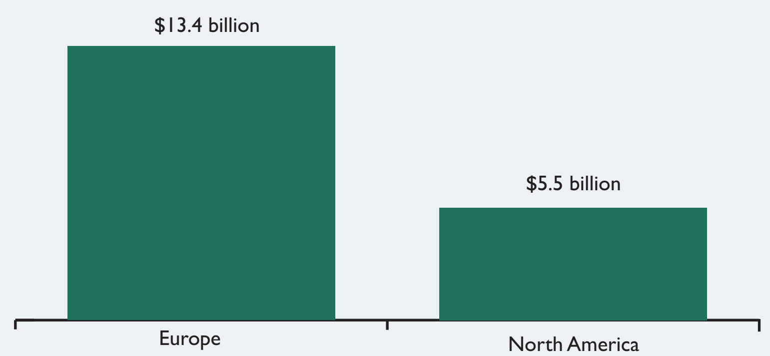
Between the back and forth of tariffs on imported goods, known the world over as the trade war, and the inclusion of the Foreign Investment Risk Review Modernization Act (Firrma) into the National Defense Authorization Act in June 2018, it is no surprise that deal flows, investments and trade more broadly between the two countries have all slowed significantly.

Data provided by economic research firm Rhodium Group suggests that foreign direct investment (FDI) into the US from China has fallen by as much as 90% since 2016 – from the lofty heights of $46.5 billion, to a mere $5.4 billion last year. "When I'm in China speaking to corporate clients in the consumer or agriculture sectors I can really feel the pain," says Samson Lo, head of M&A at UBS, Hong Kong SAR. "Consumer industrial companies can really feel it – prices go sky high and goods are less affordable for the general consumer."

FDI is quantifiable. Exactly what is causing it to fall, however, is up for discussion. IFLR put this question to a number of in-house lawyers and dealmakers.

The chairman of the M&A group at

Chinese investment volumes in 2019



Source: Baker McKenzie

40%

drop in Chinese investment into Europe in 2019

Source: Baker McKenzie

another major international bank in Hong Kong SAR says there are a number of factors at play: "The trade war hasn't had as big an impact as other things – the regulatory environment affects valuation levels for M&A, as well as strategy implications like technological disruption. Those things are far more important to M&A volumes and sentiments than the trade war, in my opinion," he says.

The view from private equity is much the same. While the trade war is of course impacting the economy, when it comes to investments and targeted acquisitions it remains only one of the risk components of how a firm would evaluate strategy from a macro perspective. "As we make decisions in the short and medium term about putting capital to work, the noise [around trade wars] is hard to deal with," says a partner at a New York private equity fund. "But it's only one of a range of concerns at this point."

Trade wars: Not just tariffs

Regulations are impacting deal flow between the US and China just as much as, if not more than, the imposed tariffs.

The landscape is highly unusual. On the US side is the beefed-up multi-agency-led Committee on Foreign Investment in the United States (Cfius), which is throttling Chinese investment into the US. On the other side, the Chinese government is implementing a number of reforms designed to attract foreign investment – including from the US.

As laid out by Jason Yang, head of corporate and institution coverage for the Americas at ICBC Standard Securities – the largest bank in China – the country and the bank are trying to encourage US clients to enter. "We all know the Chinese economy has slowed, and that confidence between the US and China over the last two years has also slowed," he says.

"But the Chinese regulator has also reduced its bank shareholder limitations, which means US [and other jurisdictions] banks, insurance companies, security firms or others, can hold a majority shareholding in China to acquire majority shares of that institution under a new entity." This implies huge potential for international banks' ability to compete.

"If you look at these banking regulations relative to the new foreign investment law,

Contract lawyers' coronavirus solution

From manufacturing delays to store closures, the impact of the coronavirus has rattled China and all supply chains connected to the country. Many businesses are affected, faced with delays or the failure to fulfil contractual obligations. To date, Chinese buyers of copper and liquefied natural gas have declared *force majeure*. While *force majeure* clauses may be relied upon – the Chinese government is encouraging their use – lawyers warn that they may not have been negotiated properly into agreements.

If there is a *force majeure* clause in the contract, it has the power to remove liability for natural and unavoidable catastrophes that interrupt the expected course of events and restrict contractual parties from fulfilling obligations. If there is no *force majeure* clause in a contract, contractual parties are liable for what they cannot perform even if specific circumstances beyond their control occur.

"While *force majeure* clauses are found in the majority of contracts, in practice, parties to a commercial contract frequently don't spend enough time on the negotiations and drafting of such clauses," says Julien Chaisse, professor of law at the City University of Hong Kong. "There is widespread assumption in the business world that the *force majeure* risk will not affect parties, or the *force majeure* clause is a legal necessity and does not impact business risk allocation under the contract."

He continues: "These types of assumptions are widespread, dangerous, and largely wrong. The problem now will be establishing how many *force majeure* clauses were drafted in recent months and years in the thousands of contracts that regulate trade with Chinese parties."

Some contracts will feature clauses that capture the epidemic risk and relieve the parties from performing their contractual obligations. Others will not, meaning parties are obliged to perform their duties. "A third category – probably the most problematic – will only provide for ambiguities, leading to many disputes which will have to be decided by domestic courts and arbitral tribunals," says Chaisse.

According to Vivian Mao, partner at Dezan Shira & Associates, if specific circumstances such as epidemics, diseases and plagues have been included in the *force majeure* clauses under executed contracts, the coronavirus can easily be identified as a *force majeure* event. If that's not the case, typically arbitrators and courts will judge whether the event falls into *force majeure* by judging whether the event conforms to the associated characteristics: unpredictability, unavoidability, and insurmountability.

The China Council for the Promotion of International Trade (CCPIT) will play a pivotal role by providing *force majeure* certificates to companies affected by the virus. However, there are conditions to obtain these certificates.

"The ongoing situation in China has understandably resulted in some suppliers being unable to deliver on contracted inputs to their downstream customers, including European companies both in China and abroad," says a spokesperson at the European Chamber of Commerce in China (EUCCC). "In response, the Chinese government has taken the highly unusual step of issuing *force majeure* certificates to absolve qualifying suppliers of their contractual obligations."

There is a widespread assumption in the business world that the force majeure risk will not affect parties

The *force majeure* certificates issued by CCPIT have been recognised by the governments, customs, chambers of commerce and enterprises of more than 200 countries and regions and have relatively strong enforceability. However, whether the *force majeure* certificates issued by CCPIT will fully or partially exempt the contractual parties' liabilities for breach of contract will depend on a number of factors. "In practice, the epidemic duration, the detailed provisions in contracts, scope of government order, and impact on fulfilment of the contract should be fully considered," says Mao.

US President Donald Trump's America First policy has been an obstacle for Chinese authorities

A lawyer's immediate reaction is that of course it will trigger a Cfius review

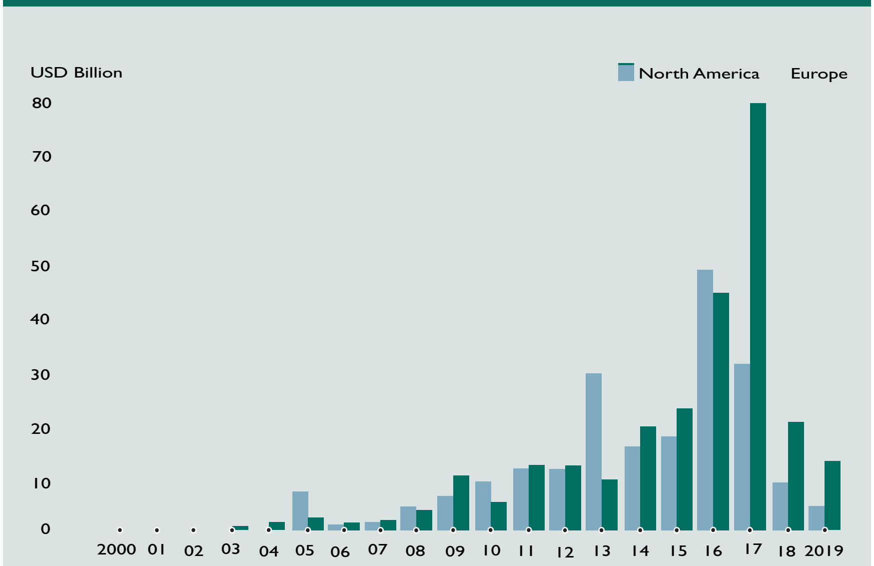
they're much more concrete. They are quite forward and market-leaning in terms of liberalisation," says Harry Broadman, emerging markets practice chair at Berkeley Research Group and former member of Cfius.

"It signals to me that the policymakers regulators in China realise that in order to continue to grow they need other sources of financing from the outside world, not just state-owned banks or the smaller domestic banks in China. It is a helpful change in policy, if it is enforced."

In addition, China's State Administration of Foreign Exchanges (SAFE) has introduced new draft measures that will allow foreign institutional investors to participate in interbank FX derivatives and to manage foreign exchange risk arising from interbank bond investments.

"China has the third-largest stock and bond market in the world – it's hard for us to ignore that. The local market is very significant for an institution to be successful," says Lu Cao.

Chinese investment volume patterns



Source: Baker McKenzie

Internally, China is going through significant, structural economic changes, and as it works through that process there will be ups and downs. Regulators are working to ensure that the country and its financial system progresses as smoothly as possible through that journey.

Trade wars: Just blame Cfius

Like many disputes before it, the ongoing trade war between the US and China is being fought on many fronts. As well as the restrictions and tariffs being imposed on either side, strong regulatory protections have been installed in the US that prevent Chinese investors from acquiring companies that its government deems to be of significant national importance.

The regulation falls under the jurisdiction of Cfius, an interagency committee with the authority to review transactions that may result in foreign persons or businesses controlling certain types of business in the US, to ascertain their impact on US national security.

On January 13, the US Treasury Department issued two sets of final regulations under FIRRMA. The first related to Cfius' expanded jurisdiction over certain types of investments, including non-controlling investments in certain US businesses, while the second related to its expanded jurisdiction over certain foreign investments in real estate.

The link between the tariff escalation and Cfius' new powers might not be direct – but it exists. "While Cfius is not directly related to the trade war, it is in the minds of directors and sellers. There is the general preoccupation with both," says Randy Cook, senior managing director at consulting firm Ankura. "Because of this discussion of tension – even though it doesn't really relate to investment – people are panicky to do things at a psychological level."

Not all parties agree that Cfius has a major impact on the trade war though. "It's tempting to focus on the impact of the new Cfius regulations on the US-China relationship, not least because when the law underlying these regulations was passed in 2018, members of Congress and the administration emphasised the potential threat to national security posed by Chinese investment in the US," says Jeremy Zucker, partner at Dechert in Washington DC.

Either way, US companies and foreign investors from around the globe – not just China – should recognise the impact these new regulations will have. Cfius' jurisdiction over foreign investment transactions has expanded in a meaningful way to cover new types of investments, and filings are now mandatory for certain transactions.

"Chinese buyers have been particularly sensitive about Cfius approval – in fact practically anything to do with the US – for the last few years anyway. They have to ask the question: 'is it likely to trigger Cfius?'," says UBS' Lo.

Putting aside the spillovers from the trade frictions between China and the US – which will not go away anytime soon – changes to the policy environment governing Chinese investments into the US are conditioned by the enactment of FIRRMA and its implementing regulations. However there are other factors – more mundane perhaps, but critical – that need to be considered carefully when assessing cause and effect.

Few clients have been moving in to mainland China

It's also worth noting that the most obvious gauge of sentiment – FDI levels – do not tell the full story. "I'm always wary of most analysts' view of China's FDI statistics for two reasons. First, they are largely based on signed commitments made by the Chinese side to invest; rarely do they measure actual consummation of investments on the ground," says Berkeley Research Group's Broadman. "Inflows and outflows of FDI are indicative, but I am not sure they provide any hard and fast conclusion that is economically meaningful."

Either way, there's little question that Chinese investors have been put off by both FIRRMA and the current administration's Cfius approach. In meetings with Chinese investors and US firms looking to attract more capital from China, as well as US law firms advising such businesses, Broadman has heard a palpable, consistent refrain from the Chinese side that the US is closed. "This perception is, to some extent, misplaced," he says. "It's typically based on the false assumption that the only US sectors worth investing in are the so-called pilot industries specified under the Cfius regulations."

By and large, though, Chinese firms are not pursuing US deals – even in non-contentious areas. This could be because guidelines on when a Cfius notification is triggered are quite vague. That decision is largely subject to the administration's feeling on the specific deal – which doesn't scream predictability.

Even minority stakes are now up for review now too, which was not the case previously. "Dealmakers just don't know how to interpret it. In the absence of better information or precedent, they think it makes more sense to just stop completely," says Lo.

"A lawyer's immediate reaction – in some cases before they've looked at the particulars – is that of course it will trigger a Cfius review. Then comes the recommendation for a full team of Washington lawyers," he says.

It's worth noting that national security concerns about Chinese investment are not unique to the US. For decades now there's been a steady flow of capital from the country into practically every region; the high watermark probably being the ChemChina acquisition of Syngenta in 2017. "Since then, if there have been deals, players have been quite proactive about security and regulatory concerns," the head of M&A at a major global bank tells IFLR.

M&A is impossible if you can't actually go to the country

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CAPITAL MARKETS
BARBADOS DEBT RESTRUCTURING

Building a climate resilient debt portfolio

Lawyers who worked on Barbados' recent debt restructuring explain how it came together, including an analysis of the innovative natural disaster clause

1 MINUTE READ

On December 11 2019, the government of Barbados announced that it had commenced settlement of new bonds and cash consideration following a successful exchange offer and consent solicitation process in respect of its US dollar-denominated commercial debt restructuring. The announcement marked the culmination of a complex sovereign debt restructuring for the island nation's public debt that took more than 18 months to complete. Following the restructuring, Barbados became the only country in the world whose public debt portfolio is climate resilient as a result of the inclusion of the ground-breaking natural disaster clause.

The Barbados debt restructuring, which completed in December 2019, involved two main stages. The first was the restructuring of Barbados dollar-denominated debt totalling approximately the equivalent of US$5.95 billion. This was achieved using the local law advantage to ensure an efficient process and maximum participation.

The second stage was the external debt exchange offer and consent solicitation. This involved the exchange of three series of English law eurobonds, two New York law syndicated bank loans and certain Barbados law bonds for new English law US dollar-denominated bonds due 2029 with a 6.5% coupon, shorter maturity bonds representing post-default interest, plus cash consideration. The exchange allowed Barbados to reduce the original principal amount of the debt obligations and past due interest as of October 1 2019 by 26.3%. The external exchange secured the approval of holders of 94% of the affected debt obligations. This article describes the key innovations and evolutions that Barbados made use of in its 2018/19 restructuring.

Using the 'local law advantage' and collective action clauses

Sovereigns which have debt governed by the local law have occasionally used what is known as the 'local law advantage' in sovereign debt parlance. This technique involves passing a law to change provisions of the debt instruments governed by the laws of the sovereign retroactively. Greece used the local law advantage in 2012 to retrofit a class voting mechanism, which enabled Greek law-governed sovereign debt to be treated as a single class for voting on a restructuring: if a 50% quorum threshold was met and two-thirds of the principal amount of those voting voted to accept the terms, the restructuring could proceed.

This technique of retrofitting a collective action clause was used in the Barbados domestic restructuring to allow the efficient and orderly modification of the terms of the local law-governed debt. Barbados passed the Debt Holder (Approval of Debt Restructuring) Act, 2018

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Collective action clause	Quorum requirement for cross-series modification	Voting threshold for cross-series modification
2014 ICMA form *(multiple series aggregation, 'single limb voting')*	*Not applicable*	*75% of outstanding aggregate principal of all affected series*
2014 ICMA form *(multiple series aggregation, 'two limb voting')*	*Not applicable*	*(a) Two-thirds of outstanding aggregate principal of all affected series* plus *(b) 50% of outstanding aggregate principal of each affected series*
2012 European Stability Mechanism form *(multiple series aggregation, 'two limb voting')*	*Two-thirds of outstanding aggregate principal*	*(a) affirmative vote of 75%, or a written resolution of two-thirds, of outstanding aggregate principal of all affected series plus (b) affirmative vote of two-thirds, or a written resolution of 50%, of outstanding aggregate principal of each affected series*
Greece restructuring CAC *(2012)*	*50% of outstanding aggregate principal (across all series)*	*Two-thirds of value-weighted votes*
Barbados restructuring CAC *(2018)*	*50% of outstanding aggregate principal (across all series)*	*75% of value-weighted votes*

in October 2018, which enacted that the restructuring proposal would be deemed accepted where holders of 50% of aggregate outstanding principal amount of the instruments submit voting forms and 75% of those voting vote in favour.

The above table compares the thresholds for the retrofitted collective action clauses used in the Greece and Barbados restructuring with the collective action clauses published by the International Capital Market Association (ICMA) and the European Stability Mechanism.

Diversity of debt and holders

One complexity that Barbados had to overcome was the diversity of domestic debt obligations that were needed to be included in the restructuring. The universe of debt falling within scope of the Barbados domestic restructuring was vast and included treasury bills, treasury notes, debentures, loans and bonds owed by Barbados and certain state-owned enterprises (SOEs) and other entities that receive transfers from the state budget, and certain arrears owed by Barbados and its public sector.

The debtholders were equally varied, ranging from individuals – including pensioners – to local banks and insurance companies. In order to balance the needs of this diverse group of creditors holding different types of debt, Barbados had to offer various series of new instruments in exchange for existing instruments, where eligibility for each instrument varied depending on holder and instrument type. For example, individual holders were offered a portfolio of new instruments with longer repayment periods and lower interest rates but, crucially, with no reduction in the face amount (that is, no principal haircut) of their claims. This differential treatment can be contrasted with the Greek debt restructuring in 2012 where only one package of consideration was offered to the affected holders and the ICMA form of collective action clause, which requires the issuer to fulfil the 'uniform applicability' condition to aggregate across different series of debt.

In the end, the domestic restructuring garnered the overwhelming support of holders, totalling 97% of eligible claims, which was well above the relevant thresholds required in the domestic legislation.

The 'natural disaster clause'

In recent decades, extreme weather events and natural disasters have taken a huge toll on economies around the world. For particularly vulnerable countries, it is imperative to mitigate the costs to the extent possible. Apart from the immediate human and financial costs of natural disasters such as hurricanes, droughts, floods or earthquakes, the disruption of an economy may continue for many years after the event. Infrastructure must be rebuilt, economic growth plans may be derailed, and tax receipts can plummet.

There are a number of methods by which countries might improve their financial resilience in the face of natural disasters. One way is to embed clauses within a sovereign issuer's debt obligations that provide for a cessation of payments during the most challenging period for an economy immediately following a catastrophe. These natural disaster clauses are, in broad terms, drafted to allow a temporary suspension of principal and interest payments in the event that certain triggers occur.

The clause was first used in the Grenada restructuring in 2015 following the devastation of Hurricanes Ivan and Emily. In the Grenada bonds, upon a tropical cyclone causing a modelled loss pursuant to the Caribbean collective insurance policy above $15 million, there would be a period of time

Extreme weather events and natural disasters have taken a huge toll on economies around the world

during which no payments on the new instruments would be made. At the end of such period, the remaining scheduled principal and amortisation payments would all increase *pro rata* by the amounts deferred during such period.

In 2018, ICMA published a model clause, which structured the payment suspension slightly differently. Under the ICMA model, the issuer may defer repayment of the relevant principal and interest amounts to the date which falls three years after their original due dates, as opposed to increasing the remaining scheduled principal amounts *pro rata*.

In the Barbados restructuring the concept was developed, and a number of innovations were introduced. The payment moratorium was structured as it was for Grenada (i.e., with *pro rata* increases in remaining payments as opposed to pushing out payments by three years in the ICMA model). However, while Grenada and the ICMA model included only tropical cyclone events as the potential trigger, Barbados expanded the trigger events to include earthquakes and floods in addition to tropical cyclones. Compared to Grenada's $15 million threshold, the threshold of loss for Barbados was reduced to $5 million for the local bonds for all events, $5 million in the case of earthquakes and floods, and $7.5 million in the case of hurricanes for the external bonds.

The domestic restructuring garnered the overwhelming support of holders, totalling 97% of eligible claims

Another innovation in the Barbados restructuring is that upon the issuer triggering the natural disaster clause, holders of 50% of the principal amount of the external bonds have the ability to block the deferral of payments within 15 days. This provides the bondholders with some comfort that they can reject any illegitimate triggering of the natural disaster clause. The main attraction of the natural disaster clause is that it embeds within the contractual terms an automatic debt restructuring mechanism (automatic deferral of payments) without the associated costs of a formal restructuring process. It would not be in the creditors' interests to force a formal restructuring by blocking the issuer's exercise of the natural disaster clause in situations where it is clear that the country has suffered a catastrophic loss and will not have sufficient funds to service its debt obligations.

As a result of the restructuring, Barbados is now the only country in the world with a climate resilient debt stock. Other countries that are vulnerable to natural disasters may look to the Barbados example and consider including such clauses in their debt instruments. Barbados' pioneering use of the natural disaster clause across its entire public debt stock and the other innovative features discussed herein will no doubt be a yardstick for other sovereigns in the future. While no two countries are exactly alike, they can certainly learn from one another.

All instances of $ refer to US dollars unless otherwise specified.

As a result of the restructuring, Barbados is now the only country in the world with a climate resilient debt stock

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CAPITAL MARKETS
DUAL CLASS SHARES

The revival of dual class shares

A number of high profile listings including Facebook, Snap, Alibaba and LinkedIn have thrust dual class shares back into the spotlight. Baker McKenzie lawyers consider the model in various jurisdictions

With household names such as Pinterest, Lyft, Xiaomi, Snap, Alphabet, Facebook, Alibaba and LinkedIn opting for dual class share structures and grabbing media headlines with their blockbuster initial public offerings (IPO) over the past few years, you might be forgiven for thinking that such structures are a relatively recent phenomenon. But dual class share structures, also referred to as weighted voting rights (WVR), have been around since the inception of the corporate form.

The controversy surrounding such structures first began in 1925 when the motor vehicle company Dodge Brothers Inc., proposed issuing non-voting stock to the public while the voting stock was retained by the shareholder, investment group Dillon Read & Co. At the time, the Harvard University professor of political economy William Ripley described non-voting stock as the "crowning infamy" of the developments taking place to disenfranchise investors. The resulting public protests led the New York Stock Exchange (NYSE) to declare that "the committee, in considering applications for the listing of securities, will give careful thought to the matter of voting control". The NYSE updated its policy in 1940 to limit the listing of non-voting common stock, although the Ford Motor Company was permitted to list with a dual class share structure in 1956. The basic prohibition remained in place until the 1980s, when companies successfully pressured the NYSE to relax its stance by threatening to move to an alternative market without such restrictions.

The spate of recent high-profile dual class share listings – and the decision in 2018 by both the Hong Kong SAR and Singapore stock exchanges to permit dual class shares – has thrust the subject once more into the public eye. While it brings opportunities for some companies to list on their preferred exchange, it also effectively paints a target on their back as both investors and regulators call for legislative and regulatory change. Will the competition among global exchanges offset growing pressure to limit disparate voting arrangements?

1 MINUTE READ

In 2018 both the Hong Kong SAR and Singapore stock exchanges revised their listing rules within months of each other to permit the listing of companies with dual class or weighted voting right shares and last year the Shanghai exchange launched a new board that permitted this structure. At the same time, a number of high profile listings have reignited the corporate governance debate as institutional investors and index funds begin a campaign to see further limits and protections imposed on their use. This article considers the dual class share landscape and the strategy adopted by Asian and other global stock exchanges.

US scrutiny

In the US, offerings by companies with dual class structures and proposed restructurings which seek to implement similar arrangements following an IPO have served to reinvigorate a corporate governance debate that has been ongoing since the 1980s. Perhaps the market's voice is getting louder with the critical spotlight recently thrown on WeWork's super voting rights structure, which would have entrenched the voting power of its founder and CEO Adam Neumann. Concern over this was a key reason for the precipitous fall in the company's valuation, which eventually led to WeWork abandoning its IPO plans. The debate has also been joined by a US Securities and Exchange Commission (SEC) advisory panel, a Trump-appointed SEC commissioner, the investment management industry, and Congress. While proponents continue to emphasise the benefits of private ordering and opponents decry the agency costs that such structures may bring, evolving market dynamics and global competition may ultimately determine the continuing viability of disproportionate governance structures for listed companies.

The last ten years has seen a dramatic increase in the level of capital allocated to passively-managed, pooled investment vehicles. Over the corresponding period and as a consequence of enhanced scrutiny following the Great Recession, a number of significant institutional investors and asset managers in the US have adopted stewardship codes and are becoming more active and engaged in the oversight function associated with their investment activities. Several large institutional investors and asset managers, as an element of their stewardship codes, have advocated for modifications to the current permissive environment that allows companies to adopt dual class voting structures. The concerns related to disparate voting rights are particularly acute for index funds, which cannot sell a security that forms a part of an index even if the company is being badly managed. For such funds, meaningful voting rights are a critical enabler of their stewardship function. While there may be support for a change to the current environment permitting dual class structures, any such change would potentially result in a competitive disadvantage for the US exchanges.

Other exchanges have signaled some flexibility in addressing the issue of dual class voting structures by endorsing sunset provisions, or the potential for the non-affiliate shareholders to vote periodically to eliminate the dual class structure. In any event, with passive investment vehicles projected to exceed 50% of assets under management in the US by 2024, asset managers will play an increasingly important role in all aspects of shareholder rights, including voting rights.

With the growth of assets in passively-managed funds, the developers of popular indexes – including S&P, MSCI and FTSE Russell – have taken notice of the growing concerns regarding weighted voting. These groups have solicited the views of the asset management industry regarding potential selection criteria for companies being considered for inclusion in an index based on a company's voting structure. The Council of Institutional Investors (CII) responded in line with several other organisations, confirming its commitment to proportional voting rights and proposing that dual class companies only be included in an index provided they adopt a sunset provision. The CII proposal would allow a company to maintain its dual class structure for a period of years, and then the higher voting stock would have voting rights identical to the other class of common stock – provided the unaffiliated shareholders could vote to extend the dual class arrangement for an additional period without jeopardising inclusion in the index.

> **The last ten years has seen a dramatic increase in the level of capital allocated to passively-managed, pooled investment vehicles**

Other views relating to dual class structures

In February 2018, the SEC's Investor Advisory Committee issued a paper regarding dual class and other "entrenching governance structures" and made a series of recommendations to the Division of Corporation Finance. The proposals included additional disclosures relating to risks that may accompany dual class structures, as well as enhanced information regarding the difference between the economic ownership of the control group versus the voting rights that accompany the super voting shares owned by that group. The recommendations reflect the traditional approach of the SEC to focus on disclosure as a means of addressing issues rather than mandating governance modifications, as in the case of some Asian stock exchanges such as the Hong Kong Stock Exchange (HKEX). While the recommendations were limited principally to disclosure items, the subcommittee's report was animated by serious reservations regarding the growing use of dual class structures by companies going public in the US.

In response to the recommendations of the Investor Advisory Committee, a bill has been introduced in Congress (the Enhancing Multi-Class Share Disclosures Act) that would enhance the disclosure obligations of issuers with respect to disparate voting structures. The enhanced disclosure would require companies to clearly show the difference between the voting power and economic rights of a shareholder or group of shareholders owning super voting shares.

The draft legislation is most notable for what it does not address. In its current form it does not authorise the SEC to adopt new rules relating to voting structures, nor does it seek to amend the federal securities laws to otherwise mandate a one-share, one-vote standard of corporate governance which, in any event, would likely be subject to constitutional challenge.

While the SEC's rule-making authority in the context of voting rights is constrained by a 1990 DC Circuit Court decision which struck down a prior SEC rule making intended to eliminate disparate voting arrangements, Commissioner Robert Jackson has urged US exchanges to adopt rules designed to preclude companies with perpetual dual class voting structures from listing on the exchanges. Instead, Commissioner Jackson proposed that the exchanges should require companies with dual voting classes to adopt sunset provisions as a condition to listing. In his comments regarding current practice, Commissioner Jackson noted that perpetual super voting shares that put "eternal trust" in the hands of insiders is "antithetical to our values as Americans".

Evolving position in Hong Kong SAR

As widely reported, Alibaba chose the NYSE for its 2016 IPO in part because the HKEX would not grant an exception to its rule prohibiting disproportionate voting arrangements. Following a public consultation in early 2018, on April 30 2018, the HKEX began accepting applications for the listing of innovative companies with WVR structures under the new Chapter 8A of the Main Board Listing Rules. Under the HKEX's reforms, only innovative companies are permitted to adopt the WVR structure for stock listings in Hong Kong SAR.

The HKEX's new rules reference the ability of companies with WVR structures to list, subject to certain limitations. To limit applicants to well-established and high-profile companies, the expected market capitalisation of a WVR company is proposed to be at least HK$10 billion (approximately $1.28 billion) and at least HK$1 billion of revenue if expected market capitalisation is less than HK$40 billion. In addition to a minimum market cap, the exchange has indicated that it will consider factors including the nature of the business of the applying company (it must be an "innovative company" with significant value and substantial expected R&D activities). Importantly, the holder of the weighted voting shares must be a person who has been responsible for the growth of the business and has an active role as an executive and director of the enterprise.

Safeguards

A basket of safeguard measures will need to be incorporated in a WVR company's constitutional documents to allow shareholders to take civil actions against the company if needed. The HKEX has also imposed other limitations intended to protect minority shareholders, such as requiring the holders of the weighted shares to hold at least 10% of the economic interests of the company, requiring a natural sunset clause. This generally dictates that the weighted voting arrangement will cease upon the transfer of the beneficial ownership of the shares or cessation of directorship in the company, and permits the non-controlling shareholders to cast at least 10% of the votes on matters presented to a general meeting.

The higher voting shares may not have voting power that is greater than 10 times that of the ordinary shares: a ratio that is commonly, although not universally, adopted among US-listed companies with dual class share structures. Additionally, resolutions relating to modifications to the constituent documents of the entity, changes to voting rights of any class of shares, the appointment of auditors and the dissolution of the entity require a vote of all shareholders on a one-vote-per-share basis.

The HKEX is selective in opening up this listing in Hong Kong SAR due to so-called centre of gravity restrictions are now permitted to have a secondary listing in the jurisdiction, provided they are eligible tech companies that are already listed on those qualifying stock exchanges. Some commentators suggest that this is an attempt by the HKEX to lure tech companies listed on other major stock exchanges – such as Alibaba – to return. In the context of spinoffs of WVR companies, the HKEX launched a separate

The draft legislation is most notable for what it does not address

new weighted share regime to new issuers. It has indicated that it will review applications on a case-by-case basis and apply the new rules subjectively, with a view towards providing additional guidance in the future. It has also made clear that satisfying the requisite listing criteria for weighted share structures does not automatically give a tech company an entry ticket to listing on the HKEX. The HKEX must also be satisfied that such issuer is the type of tech company that the HKEX wishes to attract to list in Hong Kong SAR. While the HKEX has made an unprecedented move to adopt a dual class regime to cater to market needs and increase its competitiveness in the global capital markets, it is evident that the HKEX is cautious in opening up and revolutionising its traditional one-share-one-vote regime; and safeguarding investors' interests remains one of its priorities and main focus areas.

In contrast to the US listing regime that adopts a disclosure-based regime with fewer restrictions on the WVR structure, Hong Kong SAR has adopted an enhanced disclosure and corporate governance structure. WVR companies are required to display warnings and a distinctive W stock marker on listing documents and corporate communications.

For qualifying international companies already listed on the NYSE, Nasdaq, and the premium market of the London Stock Exchange (LSE), and for qualifying Chinese companies already listed on those stock exchanges before December 15 2017, their secondary listing in Hong Kong SAR may not require any changes to their existing WVR structures and constitutional documents. Most importantly, Chinese companies that were previously prohibited from secondary consultation on corporate WVR beneficiaries in January 2020.

Singapore plays catchup

In June 2018, after two rounds of consultation, the Singapore Exchange (SGX) followed the HKEX and also introduced new rules permitting dual class share structures. Announcing the rule change, Loh Boon Chye, CEO of SGX said: "SGX…joins global exchanges in Canada, Europe and the US where companies led by founder-entrepreneurs who require funding for a rapid ramp-up of the business while retaining the ability to execute on a long-term strategy, are able to list." In doing so, Loh highlighted the increasing global acceptance of the structure, premised on the desire by exchanges to meet the demands of new economy companies with strong founder-led businesses.

Similar to the HKEX, the SGX introduced a number of safeguards intended to mitigate the risk of disparate voting structures on a non-WVR shareholder. These require an enhanced voting process where all shares carry one vote each regardless of class for the appointment and removal of independent directors and/or auditors, variation of rights attached to any class of shares, a reverse takeover, winding-up or delisting; the majority of the audit committee, the nominating committee and the remuneration committee, and each of their respective chairs, must be independent directors; multiple voting shares are capped at 10 votes a share with holders of such share limited to named individuals, or permitted holder groups whose scope must be specified at the time of the IPO, and the multiple voting shares must include sunset clauses where such shares will auto-convert to ordinary voting shares under circumstances the company must stipulate at the time of the IPO. The new rules adopted by both exchanges attempt to reach a middle ground, permitting flexibility for high-growth companies while mitigating the governance risks associated with dual class structures.

China's rapid capital market reforms

China's company law stipulates the principle of one-share, one-vote for joint stock companies and places emphasis on equal protection for all holders of ordinary shares, in particular, equal voting rights. Against the backdrop of the Chinese government's legislative changes on company law, foreign exchange relaxation and the goal of developing a mature capital market, the WVR structure in the PRC has now been accepted as public policy. Equity securities with unequal voting rights have historically been prohibited from listing on domestic Chinese stock exchanges, and fast-growing new economy companies in China with WVR structures have faced restrictions on listing their equity securities.

When these companies have advanced to a stage that requires large-scale capital fundraisings, listing their equity securities outside of China becomes an attractive option. In the past, these companies either had to abolish their WVR structures to be eligible to list their equity securities in Hong Kong SAR, or (for those who refuse to compromise on the founders' control over the company), choose other listing venues such as those in the US. Faced with the continued loss of such companies to overseas exchanges, the Chinese government has responded. On November 3 2018, President Xi Jinping announced the decision to launch a science and technology innovation board (STAR Market), drawing immediate comparisons with the Nasdaq exchange in the US.

Moving quickly to implement this policy decision, on March 1 2019, the China Securities Regulatory Commission and the Shanghai Stock Exchange (SSE) issued a series of immediately-effective listing rules and guidance materials for the new board. One of the stated targets of the STAR Market is to attract companies with WVR structures. Such a structure must be adopted before listing and comes with other preconditions: (i) a minimum expected market cap of CNY10 billion (approximately $1.4 billion); or (ii) a minimum expected market cap of CNY5 billion and at least CNY500 million operating income for the most recent year. UCloud Technology, which operates a cloud computing service platform, became the first company to list on the STAR Market with a WVR structure in January 2020.

As with Hong Kong SAR and Singapore, certain protections have been built in for shareholders of non-WVR shares listed on the STAR Market. The proportion of voting rights of ordinary shares shall not be less than 10%; shareholders individually or in aggregate holding more than 10% of the issuer's voting shares can convene an extraordinary general meeting; and shareholders individually or in aggregate holding more than three percent of the issuer's voting shares can propose a resolution at a general meeting.

London remains an attractive option for many issuers even while it retains its limits on dual class share structures

Can the UK hold out?

The Financial Conduct Authority has on several occasions over recent years conducted consultations with respect to potential changes to the Listing Rules that would have allowed companies with a premium listing on the Main Market of the LSE to have shares with equal economic rights, yet disproportionate voting rights, admitted to trading. The premium listing principles, set out in rule 7.2.1A, state that "all equity shares in a class that has been admitted to premium listing must carry an equal number of votes in any shareholder vote" (premium listing principle 3) and, perhaps equally importantly, that "where a listed company has more than one class of securities admitted to premium listing, the aggregate voting rights of the securities in each class should be broadly proportionate to the relative interests of those classes in the equity of the listed company" (premium listing principle 4). It is noted that the admission of non-voting shares to trading is permitted for companies with a (less prestigious) standard listing on the Main Market, although very few companies have taken that option and those which have are excluded from such indices as the FTSE.

Interestingly although the AIM rules, which apply to the LSE's junior market, do not explicitly prohibit the admission of a class of shares with restricted or no voting rights, it has been made clear in the past that AIM regulation would be highly unlikely to consider such shares eligible for admission. There is continued strong support in the UK among institutional investors for the one-share, one-vote principle to be preserved for premium-listed and AIM-quoted companies, and so far this market pressure seems to have prevailed in the corporate governance argument as to whether to allow dual class shares.

Despite pressure and the changes to the listing rules seen in Asia, London remains an attractive option for many issuers even while it retains its limits on dual class share structures. A premium listing on the LSE remains prestigious and sends a strong signal to investors about the high level of disclosure, corporate governance and regulation.

In April 2019, the Dubai-based digital payments provider Network International obtained a premium listing on the Main Market without dual class shares in the LSE's largest tech IPO since 2015. While exchanges in other money centres are relaxing regulations to encourage new economy and technology companies to list, London, for now, appears to be taking the principled stance that the dilution to its brand that it perceives would come from such a relaxation is not worth it. Arguably, the Network International listing shows that, even in otherwise dire market conditions, London remains able to attract technology companies to its board even without offering up the carrot of a dual class share structure. The question remains as to how long London's regulators and investor community will retain this confidence.

A continental perspective

While the corporate governance debate in many countries around the world has centered on the costs and benefits of allowing companies to issue multiple share classes, in recent years one line of discussion that has emerged in mainland Europe focuses on short-termism and the risk that some market participants, including shareholders, may prioritise short-term profiteering to the detriment of the company. To counter the perceived harm of the activities of certain investors such as hedge funds, some countries, including France and Italy, have adopted tenured voting (also known as time-phased voting rights or loyalty shares). These reforms are based on an argument that the long-term interests of the company are best served by long-term shareholders. To align these interests and ensure good corporate governance, long-term shareholders are rewarded with enhanced voting rights in the belief that this will defend against myopic corporate actions and promote a greater level of responsible corporate governance.

Following an earlier decision by the steel company ArcelorMittal to close its operations in Florange in France in 2014, the French government passed a new law – the *Loi Florange* – to give double voting rights to shareholders holding shares for a period of more than two years. A French company that does not wish to provide for differentiated voting rights in this manner must specifically disapply this in its constitutional documents.

There are a number of question marks that hang over this approach to long-termism. BlackRock's investment stewardship team recently released a commentary paper on the topic, in which they argue that a number of assumptions about the benefits of differentiated voting rights need to be revisited. Blackrock cites research that "introducing enhanced voting rights…will not lead to a material change to the time-horizon of investment in that company. Rather, these measures are simply control mechanisms and may be counterproductive, entrenching a core group of shareholders to the detriment of minority shareholders". It is also argued that such shareholder entrenchment produces less engagement and may raise the cost of capital.

It is argued that shareholder entrenchment produces less engagement and may raise the cost of capital

Implications for dual class structures

A 2007 report issued by the OECD states the issue well: "…discrepancies between ownership and control can exacerbate the misalignment of incentives of controlling and non-controlling shareholders and… a separation of voting and cash flow rights may compromise the efficiency of markets for corporate ownership and control. The questions facing authorities is whether these potential drawbacks actually manifest themselves and, if so, whether their economic costs are sufficiently large to justify regulation." There is no global consensus with respect to this issue and it remains to be seen whether competition among the major exchanges can be reconciled with evolving views of corporate governance in the asset management and institutional investor community.

No matter the outcome, the growing engagement and influence of institutional investors and asset managers with respect to the exercise of their stewardship undertakings has the potential of increasing pressure on legislators, regulators and the exchanges in the US and elsewhere to eliminate or restrict disparate voting structures. The question is whether any resulting modifications to the existing permissive private ordering approach in the US will allow for some flexibility, such as sunset provisions, or a modified listing structure like that adopted by Asian bourses as a means of protecting the competitive position of the exchanges while responding to the demands of large institutional investors and fund managers.

While a consensus may be developing in the US for the imposition of limitations on dual class voting structures, the same is not the case in other countries, with the opposite direction of travel often seen. Many foreign countries permit disproportionate voting arrangements and the stewardship codes adopted in countries outside the US do not include a one-share, one-vote principle. Moreover, the launch of the STAR Market on the SSE and the relaxation of the listing standards by the Hong Kong SAR and Singapore exchanges, to permit the listing of companies with disproportionate voting rights subject to certain conditions, presents a competitive challenge for the US exchanges seeking listings of the emerging Chinese tech giants.

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CORPORATE

EU SUSTAINABLE FINANCE

Sustainable finance reforms: threat or opportunity?

The EU's proposals should be top of the agenda for in-house lawyers of asset managers and institutional investors in 2020

1 MINUTE READ

The EU's sustainable package reforms will fundamentally reshape the way in which buyside firms incorporate a consideration of environmental, social and governance (ESG) factors into their investment and risk management processes. Asset managers and institutional investors will need to work closely with their general counsel and sustainability experts to ensure they are prepared for the incoming obligations and have minimised legal and reputational risk arising from the new requirements, in particular the mandatory disclosures.

Since the European Commission (EC) adopted an action plan on sustainable finance in March 2018, a package of reforms pushing the sustainability agenda forward has now been finalised. These reforms will reshape the way institutional investors and asset managers integrate environmental, social and governance (ESG) factors into their investment decision-making, and how they market green financial products. Buyside firms have a significant amount of work to do over the next 12 months to establish the key issues and prepare themselves, and should expect their approach to sustainable investing to be of increased interest to both investors and the media, amid mounting fears about the risks posed by climate change to the global economy.

What's in the package?

The EU's sustainable finance package introduces three new core regulations to the EU financial regulatory landscape.

The ESG Disclosure Regulation aims to facilitate market-wide transparency on the ESG profile and capabilities of financial services firms, and prevent the greenwashing of financial products being offered or marketed to investors. To achieve this, the regulation will require (i) managers and financial advisers to disclose at an entity level how they incorporate sustainability into the services they provide, and (ii) managers offering funds or strategies with a sustainable objective or with environmental or social characteristics to evidence – through disclosure at a product level – how those characteristics or objectives are met.

Asset managers and institutional investors will therefore need to disclose an ESG policy and report on various matters, including their approach to due diligence, and how sustainability risks are taken into account in investment decision-making. They will also need to publish information on how remuneration policies reflect the integration of sustainability risks. The first mandatory disclosures will need to be made by March 10 2021.

The ESG Taxonomy Regulation aims to create a common language across the EU in describing and measuring the sustainability of economic activities. Once the regime is in force, all financial products will have to refer to the ESG Taxonomy Regulation; products held out

> **Under the proposed amendments to Mifid II, firms will need to integrate sustainability factors within suitability and product governance assessments**

to be sustainable will need to disclose how and to what extent the taxonomy has been used to reach this conclusion, and other products (including those with environmental or social objectives, but which do not qualify as sustainable) will need to include a statement that the investments underlying the financial product in question do not take into account the EU criteria for environmentally-sustainable investments.

Solid fuels are excluded from the taxonomy, and investments in them will not be eligible for sustainable finance treatment. Gas and nuclear, in contrast, are considered transition economic activities; they will be subject to the other requirements in the ESG Taxonomy Regulation, including in particular the requirement to "do no significant harm": the test for which will be the subject of technical standards and guidance to be developed over the next 12 months. Further work is still to be done by the technical expert group on transition or brown activities and enabling activities (i.e. those that are necessary to deliver sustainable activities) and how these might sit within the taxonomy.

The ESG Taxonomy Regulation will be finalised and published in the Official Journal by the end of May this year, meaning the taxonomy will likely apply by the end of 2022.

The ESG Benchmarks Regulation will introduce low-carbon and carbon-neutral benchmarks, both of which are underpinned by a methodology linked to commitments laid down in the Paris Agreement on carbon emissions. This regulation applies to benchmark administrators from April 30 2020, and the information they will be required to publish on the sustainability of the investments comprising benchmarks should help managers in their product level disclosure obligations under the ESG Disclosure Regulation.

Parallel amendments to existing legislation

Near-final amendments to delegated acts for sectoral legislation – including Mifid II [Markets in Financial Instruments Directive], AIFMD [Alternative Investment Fund Managers Directive], Ucits [Undertakings for collective investments in transferable securities] Directive, Solvency II and the Insurance Distribution Directive – are also taking place simultaneously. This will require an embedding of sustainability risks into investment decision-making and internal risk management processes.

Under the proposed amendments to Mifid II, for example, firms will need to integrate sustainability factors within suitability and product governance assessments. Asset managers and financial advisers will therefore need to carry out a mandatory assessment of their clients' sustainability preferences.

> **Asset managers and institutional investors have a significant amount of work to do over the next 12 months**

Key issues for asset managers

Many asset managers and institutional investors already incorporate a consideration of ESG-related risks into their investment decision-making processes, and such risks are increasingly being categorised as financial risk factors in much the same way as factors such as credit risk or liquidity risk are. A growing number of asset managers already offer sustainable finance strategies such as negative screening, best-in-class, ESG integration and impact-driven investment, recognising the increasing number of investors who want to direct capital towards sustainable activities.

However, the package of reforms represents the first time that firms will be required by regulation to incorporate a consideration of sustainability risks into their investment process and provide disclosures specifically relating to sustainability. Asset managers and institutional investors therefore have a significant amount of work to do over the next 12 months to ready themselves for the new regime, and there are multiple practical issues that in-house lawyers will need to tackle to help their businesses work through this process.

Lack of comprehensive ESG data There is a significant lack of reliable, consistent and comprehensive ESG data available to investors, which makes it difficult for firms to ascertain the extent to which a particular investment is sustainable. As a result, asset managers and financial advisers will likely face substantial challenges when looking to meet their client's sustainability preferences, exposing themselves to potential liability risks along the way.

Lack of legislative detail The level 2 rules setting out the substance of the ESG Disclosure Regulation's obligations are unlikely to be finalised until December 30 2020, giving firms limited time to comply with the new disclosure regime, the first requirement of which will need to be complied with by March 10 2021. Additionally, the taxonomy will not be fully functioning until the end of 2022, meaning that for nearly two years, firms will be subject to disclosure requirements without a full and final methodology for determining whether an investment or activity is sustainable.

Product scoping The product level disclosure obligations apply where products are promoted as having environmental or social features, even if they do not have a sustainable objective. Firms need to review product features and disclosures with this broader definition in mind for scoping purposes.

Geographical reach Applying these standards across complex delegation models and to investee companies outside Europe (particularly in emerging markets and less developed economies) will be a key challenge.

Remuneration Firms are required to disclose how their remuneration policies are consistent with the integration of sustainability risks, but it is not clear what this would mean in practice.

Suitability Given the potentially vast number of different sustainability preferences clients could have, firms may struggle to continue to offer or recommend standardised products or strategies. Helpfully, guidance indicates that sustainability preferences should be a secondary consideration that does not outweigh the relevance of other suitability criteria, but asset managers will need to think carefully about how this will be assessed and communicated to clients in practice.

These difficulties arguably present a real opportunity for ambitious asset managers

Threat or opportunity?

While the buyside is largely in favour of the core aims of the EU's sustainable finance package, there is a growing concern that the ambition with which the reforms have been drafted and the speed with which they have been brought through the legislative process could lead to unintended adverse consequences on sustainable investing in Europe.

Under the new legislation, financial products with sustainable objectives must not only pursue a particular environmental or social goal, but also must not significantly harm other sustainable objectives, and must ensure that minimum governance standards are met by investee companies: the idea being that overall the product should do "more good than harm" to sustainability. There is a concern that only the narrowest and darkest shade of green investing could satisfy the criteria of not significantly harming sustainable objectives, potentially leading to the perverse effect of a significant drop in products available in the market that are classified as sustainable.

If the universe of products qualifying as having a sustainable objective is small, then the resulting rump of products that do not satisfy the relevant criteria will be correspondingly large. Given all such non-qualifying products will be required to include a statement that the underlying investments do not take into account the taxonomy (even if they do in practice have environmental or social objectives), there is also a risk of reputational damage to asset managers and investors who hold themselves out as making sustainable investment a key priority, but for whom a large portion of their product offerings or investments include an unsatisfactory disclaimer warning that they do not factor in the EU taxonomy for environmentally sustainable investments.

These difficulties, however, arguably present a real opportunity for ambitious asset managers to create financial products that do satisfy the criteria necessary to be marketed as having a sustainable objective. Those successful managers will potentially be in an elite group and will likely be the recipients of both significant amounts of investor interest and positive press attention. The development by the EU of Ecolabel criteria for retail financial products, to introduce an optional badge that can be borne by the most environmentally friendly products, represents another opportunity for sustainably-focused managers to seize a growing corner of the market and take advantage of snowballing investor interest in green investing.

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Why is insider trading illegal?

US legislation is unclear on the issue, resulting in surprising outcomes in government enforcement efforts

It has been clear, at least since a Securities and Exchange Commission (SEC) administrative decision in 1960, that as a general matter it is unlawful in the US for a person to purchase or sell securities of a corporation when in possession of material nonpublic information about the corporation. Trading by an insider, or by a tippee, can violate Section 10(b) of the Securities Exchange Act of 1934, and in particular the anti-fraud provisions of SEC Rule 10b-5. A number of former corporate insiders are in jail for ignoring the insider trading prohibition.

What is not clear is what causes insider trading to violate Section 10(b) and Rule 10b-5. This lack of clarity has led to more than 50 years of litigation.

There are two theories for why trading by insiders when they are aware of material nonpublic information is unlawful. One is that the insider is committing a fraud on the person from or to whom the insider purchases or sells securities, because the insider is aware of important information that is not available to the other person. The second is that an insider's fiduciary relationship with the shareholders of the corporation requires the insider to be sure that the shareholders with whom the insider deals have all relevant information of which the insider is aware. Neither of these rationales is entirely satisfactory.

The first theory would apply to persons who have no relationship to a company to the same extent it would apply to corporate insiders or people who obtain nonpublic information from corporate insiders. That clearly is not intended to be the case. There is general agreement, for example, that if someone on the street saw a building collapse, it would not be unlawful for that person to immediately call his or her broker and place an order to sell stock of the corporation that owned the building.

Also, fraud customarily requires harm to the defrauded person. With regard to securities traded on exchanges, if an insider does not sell stock because he or she is aware of material nonpublic information, the person who would have bought the stock from the insider at the prevailing market price will simply purchase the stock from somebody else at that prevailing market price (or the person who would have sold stock to the insider will sell it to somebody else for the prevailing

1 MINUTE READ

It has been clear for at least 60 years that as a general matter it is unlawful in the US for a person to purchase or sell securities of a company when in possession of material nonpublic information about the company. But courts have struggled to come up with the rationale for why this is the case, which has sometimes led to surprising results when the government has tried to punish insider trading. The House of Representatives has recently passed a bill that purports to clarify the law regarding insider trading. However, that legislation is likely to create as many problems as it would solve. What is needed is clear, simple legislation that puts in place the broad prohibition that most people think already exists.

market price). Unless the insider purchases or sells stock in market-moving volumes, the person who would have sold stock to, or purchased stock from, the insider will probably not be affected at all by whether the insider refrains from trading.

The second theory also does not always work. While an insider who buys stock is always dealing with a stockholder of the corporation, there is no reason to think that when an insider sells stock, the person who buys it will be an existing stockholder. Therefore, there is no reason to think an insider who sells stock will have a pre-existing fiduciary relationship with the person who buys it.

The securities fraud statute applies only if there is a false or fraudulent statement, which is not the case in most instances of insider trading

Beginning in 1980, the US Supreme Court began to address what makes it unlawful for a person to purchase or sell securities when in possession of material nonpublic information. Three decisions were particularly important in addressing this question.

The first decision, rendered in 1980, related to Vincent Chiarella, an employee of a financial printer who sometimes worked on documents relating to tender offers. Tender offers almost always involve purchases at substantial premiums above the pre-tender offer market prices of the target company stock. Chiarella used his advance knowledge of five tender offers to purchase stock of the target companies before the tender offers were announced and profited from the price increases resulting from them.

Chiarella was convicted of violating federal securities laws. But the Supreme Court reversed the conviction, stating that the trial court had incorrectly charged the jury that Chiarella could be convicted for trading on the basis of nonpublic information without also telling the jury that in order to convict, it had to find that Chiarella had had a duty to disclose the information. The Supreme Court did not address whether Chiarella had had such a duty.

The second decision, rendered in 1983, related to Raymond Dirks, an officer of a brokerage firm, who had been told by a former officer of a large insurance company that the insurance company's assets were hugely overstated as a result of fraud, but that regulatory agencies had failed to act on charges made by company employees. Dirks tried to encourage the Wall Street Journal to expose the fraud, but it wouldn't publish the story. Meanwhile, Dirks told customers of his firm what he had learned, and some of them sold stock of the insurance company. Eventually, the fraud was uncovered, and the insurance company went into receivership.

The SEC ruled that Dirks had violated Section 10(b) by telling customers about the fraud, stating that when tippees come into possession of material information they know or should know which came from a corporate insider, they must either publicly disclose the information or refrain from trading.

The Supreme Court disagreed with the SEC. It acknowledged that if a person who is tipped about material information knows the information was disclosed in breach of the tipper's duty, the tippee acquires the tipper's duty to disclose the information or refrain from trading. However, the Supreme Court said that an insider is not liable for disclosing nonpublic information to a person who trades on it unless "the insider receives a direct or indirect personal benefit from the disclosure, such as a pecuniary gain or a reputational benefit that will translate into future earnings" or the insider "makes a gift of confidential information to a trading relative or friend". The Supreme Court said that because the former insider who told Dirks about the fraud had not received a personal benefit from making the disclosure, the former insider had not violated the securities laws, and therefore people who traded on the basis of what the former insider had disclosed did not violate the securities laws.

Since the Dirks decision, there has been frequent litigation regarding what constitutes personal benefit to an insider, including another decision of the Supreme Court, and the question is still not fully resolved.

The third important US Supreme Court decision involved James O'Hagan, a lawyer who learned that a client of his firm was going to make a tender offer for stock of a company that was not a client of the law firm, and purchased stock of the target company before the tender offer was announced. O'Hagan was convicted of violating Section 10(b), but an appellate court reversed the decision, because there was no fiduciary or other relationship that created a duty for O'Hagan to disclose the likelihood of a tender offer to the persons from whom he purchased stock.

The Supreme Court reinstated O'Hagan's conviction, finding that O'Hagan had violated Section 10(b) by misappropriating information about the tender offer from his law firm and its client. In other words, O'Hagan was convicted of breaching an obligation to the source of the information, even though he had no obligations to the people from whom he purchased stock. The Supreme Court did not discuss what would have happened if the law firm's client had told O'Hagan he could purchase the stock.

In addition to being convicted of violating Section 10(b) and Rule 10b-5, O'Hagan had been convicted of violating Section 14(e) of the Securities Exchange Act and Rule 14e-3(a) under it. Section 14(e) prohibits fraudulent or deceptive acts in connection with a tender offer, and directed the SEC, for purposes of that subsection, to "prescribe means reasonably designed to prevent, such acts that are fraudulent, deceptive, or manipulative". Rule 14e-3(a) makes it unlawful for a person who knows that someone is taking steps to commence a tender offer because of information obtained from the offering person or the issuer of the securities being sought, to purchase or sell the securities being sought before the information is publicly disclosed. It totally prohibits a person from purchasing or selling securities when in possession of nonpublic information that someone is going to commence a tender offer, even if there is no fiduciary or other duty to disclose.

The appellate court that reversed O'Hagan's conviction for violating Rule 10b-5 also reversed his conviction for violating Rule 14e-3(a), stating that the SEC had exceeded its powers in adopting a rule that was not limited to instances in which there was a duty to disclose. The Supreme Court reinstated the conviction, stating that the SEC had authority under Section 14(e) to create an absolute "disclose or abstain from trading" rule. It expressly did not address whether the SEC's rulemaking authority under Section 14(e) was broader than its authority under Section 10(b).

The adoption of Rule 14e-3 in 1980 was the first, but not the last, time the SEC used its rule-making power to address trading when in possession of inside information. In 2000, the SEC adopted Regulation FD, which, with some exceptions, prohibits an issuer of securities from disclosing material nonpublic information regarding that issuer or its securities to an investment professional or to "a holder of the issuer's securities, under circumstances in which it is reasonably foreseeable that the person will purchase or sell the issuer's securities on the basis of the information". Regulation FD was directed primarily at the practice of companies giving securities analysts information that was not available to the investing public generally. It was not viewed as a general prohibition against trading on the basis of material nonpublic information.

Nine years later, the SEC adopted two more rules directed at insider trading, Rules 10b5-1 and 10b5-2. Rule 10b5-1 prohibits the purchase or sale of a security by a person who is aware of material nonpublic information about the security or its issuer "in breach of a duty of trust or confidence owed to the issuer of the security, to shareholders of the issuer or to any other person who is the source of the material nonpublic information". Rule 10b5-2 defines a duty of trust or confidence to exist when (a) a person agrees to maintain information in confidence, (b) the person communicating the material nonpublic information and the person to whom it is communicated have a history, pattern or practice of sharing confidences, or (c) a person receives material nonpublic information from his or her spouse, parent or child. Therefore, the prohibition in Rule 10b5-1 applies to only a very limited number of situations.

Despite the unwillingness of both the courts and the SEC to enunciate an outright prohibition against trading in securities when in possession of material nonpublic information, there is a widespread belief that such a prohibition exists. Financial institutions maintain detailed compliance programmes aimed at ensuring that nobody trades when in possession of material nonpublic information. Companies create blackout periods beginning two to four weeks before the end of each fiscal quarter when nobody with access to financial information is permitted to trade in the companies' securities. Syndicated loan agreements often enable lenders that have securities trading operations to elect not to receive nonpublic information that is given to the lending group.

The law regarding insider trading remains fluid, as demonstrated by two court decisions in 2019. One is a December 30 2019 decision of a federal appellate court upholding a conviction under a criminal statute relating to securities and commodities fraud for unauthorised disclosure of a pending governmental rule change. The court analogised the unauthorised disclosure to embezzlement and ruled that the conviction could stand even if the person who disclosed the information received no personal benefit from the disclosure. But the securities fraud statute applies only if there is a false or fraudulent statement, which is not the case in most instances of insider trading. Also, the criminal statute is available to the Department of Justice, but not to the SEC.

The other occurrence was the passage by the House of Representatives in December 2019 of a proposed Insider Trading Prohibition Act, that specifically addresses when trading while in possession of material nonpublic information is unlawful. Under the Insider Trading Prohibition Act, if it were enacted into law:

- It would be unlawful for any person to purchase or sell a security while aware of material, non-public information relating to the security, or material nonpublic information, from whatever source, that would reasonably be expected to have a material effect on the market price of the security, if the person knows, or recklessly disregards, that the information was obtained wrongfully, or that the purchase or sale would constitute a wrongful use of the information.
- It would be unlawful for a person whose own purchase or sale of a security would violate the Act, wrongfully to communicate material nonpublic information to a person if (1) the person to whom the information is communicated (a) purchases or sells any security to which the communication relates, or (b) communicates the information to another person who makes such a purchase or sale, and (2) the purchase or sale was reasonably foreseeable.
- Trading while aware of material nonpublic information, or communicating material nonpublic information, would be wrongful only if the information was obtained by, or its communication would constitute,
  - o theft, bribery, misrepresentation or espionage;
  - o violation of a federal law protecting computer data or the intellectual property or privacy of computer users;
  - o conversion, misappropriation, or other unauthorised and deceptive taking of the information; or
  - o breach of a fiduciary duty, a confidentiality agreement, a contract, a code of conduct or ethics policy, or a personal or other relationship of trust and confidence for a direct or indirect personal benefit (including pecuniary gain, reputational benefit, or gift of confidential information to a trading relative or friend).
- It would not be necessary that a person trading while aware of information or communicating information know the specific means by which the information was obtained or whether any personal benefit was paid or promised to any person in the chain of communication, so long as the person trading while aware of the information or communicating the information is aware (or consciously avoids becoming aware) that the information was wrongfully obtained, used or communicated.

The principal change in the law that would be made by the Insider Trading Act is that it would eliminate the need for the person who communicates nonpublic information to receive personal benefit, and substitute a requirement that the person who trades on the basis of nonpublic information know (or consciously avoid learning) that the information was "wrongfully obtained, improperly used or wrongfully communicated". It seems likely that would lead to frequent litigation about whether something was or was not wrongful. And it seems to make it lawful for insiders to trade on the basis of nonpublic information that a company authorises them to use.

The efforts of the courts to find a rationale for why insider trading is unlawful have probably done more to confuse the issue than to clarify it

It is unfortunate that the proposed legislation does not simply prohibit trading when in possession of material nonpublic information obtained as a result of being an insider or obtained directly or indirectly from a person known to be an insider. The vast

The efforts of the courts…have probably done more to confuse the issue than to clarify it

majority of US investors, including sophisticated investment professionals, avoid trading when they have anything that might be viewed as material nonpublic information about a publicly traded company. With rare exceptions, the court decisions defining boundaries of the prohibition against insider trading have involved people who knowingly ignored the prohibition, and whose lawyers tried to come up with technical arguments why they should not be punished for doing so.

The efforts of the courts to find a rationale for why insider trading is unlawful have probably done more to confuse the issue than to clarify it. Use of the criminal prohibition against commodities and securities fraud may avoid many of the complications of using the securities laws to prohibit insider trading, but that prohibition only applies to situations involving false or fraudulent statements. It would be far preferable if the Insider Trading Prohibition Act were modified simply to prohibit trading when in possession of material nonpublic information obtained directly or indirectly from a company or a person known to be an insider. That would make the law clear and simple, and put in place the prohibition that most people think already exists.

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A guide to Switzerland's new licensing rules for portfolio managers

Loyens & Loeff associate Diana Lafita explains what portfolio managers need to know about the new requirements and how they fit into the existing regulatory framework

The regulation of the world's financial market has reached a peak in the aftermath of the last global financial crisis. After the banks, who were the first to undergo more stringent capital requirements, other financial players have become next in line to face more severe regulatory control: potentially a direct consequence of a crisis that affected investors in a variety of circumstances.

Along with a desire for efficiency, this has led Switzerland to homogenise regulatory requirements and apply them to all financial market players following the golden rule 'same business, same risks, same rules'. For this purpose, a new cross-sectorial financial markets architecture has been developed with the aim of creating a level playing field for all market participants.

In this context, the Financial Services Act (FinSA) and Financial Institutions Act (FinIA) entered into force in January 2020 as a central piece of the new financial market architecture in Switzerland, having a horizontal impact across different sectors of the financial market, and including asset managers. Of all financial players, the new regulations are undoubtedly having the greatest impact on asset managers.

As a direct result of the new regulations, asset managers face the regulatory duties of FinSA at the point of sale, and of FinIA by means of a new licensing requirement and a corresponding supervisory framework.

Among financial institutions, FinIA lists the following five categories:

- Portfolio managers (*Vermögensverwalter* – this is the new designation of asset managers and will be used in the remainder of this article);
- Trustees;
- Managers of collective assets (*Verwalter von Kollektivvermögen* – this is the new designation for managers of collective investment schemes);
- Fund management companies (*Fondsleitungen*);
- Securities firms (*Wertpapierhäuser* – this is the new designation for securities dealers).

This article addresses the new licensing requirements for portfolio managers and trustees as well as the relevant transitory provisions.

1 MINUTE READ

The new Financial Institutions Act (FinIA) and the implementing Financial Institutions Ordinance (FinIO) are effective in Switzerland as of January 1 2020. Under the previous regime, asset managers of individual portfolios (portfolio managers) were not subject to any licensing requirement nor prudential supervision, except from compliance with AML requirements and sector-specific standards.

Portfolio managers that were active and compliant with the old regime before January 2020 will have three years to comply with the new licensing requirements and file an application for a licence with FINMA. Portfolio managers starting their activities in 2020 will mainly be subject to the new licensing requirements from the beginning, with certain exceptions.

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> **A new cross-sectorial financial market architecture has been developed with the aim of creating a level playing field**

The previous system

Formerly referred to as independent or external asset managers, portfolio managers historically operated without a licence and were not subject to prudential supervision. However, they were obliged to comply with anti-money laundering (AML) regulations and to be affiliated with a self-regulating organisation (SRO) for the purposes of compliance oversight with AML and sector-specific standards. Alternatively, they could operate as Directly Supervised Financial Intermediaries (DSFIs) under the supervision of the Swiss Financial Markets Supervisory Authority (FINMA) with regard to AML.

Prior to this rule change, managers of collective assets were already subject to a licensing requirement under the old regime and were supervised by FINMA. An exception to this is when the collective investment fund's units were exclusively distributed to qualified investors and the assets under management did not exceed a *de minimis* threshold.

New licensing requirements for portfolio managers

General

FinIA provides that all financial institutions, including portfolio managers, require a license from the FINMA. Only after obtaining such a license shall portfolio managers be able to register with the Commercial Registry and start their activity.

The institutions regulated by FinIA are mainly dedicated to deal with assets of third parties. Therefore, FinIA has come up with a licensing cascade in the form of a regulatory pyramid allowing institutes with higher regulatory requirements to carry out the activity of those with lower regulatory requirements, without having to request an additional license.

Activities in scope of the licensing requirement

The core element of the activity of a portfolio manager is the right of disposal of individual portfolios belonging to third parties. All types of disposition are in the scope of the regulations, from fully discretionary mandates to the mere execution of transactions on behalf of clients. The provision of investment advice, portfolio analysis and offering of financial instruments are activities that may typically be offered on top of the core activity of portfolio managers, but such activities do not trigger any licensing requirement – although they are subject to other regulatory requirements under FinSA.

Although similar licensing requirements apply to them, trustees are assigned a different regulatory category than portfolio managers, and thus require a separate license, except when their activity is conducted by an institution higher in the regulatory pyramid as described above. Their activity is defined as the management or disposal of assets of a trust.

Furthermore, the activity of portfolio managers and trustees must be conducted on a commercial basis. This is the case if one of the following criteria is met:

- Yearly gross income of more than CHF50,000 ($51,000);
- Onboarding more than 20 clients a year that do not entail one single activity, or maintain more than 20 client relationships in a year; or
- Have fully discretionary mandate(s) of assets amounting to more than CHF5 million at a particular point in time.

Some activities are excluded from the scope of application of FinIA, of which the following two can be highlighted: a) management of assets of persons with business or family ties (e.g. single-family office exemption); b) management of assets within the context of employee participation plans.

From a territorial point of view, the portfolio managers subject to authorisation and supervision by the FINMA are those who are active in Switzerland or from Switzerland, including, therefore, those who are based in a foreign country and become active in Switzerland or towards investors domiciled in Switzerland. Cross-border matters are covered later in this article.

The portfolio manager licence also allows managers to be active as a) a manager of collective assets under a *de minimis* threshold and if distribution is limited to qualified investors and b) a manager of funds of occupational pension schemes, also under a particular threshold.

Licences, supervision and audit

The new supervision of portfolio managers and trustees can be described as a tripartite supervision. Even if portfolio managers and trustees have to be licensed by FINMA, the direct ongoing supervision will be carried out by a new body to be referred to as a

Figure1

Supervisory Organisation (SO). The SO's activity will be conducted by one or more private organisations authorised by FINMA (see for instance FINcontrol Suisse AG, which has been established for this purpose and is a subsidiary of the SRO VQF).

It is expected that one or more SOs will be authorised by FINMA in the coming months. If no such SO is authorised by FINMA, supervision would revert to FINMA. The SO can also be, at the same time, an SRO for the purposes of supervision of members with AML regulations. FINMA is the higher supervisory body that will be in charge of licensing the SO, as well as of enforcement actions against portfolio managers and trustees.

Portfolio managers and trustees have to be audited yearly, extendable to once every four years, based on the particular risks of the business. The audit can be conducted by either an audit firm or by the SO.

An overview of the new licensing requirements established by FinIA follows below. FINMA provides a web-based application platform for the submission of encrypted licensing applications in electronic form.

Legal form Portfolio managers or trustees having their registered office or place of residence in Switzerland have to be constituted as either a) a sole proprietorship (*Einzelunternehmen*); b) a commercial enterprise (*Handelsgesellschaft*); or c) a cooperative (*Genossenschaft*); and be registered with the commercial registry.

Fit and proper requirements Directors and executive members, as well as persons or entities with a qualifying holding, must have a good reputation and ensure that their influence is not detrimental to a prudent and sound business activity.

Management The management body must consist of at least two duly qualified persons with representation powers of joint signature. If going concern operations are guaranteed, the management may only consist of one qualified person. At least five years' experience and 40 hours of training in the particular field of activity is considered sufficient for fulfilling the criteria of management qualification.

Financial institutions must effectively be managed from Switzerland. Therefore, managers must be a resident of a place from which they can exercise such management effectively. At least one person that can represent the portfolio manager or the trustee must be resident in Switzerland and be a member of the management or of the supervisory body.

Organisation Financial institutions must establish an organisational framework in order to ensure compliance with the applicable regulations (such as the FinSa). To this end, they have to define their material and geographical scope of activity, assign sufficient qualified staff, and define appropriate risk management and effective internal controls, all in proportion to the size and the risks of the business.

Minimum capital and own funds The minimum capital to be fully paid-in amounts to CHF100,000. In addition, portfolio managers and trustees have to either a) dispose of adequate collateral; or b) take out professional liability insurance which can be accounted to up to half of the own funds to cover the risks of the particular business.

The own funds have to amount to a quarter of the fixed costs of the most recent reported annual financial statements, but do not have to exceed CHF10 million.

Operations Clients' assets have to be deposited separately with a supervised bank or securities firm, and managed based on a power of attorney that allows proof by means of text.

Transitory provisions

Portfolio managers and trustees who started their activities before January 1 2020 and are affiliated with an SRO will have to contact FINMA by July 1 2020 in order to file an application for the corresponding licence, as well as comply with the licensing requirements by January 1 2023. Until the licence is granted, they must continue to be affiliated with an SRO for AML compliance purposes.

Portfolio managers starting their activities during 2020 are required to contact FINMA and immediately comply with the licensing requirements, except for the requirement of supervision by the SO. At the latest, one year after the approval of an SO, portfolio managers and trustees that started their activities in 2020 will have to affiliate an SO and file an application for a licence with FINMA. Until they have been granted such licence, they are obliged to be affiliated with an SRO for AML compliance purposes.

Figure one on the previous page provides an overview of the transitory provisions of FinIA for portfolio managers, trustees and managers of collective assets.

Practical insights

Provided that grandfathering provisions were rejected during the legislative process, portfolio managers who do not reach the size of a profit-based business when taking regulatory costs into account will have to redefine their structure, maximising efficiencies, to survive. Outsourcing certain activities to the extent legally permissible, like risk management, compliance and the internal control system, or the merging of several portfolio managers, may be successful strategies to overcome regulatory challenges.

Cross-border aspects and the EU

According to the Swiss Bankers Association, as of the end of 2018, Switzerland remains the largest market for cross-border wealth management worldwide, managing 27% of global assets managed cross-border. This data includes the business of banks that manage the assets of foreign clients. It is worth addressing some aspects of the cross-border framework of asset management in Switzerland, both inbound and outbound.

Even if non-Swiss portfolio managers do not permanently employ staff to represent them in Switzerland, conducting activities considered as a financial service according to FinSA (such as portfolio management, investment advice or distribution of financial instruments) towards clients in Switzerland triggers the regulatory duties of FinSA - subject to transitory provisions - like the compliance with conduct rules and organizational measures, the affiliation with an ombudsman or the registration with a client advisory registry, with certain exceptions. The offer of fund units by a non-Swiss financial service provider to clients in Switzerland may in addition be subject to further regulatory requirements according to the Swiss Collective Investment Schemes Act.

Non-Swiss portfolio managers that permanently employ staff to represent them in Switzerland require a licensed representation or branch in Switzerland. Financial services – including asset management – of non-Swiss financial services providers which are requested at the express initiative of the client, are subject to certain conditions, deemed not to be provided in Switzerland (self- or reverse-solicitation).

According to Mifid [Markets in Financial Instruments Directive] II, EU member states may decide whether they require the establishment of a licensed branch for the provision of investment services by third-country providers in the EU. Portfolio managers based in Switzerland are generally not allowed to freely provide their services to retail investors which are domiciled in the EU, except by establishing a licensed EU branch or subsidiary, for which purpose they have to notify FINMA in advance. However, in certain member states, Swiss portfolio managers can provide services to professional and institutional clients, subject to the fulfilment of certain conditions. This particular structure is popular due to the good reputation of Swiss portfolio managers. Furthermore, the figure of self-solicitation under Mifid II allows EU investors to approach Swiss portfolio managers at their own exclusive initiative.

For Swiss managers of collective assets, in the past the Alternative Investment Fund Managers Directive (AIFMD) generated some expectations for a so-called third country passport. However, at the moment, the only passport that exists is among EU countries. For Swiss portfolio managers to be active in the EU, EU AIFMs often use the figure of the delegation which *inter alia* requires the cooperation between regulatory authorities. Alternatively, EU member states may allow third country AIFMs to market AIFs outside the scope of the AIFMD, by establishing a national private placement regime.

Outlook

The Swiss asset management industry faces a considerable regulatory challenge as detailed above but will profit of an enhanced reputation in the global financial arena. The industry will remain alert and will continue to closely follow developments, which will now turn to questions regarding the implementation of the new provisions and the related market practice.

BANKING & PROJECT FINANCE
DIGITAL CURRENCIES

Sand dollars: a postmodern monetary architecture

The Bahamas has introduced one of the world's first central bank digital currencies as it looks to improve access and efficiency for payment systems

Cryptocurrencies like Bitcoin and Ethereum, as well as so-called stablecoins such as Facebook's Libra and the US dollar connected Tether, are garnering a lot of attention these days. However, central bank digital currencies (CBDCs) may actually see faster mainstream adoption and eventually have a more penetrating impact on the economy.

Essentially digital versions of fiat money, CBDCs are legal tender, created and backed by a central bank or monetary authority and represent a liability on the balance sheet of the issuing institution. Being digital, CBDCs are by necessity cryptographically secured and, crucially, their minting and supply are regulated by the central bank issuing the CBDCs, just like regular bank notes.

CBDCs are legally distinguishable from the thousands of private, non-fiat cryptocurrencies currently in circulation and are not stablecoins since their value does not derive from a commodity or other underlying asset or touchstone other than the "faith and credit" of the issuing central banking authority. Functionally speaking, CBDCs fulfil the requirements of a fee-free medium of exchange, a legally recognised unit of account and a stable store of value.

They are the modern digital expressions of money as envisioned under G F Knapp's "state theory of money", and, in that sense, represent the antipodean counterpart to cryptocurrencies, which are based in "societary money" justifications, ideologically fuelled by the ethos of anti-authority decentralisation.

The Central Bank of the Bahamas (CBOB) issued one of the world's first CBDCs that is widely available to the general public late last year, known as the sand dollar. Given the influence of digital transactions to the modern economy, the implications of CBDCs like the sand dollar are sweeping and profound.

Bitcoin: the original blockchain

Technical conceptions of central bank issued digital money are decades old. It wasn't until the arrival of Bitcoin in January 2009 that the technological state of the art had been pushed enough to enable the

1 MINUTE READ

Bitcoin pointed out the inherent weaknesses of a trust-based model of online commerce where intermediaries are relied on to process payments. Central bank digital currencies (CBDCs) can overcome the drawbacks of trust-based models while still being centralised enough to satisfy legal and regulatory concerns. The sand dollar is issued by the Central Bank of the Bahamas and is among the first digital currencies to be legal tender and useable by the public. Not only does it address the technical issues Bitcoin was aiming to solve, but it provides the tools to tackle such intractable problems as financial inclusion and identity, and provides the key digital infrastructure to enable a hyper-connected, postmodern economy.

creation of unique digital tokens that did not suffer from the fundamental drawback inherent to digital money – how to know whether a given digital note hadn't been perfectly counterfeited. It is the double-edged sword of the digital revolution, where the millionth copy of a digital file is highly indistinguishable from the original. Virtually perfect replication was literally a click away.

The obvious way through this issue is to introduce third-party intermediaries, such as financial institutions, which are relied on to confirm the availability of funds and the validity of transactions. This trust-based model, where trusted financial institutions reconcile information stored on multiple databases and mediate disputes if necessary, provides the framework for digital payments and online commerce as we know it today. But this model is not without its own set of technical problems and tends to feature higher transaction costs, delays and loss of efficiency, elevated levels of risk associated with centralised client-server network designs that have a single point of failure, and the increased chance of uncertainty due to the reversibility of transactions.

Centralised authority, not necessary

Satoshi Nakamoto, the (presumably pseudonymous) creator of Bitcoin, proposed to deal with these weaknesses in the trust-based model by way of a novel system of peer-to-peer distributed timestamp servers or nodes known as miners that would generate, as he described, "computational proof of the chronological order of transactions". This would create a decentralised ledger highly resistant to hacking or any form of tampering, which would be, for all practical purposes, immutable.

The system would be secure so long as the collective computational power of "honest nodes" maintaining the integrity of the chain of information – the blockchain – exceeded those of an attacking group of nodes attempting to reverse spent transaction records. CPU cycles and energy are expended to maintain the system and rewarded through digital tokens, Bitcoin, to incentivise the component nodes to participate. In this way, a trust-based system could be replaced by a trustless system that relied on computational power and energy to maintain system-wide integrity. In practical terms, the Bitcoin blockchain not only enabled the existence of fungible and immutable digital assets, thereby solving the so-called double-spend problem of digital money, but in the process, addressed the various deficiencies in the trust-based model associated with the use of trusted intermediaries.

CBDCs are legally distinguishable from the thousands of private, non-fiat cryptocurrencies currently in circulation, and are not stablecoins

The central conceit of Bitcoin is that centralised authority is not only unnecessary but represents an impediment to economic freedom in the digital world. It's no coincidence that it arrived in 2008 as the global financial crisis was picking up steam. Embedded within the genesis block of the Bitcoin blockchain is a textual reference to the bank bailouts that were taking place at the time.

It was a damning digital rebuke of the modern paradigm of centralised economic stewardship, encased in code and preserved for posterity. With Bitcoin and the thousands of cryptocurrencies that followed, trust in central authorities and financial intermediaries had reached a modern historic nadir, and the claim by some was that there was no going back.

But a radical reaction to an established model can itself beget a forceful counter-reaction. Over the past several years, there has been an explosion of activity by central banks globally to develop and implement CBDCs. In a recent survey conducted by the Bank for International Settlements, over 50 central banks were found to be engaging in CBDC work in various forms. Why the specific interest in CBDCs? As it turns out, due to their technical and legal features, CBDCs provide a means to overcome the drawbacks of the trust-based model, but without resorting to completely decentralised, trustless systems with no intermediaries. Instead of relying on autonomous, decentralised code, the underlying blockchain technology can be leveraged by central banks to securely issue digitalised cash with all of its legal properties intact and, in effect, digitally replicate the direct person-to-person transaction experience of physical cash.

Project sand dollar

Among the very first retail CBDCs to proceed to public implementation is the sand dollar issued by the CBOB. This digital version of the Bahamian dollar went live for public use on December 27 2019, and consumers, merchants, banks and other financial institutions, even street vendors, have begun transacting in sand dollars. For the Bahamas, the introduction of sand dollars is a continuation of the Bahamian Payments System Modernisation Initiative (PSMI), which began in the early 2000s.

The Bahamian PSMI seeks to improve outcomes for financial inclusion and access, increasing the efficiency of payment systems, as well as to foster greater participation in the financial services market by non-traditional providers such as fintech companies.

Trust in central authorities and financial intermediaries had reached a modern historic nadir, and the claim by some was that there was no going back

CBOB ran a competitive public tender process and selected NZIA Limited as its exclusive technology partner to architect and develop the sand dollar system. The resulting software/hardware hybrid architecture of sand dollar provides for an extremely robust system that features high system availability, ledger immutability, superior security, ease of use and high transaction speeds.

Sand dollars provide for an extremely robust system that features high system availability, ledger immutability, superior security, ease of use and high transaction speeds

The blockchain underpinning sand dollars is private and permissioned and does not suffer from the scalability and speed issues that can plague public, open-source blockchain systems like Bitcoin and Ethereum. The system has multiple redundancies and leverages edge computing capabilities to provide localised access to sand dollars from remote places even with the loss of internet access.

Sand dollars are designed to be extensible and avoid disruption to the existing financial infrastructure, with protocols and development kits being made available to financial institutions and fintech companies to allow for easy integration. Since KYC/AML considerations must be observed, the anonymity of cash is not being completely replicated, although the sand dollar infrastructure incorporates a number of cutting-edge confidentiality and data protection safeguards to balance the interests of privacy and regulatory supervision. This is an important feature. Without such protections there is a risk that the confidence required for population-wide adoption of the digital currency could be undermined.

The CBOB and the Bahamian government are keen to achieve a number of measurable outcomes through the introduction of sand dollars in the economy, such as providing universal access to banking and digital payment services, reducing the volume of unrecorded economic activities that take place using physical cash, and help bring all legacy businesses into the digital space. In particular, a risk-based, multi-tiered KYC regime is being applied to onboard the unbanked to the sand dollar system, which should boost inclusion in the mainstream financial system and eventually result in credit generation. Sand dollars, through their traceability features, are expected to strengthen regulatory capabilities against money laundering and other illicit activities, as well as helping realise efficiencies in the government's expenditure and tax administration systems.

Towards a postmodern monetary architecture

CBDCs could have other benefits and consequences. For example, since CBDCs are legal tender, online transactions can be settled near-instantaneously and drastically reduce their costs. We may see the advent of novel financial solutions such as CBDC-based smart contracts that can supplant the complicated and archaic system of letters of credit currently used in international trade.

Macroeconomically, the velocity of M1 money supply through the economy should increase given the removal of friction at the transaction and settlement levels, while the reduction of the carrying costs of physical cash could result in improvements to the GDP by up to several percentage points. A digital currency ecosystem can even be leveraged into national identity schemes, an issue which has until now proven intractable in many underdeveloped regions of the world.

For central banks, potential digital features and the application of smart contracts could mean a radical enhancement to their ability to implement and apply monetary policy tools. Seigniorage may be maintained despite the declining use of cash through efficiency gains in fiat money distribution and management costs. CBDCs could be the key public infrastructure enabling the world to transition to a hyper-connected, post-modern economy. The possibilities are exciting, wide-ranging and not yet fully quantifiable, and they're probably coming our way sooner rather than later.

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BANKING & PROJECT FINANCE
FRANCE'S PACTE LAW

Progress at the cost of protection

Paris-based DLA Piper lawyers explain what investors, digital asset providers and their advisors need to know

1 MINUTE READ

France's new action plan for business growth and transformation regulation (PACTE Law), introduced on May 24 2019, uncovered a new and previously unheard of investment product. The PACTE Law set out the concept and the legal provisions of digital assets, as defined by article L. 54-10-1 of the French Monetary and Financial Code (FMFC). The creation of this new investment product calls into question the scope of investor protection under the PACTE Law, revealing a dichotomy between the innovation and the reality of its implementation.

France's new action plan for business growth and transformation regulation (PACTE Law), introduced on May 24 2019, uncovered a new and previously unheard of investment product. The PACTE Law set out the concept and the legal provisions of digital assets, as defined by article L. 54-10-1 of the French Monetary and Financial Code (FMFC). The creation of this new investment product calls into question the scope of investor protection under the PACTE Law, revealing a dichotomy between the innovation and the reality of its implementation.

In accordance with the conditions set forth in the PACTE Law, investments in digital assets may be made either directly by an investor to an issuer by subscribing units or shares of an investment fund, or where appropriate, by concluding financial contracts involving one or more digital assets as underlying assets (or an index related to the evolution of these assets' value).

In line with article L. 54-10-1 of the FMFC, as amended by the PACTE Law, a digital asset consists of either a token within the meaning of article L. 552-2, a cryptoasset such as a cryptocurrency, or more broadly: "any digital representation of a value which is neither issued or guaranteed by a central bank or by a public authority; is not necessarily related to a currency which is a legal tender; and does not have the legal status of a currency; but is accepted by legal entities or natural persons as a mean of exchange and can be transferred, stored or exchanged digitally".

In this, way, the regulations introduced in the PACTE Law complete Statute n° 2014-559 of the May 30 2014 on crowdfunding, which allows the use of distributed ledger technology such as blockchain for such operations. This is a new concept in French law.

ICO rules

An alternative to blockchain financing is an initial coin offering (ICO), a fundraising operation whereby a company issues tokens to investors who pay in a cryptocurrency.

These utility tokens are traditionally opposed to tokens which confer voting or financial rights (security tokens/security token offering or STO), which are more similar to financial instruments. These allow investors to benefit from the company's products or services.

This distinction is clearly drawn in the PACTE Law, which excludes financial instruments from the scope of the notion of token, defined as "any intangible asset representing, in a digital form, one or several rights capable of being issued, written, stored or transferred by means of a blockchain which allows, directly or indirectly, the identification of the owner of the aforementioned asset".

Investment in digital tokens will naturally shift towards offers subject to an optional visa by the *Autorité des marchés financiers* (AMF). Indeed, the PACTE Law implements a specific regime under which companies willing to acquire a visa must, among other things, produce a white paper containing sufficiently clear, precise information about the issuer and the ICO.

When granting the visa, the AMF confirms that is has verified the offer's white paper and that it is complete and understandable for the investors. The AMF will then publish a white list on its website of the ICOs that have been granted visas, along with a black list of issuers or ICOs that do not comply with the AMF regulations, for investors and the public.

The AMF's rules concerning ICO visas state that the duration of the visa shall not exceed six months, and may only be delivered in regard to the ICO itself, not the issuer orissuing company of the tokens. During this time period the AMF may withdraw the visa in the case where the ICO becomes incompatible or non-compliant with the white paper. Besides, attention should be drawn to the fact that as the ICO is by nature based on the blockchain technology, the AMF does not check the computer programmes linked to the digital offer of tokens.

Other protective measures for investments in tokens established by the PACTE Law include the obligation for the issuer of tokens to implement a process for tracking and safeguarding the assets, which requires further regulatory input.

Investor protection

One of the main investor protection tools lies in digital asset service providers' obligation to register with the AMF. Digital asset service providers are a brand new category under French law, which is specific to France and therefore not currently eligible to any EU passport mechanisms, unless relying on another regime such as electronic money, and through such regime exclusively. They are defined as companies providing digital asset custody services or those who buy and sell digital assets in exchange for legal tender currencies.

It is important to ensure that this latter business, and more generally the services delivered by the provider throughout the blockchain, does not constitute an operation of issuance or distribution through the blockchain of an electronic payment instrument or the delivery of a payment service, which would otherwise require specific authorisation (unless exempt). A violation of such rules would trigger criminal sanctions as a matter of French law.

This new opportunity may allow…the exposure of certain types of life insurance contracts to digital assets

Other services on digital assets are regulated by a regime of optional authorisation by the AMF, including the reception and transmission of orders on digital assets on behalf of third parties, and the sale and purchase of digital assets in exchange for other digital assets (brokerage of digital assets).

Unless they are authorised as payment service providers or are exempt from such authorisations, a digital assets service provider, even licensed to provide one or more services on digital assets, shall not deliver payment services – unless specifically licensed to do so in accordance with the Payment Services Directive 2 (PSD2) licensing framework.

Likewise, the financing of a purchase of digital assets is likely to enter the scope of the banking monopoly (article L. 511-5 *et seq.* of the FMFC) and the performance of transactions on financial contracts (such as derivatives contracts) involving a digital token, or an index based on the evolution of that token's value, may require an authorisation as investment services provider (unless, here again, an exemption is applicable) for each relevant investment service on such contracts.

The terms for the constitution of rights, particularly rights in rem rights such as a pledging of digital assets or title transfer agreement on such assets, will require the applicable regulations to be clarified along with the conditions of their potential sale or transfer. In the current state of the law, it is relevant to question the terms and conditions of the assignment of a digital asset as collateral or security under the French regime set forth in article L. 211-38 of the FMFC aiming to implement the EU Collateral Directive into French law. Further, a legal instrument should be created under private international law determining with clarity the law applicable to digital assets de minima at an EU or EEA level.

In addition, the market expects regulators to further clarify the regulatory framework of the secondary market for tokens. The existence of a secondary market must be expressly specified on the white paper the AMF receives (where the issuer has chosen the regime with the optional visa referred to above). Besides, the management or operation of a service of trading platform on digital assets falls within the scope of the provision of services on digital assets submitted to a regime of optional authorisation, which triggers the supervision of the regulator – representing further protection for investors.

With this in mind, if the AMF visa does not itself amount to a condition for the validity of the ICO, the absence of that visa limits the possibilities of marketing or commercialising the token. Solicitation canvassing, public offer and sponsorship in particular are generally prohibited for ICOs which have not obtained a visa from the AMF and for providers that are not authorised as digital asset service providers in accordance with the PACTE Law. The involvement of the AMF as a regulator for investments in digital assets provides protection for investments but limits the powers of investors to freely operate.

Fund opportunities for professional investors

Specialised professional funds (SPFs) and private equity professional funds (PEPFs), both of which are open to professional investors, will be able to invest in digital assets. This new opportunity may allow, subject to compliance with certain conditions, the exposure of certain types of life insurance contracts to digital assets.

So far, only alternative investment funds by purpose (other AIFs) were able to invest in digital assets as they're not subject to restrictions on the composition and nature of their assets, as opposed to SPFs and PEPFs (which are alternative investment funds by nature).

Therefore, Article 88 of the PACTE Law widens the scope of assets that are eligible to an SPF to those registered in a blockchain. Article L. 214-154 of the FMFC provides that: "notwithstanding articles L. L. 214-24-29, L. 214-24-34 and L. 214-24-55 [of such code], a specialised professional fund may invest in property if they comply with the following rules: The ownership of the asset is based either on a register, an authenticated/certified document or a private agreement whose value is recognised by French law; the condition pertaining to the register is deemed fulfilled for the assets registered on a blockchain".

It is also possible, on the basis of article L. 214-154 of the FMFC, that an SPF be exposed to tokens or cryptoassets by holding financial derivatives whose underlying assets are tokens or cryptoassets. As a reminder, in 2018, the AMF clarified that a derivative whose underlying asset is a cryptoasset and which closes out by a payment in cash is deemed a financial contract.

In the same vein, the PACTE Law widens the scope of assets that a PEPF may hold. The Senate introduced this measure and justified via rapporteur that the new legal provisions initiated by this amendment were encouraged by a will to create investment opportunities for "informed professionals with a strong appetite for risk".

The goal of allowing a French private equity vehicle to invest in this new category is to stimulate digital asset fundraising in France, in conjunction with the implementation of the optional visa also provided in the PACTE Law. This opening is yet limited: given the risks at stake, investments in digital assets cannot exceed 20% of the fund's assets (article L. 214-160 of the FMFC). Plus, holding derivatives whose underlying asset consists of tokens or cryptoassets is not possible for a PEPF according to the conditions applicable to the holding of financial contracts by a PEPF and mentioned in articles R. 214-32-22 to R. 214-23-26 of such code.

The goal of allowing a French private equity vehicle to invest in this new category is to stimulate digital asset fundraising in France

The issue of the custody of this category of assets by the depositaries of these investment funds shall also be raised: they may be unwilling to offer such a service when one considers the reluctance of credit institutions to open a deposit and payment account to token issuers and digital asset service providers. Such reluctance has indeed pushed the legislator to widen the scope of the right to an account to these same operators (article L. 312-23 of the FMFC).

Lastly, the PACTE Law has introduced the possibility of investing in SPFs and PEPFs, thus allowing indirect exposure to cryptoassets in life insurance contracts (article L. 131-1-1 of the French Insurance Code (*Code des assurances*). On the basis of decree n° 2019-1172 aiming at encouraging investment in the real economy via private equity, this exposure should remain relatively limited due to several constraints.

The first pertains to the holding limit of digital assets to 20% of the assets of a PEPF, which is expected to be transposed to the PEPF whose subscription would occur via life insurance contract units. The second restriction is applicable to investments in PEPFs and professional funds dedicated to retail investors, stating that it shall not exceed 50% of such units of account products assets, and 10% for PEPFs.

In a nutshell, the use of these new financing instruments appears to be more accessible when implemented directly by investors rather than indirectly through investment funds. this may occur at the cost of investor's protection as regulations applicable to third party asset management provide that, through funds exclusively open to professional investors, investors may access digital assets in a more robust and protective regime, which includes the supervision of the manager by the AMF, the controls operated by the depositary and the auditor of the fund on the fund's assets, and of eligibility limited to professional clients within the meaning of Mifid II.

This first attempt at establishing a legal framework for the new market of digital assets in France by the PACTE Law should be adjusted in light of feedback from the operators of this growing market.

Translations to English are for information purposes only in the context of this article and are not meant to constitute an official translation of such provision. Only the original provision in French language set forth in the French Journal Officiel is legally binding as a matter of French law.

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BANKING & PROJECT FINANCE
DISTRIBUTED LEDGER TECHNOLOGY

Demystifying blockchain regulation in Switzerland

Innovation in distributed ledger technology will be balanced with investor protection under proposed new rules

On February 16 2019, the Swiss Financial Market Supervising Authority (FINMA) was the first regulator to release guidelines on how to treat blockchain-based coins issued in an initial coin offering (ICO) on February 16, 2019. Finma generally distinguished between asset, payment, and utility tokens while acknowledging that hybrid forms may exist. Practice has shown that tokens issued are very likely to fit more than one single category. Consequently, the relevant issuer would be required to follow all applicable rules. While some regulators and commentators argue that all tokens were securities, Finma emphasised that it would not qualify tokens as securities unless their functionality was similar to traditional securities. Regardless of the ICO guidelines, uncertainties have remained. In particular, it remained unclear if and to what extent existing regulation applies to the underlying business models.

Independently, the Federal Council of Switzerland, the executive branch of the national government, launched a survey asking market participants to comment on the digital suitability of Swiss laws. Although this 2018 report was not directly intended to tackle blockchain related issues, some of the comments obviously related to this nascent business sector. While some regulatory relief regarding innovative companies in the financial sector was proposed, more work is required on the private law aspects. For example, how should tokens be qualified under Swiss private law as assets or claims and how can ownership in a token be validly transferred.

Following the 2018 report, the Federal Council published a proposal to amend federal law in accordance with the development of the distributed ledger technology (DLT) on March 22 2019, and invited interested stakeholders to comment on it. On November 27 2019, the Federal Council published the updated proposal of the new law and sent it to the national assembly for consideration. This article outlines the core proposals of the DLT report and the proposed new law which includes changes to civil law, insolvency law as well as financial markets regulation.

1 MINUTE READ

Michael Mosimann and Christian Schönfeld of Prager Dreifuss outline the changes the Swiss legislator intends to introduce in order to provide more clarity to the legal framework for distributed ledger technology (DLT) business models. These include the introduction of DLT securities and changes to laws on financial regulation and insolvency. This article follows up on some topics raised in Michael Mosimann's article Searching for clarity in the February/March 2019 issue of IFLR.

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Michael Mosimann practises in the areas of M&A, contract, commercial and corporate law, and is the head of Prager Dreifuss' venture and ICO team. His particular interests are socially responsible investments (SRI), focusing especially on impact investments, which was the topic of his PhD thesis.

In addition, he is an expert on regulatory and corporate legal matters pertaining to blockchain technology. He advises founders of cryptocurrency companies in all legal matters and assists them with the planning, preparation and execution of their private and public token offering. He is a regular speaker at events in his practice areas.

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Christian Schönfeld is a member of the banking & finance, fintech and capital markets teams at Prager Dreifuss. His main areas of expertise are corporate, commercial, banking and capital markets law, as well as the related regulatory matters including data protection law. He works for domestic and foreign clients in these areas. He is also a member of the corporate and M&A team.

Before joining Prager Dreifuss as an associate, Schönfeld worked as an assistant for Prof. Dr. Urs Bertschinger at the University of St. Gallen (HSG) while writing his PhD thesis on the law of collective investment schemes. He holds a data protection officer certificate from the University of Maastricht.

Introduction of DLT securities

The most significant amendment relates to the introduction of purely register-based intermediated securities (DLT securities), which are added to the existing mix of securities, such as negotiable securities (*Wertpapiere*), uncertificated securities (*Wertrechte*) and intermediated securities (*Bucheffekten*).

In order to qualify as a DLT security, the register based on which the relevant security is issued must meet certain requirements:

- it must grant the creditor of the relevant security the power to dispose of it;
- it must be protected from unauthorised amendments by way of technical and organisational measures, for example, through the joint administration by several independent participants on a distributed ledger or blockchain;
- the content of the security, the functionality of the register and the registration agreements are recorded either in the register or in associated repositories; and
- the creditors must be able to review and inspect all information and register entries related to them as well as the integrity of the register entry pertaining to them independently without the support of a third party.

If the register meets these requirements, a DLT security is a valid security and the creditor of the relevant DLT security indicated by the register may enforce its claim towards the issuer. It also means that the issuer may only satisfy the claim represented by the relevant DLT security by performance to the creditor indicated by the register. The DLT security is validly created and issued based on the relevant register and can only be enforced and transferred through the register.

In particular, the amendment provides clarity on transferability through the register. According to existing laws, the transfer of most securities under Swiss law requires a written assignment declaration or an equivalent declaration on the security itself. The only exception are intermediated securities, which are created by way of credit by a custodian such as a bank or security dealer to a securities account. The custodian accepts certificated securities, global certificates, or uncertificated securities into custody and then credits the relevant rights to one or more securities accounts that belongs to the owner of the security. In this system, intermediated securities are validly transferred by way of credit to the securities account of the acquirer upon instruction of the transferor. Most securities issued on a blockchain do not qualify as intermediated securities and would always require a written assignment declaration in order to be validly transferred. The transfer of tokens representing blockchain-based securities without a written assignment declaration is potentially invalid.

As proposed, the DLT law would allow for a similar system as intermediated securities by essentially deferring to the rules on transferability of the relevant register based on which the DLT security has been issued. Therefore, the register rules could provide for a valid transfer of the DLT security if the token representing the DLT security was credited to the acquirer's wallet upon instruction of the transferor.

Changes to insolvency law

Segregation of cryptobased assets

The Federal Council identified in its 2018 report a clear need for the possibility to segregate crypto-based assets in a bankruptcy. However, it is unclear under the current Swiss insolvency regime whether this is possible. The Federal Council, therefore, proposed that a new provision be introduced into the Swiss Debt Enforcement and Bankruptcy Act (DEBA). This new provision is intended to address the question of segregation of crypto-based assets.

Under this new provision, it is possible to segregate crypto-based assets from a bankrupt estate if these assets are either allocated individually to a third party or if there is a joint allocation to third parties and it is evident what the exact share of a specific third party will be.

It is worth noting that the preliminary draft in the 2018 report had previously only provided for a segregation right limited to means of payment (*Zahlungsmittel*). This has been widely criticised. As a result, the Federal Council's draft proposal now offers the possibility to segregate all kinds of crypto-based assets (*Vermögenswerte*).

The Federal Council does not share FINMA's view. Rather, it argues for a strict separation of private law questions and questions of banking regulation, the latter of which will be addressed in the relevant financial market regulation, in particular the Swiss Banking Act (SBA). Consequently, the Federal Council proposes to address this issue by amending the SBA.

Access to data in bankruptcy

Furthermore, the DLT report proposes to create a legal basis which would allow for access to data over which a bankrupt estate has control if a person is able to prove his or her legal or contractual personal entitlement to the data in question.

Changes to financial markets law

While the DLT report acknowledges that there are various points of contact between applications based on DLT and financial market law and regulation, including banking law, the law of collective investment schemes, regulation of financial infrastructures, it concludes that no fundamental amendments to Swiss financial market law are required at the moment. However, selective amendments are deemed to be beneficial, namely to provide more legal flexibility to potential providers of DLT–based financial services.

Namely, the DLT report expands on Swiss financial markets infrastructure law by providing a new licensing category for infrastructure providers in the area of DLT.

In essence, the DLT trading system should enable the simultaneous exchange among several participants for the purpose of concluding contracts pursuant to non-discretionary rules with respect to DLT securities.

The Federal Council's proposed expansion of the Federal Act on Financial Infrastructures

Switzerland's attractiveness for projects in the area of DLT benefits more from a comprehensive and sensible regulatory framework than it would from the absence of regulatory requirements

and Market Conduct in Securities and Derivatives Trading (FinMIA) strikes a balance between the market's need for flexibility and the desire to protect customers with stringent rules. The Federal Council expressly rejected further liberalisation, for instance the introduction of entirely unregulated areas. While this might further increase potential innovation, it would jeopardise the protective goals of financial market regulation as well as lead to unfair competitive advantages of certain financial service providers over others, incentivise regulatory arbitrage and, thus, affect the reputation of the Swiss financial centre. Furthermore, the Federal Council is of the opinion that Switzerland's attractiveness for projects in the area of DLT benefits more from a comprehensive and sensible regulatory framework than it would from the absence of regulatory requirements in the name of further liberalisation.

Also, an amendment to the definition of securities firms in the Federal Act on Financial Institutions (FinIA) which entered into force on January 1, 2020 stipulates that service providers which employ DLT only to run an organised trading system without pursuing further securities trading activities may apply for a licence as a securities firm nonetheless.

Furthermore, the amendment to DEBA regarding the possibility to segregate crypto-based assets from a bankrupt estate will have to be mirrored for banks in the Swiss rules on banking insolvency. Also, in view of the possibility to segregate crypto-based assets the scope of the SBA will be extended. In the future, the SBA will not only apply to the traditional banking activity of accepting deposits from the public but also to anyone accepting crypto-based assets. The exact details of this new rule will be laid down by the Federal Council in the ordinance to the SBA.

The Federal Council's draft proposal in the DLT report suggests some minor amendments to other statutes, including the Federal Act on Combating Money Laundering and Terrorist Financing and the Federal Act on the Swiss National Bank.

It is worth pointing out that except for a merely technical amendment to the definition of the term securities, the Federal Council refrains from any further amendments to the Federal Act on Financial Services (FinSA). Rather, it expressly acknowledges the need for financial service providers that use DLT to adhere to the obligations to provide comprehensive information about the financial services offered to customers due to the novelty nature of crypto-based assets as well as the fact that their evaluation may be more difficult in comparison to traditional asset classes.

Further clarity needed

The draft proposal pursuant to the DLT report expressly refrains from dealing with some questions in connection with DLT under Swiss financial market law and regulation. The Federal Council states that these issues will be examined at a later point in time, if the need arises, as it fails to see any urgent need to address them now. The questions to be postponed include the following:

- The application of DLT in the area of collective investment schemes. While this has been a hot topic, practical implementation of the discussed ideas remain at an early stage. Therefore, not only is there no need for action at the moment but it is also too early to definitively assess the changes that DLT will bring to the area of collective investment schemes regulation.
- The same holds true for potential applications of DLT insurance. The Federal Council will revisit these issues at a later time.

In the area of financial infrastructure law, the Federal Council limits the proposal in the DLT report to what is described as the most urgent questions. Further amendments which may have wider consequences will be assessed in the course of a general assessment of the effects of the FinMIA which the Federal Council will conduct over the next couple of years. Potential amendments to be assessed may include general decreases in regulatory requirements for all types of regulated financial infrastructures. The Federal Council intends to coordinate this general assessment with developments on financial market regulation on an international level as well as with technological developments which might make amendments to the FinMIA necessary.

> **The Federal Council endeavours to ensure adequate protection of investors and the financial market by not abandoning regulation of DLT service providers entirely**

In anticipation of regulatory changes

The introduction of DLT securities would provide clarity to the legal validity of transfer of ownership of blockchain-based securities. While the current law providing for written assignment declarations is not practical in a distributed ledger environment, the DLT law would provide for legally valid transfers by way of transfer on the blockchain.

The proposed amendments of DEBA clarify whether crypto-based assets may be segregated in bankruptcy proceedings and, thereby, increase legal certainty for investors. In addition, the proposed right to access data increases the rights of creditors in bankruptcy proceedings.

Furthermore, the proposed amendments to Swiss financial markets law aim to enable financial service providers to implement solutions based on DLT. However, at the same time, the Federal Council endeavours to ensure adequate protection of investors and the financial market by not abandoning regulation of DLT service providers entirely. In addition, the Federal Council is proceeding carefully with amendments of Swiss financial markets regulation and expressly reserves the right to revisit further potential issues at a later point. It remains to be seen to what extent the proposed amendments will make it through the parliamentary process and what effect they will have if and once they enter into force.

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FINTECH FOCUS CONTENTS

Fintech market enters a new stage of maturity

Fintech is gearing up, shifting away from the start-up world to mature big ticket transactions. Richard Woods, Clive Cunningham and Wendy Saunders of Herbert Smith Freehills review macro-developments in Europe

Fintech refers to the many ways in which businesses are using technology to change and improve the provision of financial services. There are many ways in which regulators are reacting to and supporting the continued growth of fintech, and how ambitious businesses are adapting to that regulatory landscape.

We see 2020 as being a year of consolidation as much as transformation, both in terms of firms' reaction to the regulatory environment, and in terms of transactional activity.

In the last two years, a number of fundamental regulatory developments took effect in the region and these are now an established part of the regulatory framework. In particular, the second Payment Services Directive (PSD2 – January 2018), Mifid II (January 2018) and the General Data Protection Regulation (GDPR – May 2018) established a new architecture in which fintech businesses must operate. Although the next phase of regulation is never far away (the Fifth Money Laundering Directive very recently took effect on January 10 2020) in 2020 fintechs will, for a while, have an opportunity to work within a relatively well-established regulatory framework.

2020 may well be the year in which open banking becomes more widely adopted. Open banking allows customers to authorise their banks to share their financial data with third party providers. It is designed to increase competition and innovation in favour of consumers. It is the best-known ambition of PSD2. Two years after PSD2, businesses are better able to deploy technology, are more familiar with other relevant laws (including GDPR), and in several cases have implemented significant commercial partnerships that are designed to capitalise on PSD2. All of this should enable open banking to become a greater part of daily life for many consumers.

There is an obvious exception to this: the UK. The UK left the European Union on January 31 2020 and, on the current timetable, will leave the European single market on December 31 2020. The last few years have repeatedly proved the unreliability of Brexit forecasting – so we will not attempt to do so here. Suffice to say, it is not clear how quickly and to what extent financial services law in the UK will diverge from EU law from January 1 2021 or, more particularly, to what extent a workable framework for UK-EU access in cross-border financial markets may be retained after January 1 2021.

The best-managed and best-advised businesses have been planning for the most challenging Brexit outcomes for some time. The loss of passporting will be fundamental for many UK headquartered but Europe-wide businesses, so many have been obtaining EU financial

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services licences to ensure continued access to EU markets. Businesses will need to move fast now that the outcome of Brexit is clearer.

The transactional landscape

Aside from the regulatory backdrop, what do we anticipate in terms of commercial legal activity in 2020?

Fintech businesses have attracted enormous levels of investment in recent years, driven by historically low interest rates, readily available venture capital funding, promotion of competition by regulators and concentrations of capital in ambitious investors (particularly in East Asia, such as SoftBank and Ant Financial). 2019 was another record year for venture capital investment in fintech: $37.4 billion was invested in the UK. Incumbent institutions (such as Goldman Sachs and RBS) are involved in investment activity too – and, when they are not taking stakes in growing fintechs, they are seeking to offer products with comparable user experience. Witness, for example, the success of Goldman Sachs' retail offering, Marcus.

2019 was another record year for venture capital investment in fintech: $37.4 billion was invested in the UK

Will the same levels of funding be sustained in 2020? The market might not be slowing, but it appears to be changing. Although capital has continued to pour into fintechs, the number of early-stage deals has been dropping year-on-year. This suggests that the explosion of brand new fintech businesses is slowing, and that the

Fintech is now a mature market for very large M&A transactions, particularly in the payments sector

market is focussing on more mature businesses which have a clear path to profitability. Indeed, the proportion of funding represented by mid-market fintech deals has grown year-on-year since 2014.

At the same time, the types of activity are changing. Along with major funding rounds, fintech is now a mature market for very large M&A transactions, particularly in the payments sector – for example, in the US, FIS' acquisition of Worldpay for $43 billion, Global Payments' $21.5 billion deal for TSYS, and Worldline's recent $7.8 billion deal for Ingenico.

The growing number of 'unicorns' in Europe – such as TransferWise, Revolut, Monzo, N26 and Klarna – suggest that this kind of activity is likely to occur in EMEA too. And, if these businesses do not seek an exit or become targets themselves (as iZettle was when it was acquired by PayPal for $2.2 billion), it seems likely that they and other highly-valued businesses will seek to grow inorganically, supporting the growing mid-size M&A market in EMEA fintech.

Aside from M&A, commercial partnerships will continue to be an active area in 2020. Many 'start-up' fintech businesses are now several years old and are partnering with each other and with incumbents. There have been several significant deals recently, including TransferWise's deals with N26 and Monzo, Starling Banks's deals with MoneyBox and PensionBee, and OakNorth's deal with ClearBank. We expect there to be more of this in 2020.

Looking ahead

All of these deals are part of a thematic re-alignment of the financial services landscape in Europe, in which growing businesses and incumbent institutions are battling to win and maintain market share – and ultimately, to become the rails on which Europe's financial services run for the foreseeable future. And of course, all of this is driven by public policy, financial regulation and by the commercial development which that has fostered. We look forward to another exciting year in European fintech.

FINTECH FOCUS
SLOVENIA

Slovenia's fintech ambitions risk falling short for lack of regulation

Uroš Čop of **Miro Senica** overviews the regulatory environment for fintechs in Slovenia, a jurisdiction that has been touted as a European fintech hub

In 2015, Slovenia was emerging out of the financial crisis. A lot of companies were seeking financing, however, banks and other financial institutions, having a bad experience from the previous five dark years, imposed stricter conditions for loans. Small and new companies turned to other means of financing. They were not merely looking to get financing, but they were also looking for services that would help them to better manage their financial operations and processes by using software and algorithms. They turned to fintech.

In a time when terms like blockchain, ICO, sandbox and others were still far from household names, a group of Slovenian start-ups performed initial coin offerings (ICO) and collected over $20 million. ICOs as a new form of fundraising that allowed start-ups to raise capital directly from investors became a solution for these companies that were seeking alternative financing. All of them were among the most successful crowdfunding campaigns of that time. Since good news travels fast and everyone loves a success story, others followed and in 2017, approximately $43 million was collected through ICOs. Slovenia was on its way to becoming a fintech hub.

Many viewed Slovenia as a potential blockchain innovation hub and some even named it "blockchain heaven". The prime minister stated that he wanted "to position Slovenia as the most recognised blockchain destination in the European Union", with the president adding that regulation must exist, but it must not stifle Slovenian blockchain companies.

This has so far mostly been the case. In a country that tends to overregulate, the fintech sector has remained relatively free from regulation. The government developed an action plan entitled 'Slovenia – the land of innovative start-ups', along with an action plan for blockchain. Both envisioned various policy proposals, though most of them have not yet been implemented.

The question of regulation in the field of fintech is an important one, since financial services are among the most heavily regulated sectors in the world. So far in Slovenia, fintechs have mostly to adhered to certain rules that govern the banking sector, the classification of

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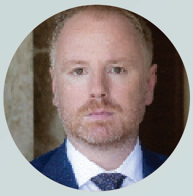

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financial instruments, the prevention of money laundering and rules of general application, such as personal data protection and tax legislation.

Banking sector and financial instruments

Companies offering payment services – including enabling cash deposits and withdrawals to and from a payment account, enabling the execution of payment transactions and the execution of money remittance – are bound by the Payment Services Act, which implemented the EU rules embodied in the Payment Services Directive 2 (PSD2) and the E-Money Directive. The Act also lists payment service providers and regulates the issuance of electronic money. Providers of mobile and contactless payments, as well as various forms of e-wallets, fall into the scope of the Act.

Companies offering financial services, such as the granting of loans, financial leasing (lease or rent) of assets, the issuing and managing of other payment instruments (for example, travellers' cheques and bankers' drafts), the issuing of guarantees and other sureties, and the trading of accounts or client accounts, are bound by the Banking Act. It is worth noting that banks, e-money institutions, payment institutions and waived payment institutions are required to obtain authorisation to provide payment services from the Bank of Slovenia (BS), if established in Slovenia. This is not the case for other such companies that are not banks or are established in the EU and have obtained authorisation in another EU member state, unless specifically stated otherwise.

In the Slovenian banking sector, the biggest questions have revolved around cryptocurrencies, since fintech and especially ICOs, are poorly regulated and have become a sandbox for scams and frauds. At the end of 2017, when the number of ICOs was at an all-time high, the Financial Stability Board (FSB) warned consumers about the risks associated with cryptocurrencies and ICOs, highlighting the lack of regulation and supervision.

The Slovenian Securities Market Agency (ATVP), followed up with a consultation paper focused on ICOs and identified the areas where regulation was needed. It also questioned the appropriateness of local legislation in cases that go beyond the Slovenian jurisdiction and have an expressly cross-border character. The paper warned potential investors about the risks of ICOs and branded them "a speculative investment". The ATVP also opined that ICOs represented a phenomenon that differed from existing financial instruments on the market which posed many new challenges and issues. It concluded that *sui generis* regulation would be much more suitable, while also taking into account the principles that are applied in the field of financial instruments.

BS, the regulatory body for ICO transactions, issued a statement explaining that the trading of virtual currencies was not systematically regulated and supervised and also published a Q&A on virtual currencies, again emphasising the lack of regulation and the risks associated with that lack.

Despite these warnings, the issuing, trading and storing of cryptocurrencies so far remain unregulated, and there are no real plans underway to change that soon.

Despite these warnings, the issuing, trading and storing of cryptocurrencies so far all remain unregulated

Other applicable regulations

Globally, the tendency to adopt stricter rules for the prevention of money laundering has increased drastically in recent years, and Slovenia has followed this trend. The Prevention of Money Laundering and Terrorist Financing Act (AML Act) is one of the rare pieces of Slovenian legislation that explicitly mentions "virtual currencies" and sets out the obligations of companies that issue, manage or exchange virtual currencies. Such companies are therefore required to carry out checks of their clients (know-your-customer – KYC), monitor suspicious activities and report all of that to the competent authorities. The scope of this Act is broad enough to cover most of the fintechs operating in Slovenia. The current AML Act prescribes very strict conditions for the verification of the client and rarely allows for video identification. There has been an unsuccessful initiative by the Blockchain Think Tank Community in Slovenia to amend the AML Act and remedy this.

The AML Act implemented the EU AML Directives but has so far failed to transpose the Fifth AML Directive, which introduces even stronger requirements for the financial sector. Among others, the scope of the Fifth Directive extends to new sectors, such as cryptocurrencies and custodian wallet providers, and requires greater transparency to prevent individuals from hiding behind sophisticated networks of corporate structures. Following the failure to transpose the Fifth Directive in time, the European Commission has already sent a letter to Slovenia and seven other member states that have also so far failed to implement the new rules. The letter highlights the recent money laundering scandals that have revealed the need for stricter rules at an EU level and stressing that legislative gaps in one member state have an impact on the EU as a whole.

The Slovenian Financial Administration (FURS) issued a statement in June 2018 explaining that virtual currencies were neither monetary assets nor financial instruments. Consequently, the taxation of profits made by trading them depends on various circumstances and must be decided on a case

> **The lack of regulation also means a lack of support from the government for such technologies**

by case basis. The decision is based on who receives the income (an individual, an individual performing a business activity or a legal person) and on what basis (income from creating virtual currencies, from buying and selling virtual currencies, payout of another income in a virtual currency, payment for performing a service etc.). The explanation also includes concrete examples of different scenarios. According to FURS, the income related to the sale of tokens (in the context of ICOs) and virtual currencies are usually subject to corporate tax but not to VAT.

As in other EU countries, the collection, processing and transmission of personal data has been regulated by the General Data Protection Regulation (GDPR) since May 2018. Some aspects of personal data protection, such as the personal data of employees, are regulated by the Personal Data Protection Act, which is in the process of being amended.

GDPR applies to all companies, including fintechs, and requires them to give individuals access to their personal information, with rights of correction, deletion and to be forgotten. The regulation also limits the processing of data and contains rules on the international transfer of data. It is important to note that GDPR applies extraterritorially to any entity processing personal data of individuals residing in the EU, regardless of where it is located.

Lack of regulation means lack of support

All of the above shows that Slovenia has taken a rather relaxed approach to regulating financial technologies and has instead left the industry to self-regulate. In the fast-changing and complex environment that is fintech, such an approach might be more appropriate. However, the lack of regulation also means a lack of support from the government for such technologies, as these are consequently left to fend for themselves.

While relying on the existing financial sector rules and on the regulations and directives coming from the EU may suffice for certain aspects of fintech, it will not be enough for others. The automation of processes, digitalisation of data and vulnerability to attacks from hackers can only be adequately dealt with by specific regulation. But because of the diversity of offerings in fintech and the various industries it impacts, formulating a single and comprehensive approach will be a challenge.

The adopted action plans and the general interest shown by the government is a start, but all the progress made so far will likely be disrupted by the current lack of an efficient government in place. Slovenian Prime Minister Marjan Šarec has announced he is stepping down in a bid to push for a snap election. As of January 29 2020, the Slovenian government is performing only its regular duties. This will have a significant impact on fintech regulation and will prolong it indefinitely. It seems that, once again, Slovenia will miss its chance to be a global innovative leader. Or, who knows, maybe this time it will be different.

FINTECH FOCUS
SWITZERLAND

DLT and blockchain framework is set for change

A new set of rules applicable to DLT and blockchain-related business activities could come into force by 2021. Daniel Haeberli and Urs Meier of Homburger dig into key aspects of the existing and potential future Swiss regulatory framework

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In December 2018, the Federal Council (ie Switzerland's federal government) published a detailed report covering the legal framework for DLT and blockchain in Switzerland. The report concluded that the existing Swiss regulatory framework was fit-for-purpose for technical developments such as DLT and blockchain but it also identified a need for selective improvements.

Just a few months later, the Swiss federal government had an initial draft law prepared, which then went through a comprehensive public consultation process. Based on feedback in that consultation, the Swiss federal government published the finalised draft law on November 27 2019 (DLT Draft Law). The DLT Draft Law is currently being discussed in the Swiss parliament and its entry into force in 2021 seems possible.

Current framework

Under current Swiss law, there are three key regulatory aspects usually relevant in the context of DLT and blockchain-related business activities: first, the general token categories; second, the categorisation of stablecoins; and third, which tokens qualify as financial instruments.

General token categories

Tokens can be defined as data or information units, which are stored in a DLT or blockchain based register. In its 'Guidelines for enquiries regarding the regulatory framework for initial coin offerings' of February 16 2018 (ICO Guidelines), the Swiss Financial Market Supervisory Authority (FINMA) distinguishes the following three basic categories of tokens.

Payment tokens: according to FINMA payment tokens are synonymous with 'pure' cryptocurrencies. They are tokens which are intended to be used, now or in the future, as a means of payment for

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acquiring goods or services or as a means of money or value transfer. These cryptocurrencies do not give rise to any claims towards an issuer or a third party. Consequently, according to the prevailing view of Swiss legal scholars, the tokens are "purely factual intangible assets". Examples of these cryptocurrencies are Bitcoin (including numerous altcoins built upon the basic technical framework used for Bitcoin) or Ether.

Utility token: utility tokens are tokens that are intended to provide access digitally to an application or service by means of a DLT-based infrastructure.

Asset tokens: asset tokens represent assets such as a debt or equity claim against the issuer. Asset tokens promise, for example, a share in future company earnings or future capital flows. In terms of their economic function, therefore, such tokens are analogous to equities, bonds or derivatives. According to FINMA, tokens which enable physical assets to be traded on a DLT-infrastructure also fall into this category.

FINMA furthermore also points out that tokens may fall into more than one of the three basic categories; such hybrid tokens include, for example, asset tokens or utility tokens, which at the same time also qualify as payment tokens.

Stablecoins

On September 11 2019, FINMA published a supplement to its ICO Guidelines that focused exclusively on stablecoins (Stablecoins Guidelines). These additional guidelines were published against the background of a request by the Libra Association, the not-for-profit entity domiciled in Geneva, which fosters the development of the envisaged global currency Libra. The Libra Association had asked FINMA for an assessment of how the Libra project, in particular the issuance of the Libra stablecoin, would likely be treated under Swiss financial market law. FINMA took this opportunity to not only provide its initial views on Libra, but to also publish the comprehensive Stablecoins Guidelines, which indicate how FINMA will likely assess projects involving tokens linked to assets in general.

In the Stablecoins Guidelines, FINMA pointed out that it will continue to apply a substance-over-form approach as a general principle and also with regards to stablecoins, just as it did and still does with any other kind of tokens. FINMA also mentioned that the design and the technical details of stablecoins vary substantially. Nonetheless stablecoins may, on a high-level, be categorised based on two key features: the type of 'underlying' or asset backing the coin, and the rights which coin holders have. We must therefore look in detail at the key characteristics and the design of each stablecoin.

If a stablecoin is backed by currencies and the coin holders have a right towards the issuer to redeem the coin at a fixed price (for example, one coin for one Swiss franc), the issuer may be deemed to be accepting deposits from the public and hence the licensing requirements under the Swiss Banking Act might be triggered. If a coin is backed by a basket of currencies and if the coin holders have a right towards the issuer to redeem the coin at the current value of the basket (the net asset value), the coin may qualify as a unit in a collective investment scheme and trigger licensing requirements under the Swiss Collective Investment Schemes Act. And finally, currency-backed stablecoins may also constitute a payment system under the Swiss Financial Market Infrastructure Act.

If a stablecoin is backed by commodities, the regulatory consequences depend on the type of commodity and whether the coin holders only have a contractual claim against an issuer or a right *in rem* with regards to the underlying commodity. In the latter case, financial market regulation does generally not apply and the stablecoin does in particular not qualify as a security, if certain requirements are met. If the coin only grants a contractual claim, however, this likely triggers requirements under the Swiss Banking Act (if the commodities are precious metals) or the

FINMA will continue to apply a substance-over-form approach as a general principle and also with regards to stablecoins

coin may qualify as a security or a derivative (if the commodities are other commodities than precious metals). Furthermore, commodity-backed stablecoins may also constitute units in collective investment schemes.

If a stablecoin is backed by real estate, the coin likely constitutes a unit in a collective investment scheme and triggers licensing requirements under the Swiss Collective Investment Schemes Act.

If a stablecoin is backed by a single security – for example shares of a particular company – then the coin will likely qualify as a security too and may, depending on the specifics of the case, constitute a derivative or even a structured product. If the coin is backed by a basket of securities, however, it will in most cases constitute a unit in a collective investment scheme.

It must be noted that FINMA's Stablecoins Guidelines are of indicative nature only and not legally binding. In any case, the particularities of a stablecoin project will need to be assessed based on the relevant details of the envisaged design of the coin and the legal relationships between the parties involved.

What tokens qualify as financial instruments?

On January 1 2020, the new Swiss Financial Services Act (FinSA) entered into force. It primarily establishes rules on how financial services have to be provided and how financial instruments have to be offered.

Under the FinSA, the definition of "financial instrument" covers equity and debt securities, including bonds, units in collective investment schemes, structured products, derivatives and certain types of deposits. To decide whether a token (or coin) qualifies as a financial instrument for the purposes of the FinSA, several considerations must be taken into account.

Whether a token is a financial instrument or not depends on its economic function and, derived from this, the rights that are represented by or linked to that particular token. Consequently, whether a particular token is a financial instrument from a Swiss law perspective must be assessed on a case-by-case basis.

Asset tokens, hybrid tokens and stablecoins that grant their holders participation and voting rights in a corporation or rights to the repayment of debt, for example, are likely to be classed as financial instruments for the purposes of the FinSA. Payment tokens are, to date, not treated as securities by FINMA and are generally not financial instruments for the purposes of the FinSA. Utility tokens are also not treated as securities by FINMA, provided that their sole purpose is to confer digital access rights to an application or service and that the tokens can already be used in this manner when they are issued. Such 'pure' utility tokens, which neither partially nor exclusively function as an investment in economic terms, are also not classed as financial instruments for the purposes of the FinSA.

Future framework – what are the cornerstones of the DLT Draft Law?

The cornerstones of the DLT Draft Law of November 27 2019 are the introduction of "uncertificated register securities", an envisaged new licence category for operators of DLT trading venues, and the introduction of rules governing the segregation of cryptoassets as well as data in insolvency.

The DLT Draft Law proposes the introduction of a new concept of so-called "uncertificated register securities" (*Registerwertrechte*), which aims to increase legal certainty in connection with the "tokenisation" of rights and financial instruments. If this concept is introduced as envisaged, Swiss law would provide for the possibility of an electronic registration of rights that has the same functionality and entails the same protection as a negotiable security.

Legal positions admissible as underlying rights of such uncertificated register securities include rights against issuers, such as contractual claims or membership rights (for example, shares in a corporation). Consequently, asset tokens, utility tokens, hybrid tokens, as well as stablecoins, may be issued in the form of uncertificated register securities. Payment tokens however, cannot be issued in this form since they do not give rise to any claims, which could serve as an underlying right.

In order to create uncertificated register securities, the parties (for example, the issuer of an instrument as debtor and the holders of the instrument as creditors) need to enter into a registration agreement. Based on this agreement, the relevant right is entered into a register of uncertificated securities and may exclusively be asserted based on and transferred via this register.

The register used must meet certain statutory minimum requirements:

- the register must, by means of technical procedures, grant the creditors, but not the debtor, power of disposal over their rights;
- the register's integrity must be ensured by implementing the appropriate technical and organisational protective measures that prevent unauthorised changes (for example, joint administration by several independent parties);
- the content of the registered rights, the functioning of the register itself and the registration agreement need to be recorded either directly in the register itself or in accompanying data / documents (for example, a prospectus or articles of association) linked to the register;
- creditors must be able to view the information and data which concerns themselves and they must be able to verify, without third party support or intervention, the integrity of the content of the register concerning themselves.

In its dispatch of the DLT Draft Law, the Swiss federal government mentions certain existing DLT-systems that are currently deemed suitable to fulfil the statutory minimum requirements. Both permissionless (for example, Ethereum) as well as permissioned (for example, Corda and Hyperledger Fabric) systems are mentioned in this (non-exhaustive) list.

Should the DLT Draft Law enter into force as currently planned, it will also allow participants to bridge the new framework with the 'traditional' book-entry securities concept. In particular, it will be possible to

It will be possible to register uncertificated register securities with a 'traditional' custodian (for instance a bank)

register uncertificated register securities with a 'traditional' custodian (for instance a bank) and to subsequently book them into a 'traditional' securities account. Hence, uncertificated register securities could easily be transferred to the 'old world', if desired.

DLT trading venues

Under current Swiss law, there are three categories of trading facilities: stock exchanges, multilateral trading facilities and organised trading facilities. Due to certain reasons, these categories are deemed unsuitable for trading involving cryptoassets, for example, because retail clients may to date not have direct access to stock exchanges or multilateral trading facilities. Instead, these trading venues are currently only open to holders of a securities firm licence and certain other regulated participants.

In the DLT Draft Law, the Swiss federal council therefore proposes the introduction of a new licence category for (centralised) financial market infrastructures. These DLT trading venues may offer services in the areas of trading, clearing, settlement and custody of DLT-based assets not only to regulated financial market participants but also to unregulated corporates, as well as individuals, potentially including retail clients.

A DLT trading venue licence will be obtainable by trading venues that allow for the simultaneous exchange of offers between several participants and the conclusion of contracts based on non-discretionary rules and, in addition, provide for: (1) the admission of unregulated corporates or individuals; (2) the custody of DLT securities based on uniform rules and procedures; or (3) the clearing and settlement of trades in DLT securities based on uniform rules and procedures. DLT securities are securities that are suitable for mass trading and either have the form of uncertificated register securities or other uncertificated securities held in distributed electronic registers and which, by means of technical procedures, grant the creditors, but not the debtor, the actual power of disposal over the uncertificated securities.

The licensing requirements for DLT trading venues are largely modelled on the existing requirements for traditional trading venues (for instance stock exchanges and multilateral trading facilities). However, they are modified by adding specific rules with respect to, for example, the admission of participants and the admission of DLT securities.

Insolvency

Cryptoassets (*kryptobasierte Vermögenswerte*) such as cryptocurrencies and tokenised financial instruments are often stored with third party custodians, for example exchanges or wallets providers.

It is currently unclear whether cryptoassets held by a custodian on behalf of a client will be segregated in bankruptcy, especially if the creditor or investor does not hold (any) private key(s). The DLT Draft Law proposes to introduce a new segregation regime that will allow the segregation of cryptoassets for the benefit of the relevant creditors or investors, if certain requirements are met, including, in particular, the following:

- First, the relevant custodian must have the obligation vis-à-vis the relevant creditor or investor to keep the cryptoassets available for him at all times. This means that the custodian cannot, for example, use the cryptoassets for proprietary business or own-account transactions.
- Second, the cryptoassets will only be segregated if they can be either unambiguously allocated to the individual creditor or investor (however, there will be no need that such allocation occurs directly on the relevant DLT-system itself) or allocated to a community and it is evident what share of the joint holdings belongs to a given creditor or investor. The latter option will allow a pooling of cryptoassets held for several creditors or investors.

In addition, the access to data in insolvency in general shall become regulated too. Under current Swiss law, it is unclear whether digital data stored by a third-party custodian (for instance a cloud provider) can be segregated from the bankruptcy estate, if such a custodian becomes insolvent. The Swiss federal government therefore proposed an amendment to Swiss insolvency law, which would establish a right to request segregation of digital data regardless of whether such data has any (market) value or not (for example a holiday picture). The person requesting the segregation must show that they have a particular entitlement to the data to be segregated (for instance, a statutory or contractual claim).

The licensing requirements for DLT trading venues are largely modelled on the existing requirements for traditional trading venues

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Will public and private payment systems coexist?

Wendy Saunders, Clive Cunningham and **Richard Woods** of **Herbert Smith Freehills** explore stablecoins and how they may influence fintech regulation

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The payments sector is one of the fastest growing sectors within the financial services industry. It is underpinned by consumers' widespread move away from physical cash and towards electronic payments. Whether consumers are using payment cards or apps, the result has been a continual increase in the volumes of payments being processed electronically. This has created an enormous opportunity for payments businesses such as FIS and Fiserv (in the US) and Nexi and Klarna (in the EU) to establish themselves as key players in the payment chain, with the potential to become systemically important.

These businesses participate in a well-developed and very active area of the payments sector. So, what comes next?

The use of distributed ledger technology (DLT), and the associated use of cryptocurrencies and other cryptoassets, has long been discussed as a potential means for making global payment systems more efficient and more secure. For many years, payment processing has relied on centralised channels to transfer money, by established participants such as card issuers, clearing banks, and merchant acquiring banks and card schemes. By contrast, DLT involves a decentralised, shared ledger, with no need for central intermediation. It is considered immutable.

The question is, to what extent will cryptoassets become more widely used in the payments sector, including their potential use by central banks. Stablecoins, a relatively recent and topical sub-class of cryptoassets, may play a key role here. It will be interesting to see what types of stablecoins emerge and how they fit into the broader UK regulatory framework applicable to cryptoassets. Another important issue derives from two key aspects of stablecoins that are designed to facilitate payments: (i) in relation to the asset itself – concerns raised by private stablecoins, and whether a central bank digital currency could be an alternative; and (ii) in relation to the technology underlying it – its possible utility as a private payment system and question marks over whether it can co-exist with or link into public payment systems.

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Stablecoins: how are they categorised and why does it matter?

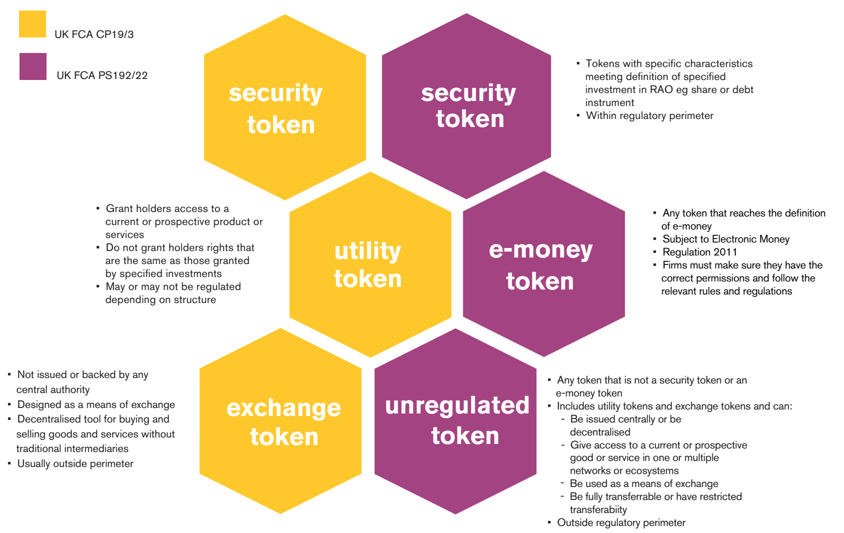
"Bitcoin, the first and still the most popular cryptocurrency, began life as a techno-anarchist project to create an online version of cash, a way for people to transact without the possibility of interference from malicious governments or banks." (The Economist, August 30 2018)

Sadly for the original creators of cryptocurrencies – and despite their anarchistic intentions, cryptocurrencies and other types of cryptoassets cannot be exempt from the application of law and regulation just because they are a technological construct. The tone for the UK regulatory approach was set in the UK Cryptoassets Taskforce report, where the government stated its ambition for the UK to be the world's most innovative economy and to maintain its position as one of the leading financial centres globally, to be achieved in part by "allowing innovators in the financial sector that play by the rules to thrive". The message is clear: innovation is encouraged, but only where it complies with high standards of regulation.

The genesis of stablecoins, a relatively recent sub-category of cryptoassets, was an attempt to address the high price volatility exhibited by many cryptoassets so far. Stablecoins are, in short, cryptoassets that are backed by other assets, including fiat,

> **Cryptoassets cannot be exempt from the application of law and regulation just because they are a technological construct**

Figure 1



commodities or other cryptocurrencies (a fuller definition is contained in the Financial Stability Board's (FSB) 'Regulatory issues of stablecoins', October 18 2019).

There are many types of stablecoin, each with different structures, functions and uses. Despite the word 'coin', a stablecoin could constitute a financial derivative, a unit in a collective investment scheme (fund), a debt security, e-money, or another type of specified (regulated) investment. They could potentially fall within any of three broad categories of cryptoassets as described by the UK Financial Conduct Authority (FCA), the categories having been revised in July 2019 following an earlier consultation. The diagram in Figure 1 compares the prior and current UK FCA categories of cryptoassets.

The position could change. During 2020 UK HM Treasury is expected to consult on expanding the regulatory perimeter. The EU Commission is also consulting on an "EU framework for markets in crypto-assets".

It was the prospect of a stablecoin achieving, in a very short timescale, widespread adoption for transactions currently processed by retail and wholesale payment systems, particularly if integrated into existing online platforms or social media, that brought stablecoins into the sharp focus of national and international regulatory bodies. In a Bank of England speech (Responding to leaps in payments: from unbundling to stablecoins), Christina Segal-Knowles noted that: "In India, Google Tez reported having 50 million users 10 months after its launch in September 2017. In China, Alipay and WeChat Pay by some measures handled more than $37 trillion in mobile payments in 2018".

The UK and other regulators consider that an appropriate regulatory framework needs to be adopted for stablecoins prior to their launch.

If stablecoins reach a global scale, they could pose challenges and risks to monetary policy, financial stability, the international monetary system and fair competition

Global stablecoins as a payment asset

Key drivers for the creation of stablecoins as an alternative payment asset include improving cross-border payments, to increase speed and reduce costs; assisting with financial inclusion and providing payment tools for people who are underbanked or underserved by financial services; and the growing preference in society for peer to peer interactions.

However, there are significant challenges and risks arising from use of stablecoins. These include difficulties with legal certainty, sound governance, AML/CFT compliance, operational resilience (including cyber security), consumer/investor and data protection and tax compliance. If stablecoins reach a global scale, they could pose challenges and risks to monetary policy, financial stability, the international monetary system and fair competition.

Here are a selection of key policy points identified by the G7 Working Group on Stablecoins, highlighting why regulators are so concerned about global stablecoins:

- Competition: global stablecoin arrangements could achieve market dominance due to their strong existing networks and the large fixed costs that a potential competitor would need to implement large-scale operations, and the exponential benefit of access to data.
- Stability mechanism: the mechanism used to stabilise the value of a global stablecoin must address market, credit and liquidity risk. If these are not adequately addressed, it could trigger a run, where users would all attempt to redeem their global stablecoins at reference value. Other triggers for a run could include a loss of confidence resulting from a lack of transparency about reserve holdings or if the reporting lacks credibility.
- Credit risk: global stablecoins whose reference assets include bank deposits may be exposed to the credit risk and liquidity risk of the underlying bank.
- Increased cost of funding for banks: if users hold global stablecoins permanently in deposit-like accounts, retail deposits at banks may decline, increasing bank dependence on more costly and volatile sources of funding.
- Change in nature of deposit: in countries whose currencies are part of the stablecoin reserve, some deposits drained from the banking system when retail users buy global stablecoins may be repaid to banks by way of larger wholesale deposits from stablecoin issuers. If banks were to counter this by offering products denominated in global stablecoins, they could be subject to new forms of foreign exchange risk and operational dependencies.
- Exacerbation of bank runs: easy availability of global stablecoins may exacerbate bank runs in times when confidence in one or more banks erodes.

It no longer seems fanciful to talk of cryptoassets forming a daily part of the mainstream payments system

- Shortage of high-quality liquid assets (HQLA): purchases of safe assets for a stablecoin reserve could cause a shortage of HQLA in some markets, potentially affecting financial stability.
- Reduced impact of monetary policy: this could happen in several ways. If, for example, there were multiple currencies in the reserve basket, the return on global stablecoin holdings could be a weighted average of the interest rates on the reserve currencies, attenuating the link between domestic monetary policy and interest rates on global stablecoin deposits. This would be particularly true where the domestic currency is not included in the basket of reserve assets.

The FSB is due to submit a consultative report on stablecoins to the G20 Finance Ministers and Central Bank Governors in April 2020, with a final report in July 2020.

Central bank digital currencies: alternative, interoperable or additional solutions?

Central bank digital currencies (CBDCs) are new variants of central bank money that differ from physical cash or central bank reserve/settlement accounts. There are two potential types of CBDCs: (i) a "wholesale" or "token-based" CBDC – restricted-access digital token for wholesale settlements (for example, interbank payments or securities settlement); and (ii) a general-purpose variant available to the public and based on tokens or accounts, allowing for a variety of ways of distribution.

So how would a CBDC act as an alternative to global stablecoins? A general-purpose CBDC would essentially give effect to a disintermediated currency of which the central bank, rather than a private entity, would keep control. The view of the UK central bank, which first raised the possibility of CBDCs in 2015, seems to be evolving. Back in 2018, in his 'The Future of Money' speech (March 2 2018), Bank of England Governor Mark Carney identified that a general-purpose CBDC could mean a much greater role for central banks in the financial system. He noted that central banks could find themselves disintermediating commercial banks in normal times and running the risk of destabilising flights to quality in times of stress.

An independent report commissioned by the Bank of England on the Future of Finance noted that there was no compelling case for CBDCs and that the focus should be on improving current systems to allow for private sector innovation. However, in January 2020 the Bank of England announced that it would be participating in a central bank group with six other banks to assess potential use cases on CBDCs.

Payments systems and the transfer technology underlying stablecoins

In his 'The Future of Money' speech in 2018, Carney noted the potential for underlying technologies to transform the efficiency, reliability and flexibility of payments by increasing the efficiency of managing data; improving resilience by eliminating central points of failure, as multiple parties share replicated data and functionality; enhancing transparency (and auditability) through the creation of instant, permanent and immutable records of transactions; and expanding the use of straight-through processes, including with smart contracts that on receipt of new information automatically update and if appropriate, pay.

An European Central Bank (ECB) Occasional Paper ('In search for stability in crypto-assets: are stablecoins the solution?') notes that: "A platform for the recording of stablecoins and other assets using DLT and smart contracts may either benefit interoperability and competition among different DLT-based infrastructures and issuers – if its governance aims at harmonising the business and technological standards adopted by different operators and issuers competing in the market –, or lead to increased fragmentation if multiple initiatives emerge that compete for the market."

The Bank of England confirmed in July 2018 that its renewed real-time gross settlement (RTGS) service would support DLT settlement models following a successful proof of concept.

Cryptoassets are a daily reality

The prevailing market views seems to be that in the short to medium term, DLT will augment rather than replace RTGS. Interoperability remains a key challenge, as do the technological and energy requirements of a successful and permanent DLT-based payments system.

Nevertheless, it no longer seems fanciful to talk of cryptoassets forming a daily part of the mainstream payments system. They are no longer only the preserve of speculators, or of payors seeking anonymity. The number of transactions in cryptoassets continues to grow rapidly, and regulators are focused on managing their increasing role in day-to-day financial services. It will be fascinating to see how central banks and regulators continue to respond to the growth of cryptoassets, and where this sector will go next.

CHINA
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A market-oriented loan market interest rate

Since the 1990s, all the financial institutions in China's loan market have determined their interest rate by floating up or down certain proportions of the benchmark interest rate announced by the People's Bank of China (PBOC Base Rate). Because the PBOC Base Rate is not closely aligned to the immediate supply-demand dynamics and also because it lacks a transparent pricing calculation formula, the PBOC Base Rate is generally considered as an administrative guidance price rather than a market-oriented price.

In the second half of 2019, the PBOC issued [2019] Notices 15 and 30 aiming to reform and improve the loan prime rate (LPR) mechanism debuted in October 2013. The Notices stipulated that the facility interest rate must be quoted by reference to the LPR, which is calculated on the basis of the LPR quotations submitted by 18 quotation banks on the 20th of every month.

The reformed LPR appears to be more reasonable. For example, the quotation banks cover a more varied type of banks, including national banks, urban commercial banks, rural commercial banks and foreign banks. However, over decades of implementation of the PBOC Base Rate, all financial institutions in China rely heavily on the guiding benchmark rate to price their own interest rate. A predominant, scientific and market-oriented pricing system is still absent in the open market, and even within the member groups of financial institutions, there is a low level of transparency in the rate pricing mechanism. As a result, the majority of the financial institutions in the China market now face an unusual dilemma: on the one hand they have no clue as to how to quote a proper interest rate, and on the other, they have strong doubts about how the final LPR formed on the basis of quotations could reflect their actual funding costs and the loan price. This dilemma casts a shadow over the future of the LPR.

Seeking innovation is the best way to escape the existing situation. On the one hand, financial institutions urge the establishment via fintech of a scientific pricing mode. On the other hand, in order to prevent to the extent possible the variable risk in medium and long-term facilities, it would be advisable to perfect the provisions related to market interest rate (for example, to add a market disruption definition, a flexible pricing adjustment mechanism, and so on) and strive for more bargaining powers in the financing documents.

Seeking innovation is the best way to escape the existing situation

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Ratification of multilateral instrument

On January 22 2020 the instrument of ratification of the Multilateral Convention to Implement Tax Treaty Related Matters (MLI), and the Cyprus position on the minimum standards of the MLI and explanatory statement, were published in the Official Gazette of the Republic.

The BEPS MLI is designed to allow countries to swiftly incorporate new tax treaty provisions in their existing bilateral tax treaties (in line with measures arising from the G20/OECD BEPS Project). The MLI does not operate in the same manner as an existing treaty protocol amendment – rather it 'complements' existing treaties and is to be read in conjunction with the treaty at hand. While the MLI provides flexibility on each state's sovereign right over the adoption of the MLI positions, some elements contained therein (*inter alia* the provisions on the prevention of treaty abuse and dispute resolution) are considered as OECD/G20 minimum standards for those jurisdictions participating in the BEPS initiative.

Cyprus approved the minimum actions as prescribed by the MLI – Action 6 (purpose of covered tax agreement [CTA]), Action 7 (treaty abuse) and Action 14 (making dispute resolution mechanisms more effective). Cyprus has covered all of its existing double tax treaties (with the exception of existing treaties which have already bilaterally agreed to the minimum actions).

The publication of the above completes the domestic procedures by Cyprus for entry into force of the MLI, with deposition of the Instrument having taken place on January 23 2020. The entry into force will take place on May 1 2020, this being the first day of the month after the three-month period following the deposition,as required in Article 34 of the Convention. For provisions relating to withholding taxes, the earliest entry into effect date will be January 1 2021 (provided that the other contracting jurisdiction has also submitted its instrument of ratification with the OECD before, or during, 2020). For provisions relating to other taxes, the earliest entry into effect date will be November 1 2021 (provided that the other contracting jurisdiction has also submitted its instrument of ratification with the OECD before, or during, January 2020).

Summary of minimum standards adopted

Action 6 – purpose of a CTA

Article 6 provides for the amendment of the preamble of tax treaties to include the purpose of a CTA.

Cyprus has provided notification of the amendments on the preamble of all its 61

CTAs through Article 6(3), clarifying that their purpose is to eliminate double taxation without creating opportunities for non-taxation, or reduced taxation, through tax evasion or avoidance (including through treaty-shopping arrangements). The provisions of Article 6(3) will only apply where all contracting jurisdictions have provided similar notifications, thus creating a 'matching position'.

Action 7 – treaty abuse

Article 7 contains a general anti-abuse rule based on the principal purpose of transactions or arrangements (PPT). It also contains an option to supplement the PPT with a simplified limitation on benefits (LOB) provision. The majority of signatories to the MLI, including Cyprus, have opted for a PPT alone. Cyprus has not provided any notification as regards adoption of the LOB provision.

The PPT effectively acts to deny treaty benefits if it is determined that the principal purpose of an arrangement, or transaction, was to obtain the treaty benefit. Persons to whom a treaty benefit is denied under the PPT may still be able to claim a treaty benefit, if they can establish that obtaining the benefit would be in line with the object and purpose of a specific treaty provision (objective test).

Cyprus has chosen to apply Article 7(4) of the MLI, in cases where the competent authority determines that such benefits would have been granted in the absence of the transaction or arrangement.

Action 14 – improving dispute resolution mechanisms

Action 14 relates to a commitment by countries to implement a minimum standard to ensure that they resolve treaty-related disputes in a timely, effective and efficient manner. Approving the integration of Action 14 ensures that Cyprus complies with minimum standards for making dispute resolution mechanisms more effective.

In addition, the MLI introduces a mandatory binding arbitration (Articles 18 to 26) procedure. A party to the MLI that chooses to apply this procedure with respect to its CTAs must notify the 'depositary' accordingly. This procedure will apply in relation to two contracting jurisdictions with respect to a CTA only where both contracting jurisdictions have provided such a notification. Cyprus has not yet opted in for mandatory binding arbitration but may do so at a later stage.

Where Articles 18 to 26 are not adopted, treaty parties are reliant on the mutual agreement procedure (MAP) article in tax conventions.

Clients are advised to review their structures and seek to understand how these developments may affect them

Impact of the MLI on Cyprus tax resident entities

The PPT in effect is an anti-treaty abuse provision within the treaty itself. It seeks to disallow particular treaty benefits where, broadly, the principal purpose of establishing a particular transaction was to obtain the benefits of a tax treaty.

The PPT aims at tackling artificial arrangements and so the OECD makes it clear that where there is a core business activity and other reasonable explanations for setting up a transaction in a certain way (or in a certain jurisdiction) then the mere existence of a tax treaty benefit should not be sufficient to consider that such a benefit was one of the principal purposes.

As a result, treaty benefits linked to the use of a Cyprus tax resident entity will follow a pragmatic approach. Existing and new structures will need to ensure and display the by now known, globally accepted 'substance' requirements. Cyprus tax resident companies must ensure that their interests are protected via the application of the relevant objects and purpose of the international treaties and requirements imposed therein. Failure to adhere to these requirements may result, *inter alia*, in recharacterisation of incomes, loss of treaty benefits, double taxation, enhanced rates of withholding taxes, monetary penalties/prosecutions and application of controlled foreign corporation rules. In light of these developments, clients are advised to review their structures and seek to understand how these developments may affect them.

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Investment in nursing homes

Investment in nursing homes for the elderly through acquiring real estate or the shares of companies managing such homes is increasing in Japan. Generally, investors should be aware of the relevant regulations in order to consider risks; however, the structure of Japanese laws and regulations on these homes is complicated because there are historically two authorities involved, each having established different regulations. The following is a brief introduction from the latest legal perspective for potential investors.

The first authority involved is the Ministry of Health, Labour and Welfare (MHLW). The MHLW supervises nursing homes based on the Act on Social Welfare for the Elderly. Under this act, there is a concept of 'a fee-based home for the elderly' (Nursing Home), basically meaning a facility that provides services for taking in elderly persons and providing them with nursing care services. The MHLW published guidelines for prefectural governors on the method of administrative guidance for Nursing Homes and the desirable conditions involved, such as staffing, management, internal rules and services.

The second authority involved is the Ministry of Land, Infrastructure, Transport and Tourism (MLIT), which supervises

The structure of Japanese laws and regulations on these homes is complicated because there are historically two authorities involved

nursing homes under the Act on the Securement of a Stable Supply of Elderly Persons' Housing. This act has another definition for such facilities: 'a residence with health and welfare services for the elderly' (Service Residence), which is rental housing for the aged which provides residents with safety-check services and life-advisory services. The MLIT requires Service Residences to satisfy certain conditions that are generally looser than those of Nursing Homes.

As the descriptions above show, most Service Residences also fall under the definition for a Nursing Home. These Service Residences, therefore, must comply with both the MLIT requirements and the MHLW guidelines. However, in practice, due to the differences between jurisdictions, many of them seem to comply with only the MLIT requirements as Service Residences. Even though, in 2015, the MHLW amended its guidelines and clarified that they applied also to Service Residences that fell under the Nursing Homes definition, the authorities do not as yet appear to be enforcing this policy perfectly. The local authorities directly supervising Nursing Homes tend to overlook non-compliance by Service Residences by applying provisions in the guidelines that use the wording 'in accordance with the type of service provided' and thus allow some flexibility. However, since it is expected that administrative guidance on Service Residences will become stricter to unify the regulations, investors should carefully monitor future activities of the authorities.

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A step forward

In late December, 2019, a new and consequential step toward fiscal transparency and accountability on par with international standards was decisively taken by the Government of the Macau Special Administrative Region with the approval of Law No. 21/2019, a revision of the Complementary Tax Law.

Under the added provisions, income tax is now owed by any company incorporated in the Macau S.A.R. and classified as a so-called *"final parent entity"*, understood therein as a entity which, being a constituent company of a multinational group, holds, directly or indirectly, sufficient economic interest in one or more of that group's constituent companies such as to warrant taxation in accordance with consolidated financial statements (*i.e.*, financial statements in which the assets, liabilities, returns, expenses, and cash-flows, of the *final parent entity* and of the remaining constituent companies of the multinational group are presented as belonging to one single economic entity – the *final parent entity)* and are issued in conformity with accounting and reporting rules of the jurisdiction in which such entity keeps its effective tax residence. Law No. 21/2019 goes still one step further by providing that income tax is still owed when no consolidated financial statements are issued, but *ought to be issued*, were the final mother entity a publicly traded and owned company. For the purposes of complementary income tax, *final parent entities* are classified as a Group A tax payer and taxed according to their actual accounting statements.

Further regulation is still necessary for the new provisions to take full effect, especially in regard to *final parent entities* whose total profits exceed a yet unspecified amount which will act as a catalyst for several additional (and tailor-made) legal obligations, such as providing copies to the Macau Financial Services Bureau of financial statements issued in the jurisdiction of tax residence or keeping the records of incorporation of the multinational group's other constituent companies.

In all, the revised Complementary Tax Law (understood in connection with Law No. 5/2017, regarding the exchange of tax information, also revised on the same date) expresses one step further in Macau's commitment to honor the pledges made in the context of OECD's Action 13 of the Base Erosion and Profit Shifting initiative.

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PANAMA
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A country Brexit ready

Panama and the UK have shared diplomatic ties since 1908. The US brought the highest amount of foreign direct investment (FDI) into Panama in 2018, with the UK coming in eighth position in the FDI stakes. The 2015 FDI figures saw the UK in fourth spot after the US, Colombia and Switzerland (with a total of 6% of FDI into Panama).

The EU is Panama´s second-largest commercial partner and is in first position in terms of the export of agricultural products. In 2018, 80% of all Panamanian agricultural exports landed in the EU. Exports from Panama to the UK are not huge in terms of total exports to the EU (5% of total) but are highly concentrated (84%) in three products: pineapple, bananas and watermelon.

The trade framework with the EU is the association agreement between the EU and Central America (Association Agreement), ratified by Panama in 2013.

Mainly to protect agricultural exports and to continue to attract FDI from the UK, the Panamanian congress passed Law 103 of 2019. Law 103 ratified the agreement entered into in July 2019 between Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, Panama and the UK and Northern Ireland (CA-UK Agreement).

The CA-UK Agreement is enormous, comprising 28 pages in total (as opposed to the 4396-page Association Agreement). The relative brevity achieved is the result of the simplistic yet perfectly functional formulation of 'incorporation by reference *mutatis mutandis*' upon which the CA-UK Agreement is constructed. Under this structure, in essence, all the provisions of the Association Agreement are incorporated by reference to the CA-UK Agreement, and adjusted only as applicable and as minimally set forth in the CA-UK Agreement.

The pragmatic approach of all parties involved enabled the putting into place of a very complex trade package within a period of just a few months, ensuring the status quo after Brexit.

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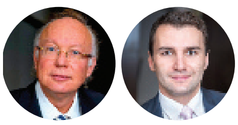

Daniel Futej and Daniel Grigel

New company liquidation rules

An amendment to the Commercial Code, introducing several important changes concerning the liquidation of companies, will come into force on October 1 2020. The amendment seeks to improve transparency in the business environment by taking aim at tax fraud as well as the deceptive practices associated with company liquidations.

The amendment seeks to improve transparency in the business environment by taking aim at tax fraud

Under the prevailing law, the winding up of a company – with or without going into liquidation – is preceded by the legal termination of the company's activities and removal of the company from the commercial register. The amendment introduces a new rule whereby a company is considered to be in 'crisis' from the time of the winding-up resolution until the time its entry into liquidation is registered in the commercial register. This will substantially limit the company in making any financial payments to members and related parties. Under the existing rules, a company goes into liquidation on the same day the winding-up resolution is adopted by the member(s) and the effect of the subsequent publication of the liquidation in the commercial register is strictly declaratory. Under the amendment, the lawful liquidation process will not begin until a liquidator is registered in the commercial register. Members will be allowed 60 days from adopting the winding-up resolution to appoint a liquidator; if they fail to do so, the court will appoint a liquidator randomly selected from the register of official receivers.

The amendment also changes how certain legal acts made by the company before liquidation are preserved. Under the amended law, when a company goes into liquidation all unilateral legal acts made by the company – in particular instructions, authorisations, powers of attorney, and procurations – will cease to exist, with the exception of powers of attorney granted for representation of the company in judicial proceedings. A new step has also been introduced in the liquidation process, requiring the liquidator to draw up a list of the amounts owed to all of the company's creditors within 45 days after liquidation of the company is published in the commercial register. The purpose of this list is to allow the creditors to register their claims for payment out of the liquidation proceeds. However, the company is not released from its obligations to creditors who are not on the list, or even to those creditors who turn up after the 45-day period during which the list of creditors must be drawn up.

The amendment prescribes continuing settlement of the claims registered in the liquidation in the order in which they are received. Claims that in a bankruptcy would be settled as low-ranking claims, such as contractual penalties and the claims of shareholders of other related parties, will only be paid in a liquidation after all other claims of the creditors in the liquidation have been fully settled.

Some of the bureaucracy involved in lodging the application to strike a company from the commercial register upon completion of the liquidation has also been eliminated. The amendment no longer requires the mandatory consent of the tax authority and the Social Insurance Agency to the striking of a company, which will speed up the liquidation process. In addition, the amendment provides clarification of some issues that in practice have been subject to lengthy and complicated solutions offered by case-law. There may be situations where some assets remain after the liquidation of a company, in which case a supplementary liquidation will take place. However, after four years from the time the company is struck from the commercial register, there can be no further liquidation order, as after that time all newly discovered assets of the company automatically belong to the state.

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Security principles and excluded assets

In cross-border acquisition financing, it is common practice that so-called 'security principles' are negotiated and defined in an annex to the facilities agreement. On the one hand, it is specifically held in these security principles what security will be granted by the obligors and the target group to the finance parties; and on the other hand, it also generally describes circumstances under which an exception to the obligation to provide certain security can occur. The security principles provide guidance to the lawyers involved in different jurisdictions whose task it is to translate these principles into specific security documents.

In the case of larger acquisitions, the preparation alone of all the finance documents is associated with considerable costs. In each participating jurisdiction, lawyers must be mandated for the finance parties and for the borrower. In addition, the number of different types of security to be provided is an important driver of transaction costs. Every security comes with costs for its negotiation, perfection and possibly for its maintenance during the term of the financing. In addition, the management and shareholders of the various companies must be involved to ratify and sign the security agreements. Moreover, if changes are made to the finance documents and its parties during the term of the financing, it must often be ensured in all jurisdictions involved that the security provided continues to secure the amended finance documents and is not lost even after the amendments have been implemented. In certain jurisdictions a simple written confirmation is not sufficient in this context, but a new formal act must be carried out, for example, a new notarial act. Last but not least, the finance parties usually require that the continued validity of the security is confirmed by local lawyers by means of a formal legal opinion.

> **It is advisable to identify the material assets in Switzerland that will serve as security and adjust them from time to time**

Because of these costs and the effort involved, it is important that the parties carefully balance the need of the finance parties for security against the costs of providing it, taking into consideration the value of the security for the finance parties. Moreover, if the security created is of dubious legal quality, for example, for reasons of company law issues or financial assistance restrictions, it is also questionable whether the cost of providing such security is justified. In any case, security whose creation exposes the boards of directors of the companies involved to material liability risks or even of committing a crime must also be excluded. Also undesirable are securities whose receipt is associated with high recurring costs, for example, if it is necessary to employ personnel who must take possession of and administer certain objects such as items in a warehouse.

In Switzerland, a typical security package consists of a pledge over the shares of the local companies, a pledge over local bank accounts, an assignment for security purposes of trade receivables and intra-group loans as well as a pledge of intellectual property rights. In real estate transactions, a mortgage is created by transfer for security purposes of mortgage certificates. It is unusual for a pledge to be made over movable items such as warehouses, as these – in order to have a perfected and bankruptcy proof security – may no longer be in the possession of the pledgee. Up-/cross-stream security, in other words, security provided for the benefit of the shareholders of the security provider, generally comes with certain limitations. Despite this, the security is usually still taken out by the finance parties to secure control over the assets concerned, in other words, to ensure that these assets cannot be pledged to third parties or disposed of without the consent of the finance parties.

Usually, certain materiality thresholds are negotiated that serve to define whether a certain asset will be granted as security. The parties may, for example, agree that an asset must be worth at least $100,000 for it to require a pledge. However, certain assets may be subject to change in value, and it must be decided whether to request them as security, even if this seems to be unreasonable due to their existing low value. Other assets may (foreseeably) become less valuable over time and it would then be disproportionate to have to reconfirm or amend security over such assets whenever the facilities agreement is amended.

For assets that change or may change in value, dynamic security principles are sometimes agreed according to which an asset should be automatically pledged or automatically released from a pledge under certain conditions. In certain jurisdictions these principles seem to work and it even seems possible to stipulate the conditions under which an asset may or may not be subject to encumbrance in a general form in the respective security agreement. In Switzerland, unfortunately, such a solution is potentially contrary to certain basic principles of the law. Moreover, in the event of a financial crisis of the security provider, certain regulations for the protection of all of its creditors must be observed, in particular clawback rules (*Paulianische Anfechtung*). In this regard, provisions stipulating an automatic release of assets from the security create an inherent risk that assets are released during an inappropriate time, for example, in the early stages of a financial crisis, that may no longer be (re-) taken as security, once the financial crisis has manifested itself.

It is a basic Swiss law requirement that the assets to be pledged or assigned for security purposes are adequately specified and can be determined (principle of determinability). It must be made clear for all parties involved which assets of the security provider serve as collateral. Where, for example, a claim is assigned, the debtor's person, legal basis of the debt or the amount owed needs to be known. Further, besides security over existing assets, Swiss law also permits that security is granted over future assets that do not yet exist, as long as the security agreement sets out all the elements necessary to determine in the future whether a certain asset – once it comes into being – is subject to the security. If it cannot be determined from the security agreement which assets will be subject to the security purported to be created by it, the respective security agreement may be declared invalid.

Compliance with the principle of determinability is straightforward if all assets of a certain class serve as security. For example, if all claims in connection with loans against other members of a group of companies are defined as being assigned for security purposes, there will be no doubt whether a certain claim falls under such a definition and, thus, these claims are determinable. Moreover, the parties may validly agree that individual assets with a readily determinable value above a certain minimum threshold will be granted as security (for example, 'claims and rights arising under intercompany loans, in each case in a principal amount equal to or in excess of $1 million or its equivalent are assigned for security purposes'). These claims can be clearly identified. However, a definition of the assigned claims such as 'claims in an aggregate amount equal to or in excess of amount X will be assigned' arguably will not create valid security because such a definition would not allow the determination of whether a specific claim served as collateral. Further, general exceptions and conditions which are unclear or whose applicability is difficult to determine should also be avoided in order not to put at risk the validity of the security.

With this in mind, it is advisable to identify the material assets in Switzerland that will serve as security and to adjust them from time to time, for example, as part of a general amendment of the finance documents. Overly dynamic security concepts that attempt to anticipate any possible future development in general should not be included in Swiss law security documents.

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New private placement regulations in public companies

On November 26 2019, the National Assembly approved the Law on Securities 54/2019/QH14 (Securities Law 2019). This Law will replace the Law on Securities 70/2006/QH11, as amended in 2010, (Securities Law 2006) and will be effective from January 1 2021. In an attempt to improve the securities market, the Securities Law 2019 introduces, among other amendments, notable changes in relation to certain requirements for private placements of shares in public companies (Private Placement).

Notable changes to private placements

Under the Securities Law 2019, there is a change in the definition of private private placement is defined as an offer for the sale of securities that does not fall into the category of an offer for sale via the mass media, and that is made via either of the following methods: (i) an offer for sale to fewer than 100 investors excluding professional securities investors; or, (ii) an offer for sale to professional securities investors only (Article 4.20 of the Securities Law 2019). In comparison with the Securities Law 2006, this definition supplements that shares offered for sale to professional securities investors only are considered to be a private placement as well.

The new law imposes stricter requirements for a private placement

To offer shares through a private placement, a public company will be subject to the requirements listed below (Article 31.1 of the Securities Law 2019):

A resolution of the GMS required

Under the Securities Law 2019, there must be a general meeting of shareholders (GMS) resolution approving the private placement plan which identifies the number of potential investors as well as the criteria for selection of eligible investors (Article 31.1(a) of the Securities Law 2019). This was also the case under the Securities Law 2006 and guiding documents, and remains unchanged.

In addition, under the Securities Law 2019, the investors are not required to make a tender offer bid (TOB) if the investors purchase newly issued shares in line with an issuance plan passed by the GMS, as with the Securities Law 2006. Under the Securities Law 2006 and its guiding documents, it was understood that eligible investors should be specified in the GMS resolutions in order to be exempted from a TOB. This point is not clearly stipulated under the Securities Law 2019, but the requirement may remain unchanged.

Participants of a private placement

The Securities Law 2006 did not limit the types of the investors who could participate in a private placement. In particular, eligible investors could be decided by the GMS of the issuer. Nevertheless, the Securities Law 2019 provides that only two categories of investors are allowed to purchase shares in a private placement: (i) professional securities investors; and (ii) strategic investors.

In relation to (i), this is not a new term. However, this term covers not only financial institutions as under the Securities Law 2006, but also (a) companies with paid-up charter capital of VND 100 billion ($4.3

million) or more; (b) listed organisations; (c) organisations registered for trading; (d) individuals with securities practising certificates (which include: securities brokerage practising certificates; financial analysis practising certificates; and fund management practising certificates); and, (e) individuals holding a securities portfolio with a value of at least VND 2 billion or who had taxable income of at least VND 1 billion in the latest year (Article 11 of the Securities Law 2019).

In relation to (ii), 'strategic investors' is a new term first set forth in the Securities Law 2019, which is defined in Article 4.17 of the Securities Law 2019 as 'investors selected by the GMS according to the criteria regarding financial capability, technology expertise and who have a commitment of at least a three-year partnership with the company'. For the criteria regarding financial capability and technology expertise, each issuer at its discretion can decide how these are fulfilled. However, detailed guidance regarding 'financial capability' and 'technology expertise' has not been provided, and it is unclear which documents reflect a commitment of at least a three-year partnership. Such ambiguities may be addressed by the guiding documents to be issued by the state authorities.

Lock-up period applied to a private placement

Under the Securities Law 2006, privately placed shares were subject to a lock-up period of one year as from the date of completion of the offer tranche (Article 10a.1(b) of the Securities Law 2006). In relation to a professional securities investor, the aforementioned lock-up period is only applied when an organisational investor wishes to transfer shares privately issued to a professional securities investor, or a professional securities investor wishes to transfer its shares to a purchaser that is a non-professional securities investor.

However, the Securities Law 2019 has tightened the lock-up period by adding that the lock-up period must also be at least three

> **Determining who is deemed to be a strategic investor will require further guidance in upcoming legal documentation**

years for a strategic investor and at least one year for a professional securities investor as from the date of completion of the offer tranche (Article 31.1(c) of the Securities Law 2019). In relation to the lock-up period applied to a professional securities investor, the Securities Law 2019 allows only one exception where privately placed shares are transferred between professional securities investors.

Tranche offer requirement

A period of six months must lapse between one private placement tranche offer and the next. This requirement (Article 31.1(d) of the Securities Law 2019) remains unchanged from the Securities Law 2006.

The share offering and foreign ownership cap

The share offering must satisfy the requirements regarding the foreign ownership cap in accordance with prevailing laws. This provision is supplemented in the Securities Law 2019 (Article 31.1(dd) of the Securities Law 2019) representing no change from the Securities Law 2006 and its guiding documents. As the Securities Law 2019 provides that the government will provide detailed regulations on the foreign ownership cap, further specifications on this requirement may appear in subsequent government decrees.

Potential effects of stricter private placement requirements under the Securities Law 2019

It was reported by the Ministry of Finance in the government's proposal regarding the Securities Law Project (amended) 186/TTr dated May 9 2019 that many companies have intentionally taken advantage of the simple requirements provided under the Securities Law 2006 to avoid the strict conditions for a public offering of securities managed by the State Securities Commission. Therefore, with a view to enhancing publicity, the transparency of the securities market and improving the quality of goods on the securities market, the new law imposes stricter requirements for a private placement.

As a result, potential investors who wish to purchase shares privately placed, regardless of whether they are professional securities investors, have been voicing concerns about the restrictions set forth in the new framework. In particular, investors purchasing shares through a private placement need to give the longer lock-up greater consideration, as once an investor purchases shares privately placed, they cannot transfer those shares during the lock-up period. In addition, to avoid confusion, determining who is deemed to be a strategic investor will require further guidance in upcoming legal documentation released by the government.

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Searching for a silver lining

As IFLR goes to press the noise surrounding COVID-19 – or the coronavirus – is reaching peak hysteria. Cases have now been confirmed on six of the seven continents, with Antarctica the only region yet to report an incident. An – allegedly fake – survey reported that 38% of Americans would not drink the Mexican beer Corona under any circumstances for fear of contracting the virus, and images posted online show hundred-strong queues for basic food supplies in various locations.

Of course, law firms are not immune. Baker McKenzie sent its entire London office home at the end of February after a scare, though the firm's remote holiday only lasted a few days until the suspected patient tested negative for the virus. Linklaters reportedly has asked any employees returning from abroad to work at home for two weeks, while Shearman & Sterling has banned staff from visiting China and Hong Kong SAR. The list goes on.

If nothing else, the face that these firms are able to handle the situation without a major impact on productivity shows the relative ease with which the entire industry could become far more flexible. Young lawyers at the beginning of their careers often complain about being overloaded, spending too many hours in the office, and having a poor work-life balance. Strangely, the coronavirus could finally force this way of thinking about work and presenteeism to change.

Sticky fingers?

Banks being accused of theft is not an uncommon event. On the whole, general populations tend to find the salaries and bonuses accrued within the industry slightly unpalatable.

For one senior London-based Citibank trader, however, accusations of dishonesty have reached new highs – or should that be lows. Despite commanding a significant salary and bonus scheme, the trader was caught pilfering his lunch from the staff canteen on more than one occasion.

Why the likely millionaire felt it necessary to take and not pay for his lunch remains unclear – but this isn't the first time this sort of story has emerged from the City. Hopefully the sandwiches were worth the consequences.

Q1 in numbers

4%	of corporates expect a decline in M&A deals in 2020
$200m	drop in WeWork's valuation in the days before its IPO
0.1%	coronavirus' impact on global growth as of early March 2020
33,000	average daily volume of SOFR futures contracts in January 2020
¾	Credit Suisse clients who have not assessed their portfolios for their ocean impact
$400bn	expected global sustainable debt issuance in 2020
16,141,241	UK voters who did not want Brexit

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