IFLR

Libor: this is the end

With two of the seven USD Libor maturities discontinued at the end of 2021, we surveyed the market to gauge readiness

ESG in 2022 | Swiss AML | CBDCs | India's capital markets

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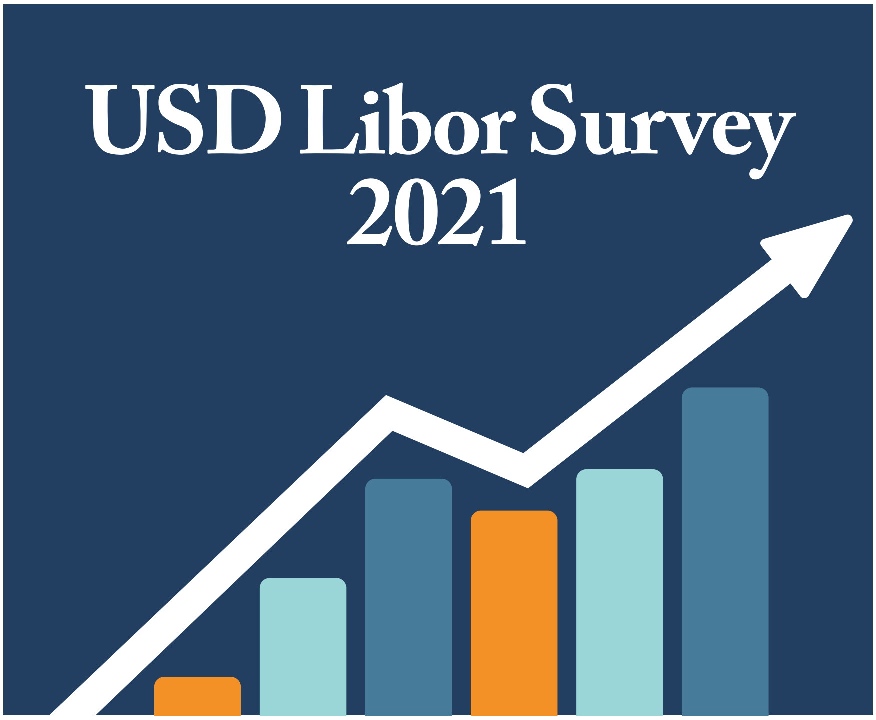

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"Once the supervisory guidance on no new dollar Libor kicks in, we'll begin to see more of an interplay between markets, regulators and best practices, and between the ARRC and other currency groups"

Tom Wipf, ARRC chair

EDITORIAL

The revolution will not be televised

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So here we are. After forty years of physical magazines, I welcome you to the first ever online only edition of IFLR magazine. For a longer discussion of the whys and wherefores of our switch to digital only, please refer to my note editorial note in the previous edition. You can, unironically, also find that on iflr.com.

For now, we will continue to create a quarterly PDF that will look pretty similar to how things used to be. You can access this, and other digital versions of previous magazines, on the website. In keeping with this digital offering, everything you see in this magazine you can find online, but for those of you who like to flick through pages – albeit digitally – we have put it all together in one place.

The cover story of this edition was several years in the making. A culmination of years of my own and senior reporter Alice Tchernookova's Libor coverage, the USD Libor Survey 2021 brought a host of experts from all walks of the financial sector together for a comprehensive, state-of-the-industry look at the Libor transition in the US. The feature runs long, but given that the transition has pushed so many questions to the forefront of the global regulatory conversation it could easily have been two, or even three times longer.

Inside the report are discussions on overall market readiness; the coexistence of multiple rates as a replacement to USD Libor; how significant the legacy issue is for the US market and whether federal legislation for legacy contracts is necessary; and how the market assesses the authorities' handling of the transition process to date. Each section has an abundance of original data to back up our arguments.

Elsewhere in the issue we have some excellent features. One from Daniel Eidan from the Bank for International Settlements on page 34 explains how the organisation is making headway in the latest central bank digital currency projects; and another from Matthew Chan and MJ Park of ASIFMA on page 37 looks at the global coordination of climate taxonomies, and the need to avoid fragmentation in India.

Our local insights section gives a snapshot of the biggest issues in our usual countries, with contributions from our ambassador firms in Switzerland, Japan, Portugal, and the UAE.

As ever, it's a great edition with some fascinating content that should offer something for everyone.

Enjoy the (digital) edition.

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COVER STORY

USD Libor Survey 2021: the time has come, the end is nigh

For this edition of **IFLR**, Senior Reporter **Alice Tchernookova** delves into the results of IFLR's extensive USD Libor survey

After several years of relentless reporting and countless twists and turns in what has been a long-winded transition process, to say the least, Libor is, truly, going away.

With two of the seven USD Libor maturities discontinued in just a month from now, and the other five – overnight, one, three, six and 12 months – to follow in June 2023, we felt now was a good time to gauge market readiness for the Libor transition.

We received an overwhelming response to the survey and have generated some very interesting data points. We tried to cover as much ground as possible in our questions, ranging from overall readiness, to credit-sensitive and term rate usage, to legacy contracts, to overall management of the transition by the authorities.

While some of your responses were largely in line with our reporting and were a confirmation of the patterns we have observed over the past few months and years, others shed a brand new light on previously uncovered aspects of this transition.

For example, we learnt that over half of respondents think the challenge of issuing no new Libor contracts beyond this year would go smoothly or with limited disruption, while the rest think it will cause significant disruption or simply aren't ready for it.

Furthermore, our survey results showed that a vast majority – roughly 75% – disapprove of the Alternative Rates Reference Committee (ARRC) and the Fed's approach and management of the transition, while the rest moderately or strongly approve.

Meanwhile, we got further confirmation that only a small portion of the market will be using SOFR as sole replacement rate, and that Ameribor and the Bloomberg Bank Yield Index (BSBY) were the most popular credit-sensitive alternatives to Libor. Roughly 75% of you also told us that tough legacy would represent a moderate or major issue in the US, while nearly 70% said the passage of the legacy bill at the Federal level is a necessity.

This four-part report will be centred around: overall market readiness ahead of no new Libor at year-end and no Libor at all by June 2023; the coexistence of multiple rates as a replacement to USD Libor; how significant the legacy issue is for the US market and whether federal legislation for legacy contracts is necessary; and how the market assesses the authorities' handling of the transition process to date.

Part one:

US market stands ready for 'no new Libor'

The first batch of our data has revealed that most market participants expect both the year-end and June 2023 phase-outs to go relatively smoothly, although additional guidance in some areas remains essential

The majority of market participants in the US are on track to stop issuing new Libor contracts as of January next year. Most are confident that the June 2023 deadline to have transitioned all legacy contracts to risk-free rates (RFRs) will be met successfully, IFLR can reveal.

Responding to the IFLR USD Libor survey 2021, 18% of participants said they thought no new Libor would go smoothly, while 35% said it would only cause limited disruption.

"The state of readiness for the new US rates, whichever one you want to use, is very high," said Adam Schneider, partner at Oliver Wyman. "Every medium to large bank we talk to is completely ready to stop Libor. Some are worried about edge cases and uncommitted lines, but overall, they're really quite happy to stop having this problem – even though some of them think [no new Libor] is a bit of a non-event, given some USD Libor rates will still exist."

A further 32% of survey respondents said the upcoming deadline to stop issuing Libor should be successfully met, but would likely cause significant disruption.

"The interdealer market is broadly ready, but there are some corners where things are late," said Alexandre Bon, head of marketing for APAC and group co-head of ibor and interest rate benchmark reform at Murex, a software company. "The buyside and corporates, in particular, haven't all moved on. We still get many questions on the fine details, especially around no new Libor for specific types of products. A lot of corner cases are still unclear."

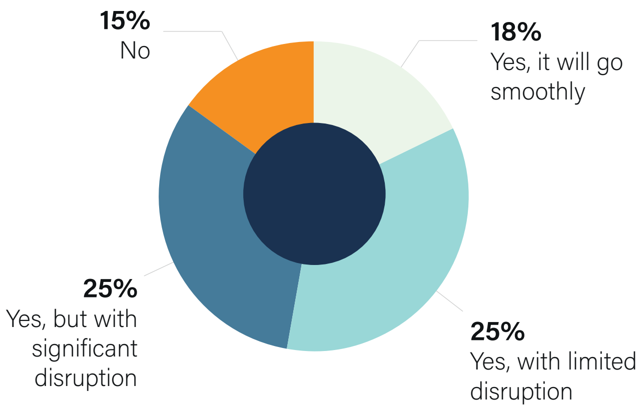
Rolled out over the past few months, the various phases of the SOFR First initiative have generated transition momentum and have bolstered liquidity. The latest figures from CME Group suggest that SOFR futures reached records across the board in November, while SOFR swaps hit a fourth consecutive record month. CME cleared SOFR swaps volumes surpassed $124 billion – an increase of 45% from October.

"Considering the widespread international reliance on Libor, it's great to look back on how far we've come and see the progress we've made across all markets," said Tom Wipf, chairman of the ARRC, during a Libor telethon. "It's been an incredible concerted international effort, especially through the work of the Financial Stability Board (FSB)."

The FSB's most recent statement to support preparations for Libor's cessation, Wipf added, has reinforced the message about the final preparations needed to cease new use of the rate by the end of the year and transition legacy contracts. "It is great to see that support as we move through what will hopefully be the last phase of this transition," he said.

"The numbers on the dashboard are looking pretty encouraging," added Edwin Schooling Latter, director of markets and wholesale policy at the Financial Conduct Authority (FCA), during the same event. "Obviously, we're not going to count any chickens until we actually see how events unfold into the new year. There is going to be some continuing work on the legacy Libor book, but at least, we can draw a lot of comfort from the fact that the new

Are you/your clients ready for "no new Libor" at the end of this year?



markets based on the RFRs are absolutely thriving as we go into the final few weeks of publication."

Mixed picture

Notwithstanding this marked progression, however, different parts of the market continue to move at various paces.

"This is really driven by the corporates, who for many do not understand SOFR," said Navin Raunier, partner at TSA Consulting. "The split in levels of readiness is largely linked to SMEs, who aren't really ready. Main Street has been putting this off for a long time, but the more they do, the more vulnerable they are by continuing to use Libor."

According to Bon, the more exotic end of the derivatives market is also lagging behind.

"Since phase three of the SOFR First initiative – focused on non-linear derivatives – kicked off, there has been good traction and progress on swaptions, especially in the interdealer market," he said. "But there is still not much trading of these products on the buyside. For anything more complex, the models and the liquidity just aren't there yet for people to feel comfortable with trading."

Although the bulk of institutions will likely be ready to stop issuing new Libor products by year-end, uncertainty remains in some parts of the market.

"As much as we have continuously advised people to avoid waiting until [Libor] liquidity goes down, we assume that many might be waiting until year-end," said Wipf. "By the time we get to next year, there will be no other option available. As we get through that deadline, I suspect those markets [dollar swaptions and cross-currency swaps] will move along. It's what we've seen across other Libor currencies, and in the US we are right in the middle of it right now."

Earlier this month, the Commodity Futures Trading Commission's (CFTC) interest rate benchmark subcommittee designated December 13 as the chosen date for the fourth phase of SOFR First, targeting cross-currency derivatives.

"This might help to refocus minds, but adding 'all other currencies' – of which there are a few – with less than two weeks' notice and two weeks before Christmas, is an interesting strategy," commented Benjamin Bullock, interest rate derivatives product manager at Bloomberg. "Unless this message is backed up by all the local official sectors and risk-free rate working groups, there is next to no chance that markets [will be] ready in many other currencies before end-2021."

Around 15% of respondents to our survey said they or their clients would not be ready to stop issuing Libor at the end of this year.

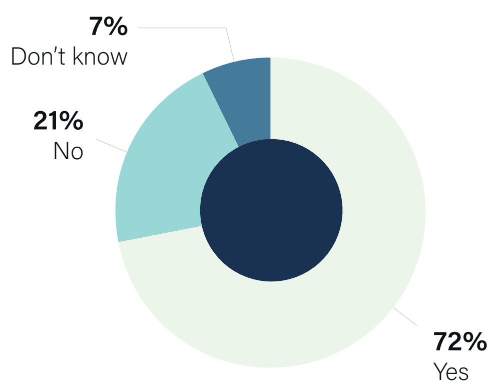
"I was a little surprised at the couple of flat-out 'no's' regarding readiness," said Anne Beaumont, partner at Friedman Kaplan Seiler & Adelman. "The regulators have really made people get serious about not issuing new Libor-based instruments. What will be interesting, is when the customers' feet are really put to the fire when they go to their bankers and request Libor-based products, and the bankers say no."

Some customers may turn to fixed-rate borrowing as an interim fallback solution, Beaumont suggested. "One thing that people often forget about in the lending sector, in particular, is that they can just skip the whole benchmark problem and use a fixed rate," she said. "We've certainly seen some of this happen along the way, though it's a little harder to detect."

January will be an interesting month in terms of observing these trends, Beaumont added.

"There are always issues, such as systems that didn't get updated, so some people might go to fixed rates for a couple of months until they are ready," echoed Schneider. "It's a question of changing customers behaviours, and in that respect, 'the Fed won't let us' is a

Do you believe that the June 2023 deadline to discontinue USD Libor across all tenors will be successfully met?



"Every medium to large bank we talk to is completely ready to stop Libor. Some are worried about edge cases and uncommitted lines, but overall, they're really quite happy to stop having this problem"

– Adam Schneider, partner at Oliver Wyman

very powerful argument for banks. Customers are going to move on, because there is no alternate: the [Libor-based] banking system will shut down."

Long-term view

While one-week and two-month USD Libor will both be discontinued at the end of this year, all the other tenors – overnight, one, three, six and twelve-month USD Libor – will continue until June 30.

"I feel reasonably comfortable that the bulk of the market will make the June 2023 deadline – there is certainly enough time to do so," said Bon. "However, there are dissenting voices and a lot of pushback in the US against the imposed transition from Libor to SOFR. A number of participants are still vocal about their dissatisfaction with what they perceived to be a forced choice, and would prefer to use something else. The debate around replacement rates in the US is not over yet."

In our survey, 72% of respondents were confident the June 2023 final deadline would be successfully met. The remaining 28% were either unsure or disagreed.

"There's no way the authorities will back off, so it will inevitably happen in 18 months – but that's a long time to complete what has to get done," said Schneider. "Most of the institutions we talk to intend to implement very rigorous customer and operational processes to move people to the new products instead of waiting for fallbacks. Most of 2022 will likely be spent reviewing portfolios and minimising the number of legacy items."

But if market pushback against SOFR continues and the migration to alternative rates isn't fast enough, Bon warned, further issues could arise.

"Things could start to move and fall into place too late in the process for people to be fully comfortable," he said. "Focusing on the development of non-linear derivatives will be the next big task. We need to get to a point where we have clear conventions and alignment on how to price and risk-manage these new products."

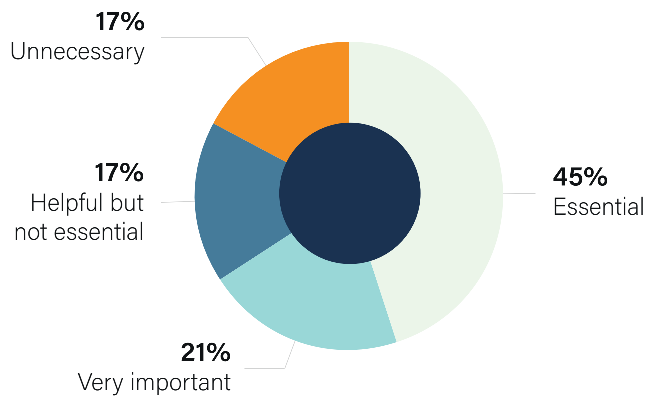
Outstanding questions

Crucially, even though year-end is now basically here and it may be too late to get answers, some market participants still require further guidance on a number of aspects.

"We all know the intent is for there to be no new use of Libor after the end of this year, but there is some lack of clarity around what 'new use' actually means," said Ian Fox, group ibor transition director at Lloyds Bank. "Unhelpfully, in the US, there is a suggestion that firms should go to their individual regulators to get clarity, but that these regulators have been giving different guidance to different firms. This means the industry doesn't have a single position to get behind at the moment."

While the UK has a good track record of having delivered a single regulatory message through the FCA that everyone

How important is additional regulatory guidance to apply 'no new Libor' after year-end?



> ***"The regulators have really made people get serious about not issuing new Libor-based instruments"***
>
> **– Anne Beaumont, partner at Friedman Kaplan Seiler & Adelman**

followed, the situation is different in the US.

People tend not to follow the regulatory guidance quite so seriously in the US: it gets more confusing where there's multiple regulators involved," explained Fox. "We're hearing different interpretations from different firms, which isn't helpful for the market and for borrowers. The US authorities need to be clearer about their products and their market, even though the industry is more diverse than in the UK."

Asked how important additional regulatory guidance on the application of no new Libor after year-end was, 45% of respondents to our survey said it was essential, and 21% said it was very important.

"If you speak to people who have been following this in the weeds, it's probably fairly clear, but I don't think it is to the broader market in terms of realising there will be no Libor next year and they just can't do those contracts," said Edward Ivey, counsel at Moore & Van Allen. "Some people still don't seem to get the differences between term and daily simple SOFR, for example."

But rather than a lack of clarity from the authorities, this could also be down to insufficient education on the transition among market participants, Ivey suggested.

"The principle of no new contracts does leave a lot of grey space," he added. "Automatically, there are going to be questions around what people can do in that grey space. This is now really hitting the broader market, so there should be an education uptick."

An equal percentage of survey respondents (17%) also said further guidance on new Libor was either simply unnecessary, or helpful but not essential.

"As we approach year-end, the biggest piece of the puzzle is the supervisory guidance for no new Libor, which gives a hard stop with very limited circumstances where an institution can continue using Libor for hedging purposes," said Wipf. "Once the supervisory guidance on no new dollar Libor kicks in, both in the US and in other jurisdictions, we'll begin to see more of an interplay between markets, regulators and best practices, and between the ARRC and other currency groups."

International cooperation, Wipf added, has become a critical component in many respects.

"It's very obvious that we're all heading towards the same goal – we just had a couple of different paths on how to get there," he said. "The hardest part is around what is or isn't new dollar Libor. There were a lot of calls for clarification heading into this, but the guidance issued most recently by the FCA and the Fed has responded to these directly, which has been very helpful for markets."

With no new Libor only three weeks away at the time of writing, it won't be long until we find whether that has truly been the case.

This is part one of our four-part survey report. The next part will focus on the multirate environment that will succeed to USD Libor, and credit-sensitive rate usage.

Part two:

Federal legacy law 'essential', says market

As the market keeps its eyes peeled while the tough legacy bill goes through the Senate, part two shows that a majority of respondents see this as a key component to a successful transition

An overwhelming majority of market participants consider the passage of a bill for tough legacy USD Libor contracts at the federal level as 'essential'.

Nearly 70% of respondents validated that statement, while 21% disagreed and a further 11% remained neutral.

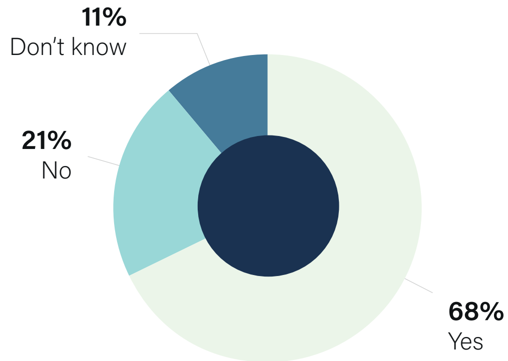
"There are simply too many situations where things are open to interpretation and no party has the power to make the judgment," said Schneider. "Without legislation, there are too many risks of getting into a bidding war. The passage of the legacy bill is, therefore, absolutely essential."

Last week, the US House of Representatives voted 415 to 9 in favour of the H.R. 4616 bill, more commonly known as the Adjustable Interest Rate (Libor) Act. The bill proposes to use the secured overnight financing rate (SOFR) plus a set spread as the common alternative rate in Libor contracts that lack adequate fallback provisions and cannot transition.

"This is a clearly bipartisan vote and a monumental accomplishment for the financial services industry – on to the Senate!", Jason Jurgens, partner at Jones Day, wrote in a LinkedIn post reacting to the news. Others, including the Alternative Reference Rates Committee and the Bank Policy Institute, also welcomed the news.

"Federal legislation is vital to the success of the transition away from Libor," said Tom Wipf, ARRC Chairman and vice chairman of institutional securities at Morgan Stanley. "As we enter Libor's final days, this targeted solution will provide certainty not only to a diverse array of corporate borrowers and

Do you believe the passage of the legacy bill at the federal level is an essential condition to remedy 'tough legacy' contracts across US markets?



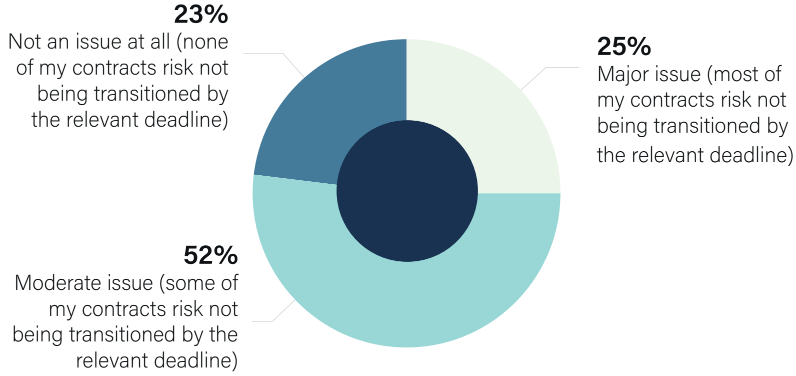
lenders, but to retail bondholders and consumers, whose student loans, mortgages, and investment accounts the legislation will protect from disruption and value degradation."

Although many agreed that the House's approval of the bill was a significant step in the right direction, others stuck to a level-headed approach. "For it to become law, it also has to pass the Senate," said Jonathan Schachter, quantitative modelling specialist and founder of consultancy firm Delta Vega. "I certainly would not consider the House's vote a huge milestone."

A key aspect is also the time it will take to go through the Senate stage: the bill had been referred to the House since July 22 and was only discharged by it on December 7.

"The main thing is timing: they need to get it done by the end of this year to allow enough time for the Fed to begin implementing the law," said Robert Mackenzie Smith, senior research analyst at Bloomberg Intelligence. "There are many more steps to this, including putting it out for market comment. It all takes time, and we are just over 18 months away from USD Libor going away for good."

How much of an issue is 'tough legacy' within your organisation?



Not all, however, agree that the passage of the bill at federal level – as opposed to state level – is necessary. At present, legacy legislation has already been approved in the states of Alabama and New York.

"I was surprised to see that many [survey] respondents think that the federal legislation is 'essential'," said Beaumont. "I think the New York legislation is widely viewed as a milestone success. This indicates that it does not quite cover the waterfront."

Beaumont expressed scepticism as to the strict necessity for the bill to apply at the federal level. "I am not sure it's needed," she said. "To the extent that you buy into the notion that the legacy problem can be fixed through legislation, the New York State bill addresses most of it. The federal legislation is aimed primarily at solving issues concerning the federal Trust Indenture Act, which I am not convinced are issues at all given the text of the New York law."

Other sources raised criticism as to the actual proposal included in the bill. "If it were properly designed, a federal fallback process could work," said George Bollenbacher, independent consultant and former head of fixed income at Tabb Group. "The problem with the current legislation, is that it mandates a yield curve that is very different from where we are today. If we still have a flat yield curve in mid-2023, this law will be very disruptive."

Getting the legislation right would be very good, Bollenbacher added. Getting it wrong, however, would simply open another avenue for litigation.

"The real disruption is that virtually every instance of Libor involves at least two parties – and sometimes hundreds of parties on one side," he said. "Getting everyone to agree on a replacement, on a way out of the mess, is really difficult."

A quarter of respondents to the survey described the tough legacy problem in their organisations as a major issue, while another 50% said it was a moderate issue.

"It's an embarrassment that we have known Libor was under attack by regulators for approximately 14 years but for most of that time have done contracts that have legacy issues and inadequate fallbacks," said Schneider. "It's a shame that this subject was never dealt with in the course of normal business – especially when there was a deadline. That is just unconscionable."

How much of a problem tough legacy is, he added, depends on product type – but it is material regardless.

"USD Libor is not only used in the US: there are dollar Libor loans in many countries that are not going to benefit from federal legislation," said Schneider. "This is a global concern and is integral for a version of stability. Ten million contracts with inappropriate fallbacks and potentially litigious people on both sides is not a good thing, whichever way you look at it."

Although the transition away from Libor is already happening and will continue regardless of the legacy bill, its passage would still be of significant help, said Alex Maia, Americas head of interest rate, FX, local markets and commodities structuring and solutions at BNP Paribas.

"As we enter Libor's final days, this targeted solution will provide certainty not only to a diverse array of corporate borrowers and lenders, but to retail bondholders and consumers"

– Tom Wipf, vice chairman of institutional securities at Morgan Stanley and chairman of the ARRC

> ***"The problem with the current legislation, is that it mandates a yield curve that is very different from where we are today. If we still have a flat yield curve in mid-2023, this law will be very disruptive"***

– George Bollenbacher, independent consultant and former head of fixed income at Tabb Group

"The bill is important to deal with contracts that, for different reasons, have not transitioned – which is a vast minority of the stock of trades," he added. "Because the volumes here are so large, it can still be a meaningful number in absolute terms. It might be a low percentage of contracts, but it represents a high dollar-value amount."

According to Bollenbacher, average new Libor swaps issuance remained above $1.6 trillion a week in Q4 2021, and totalled $7.3 trillion in November alone.

"There will potentially be $200 trillion of existing transactions as of the end of the year – the question is what we will do with them," he said. "The biggest disruption will happen in instances where there isn't a clear solution outside of going to court – where people have kept issuing Libor debt and instruments because they couldn't find an alternative that both sides were comfortable with."

Onward and upward

As the market edges closer to year-end and the deadline to stop issuing new Libor contracts kicks in, the focus will progressively shift exclusively towards solving the legacy issue.

"As we head into next year, all that remains is for market participants with dollar Libor exposure to take immediate action, which means writing new contracts based on forms of SOFR and using fallback language where needed," said Wipf. "We have a federal legislative solution in the US, which we want to see a lot of support around, as we believe it will be very beneficial to deal with tough legacy issues."

For Bon, attention should also be paid to the way the Libor cessation plays out in other currencies.

"There are two options: either everything works out perfectly, and in that case we just need to scale it up for US dollar," he said. "Or, we notice some incident and issues, but then the good news is that there is enough time to find solutions and potentially try new approaches."

The operational complexities and risks to systems and processes involved mean that things could go either way, Bon insisted. "It's about finishing the work on the products where there has been limited adoption, or where conventions and market practices are still unclear," he added. "Non-linear derivatives are a good example, but there are other corners and areas, such as tough legacy products on the banking book side."

While much of 2021 has been devoted to inputting fallback languages into contracts, the market will enter a new stage next year, suggested Ivey.

"There are two priorities: making more education material available and preparing documentation to amend existing Libor contracts that don't have fallback language," he said. "What you would not want is for [June] 2023 to be a big bang effect, so the goal is to amend as many contracts as possible to transition to SOFR ahead of time. This will be the big focus of 2022."

Others described the issue of transitioning contracts as a long-term process. "It's not going to be a big bang event on January 3 – it will be a staggered issue for those contracts as they reset over time," said Ian Fox, group ibor transition director at Lloyds Bank. "The biggest concentration will be at the end of March, as quarter-end rolls are quite common in both loans and derivatives. Some contracts will need to reset in January, but the majority will be in late March or late June."

As ever, clarity from the authorities on the approach that market participants should follow will be key. "Market participants understand what needs to happen, they just don't have an easy path to get there," said Bollenbacher. "There is a whole bunch of answers that we don't have, and we have less than a month. The regulator's harping with increasing panic in their voice on everything the market needs to do doesn't necessarily create certainty or confidence."

Part three:

Ameribor dominates the CSR landscape

In the third part of our survey, we look at the ongoing popularity of credit-sensitive rates as a replacement for USD Libor, with Ameribor and BSBY distinguishably outranking the rest

A large portion of the US market continues to prefer using other alternatives to USD Libor than SOFR.

Over half of the respondents (55%) said they were using or planning to use a credit-sensitive rate (CSR) or spread as a substitute to Libor, while 25% said they would use SOFR only. The remaining 20% said they would not use either.

"SOFR has an important place: in the US, the efficient functioning of the repo market [on which SOFR is based], particularly in times of extraordinary deficit and debt levels, is very important for the Fed and the Treasury," said Richard Sandor, chairman of the board and CEO at the American Financial Exchange (AFX), administrator of Ameribor. "Choice is now the preeminent word over here. It was our sense from the time that we set out on this journey that there was a need for that."

Over 70% of survey respondents said they would use Ameribor as their preferred CSR, shortly followed by BSBY – Bloomberg's short-term bank yield index – which gathered 60% of interest.

"For many of our banks, having a CSR that reflects their cost of borrowing is a matter of survival as they don't have the knowledge of basis risk or the bandwidth to get into the repo market," said Sandor. "We are the most credit-sensitive rate and have a particular niche, which is not the big banks, but the 5000 other banks in America. Those folks need a rate that reflects their credit risk, which is higher than big banks'."

In times of stress, Ameribor will likely behave similarly to Libor, Sandor added – an element that is at once comforting and convenient to many users.

"There are two aspects to transaction costs associated with a benchmark: one is the liquidity of a market, and the second is the basis or spread risk," said Sandor. "Our members need to have minimum basis risk because it will dominate the cost of hedging. To suit their market, they need a benchmark that reflects their particular costs and the credit risk of their borrowers – not the one associated with the repo market."

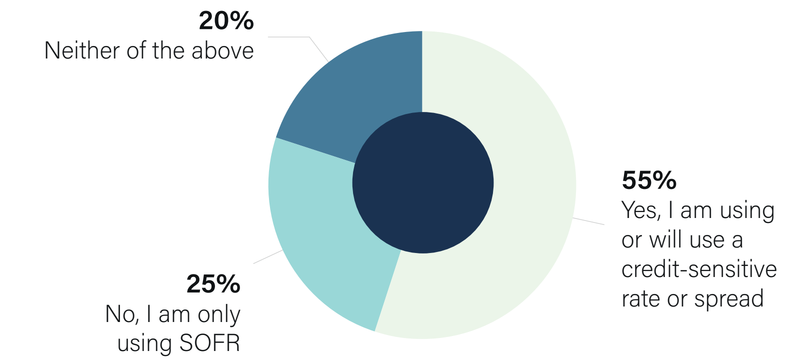
Survey respondents also expressed an interest towards other alternatives, such as IHS Markit's credit-inclusive term rate (CRITR) and credit-inclusive term spread (CRITS) (13%), ICE Benchmark Administration's bank yield index (BYI) (13%) and SOFR Academy's across-the-curve credit spread (AXI) – most of which cannot yet be used in contracts.

"This is in line with the idea that SOFR is not an all-in rate," said Navin Rauniar, partner at consultancy firm TCS. "It makes sense for Ameribor to top the lot, as it is a supporter of Main Street. The US market will definitely end up in a multirate environment, but there will likely be dropouts from the race."

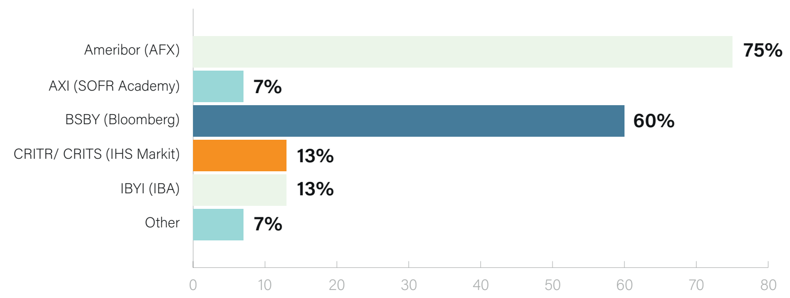
An overwhelming majority of survey respondents (90%) also agreed that a multirate world will prevail, with 55% saying it will be dominated by SOFR, and 35% saying that CSRs will concentrate an important part of the market.

"SOFR will clearly dominate the derivatives space and CSRs will mainly be used for the cash portion of the market – albeit with some derivative activity off the back of it," said Mackenzie Smith. "As for Ameribor and BSBY, they will both find

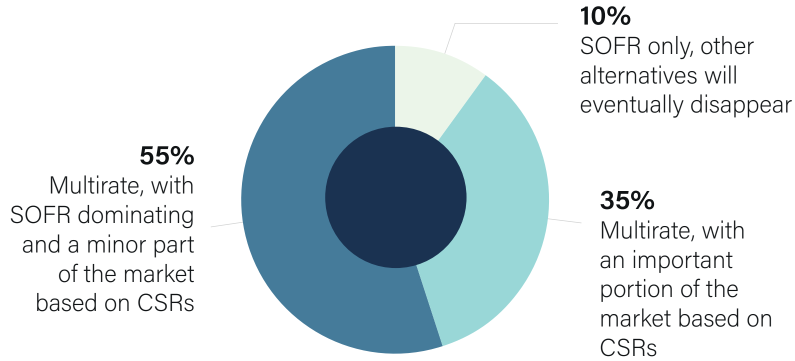
Are you/your clients using or planning to use a credit-sensitive rate/spread, either as a SOFR add-on or as a standalone rate?



Which of the following rate(s) are you using/planning to use?



Will USD Libor eventually be replaced by SOFR alone, or by multiple rates?



their niche and will be very useful to those parts of the market that want to use them."

Ivey agreed that CSRs use would be limited principally to the loan market and its potential offshoots. "If you're a bank and your whole business is just lending, like small community banks, SOFR is not really a rate that is well suited to cover your actual costs," he said. "Daily simple SOFR is not a rate that those types of lenders and borrowers were going to be willing to accept. They want to know how much they owe five days ahead as they try to do a monthly budget, which they can't just complete with a 'fill in later'."

Misfit

Overall, many sources agreed that the ARRC initial appreciation of SOFR use and demand was miscalculated, and that their approach had to be shifted along the way.

"The choice of SOFR as a benchmark replacement for USD Libor was very suboptimal," said Michael Koegler, managing principal and co-founder at Market Alpha Advisors. "Moving from an unsecured term rate to an overnight secured rate that is somewhat influenced by technicals in the US Treasury Market does not fit a lot of use cases."

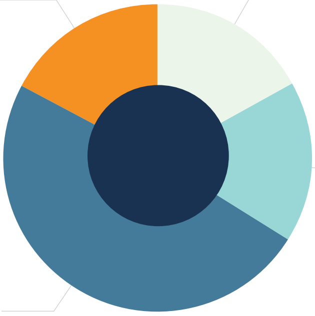
This, Koegler added, is what is blatantly obvious in the survey results. "The majority of respondents said that they may use SOFR but will be looking at other benchmarks too – which is a completely different story to what the ARRC has been trying to get people to do," he said. "There is a good reason for it: SOFR doesn't work unless you are a highly rated institution that funds very close to treasuries. It introduces real problems and inefficiencies, which will eventually be passed on to the borrower in the form of wider spreads, increasing borrowing costs."

With SOFR-based deals set to come at a higher all-in cost than with Libor, the only way for banks to protect themselves is to charge higher spreads, Koegler argued.

"While SOFR is robust in terms of being able to point to an index that has easily observable market prices behind it (overnight repo), it doesn't solve many of the problems that Libor used to," he added. "An overnight rate can't be used in a bank loan, for instance, which was one of the reasons why the Fed endorsed term SOFR. The issue is there's no transaction volume underlying three-month term SOFR: there is very little repo trading on a three-month term basis."

Other sources agreed that the ARRC's recommendation of SOFR as the replacement

Why?



rate of choice for USD Libor may not have taken all the necessary elements into account.

"The rate has been chosen on the basis of its construction, as opposed to its use," said Schneider, partner at Oliver Wyman. "It is well-designed for derivatives trading, and for lending the implication is clear: if you don't like how [SOFR] performs, change the products that use it as needed, but keep the base rate as solid as can be. It's been the theory of the case all along."

The authorities' open criticism and consistent bashing of CSRs over many months has also been deemed unhelpful to market participants. "The messaging from the authorities on CSRs has only been partially successful," said Rauniar. "The results are conflicting because the ARRC and the Fed have said numerous times that SOFR is the preferred rate, but that they are open to any other rate that is Iosco-compliant."

> ***"Moving from an unsecured term rate to an overnight secured rate that is somewhat influenced by technicals in the US Treasury market does not fit a lot of use cases"***
>
> – Michael Koegler, managing principal and co-founder at Market Alpha Advisors

Half of the survey respondents who said they were not planning to use CSRs indicated they would not do so because they followed the ARRC's and Fed's guidelines. An equal split (17%) said they either didn't need them for their products, or considered they weren't reliable enough, or did not comply with Iosco's Principles for Financial Benchmarks.

"The fact that there are applicability problems with SOFR shows that it was cobbled together because we had to get something," said George Bollenbacher, expert consultant and former head of fixed income at Tabb Group. "There isn't a volume market in term repos, so term SOFR is determined the same way that Libor is. There is a term market for Treasury bills, but that choice was passed over."

The ARRC, however, continues to stand by its recommendation and defends its track record. "We chose SOFR because it was far and away the best replacement for Libor: by nature of the transactions, the ability, the transparency, the size of the underlying markets – $800 billion to a trillion dollars a day in transactions – and the lack of reliance on quotes and expert judgment," said ARRC chair Tom Wipf during a Libor telethon. "We always worked under the assumption that as market participants began to review other alternatives, and if they took the time to know what's in their reference rate, they would probably reach the same conclusion: that SOFR was obviously the best choice to avoid repeating the mistakes of the past."

Wipf however conceded that the ARRC's initial approach may have been incomplete and had to be tweaked. "We initially focused mainly on derivatives because they made up the notionals of the market, but we very quickly learned in our work that the cash products and their variety and distribution were much more complex," he said. "It seemed to be a much bigger and deeper set of issues than one would have thought when we looked at this back in 2014. Tremendous work has been done to de-risk the derivatives market, but we ought to add to the cash markets – not just within each jurisdiction, but with comparisons across all the different [Libor] currencies."

Exponential growth

As the ARRC pursues its SOFR and term SOFR crusade, pundits predict that CSR use will keep expanding as the market stops issuing new Libor contracts as of January next year.

"Once the first round of regulatory push against CSRs concludes, we are likely to see these rates slowly gain share," said Schneider. "We will see major institutions leaning into CSRs, and therefore others will go along. Most banks are going to end up with both [SOFR and CSRs] and the market will naturally progress towards a new 'normal'."

This, Schneider added, may be influenced by the interest rate cycle. "Right now, all rates are tightly compressed, but it looks like rate increases in 2022 are likely and there may be significant differences between overnight and term rates," he said.

AFX's Sandor, meanwhile, foresees widespread adoption of non-Libor rates by 2025. "It should all be sorted by then," he said.

"So far, there hasn't been an adequate interest rate to cater for the whole market – by which I mean Wall Street and Main Street," said Rauniar. "The main market has been screaming out for alternative options, and it seems they're getting their day. What is interesting, is that Wall Street has joined the party and is now also encouraging liquidity in CSRs."

If the big banks are doing it, Rauniar added, then others are likely to follow along.

"With five of the seven USD Libor tenors published until mid-2023, there could be a kind of halfway house situation in the US," Mackenzie Smith however warned. "But given the [June 2023] deadline, the conversation around CSRs and their use cases will get a bit more forensic as of next year, and we will probably see an evolution of their usage."

Part four:

ARRC and Fed's Libor transition management deemed 'disruptive' by market

Half of the respondents to our survey disapprove of the US authorities' handling of the transition, with an overwhelming majority saying ongoing debates around credit-sensitive rates have hampered transition efforts

The ARRC and Fed's handling of the USD Libor transition has caused significant discontent among US market participants.

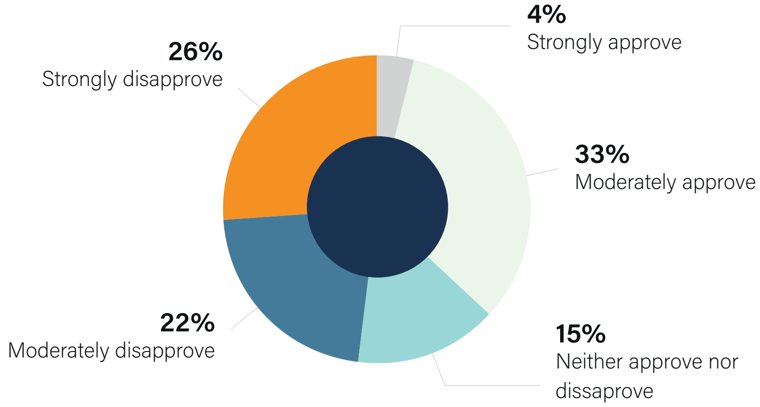
Nearly 50% of respondents either strongly or moderately disapproved of the authorities' overall approach and management of the transition, compared to 37% who strongly or moderately approved. A further 15% were neutral.

"There's some discontent in the market with the public sector's heavy-handed approach in what was supposed to be a market-led transition," said Alexandre Bon, group co-head of ibor and interest rate benchmark reform at Murex. "An institution like the ARRC should represent the entire market, yet, some view it as an echo chamber for the Fed and Libor panel banks, with an interest in getting rid and getting out of the Libor publishing mess as soon as possible – albeit with some concessions along the way, such as a late U-turn on term SOFR."

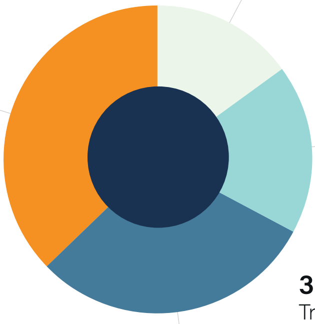
A key criticism towards the authorities has been their inability to appreciate the benefits of Libor's inherent term structure and credit sensitivity – both of which are essential features that allow financial institutions to efficiently manage their cost of funds and lower all-in costs for borrowers, explained Koegler.

"Some of the decision-makers on the ARRC either misunderstood or chose to ignore the difficulties that market participants would have in implementing SOFR for all use cases, and focused only on one aspect, which was the trading volume in overnight SOFR," he said. "Instead of

Do you broadly approve of the ARRC and Fed's overall approach and management of the transition away from USD Libor?



Regardless of your progress at this stage, which of the following would be your preferred scenario?



forcing the widescale use of a benchmark that would undoubtedly create inefficiencies, they should have reformed Libor. At this point it is too late for that, but they can stop trying to force SOFR First on everyone and being so critical of credit-sensitive rates (CSRs)."

This top-down approach was also criticised by other sources. "The senior people tell the junior ones what to do and nobody talks back," said a senior director at a bond rating agency. "The Fed is manipulating SOFR so it's been flatlining since March 2021."

"They totally missed it, but that ship has sailed," they added. "We are done looking at the wreckage of this because there's no hope, no banks will go ahead and toy with the Fed and their bank examiners."

The source also argued that the choice of SOFR as prime replacement for USD Libor may have served the interests of the few, rather than the many. "SOFR was a dream come true for large banks," the source added. "It's perfect for the derivatives market – that's what it was always designed for. Lending was a secondary idea, it was designed with futures, trading and the swaps market in mind. People who lend on OiS [overnight interest swaps] know all about this, but what about funds transfer pricing and loans?"

With some nostalgics still thinking that keeping Libor would have been a better option – 15% of respondents to our survey said so – the jury is still out on whether SOFR, designated and promoted by the ARRC, was truly the best available option.

"Almost no one in the marketplace actually wanted to make this change: the construction of Libor broke in a way, but the right answer was fundamentally to keep the rate and rebuild it," said Schneider. "When SOFR was invented we had a wonderful, global, verbose and enormously transacting financial system that didn't need this rate. It was invented for strength of construction, not for use – and not in lending. We've been fighting with how to adapt it to $10 trillion of US lending tied to Libor ever since."

Line of defence

Speaking during a private press conference last week, Tom Wipf, ARRC chair and vice chairman of institutional securities at Morgan Stanley, defended the committee's track record and decision-making.

"Given the complexity of this transition, trying to deconstruct a rate like Libor that is so widely used from consumer products all the way to the most sophisticated derivatives has, at times, been challenging," he told IFLR during the session. "Some things are also quite market-dependent. Nevertheless, when I look across the composition of the ARRC and the diversity of the membership, we've really worked hard to ensure that all voices were heard."

In a separate address during a Libor telethon, Wipf also said: "We had worked under the assumption that people would see that SOFR was obviously the best choice from a transparency perspective to avoid repeating mistakes of the past. We felt it also served to get the derivatives market focused on this, which opened the door to the CFTC's Market Risk Advisory Committee's SOFR First recommendation."

The SOFR First initiative, Wipf added, gave the ARRC enough confidence to recommend a term SOFR rate, as the volumes had followed. "When it was all over and the dust settled, sequencing might not have been perfect, but we actually got the attention of the derivatives market," he said. "We got people moving to SOFR and were able to endorse term SOFR. In the end, it [SOFR First] got us there, but I wouldn't say it was the smoothest road."

Some market participants also expressed more lenient views on the US authorities' handling of the transition, mainly emphasising the situation they were dealt with compared to other jurisdictions, such as the UK.

"It has always been difficult, because the ARRC and Fed have a very limited toolkit at their disposal and have insisted on a market-based solution that is the product of that toolkit," said Beaumont. "The FCA [Financial Conduct Authority] has a different set of tools, and much more in the way of big sticks. It can back up its implicit threats with real, binding prohibitions, whereas US regulators are not in a position to say it is illegal to enter into a Libor-based contract, which means they end up sounding less definitive than the UK regulators."

This, Beaumont continued, is an artifact of the two different regulatory and governmental systems that exist in the UK

"As term SOFR was only given the green light late in the year, banks may struggle to roll out the full suite of new products for year-end"

– Edward Ivey, partner and co-chair of swaps and derivatives practice at Moore & Van Allen and the US. "It does make one wonder what tools they wish they'd had to make things happen differently, and what they would have done differently," she added.

The very nature of the US financial market system also means there is a degree of latency and compromise between federal and state levels, according to TCS consulting partner and manging director Navin Rauniar. "In the UK, there was no split between the Bank of England, the FCA and the Prudential Regulation Authority – everything was in sync," he said.

"The ARRC and Fed have generally done a very good job at attempting to communicate what is a huge change to the marketplace," said Mackenzie Smith. "They were stuck between a rock and a hard place in that they needed for swaps liquidity to pick up in order to recommend a term rate. I wouldn't say the ARRC failed in terms of making SOFR the rate of choice or the dominant rate, but I don't think the scale of demand there was for term SOFR earlier this year was anticipated. That was obviously corrected, and now we are where we are."

Knock-on effects

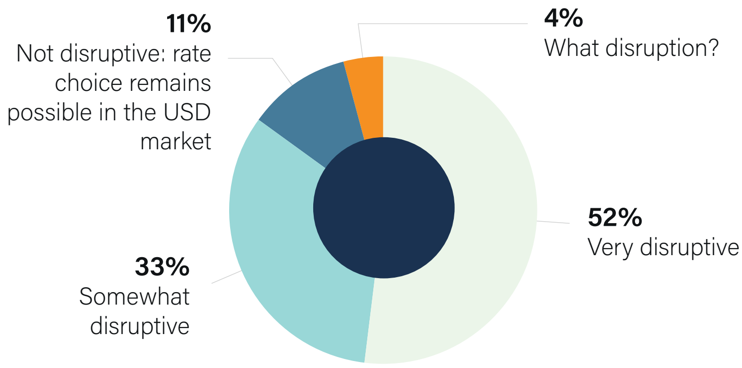
An area that has focused much of the US market's discontent around the transition is the debate around alternative rates for USD Libor other than SOFR.

As such, 52% of our survey respondents said they found the mixed messaging around CSRs very disruptive for overall transition progress, and another 33% somewhat disruptive. Only 15% said it had caused no disruption at all.

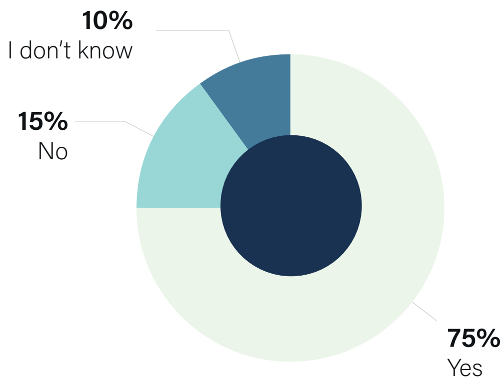
"It seems clear that the ARRC underappreciated the portion of the market that would need CSRs," said Ed Ivey, counsel at Moore & Van Allen. "They went down the route of seemingly bashing them, which resulted in clients fearing they would be using a rate that would not be approved. This could have been handled in a better way, but it wasn't, and here we are."

According to Ivey, the authorities underestimated how much demand there would be for CSRs, and how little there would be for daily compounded SOFR instead. "Daily simple [SOFR] might pick up because people appreciate that it should be a lower interest rate overall, but in the summertime, no one wanted it," he added. "The main disruption I anticipate from all this is that, as term SOFR was only given the green light late in the year, banks may

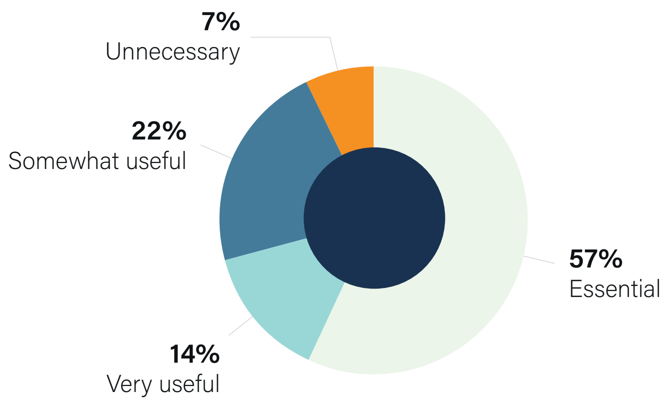
How disruptive have the mixed messaging and debate around credit-sensitive rates been to overall transition progress?



Are you actively using/planning to use term SOFR?



How important is term SOFR development and use to overall SOFR uptake in lending?



struggle to roll out the full suite of new products for year-end."

For Beaumont, the discussion around replacement rates all comes down to expectation-management. "People want things that feel familiar," she said. "They were told term SOFR was going to come, and then they were told it wasn't, which is frustrating. To an extent, they're still getting mixed messages on that."

In our survey, 75% of respondents said they were planning to actively use term SOFR, mainly for syndicated loans (65%). Over 70% of participants also deemed the development of a term rate to be either essential or very useful to overall SOFR uptake in lending.

"We see extraordinary interest in using [term SOFR], with the sole question being how to hedge it as there is no hedge market there yet," said Schneider. "The ARRC had a lot of stop and goes relative to getting term SOFR out and recommended for various products. In hindsight, had it started working more broadly on what the future of lending was, it could have gotten a quorum to that effect, which would have been an extraordinary advantage over where we are now."

Recent data from CME Group, which administrates term SOFR, also showed high demand for the rate, with over 1,400 term SOFR licenses issued to 330 firms to date.

"The regulators have been forcefully promoting plain SOFR over other viable options – largely out of ideological reasons," said Bon. "Yet, most would prefer a multi-rate environment. SOFR-sceptics would also point out that the benchmark is a much more effective means for the Fed to transmit monetary policy, but this is really not what this transition was supposed to be about."

For George Bollenbacher, independent consultant and former head of fixed income at Tabb Group, confusion among market participants continues to "reign supreme", and many will likely spend the next year and a half disentangling the mixed messaging that has arisen from the authorities' communication.

"As we approach the end of the year, there are really two areas of concern: the first area has to do with moving new products and instruments to a replacement rate – that's where a lot of the flaws, particularly in SOFR, start to be apparent," he said. "And second, the necessity to fall back. If we look at the swaps market, which is a pretty good indicator of where we're at, more than a trillion dollars a week of new Libor swaps are still issued. This will inevitably continue to make the fallback problem even worse."

Alice Tchernookova
Senior Reporter
IFLR

PEOPLE AND CULTURE

ESG

ESG in 2022: the year of implementation

While 2021 saw much useful signposting and pledge-making from both regulators and financial firms, as **Thomas Helm** reports, 2022 will be a time of meaningful action in several key green transition areas

The biggest difference between now and five years ago is that ESG is no longer a niche area but an integral part of how key players think about not only financial markets but also the real-world economy, both of which need to undergo a wholesale transformation to meet ambitious net-zero targets.

While much has already been done, and most key players are, for the first time in history, sitting at the same table with the same targets, the prevailing mood among market participants is that this is only the beginning.

2022, then, marks the next stage of the beginning, a shift from ambitious thinking, to ambitious action.

Action falls broadly speaking into "two currents": what markets are doing and what regulators are doing, according to Roland Mees, director of sustainable finance at ING. How firms and authorities implement ambitious transition plans as well as mitigate the risk that goes hand-in-hand with ambition will be a theme for the coming years.

This article attempts to provide a clear, albeit introductory, view of the fast-developing, multifaceted and risky terrain that is ESG in 2022.

1) ESG data to become more democratised

Increasing the availability of comparable and meaningful ESG information, or 'democratising ESG data', is essential to assess whether companies' sustainability strategies and initiatives are effective.

"This coming year will see more freely accessible resources: the Transition Pathway Initiative's new Global Climate Transition Centre, for example, set to open in 2022, will expand the number of companies assessed from 400 to 10,000, a 25-fold increase," said Dr Arthur Krebbers, head of sustainable finance, corporates at NatWest Markets.

Krebbers also said the EU's revised Non-Financial Reporting Directive (NFRD) will help fill the data gap. The

> ***"All the big players, be they credit rating agencies, or ESG providers, are ramping up fast to provide services and increase coverage"***
>
> – Luca de Lorenzo, head of sustainability at NIB

NFRD has been expanded to nearly 50,000 companies via the Corporate Sustainability Reporting Directive (CSRD) in April, with the first set of standards to be adopted by October 2022.

While markets generally welcome transparency initiatives such as the EU's Sustainable Finance Disclosure Regulation (SFDR), many lament the lack of data needed to fully comply with the regulation. "The process of reporting for SFDR will gradually improve as the data improves," said Hans Biemans, head of sustainable markets at ING. "The exact buckets of exposures we need to report are frequently based on data that is not yet available."

Luca de Lorenzo, head of sustainability at NIB, said he would be watching how the various disclosures and reporting regimes spur activity in the ESG data market and ultimately plug gaps. "All the big players, be they credit rating agencies, or ESG providers, are ramping up fast to provide services and increase coverage," he added.

The market is moving beyond ambitious pledges by hiring more and more ESG specialists, and spending more money on ESG tools and data as part of their implementation strategies, according to Jacob Michaelsen, head of sustainable finance advisory at Nordea Markets.

2) Disclosures across the world

Transparency will increase in sustainability markets, despite the data shortfall, as banks and corporates navigate the complex, evolving landscape for disclosure requirements. 2022 will see the finalisation of the EU standards under the CSRD, the implementation of disclosures under the EU Taxonomy Regulation and SFDR, and the development of the UK's Sustainability Disclosure Requirements (SDR).

"It is key to maximise the consistency of requirements across jurisdictions," said Oliver Moullin, managing director of sustainable finance at Association for Financial Markets in Europe (AFME). He added that all eyes would be on "the development of international disclosure standards through the newly established International Sustainability Standards Board".

Markets are also watching carefully how disclosures evolve in the US, especially the US Securities and Exchange Commission's (SEC) proposed mandatory climate disclosure rules, which could help set a global standard in non-financial reporting, if they are closely aligned with the recommendations of the Taskforce for Climate-related Financial Disclosure (TCFD).

Driven by Commissioner Allison Herren Lee, the SEC's mandatory climate disclosures seek to provide decision useful information to investor as they look to make investment and voting decisions. The exact characterisation of how these disclosures will look and feel has not yet been made clear.

"It would be helpful to have a single global standard for non-financial reporting, or as close to a single global standard as can be achieve," said Rudolf Bless, chief accounting officer at the Bank of America. "This would make it easier for investors and other stakeholders to evaluate the progress companies are making toward established goals."

As for other jurisdictions, Japan's Financial Services Agency (FSA) is considering making climate risk disclosure mandatory for listed companies on the Prime segment of the Tokyo Stock Exchange in April 2022, as well as widening their scope to include all listed companies in 2023.

3) Science-based transition plans

Leading on from the data theme, markets expect firms to deliver clearer transition plans together with the introduction of clearer regulatory guidelines as to what those transition plans should include.

Firms should expect rigorous scrutiny of transition plans by regulators, the media and NGOs.

"Those plans need to be science based," said Karen Ellis, director of sustainable economy at WWF. "For example, we need to make sure the TCFD recommendations are aligned with the standards set by the science-based targets initiative, to ensure it delivers the pace and scale of the transition required to achieve our net zero goals."

According to the UK Government's commitment to creating the first net zero aligned financial centre, financial institutions and publicly listed firms will need to produce net zero transition plans by 2023, and clear regulatory guidelines will be developed as to what those transition plans should include.

"Firms need to publish their transition plans, so they can be monitored against them," Ellis added. "They should also incorporate scope 3 emissions and interim targets, ideally focusing on 2025, to avoid the temptation of kicking the can down the road. They should involve the board in decision-making around them, so they're not just an add-on but central to the company's DNA. They should also focus on reducing emissions with a minimal reliance on offsetting."

Scope 3 emissions are the result of activities from assets not owned or controlled by the reporting organization, but that the organisation indirectly impacts in its value chain. Although difficult to calculate, Scope 3 emissions often make up the bulk of a firm's overall emissions and are therefore widely seen as critical to include in transition plans.

"Transition plans have come to the fore for financial institutions following the commitments at COP26 and an increased focus amongst regulators and investors," said AFME's Moullin. "These will be an important area as firms flesh out their plans and progress in meeting climate change objectives."

4) Prioritising holistic decarbonisation

Companies will see further pressure to reduce Scope 1, 2 and 3 greenhouse gas emissions in line with the science-based target.

"Seeking to reduce Scope 3 emissions, the ability to engage with supply chains in emerging markets is likely to present challenges," said Krebbers. "Therefore, companies will most likely rely on partnerships across sectors to deliver on broader decarbonisation targets."

5) Green and social taxonomies will move to the fore

As markets acknowledge the extensive progress made with the EU taxonomy, other jurisdictions, such as the UK, are also in the midst of developing their own taxonomies, all aiming to increase firms' reporting obligations and enable ESG criteria to be further embedded in global financing activities.

Taxonomies are essential for standardising definitions of green and reducing greenwashing risk caused by divergent standards in sustainability markets. Once an investment is taxonomy aligned, its green credentials are supposed to be watertight.

"What we want to see is how the EU taxonomy is adopted by member countries, how it is implemented by firms, and how it is received by investors, and specifically impact investors," said de Lorenzo. "Will they use it in their entirety or only elements? So far it is not entirely clear."

From 2022, the EU Taxonomy will oblige companies to report on their alignment with climate change mitigation and adaptation objectives.

"The EU has signalled a potential expansion to include social factors, with further details expected in 2022," said Krebbers. "As a result, stakeholder pressure to account for social aspects will increase."

Meanwhile, the controversial debate surrounding the potential inclusion of nuclear and gas in the EU taxonomy rages on, an area of great concern for NGOs such as WWF and other market observers that would prefer "purer" definitions of green. Nuclear has serious issues with the "do no significant harm" of the taxonomy while gas is still a fossil fuel, albeit of a lighter shade of brown.

"If the Commission goes through with its plan, there is a severe risk that market participants will simply reject a taxonomy that allows for nuclear energy to be labelled as sustainable," said MEP Markus

"We need to make sure the TCFD recommendations are aligned with the standards set by the science-based targets initiative, to ensure it delivers the pace and scale of the transition required to achieve our net zero goals"

– Karen Ellis, director of sustainable economy at WWF

> ***"I predict investors and other stakeholders will analyse corporate disclosures in greater depth and breadth – sharpening the focus on companies' projects and expenditures to ensure they can evidence the real-world impact of their claims"***
>
> **– Dr Arthur Krebbers, head of sustainable finance, corporates at NatWest Markets**

Ferber. "If the Commission takes its own aspiration to make the taxonomy the gold standard for sustainable investment seriously, it should revise the delegated act."

6) Scrutiny of greenwashing will intensify

Scrutiny of greenwashing has increased in recent times, not least because of a series of high-profile whistle-blowers.

"I predict investors and other stakeholders will analyse corporate disclosures in greater depth and breadth – sharpening the focus on companies' projects and expenditures to ensure they can evidence the real-world impact of their claims," said NatWest's Krebbers.

Nordea's Michaelsen stressed that more and more companies and investors are looking at science based standards as a way of combating greenwashing risk. "We see that more and more investors are performing a climate analysis of their portfolios, to align with the Paris Agreement and a 1.5C/Below 2C scenario," he said. Many of these have realised that their current portfolios are implicitly supporting a future well-above 2C. There is a lot of discussion at the moment around 'climate neutrality' and 'net zero'. But we have some way to go before we all are on the same page."

Regulators, the media and activists will intensify their scrutiny by sifting through the ESG data and disclosures that are released publically.

"With on-going issues with ESG standards, corporates and financials will continue to come into conflict over the quality of their disclosures and whether the rhetoric meets their commitments on ESG," said Navin Rauniar, partner at TCS. "This is a sensitive issue for the board to consider and I expect regulatory and compliance teams to be further beefed up to cope with the possible fallout, in similar ways to the issues that DWS faced in 2021."

All this means that chief sustainability officers will have their work cut out in 2022. Rauniar expects them to be placed in the difficult position of balancing the demands from cost centres and profit centres.

7) Private ESG funding markets to take off

While sustainable finance first emerged within public funding markets – the first ESG labelled instruments were bonds issued by multinational organisations – private ESG markets are catching up: ESG-labelled private debt transactions totalled around €2 billion in 2021 (Bloomberg data) due to improved ESG disclosures and data enabling investors to evaluate the sustainability characteristics of private assets

"The availability of a sustainability-linked structure for a sustainable private placement, and US-domiciled investors – which are among the largest investors in PPs – are under increasing pressure to incorporate sustainability into their mandates and will continue to drive execution dynamics in the private markets in 2022," said Krebbers.

8) Carbon markets transparency will improve

With about one fifth of the world's largest companies now having set out a net-zero or carbon-neutral pledge, Krebbers notes how attention has turned to the way firms are using voluntary carbon markets to achieve these goals.

"Companies will need to be more transparent in the use case of carbon credits, either to offset residual emissions, compensate for emissions in the value chain [Scope 3] or pursue "negative emissions"," he said. "I expect the transparency of carbon offset projects to improve in the near to medium term, as companies will want to understand what the return on each credit looks like, particularly as they seek to avoid accusations of greenwashing."

This will, he added, help carbon to be accurately priced on a company's or lender's balance sheet, and in turn, help develop the liquidity of carbon as an asset class.

Thomas Helm
IFLR reporter

BANKING & FINANCE

SWISS FINANCIAL MARKET REGULATIONS

A closer look at Swiss licensing requirements for trustees and their exemptions

Jürg Frick of **Homburger** examines the exemptions and requirements for trustees which have emerged from Switzerland's new financial market regulations

In the recent past, Swiss trustees have become subject to a licensing requirement. When Switzerland introduced new financial market regulations in 2020, such as the Financial Services Act (FinSA) or the Financial Institutions Act (FinIA), it also introduced new licensing requirements for certain financial intermediaries, including trustees. The regulations and licensing requirements entered into force on January 1 2020, and the transitional periods will expire by the end of 2021 and in certain cases by the end of 2022. In any case, time is running.

Against this background, it is high time to assess whether a trustee, who is registered or has their domicile in Switzerland, qualifies as a financial service provider in the sense of FinSA or has to be licensed by the Swiss Financial Market Authority (FINMA), in accordance with FinIA.

Since the relevant regulations are new and, more importantly, since Swiss law does not know trusts as such, there is limited knowledge, expertise and experience in the Swiss market, including with the Swiss regulator, about the activities and operations of trustees. Unsurprisingly, numerous questions surround these new regulations and a number of these questions remain to be answered.

The aim of this article is to address three main questions, which inevitably arise in connection with the new legislation: (i) Do trustees or trusts fall under the FinIA and FinSA?; (ii) What are the exemptions?; (iii) And even if trustees are subject to these regulations, what would be the consequences?

Our particular focus is on the exemptions from the licensing requirements under FinIA. Other relevant topics such the different types of trusts, differences between domestic and foreign trusts, the acknowledgement of foreign trusts, segregation rights or debt enforcement as well as the qualification of trustees as financial intermediaries under the Swiss Anti-Money Laundering Act (AMLA) will not be addressed in this article.

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Trusts and trustees under FinIA and FinSA

First, one needs to understand what Swiss law considers to be a trust or a trustee. The notion 'trust' is delicate because it is broad and flexible which is a consequence of the trust concept being challenging to classify.

Surprisingly in Switzerland, a trust is neither a legal entity nor does it have a legal personality in the sense of Article 52(1) Swiss Civil Code. Accordingly, trusts cannot be established under current Swiss law, although foreign trusts have been recognised as legal institutions sui generis since the entry into force of the Hague Trust Convention of July 1 1985, on the Law Applicable to Trusts and on their Recognition (HTC).

Nevertheless, Article 149a Federal Act on Private International Law in connection with Article 2 HTC defines the term 'trust' as legal relationships created – inter vivos or on death – by a person, the settlor, when assets have been placed under the control of a trustee for the benefit of a beneficiary or for a specified purpose. The latter may be of a general nature or involve favouring specific individuals.

In accordance with these articles, a trust has the following characteristics: the assets constitute a separate fund (getrenntes Sondervermögen) and are not part of the trustee's own estate; title to the trust assets stands in the name of the trustee or in the name of another person on behalf of the trustee; and the trustee has the power and the duty to manage, employ or dispose of the assets in accordance with the terms of the trust and the special duties imposed upon them by law.

Thus, it is clear that the trust is a three-party relationship between settlor, trustee and beneficiary, with the trustee at its centre. Even though the settlor establishes the trust and the beneficiary has the equitable interest (wirtschaftliches Eigentum) of the trust assets, the trustee is their legal owner (Eigentümer zu Vollrecht). It is they who hold and manage the trust assets (that have been entrusted to them by the settlor) and are responsible for all administrative activities.

Trustees under FinIA

Scope of application

The new Financial Institutions Act subjects trustees, but not the trusts, to a licensing requirement. Trusts are out of scope of Swiss regulation since trusts can also not be established in Switzerland. The provisions governing the trustee only rarely refer to trusts, even though trusts are of course always part of a trust structure.

Looking at a trust structure from a Swiss regulatory point of view, the relevant question is whether a Swiss party assumes the role of the trustee in the sense of FinIA and therefore falls in scope of this new act.

Should a financial institution qualify as trustee, then, as a rule, it would need to be licensed by FINMA. According to Article 17(2) FinIA, a trustee is a person who – on a commercial basis – manages or holds a separate fund for the benefit of the beneficiaries or for a specified purpose based on the instrument creating a trust within the meaning of the HTC.

First, this definition shows that the trustee is – from a regulatory perspective – perceived as an intermediary operating a vehicle for asset management (the trust), a certain type of asset manager, so to speak, even though there are fundamental differences between a trustee and an asset manager.

Differences are, for instance, that an asset manager acts as a direct representative in the name and on behalf of another person who authorised the asset manager to dispose over certain of that other person's assets. The trustee, on the other hand, is the legal owner of the assets of the trust and the trustee only acts as representative to the extent that the trustee manages the assets on behalf of the beneficiaries. Furthermore, the legal basis for an asset manager is an asset management agreement, whereas the legal basis for a trustee is the applicable trust law and act of the settlor setting up the trust.

The reason why a trustee is worth being regulated for 'investor' protection purposes is because the trustee, even though they are the legal owner of the trust assets, still manages other people's money.

Second, the aforementioned 'commercial basis' (Gewerbsmässigkeit) is often the decisive factor determining whether or not a person is actually considered to be a trustee under the FinIA. Pursuant to Article 19(1) FinIO, a trustee acts on a commercial basis if the trustee (i) generates gross earnings exceeding CHF 50,000 (approximately $54,300) per calendar year; (ii) establishes business relationships with more than 20 contractual partners per calendar year, each of which relationships is not limited to a once-only activity, or the trustee maintains at least 20 such relationships per calendar year; or (iii) has unlimited power of disposal over assets belonging to others, provided the value of such assets exceeds CHF 5 million at any given time.

For the assessment of the commercial basis and, in particular, the assessment, whether the relevant thresholds are exceeded, all relevant trustee activities of a certain party need to be taken into account. This provided, however, that activities undertaken or services rendered which do not qualify as trustee activities or services are not counted to the relevant thresholds.

If a person acts as trustee in the sense of FinIA and if it does so on a commercial basis, i.e. at least one of the thresholds set out above is exceeded, then the respective person is in scope of the Financial Institutions Act and, therefore, has to be licensed by FINMA.

There are some exemptions, which are discussed below.

Exemptions

FinIA provides for certain exemptions from the licensing requirement for trustees, whereby the most prominent exemption is set forth in Article 2(2)(a) FinIA pursuant to which the licensing requirement does not apply to persons who manage solely the assets of persons with whom they have business or family ties. The rationale of this exemption is that affiliates or other members of a group are acting under the control of a parent company and, therefore, and since such companies are not truly independent from each other, the money managed by a group's internal treasury, cash management or asset management company is not truly 'other people's money' and thus does not require investor protection regulation.

The family ties exemption applies if the respective persons are relatives by blood or by marriage. Family ties are deemed to exist insofar as trustees manage in-house funds in favour of persons who have family ties with one another, if the portfolio managers or trustees are directly or indirectly controlled by third parties who have family ties with these persons or by a trust or a similar legal construct set up by a person with family ties (Article 4(2) FinIO). The exemption of family ties also includes the activity of a family member for the family office of his or her family, or persons who are not related to the family but are nevertheless employed for the management of a single family office. This family office exclusively manages its own assets and is controlled by the family members.

Trustees acting within the framework of a private trust company are also covered by the exemption (a private trust company is a company established with the sole purpose of acting as trustee for a single trust or a group of trusts of the same settlor or for a certain group of beneficiaries, usually a certain family. Private trust companies are regularly owned by a family member or by a trust or foundation which in turn has been established by a family member).

The same is true for trustees acting on behalf of a dedicated trust company (a dedicated trust company is a company established, held and controlled by a licensed trustee at the request of a settlor and which acts as a special purpose vehicle solely as trustee for trusts established by a family member as settlor for the benefit of other family members as beneficiaries).

Finally, trustees are exempt from the licensing requirement if they exclusively act as trustees for trusts which were established by the same person or in favour of the same family and which are held and monitored by a financial institution which possesses a respective license by FINMA.

Exemption for trustees acting under control (Article 2(2)(a) FinIA)

In practice, FINMA seems to be granting the exemption of Article 2(2)(a) FinIA only under very strict requirements and only with a certain reluctance. This is critical from a legality and due process point of view because the intention of the legislator has been clearly established and set forth in the law. The intention of the lawmaker was undoubtedly to exempt trustees from a licensing requirement if they are acting under certain control, be it due to business or family ties.

As a matter of the Financial Institutions Ordinance (FinIO), the implementing ordinance of FinIA, family ties are deemed to exist insofar as a trustee manages in-house funds in favour of persons who have family ties with one another, if the trustee is directly or indirectly controlled by (i) third parties who have family ties with these persons; or (ii) a trust, a foundation or a similar construct set up by a person with family ties.

The level of control can be discussed and control can be exerted in a number of ways. In particular, the range of powers which may be exercised by a third party is broad and in particular includes powers over the trustee.

For instance, third parties may be given the right to (i) consent to actions of the trustee; (ii) give the trustee instructions, guidelines or directions; (iii) veto; or (iv) remove the trustee and appoint another trustee. The nature of these powers can be different in as much as the powers under (i) and (ii) are a priori powers, i.e. powers that give the third party the right to intervene before the trustee takes certain actions, and the powers under (iii) and (iv) are a posteriori powers, i.e. powers that give the third party the right to intervene after the trustee has taken certain actions. Which power in certain circumstances are adequate shall be dependent as always on the particular facts of the case.

There is a view that all these powers, be it each alone or combined with one another, should be sufficient for the trustee to benefit from the exemption to be licensed by FINMA. However, as a matter of fact, it seems that FINMA has a tendency that a priori powers are required in order to benefit from the exemption. This is critical because in many cases it is against the nature of a trust and the appointment of a trustee to grant a third party a priori control rights over the trustee and the parties are fine with a posteriori powers, in particular, the right, for instance, of a protector to replace the trustee in case the trustee acts against the best interests of the trust and the beneficiaries.

Licensing requirements

If a person is deemed to be a trustee under the FinIA, such a person has the duty to obtain license by FINMA. In order for a trustee to receive such a license, it must fulfil a number of requirements. A license is granted to anyone who meets the general licensing requirements and who complies with special regulations applicable to trustees. This may include, among other things, conditions regarding the legal entity form, minimum capital, compliance with capital adequacy requirements, insurance coverage, satisfaction by the managers of fit and proper tests, compliance with business conduct rules, independence of the board of directors as well as suitable risk management and internal control systems. Furthermore, the trust generally must effectively be managed from Switzerland.

According to the FinIA, the trustee's duties consist, but are not limited to, the management of separate funds, maintenance of value and employment for specified purposes (Article 19(2) FinIA). Trustees may also provide investment advice, portfolio analysis and offering of financial instruments in particular (Article 19(3) FinIA).

To summarise, these obligations show that the legislator's concern lies with ensuring that trustees meet certain professional standards. These standards aim at preventing them from causing harm to those to whom they are accountable, their counterparties, other financial market operators, or the financial markets themselves.

Trustees under FinSA

Scope of application

FinSA governs the rendering of financial services as well as offering of financial instruments. Financial services include, for instance, investment advice, investment management or receipt and transmission of orders in relation to financial instruments.

Any party carrying out these activities on a commercial basis is considered a financial services provider, irrespective of its legal

"Financial services include, for instance, investment advice, investment management or receipt and transmission of orders in relation to financial instruments"

form, and therefore, is subject to the code of conduct and the respective regulatory requirements set out in FinSA. These include, among others, the duty to provide clients with certain information, the completion of appropriateness and suitability tests, the obligation to document activities, as well as the duty to comply with the principles of good faith and equal treatment when handling client orders.

As has been seen before, the activity of a trustee basically relates to asset management or the operation of a vehicle for asset management, the trust. In any case, the trust assets constitute separate special assets (getrenntes Sondervermögen) and are not part of the trustee's personal assets.

In short, it can be assumed that the activity of a trustee generally does not fall under the definition of financial services in the sense of FinSA and therefore should also not fall under the FinSA as a whole. However, it cannot be ruled out that trustees may engage in certain secondary activities that fall within the scope of the FinSA. Therefore, in order to be able to completely exclude the application of the FinSA, all activities and secondary activities of a trustee must be subjected to an analysis.

As a rule of thumb, tax advice, legal advice, accounting, payroll, investment accounting, corporate finance activities, property management, auditing, human resources management, insurance brokerage and large parts of economic and management do not count as 'financial services'. In contrast, activities in connection with financial advice, inheritance, assistance, asset management, investment advice, credit mediation, advice on personal pensions or pension funds may constitute 'financial services' within the meaning of FinSA.

Exemptions

FinSA does not provide specific exemptions for trustees. Either a trustee provides services which are considered to be financial services and are subject to FinSA as described above or not.

FinSA requirements

If a trustee qualifies as a financial services provider under FinSA, then the trustee is subject to a number of regulatory requirements, such as the duty to provide information to the client, the assessment of appropriateness and suitability of certain financial services, the documentation and rendering of account, the transparency and due execution of client orders as well as some organisational duties or measures.

Conclusion

The Swiss legislator decided to also regulate trustees, be it under FinIA as financial institutions which are subject to a FINMA licensing requirement or, under certain circumstances, under FinSA as financial service providers. This territory is new for all of the Swiss legislators, Swiss courts and the Swiss regulator, FINMA. The Swiss legislator tried to tailor a regulatory framework which adequately addresses the key guiding principles of regulation, and which offers protection of investors and protection of the Swiss financial market. This tailor-made regulatory concept also provides for certain well-defined exemptions for the licensing requirement or regulation as a financial service provider.

In order to allow these new regulations to be well received by the market and market participants, it is important that FINMA allows the respective parties to benefit from regulatory exemptions if the requirements for such exemptions are met. It would be counter-productive and it could harm the

BANKING & FINANCE
DIGITAL FINANCE

Use of liquidity pools on DEX and the application of Swiss regulations to liquidity tokens

Daniel Haeberli and **Alexander Wherlock** of **Homburger** explore the use of liquidity pools on decentralised exchanges on the Swiss market

As one of the most crypto-friendly countries, Switzerland has experienced an exponential growth in blockchain-related companies and the development of the so-called 'Crypto Valley', housing a cluster of more than 450 blockchain-related companies in the region stretching from Zug to Zurich. Today, the hot topic in the blockchain ecosystem is decentralised finance (DeFi).

DeFi is a developing area at the intersection of blockchain, digital assets, and financial services. DeFi is the general term typically used to describe blockchain-based financial services that are provided without the involvement of centralised traditional financial intermediaries, such as custodian banks, clearing houses and trading venues.

DeFi operates in a decentralised environment on the basis of public, permissionless blockchains and services are generally encoded in open-source software protocols and smart contracts. The market experienced explosive growth since the beginning of DeFi in 2020. Yet DeFi is still in its early stages.

DeFi covers a broad spectrum of blockchain based financial services and applications, ranging from decentralised lending platforms to on-chain asset management. One of the most popular use cases implemented on blockchains are decentralized exchanges (DEX).

A DEX is a decentralised blockchain based exchange which enables direct and immediate trading of crypto assets based on a smart contract embedded on a compatible blockchain, such as Ethereum, Solana or Cardano.

The availability of liquidity on any exchange is critical. Almost all decentralised exchanges use liquidity pools to ensure and maintain a liquid market in a specific crypto asset without the maintenance of an order book typically used on centralised exchanges (CEX).

Trading on centralised exchanges such as traditional stock exchanges or certain crypto-exchanges, are based on the order

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book model. Potential buyers and sellers can submit bid and ask offers relating to a specified crypto asset which are subsequently recorded in the order book maintained by the relevant centralised exchange.

Whenever corresponding bid and ask offers are recorded in the order book, the centralised exchange matches the respective offers and the seller and buyer enter into a trade. The order book model is reliant on a constant submission of bid and ask orders. On centralised exchanges, therefore, market makers often ensure a constant exchange of bid and ask offers, by committing to quote prices at which it will acquire (bid offer) or sell (ask offer) the relevant securities or crypto assets.

Decentralised exchanges, such as Uniswap or Balancer, on the other hand, are able to function without an order book by ensuring a market for the admitted crypto assets by maintaining liquidity pools. In simplified terms, a liquidity pool is an asset pool that is filled with (usually two different) coins in a certain ratio (usually 1/1). The pool is established and maintained to enable swaps between the two coins in a liquid manner.

Thus, in a liquidity pool consisting of the notional X coins and Y coins, traders can exchange their X coins for Y coins (or vice versa) without having to rely on a counterparty willing to enter into a trade. Instead, a trader sends his X coins directly to the liquidity pool and receives Y coins from the pool in return. A liquid market can therefore be ensured by way of pooling crypto assets in the liquidity pool, with no dependence on a constant submission of bid and ask offers by participants. Liquidity pools, therefore, typically function as an automated market maker.

For DEX and the liquidity pools to function, they rely on liquidity providers. Liquidity providers make their tokens available to the liquidity pool and by doing so are able to generate passive income on the crypto assets they have sent to the pool.

Further, the establishment of liquidity pools maintained on decentralised exchanges also provides service providers assisting their customers in the tokenisation of assets with the possibility to initially ensure a liquid market for the issued tokens.

Liquidity pool set-up and involved parties

Most decentralised exchanges allow their users to create their own liquidity pools. Therefore, the specific functionalities, involved parties and features of different liquidity pools may differ in practice. A model used in the Swiss market involves a service provider (an issuer) offering tokenisation services to its clients under its blockchain based infrastructure.

As an additional service, an issuer will offer to establish and maintain a liquidity pool on a decentralised exchange in order to ensure a liquid market for such tokens issued by the relevant client under its tokenisation platform.

a) Issuance of user tokens: For this purpose, an issuer will deploy a smart contract on the ethereum, or any other compatible blockchain with a fully automated market maker function (the smart contract). The issuer will issue (via the smart contract) a user token (the user token) on a crypto exchange that can be purchased by investors against payment of a specific cryptocurrency (the cryptos). Potential cryptos will typically be liquid tokens, such as Bitcoin, Ether or Polkadot. By buying the user token, the holder acquires access to the smart contract through which he can participate in the respective liquidity pool maintained through the smart contract.

b) Pairing: The cryptos are sent from the buyers of the user token (directly or indirectly through the exchange) to an address of the smart contract on the relevant blockchain. The smart contract pairs the cryptos received from the investors with another token, typically a token created on the issuer's tokenisation platform for a client (the coin) and sends the paired coin and crypto to a liquidity pool established on a decentralised exchange (e.g. Balancer or Uniswap) on a fully automated basis.

"Switzerland has experienced an exponential growth in blockchain-related companies"

c) Minting of liquidity tokens: In return for sending the paired cryptos and coins to the liquidity pool, so-called 'LP tokens' or liquidity tokens (the liquidity token) are generated ('minted') and sent from the liquidity pool to an address of the smart contract. The liquidity token represents the liquidity providers pro rata share in the liquidity pool, determined based on the aggregate value of paired cryptos and coins sent to the liquidity pool. Further, the liquidity token serves as evidence to receive the relevant pro-rata share of the commissions realised by the liquidity pool.

d) Automated market making: As outlined above the liquidity pool enables a trading in the crypto and the coin. Any interested buyer or seller on the relevant decentralised exchange may now exchange their cryptos for coins (or vice versa) in a liquid manner without having to rely on a counterparty willing to enter into a trade. Whenever a trade is executed through the liquidity pool, the transactor is charged a transaction fee which is then distributed to the holders of the liquidity token, such as the smart contract, on a pro rata basis.

e) Distribution of fees: The commissions received by the smart contract from the liquidity pool are split between the holders of the user token (for providing liquidity to the pool by acquiring the user token with the coin) and the issuer (for deploying the smart contract allowing the holders of the user token to participate in the liquidity pool) in a pre-defined proportion in accordance with the smart contract.

Selected Swiss regulatory considerations

The use of decentralised exchanges, in general, and liquidity pools, in particular, are becoming increasingly relevant use cases as the number and value of coins and tokens increase. However, whilst such applications raise a number of regulatory questions, they remain novel applications that are typically not subject to specific regulation in the involved jurisdictions.

The decentralised exchanges on which liquidity pools are created and maintained are typically established by parties with no physical presence in Switzerland and will, therefore, generally not be subject to Swiss financial market regulation. Conversely, depending on the features and functionalities of the relevant user token, an issuer domiciled in Switzerland may potentially be subject to Swiss financial market laws.

In this short overview, we will be focusing on the applicability of the Swiss Anti-Money Laundering Act (AMLA) and the legal qualification of a user token and, as a consequence of such qualification, the applicability of the prospectus requirement under the Swiss Financial Services Act (FinSA).

a) Anti-Money Laundering Act: The AMLA imposes various obligations on Swiss financial intermediaries to prevent money laundering, such as the requirement to become a member of a self-regulatory organisation, the duty to identify the contracting party and ultimate beneficial owner and certain regulatory notification duties in case of suspicious transactions. In particular, persons or entities that provide services related to payment transactions, qualify as financial intermediaries subject to the regulatory requirements under AMLA. Such regulated payment services, include the facilitation of or assistance in the transfer of virtual currencies, such as cryptocurrencies, if such service provider (i) maintains a durable business relationship with its counterparties or (ii) may exercise control over the virtual currencies. According to recently published legislative guidance relating to the AMLA, fully autonomous systems that do not enter into a permanent business relationship with its users are excluded from the scope of the AMLA. In consequence, where the smart contract deployed by the issuer fully autonomously pairs the crytpos with the coin and subsequently sends the paired tokens to a liquidity pool, without the issuer having any control or discretion, the issuer will not be deemed a financial intermediary under AMLA and will not be subject to the requirements and duties set out thereunder.

b) Legal qualification and prospectus requirement: Pursuant to FinSA a person publicly offering securities (Effekte) to retail investors in Switzerland is required to prepare and publish a prospectus in accordance with FinSA. Accordingly, the applicability of the Swiss prospectus requirement depends on the qualification of a user token. Only in constellations in which a user token qualifies as a 'security' within the meaning of Swiss law, an issuer, subject to certain exemptions defined under FinSA, will be required to publish a prospectus, if it publicly offers the user tokens to retail investors in Switzerland.

According to Swiss law, securities are standardised certificated and uncertificated securities which are suitable for mass trading. Whether or not a specific token qualifies as a security within the meaning of Swiss law, must according to the Swiss Financial Market Supervisory Authority FINMA (FINMA) be determined on a case-by-case basis.

In this context, FINMA generally distinguishes between payment, utility and asset tokens. Payment tokens (synonymous with cryptocurrencies) are tokens which are intended to be used, now or in the future, as a means of payment for acquiring goods or services or as a means of money or value transfer. Cryptocurrencies give rise to no claims against the issuer. Utility tokens, on the other hand, are tokens which are intended to provide digital access to an application or service by means of a blockchain-based infrastructure. Finally, asset tokens represent an underlying asset such as a debt (structured product, derivative or bond) or equity claim against the issuer.

According to legislative materials and FINMA's practice, utility tokens do not constitute securities if their sole purpose is to confer digital access rights to an application or service and if such utility token can effectively be used in this manner. The same applies to payment tokens: Given that they are designed to act as a means of payment and are not analogous in their function to traditional securities, FINMA does, as a rule, not treat payment tokens as securities. Conversely, FINMA qualifies asset tokens as securities.

User tokens that merely grant an investor access to the smart contract (and no monetary claims against the issuer), allowing the holder to participate in the respective liquidity pool and to receive the corresponding commission via the smart contract, will in our view typically be deemed utility tokens within the meaning outlined above.

Whilst each token would have to be assessed on a case-by-case basis, we, therefore, believe that it can be reliably argued that a user token does not qualify as a security within the meaning of Swiss law.

However, in order to reach this conclusion, we believe the smart contract and user token will have to satisfy the following requirements:

- The holder of the user token has no contractual relationship with the issuer under which the holder acquires monetary claims against the issuer;
- The functionalities of the smart contract are operated fully autonomously on the relevant blockchain without any involvement of or control by the issuer;
- The issuer cannot unilaterally change and/or amend the smart contract; and
- The coins, the liquidity tokens, or any commissions generated under the liquidity pool are transferred fully automatically under the smart contract and the issuer at no time exercises any custody or control there over.

Conversely, in constellations in which it is not ensured by the issuer that the user token and corresponding smart contract adhere to the requirements outlined above, we believe there is a risk that FINMA may conclude that the user token qualifies as a security. In consequence, any issuance and public offering of the user tokens to retail clients in Switzerland would require a prospectus within the meaning of FinSA.

Finally, the absence of a qualification of the user token as a security is typically also of practical relevance for the admission of the user tokens to trading on a crypto-exchange, as such exchanges typically request a confirmation by potential issuers, stating that the tokens for which an admission to trading is being requested do not qualify as a securities in the relevant issuers home jurisdiction.

For the sake of completeness, it should be highlighted that the views expressed above are limited to constellations in which the relevant user token grants access to a fully automated smart contract enabling a participation in a specified liquidity pool.

In constellations in which the issuer has discretion with regard to the allocation of the involved cryptos to a specific liquidity pool, it would have to be assessed whether the issuer is performing asset management and/or brokerage services regulated under FinSA and the Financial Institutions Act.

Finally, if the issuer at any stage acquires custody over the cryptos and/or the commissions paid under the liquidity pool, the issuer may potentially be performing regulated deposit taking, requiring a banking or fintech-license under the Federal Act on Banks and Savings Institutions.

Civil liability for the functioning of the smart contract?

As outlined above, the issuer's role will generally be limited to the deployment of the smart contract and the subsequent issuance of the user token. However, in cases, in which for technical reasons the smart contract malfunctions, e.g. if the commissions realised under the liquidity pool are not correctly sent to the holder due to an error in the smart contract, and an investor incurs a loss as a consequence thereof, the question will arise whether the issuer can be held liable for any failure in the functioning in the smart contract.

The issuer deploying the smart contract and the holder of the user token will typically not have entered into a contract which would give rise to liability claims in case of the smart contract malfunctioning. Further, and in absence of fraudulent actions by the issuer, at least under current Swiss legislation there are no protective provisions (Schutznorm) in effect which would lead to a tortious liability (ausservertragliche Haftung) of the issuer in case the error in the smart contract leads to consequential losses for the holders of the user tokens.

In absence of a legal basis establishing an issuer's liability for deploying a smart contract, its business model will be highly dependent on its reputation in the DeFi-ecosystem. For the Swiss DeFi-market as a whole, we, therefore, believe it will be of great importance that relevant market standards and best practices in relation to the functioning, integrity and security of the relevant applications are developed, which could in relation to a specific tool, smart

BANKING & FINANCE

ANTI-MONEY LAUNDERING

Revisions to the Swiss Anti-Money Laundering Act expected in 2022

Corinne Nobs of **Prager Dreifuss** discusses the most important changes to the Swiss Anti-Money Laundering Act, expected to enter into force by mid-2022

In December 2016, the Financial Action Task Force (FATF) published its fourth country report on Switzerland. The report acknowledged the generally good quality of the Swiss system in place for combating money laundering and terrorist financing. However, the FATF also identified certain weaknesses and made corresponding recommendations.

The Swiss Federal Council (government) subsequently instructed the Swiss Federal Department of Finance to prepare a consultation draft that takes into account the findings and recommendations of the FATF country report and enhances the integrity of the Swiss financial centre. This consultation process ended in September 2018.

On June 26 2019, the Swiss Federal Council published the dispatch on the amended Anti-Money Laundering Act (AMLA) and its draft legislation. The revision of the AMLA has been the subject of heated debate over two years. Nevertheless, on March 19 2021, the Swiss Parliament adopted the revised AMLA. The revised AMLA, including its implementing secondary legislation is expected to enter into force by mid-2022.

One of the contentious provisions in the draft legislation was the envisaged inclusion of so-called 'advisors' in the scope of the AMLA duties. Advisors have been defined as physical or legal persons, who are commercially active in connection with the incorporation, management or administration of domiciliary companies and trusts as well as with the organisation of raising of funds in this context.

In addition, the purchase and sale of domiciliary companies as well as providing addresses or premises as a domicile for a domiciliary company or trust would have fallen under the scope of the AMLA. In particular, lawyers and notaries would have been affected by this amendment. Ultimately, this proposed amendment was rejected by the Swiss Parliament, mainly in order to protect the attorney-client privilege.

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The AMLA applies to (i) financial intermediaries as defined in Article 2 of the AMLA and to (ii) natural persons and legal entities commercially dealing in goods and which, in doing so, accept cash (dealers).

Dealers under Article 2 of the AMLA must fulfil certain duties if they accept more than CHF100,000 in cash in the course of a commercial transaction. The threshold recommended by FATF had been US$/€15,000. However, the proposed decrease of the threshold for cash payments in the precious metals and gemstone trade from CHF100,000 to CHF15,000 was rejected by the Swiss Parliament.

The most important changes to the AMLA are briefly described below.

Verification of the beneficial owner

Pursuant to the existing Article 4 paragraph 1 of the AMLA, the financial intermediary has to establish the identity of the beneficial owner with the due diligence required under the prevailing circumstances. In practice, the financial intermediary usually requires a written declaration from its customer for this purpose stating the identity of the individual who is the beneficial owner.

Pursuant to the revised AMLA, the financial intermediary will in future not only have to establish the identity of the beneficial owner but also need to verify the information so received. Article 4, paragraph 1 revised AMLA provides that the financial intermediary must exercise due diligence required under the circumstances to establish the identity of the beneficial owner and to verify his/her identity in order to ascertain who the beneficial owner is.

According to the government dispatch, the financial intermediary may take a risk-based approach and thus, depending on the type of contracting party, apply different measures to ensure the plausibility of the information on the beneficial owner. The form and depth of the review by the financial intermediary is not specified in the dispatch. It is only stated that the legal duty to verify the beneficial owner is not sufficiently fulfilled by merely requesting a copy of the identity document of the beneficial owner for the files.

Duty to update all business relationships

The current AMLA obliges financial intermediaries to repeat the verification or establishment of the identity only in the event doubts arises about the identity of a customer or beneficial owner during the course of a business relationship. In its last country report on Switzerland, the FATF qualified the lack of a general and explicit obligation to ensure that client data is up to date as a significant deficiency.

The revised AMLA now stipulates that client data must be periodically checked and, if necessary, updated. The obligation applies to all business relationships regardless of their risk. A risk-based approach only applies with respect to the frequency and scope of review.

The obligation to update client data relates both to the identification of the contracting party under Article 3 of the AMLA, the identification of the beneficial owner under Article 4 of the AMLA, and to the more general review of the client profile. The updating of data and documents shall be made in accordance with the legal provisions in force at the time of updating. This will inevitably lead to a considerable time and energy being expended by financial intermediaries with large and long-standing client bases.

Duty to report suspicious activities

A further revision of the AMLA concerns the duty imposed on financial intermediaries under Article 9 of the AMLA to report suspicious activities to the Money Laundering Reporting Office in Switzerland (MROS). Under the existing law, financial intermediaries must immediately file a suspicious activity report (SAR) in cases of "actual knowledge of or reasonable grounds to suspect" a criminal origin of assets. However, pursuant to case law, a simple suspicion already triggers the statutory duty to file an SAR. The threshold for the duty to file an SAR is thus minimal.

During the parliamentary sessions, it was argued that the low 'simple suspicion' threshold created legal uncertainty and led to a high number of SARs and a backlog at MROS. Furthermore, the Swiss Parliament noted that the violation of the duty to report can result in harsh sanctions, e.g. fines of up to CHF500,000 and/or a professional ban, therefore requiring more legal certainty.

Under the revised AMLA, Article 9 has been supplemented by a new paragraph 1quarter, which reads as follows: "In the cases under paragraph 1, there shall be a reasonable ground to suspect if the financial intermediary has a concrete indicium or several indicia that paragraph 1 lit. a) may be fulfilled in respect of the assets involved in the business relationship and this suspicion cannot be rebutted on the basis of additional verifications pursuant to Article 6". Thus, if the financial intermediary has concrete indications or several indications that assets could originate from a predicate offence to money laundering, he must investigate these indications and carry out in-depth clarifications in accordance with Article 6 of the AMLA. If the suspicion cannot be dispelled, it shall be deemed to be well-founded and a report must be filed.

The practical compliance duties for financial intermediaries under the new rebuttal process remain unclear. Article 6 of the AMLA does not explain which additional clarifications there are and how they are to be carried out. Some guidance may be derived from the ordinance issued by the Financial Markets Supervisory Authority which lists examples of means of investigations in Article 16 paragraph 1 of the AMLO-FINMA.

Thus, depending on the circumstances, investigations shall entail in particular (a) obtaining written or verbal information on the contracting party, the controlling person or the beneficial owner of the assets; (b) visits to the place of business of the contracting party, the

> *"Switzerland is likely to continue to face pressure to tighten money laundering rules in the near future"*

controlling person or the beneficial owner of the assets; (c) consultation of generally accessible public sources and databases, and (d) if necessary, obtaining information from trustworthy individuals.

Pursuant to Article 16 paragraph 2 of the AMLO-FINMA, the financial intermediary has to check the results from these investigations for their plausibility and document the process. The documentation must be sufficient in view of Article 7 of the AMLA, thus also making it possible for a competent third party to come to a reliable judgment.

MROS

In addition, Article 9b of the revised AMLA abolishes the current deadline of 20 working days for MROS to process a report and, in return, provides a right for the financial intermediary to terminate the reported business relationship if MROS does not inform him/her within 40 working days after a report lodged pursuant to Article 9 paragraph 1 lit. a of the AMLA or Article 305ter paragraph 2 of the Swiss Criminal Code (SCC) that the reported information will be transmitted to a law enforcement agency.

The financial intermediary who wishes to terminate the business relationship may only permit the withdrawal of significant assets in a form that allows the law enforcement agency to follow up their trail (Article 9b paragraph 2 of the revised AMLA). The termination of the business relationship and the date of termination must be reported to MROS without delay (Article 9b paragraph 3 of the revised AMLA).

Improvement of transparency for associations with potential risk for financing terrorism

So far, associations are entitled, but not obliged, to be registered in the commercial register. A duty only exists if the association operates a business conducted in a commercial manner for its purpose or if it is subject to auditing due to its economic importance (Article 61 paragraphs 2 and 69b of the Civil Code).

To prevent the abusive implementation of associations for terrorist financing or money laundering, associations pursuant to Article 60 et seq. of the Civil Code with an increased risk of abuse, in particular those that collect or distribute assets abroad mainly for charitable, religious, cultural, educational or social purposes, shall in future have to be registered in the cantonal commercial register.

The entry in the commercial register makes relevant information on these associations, such as purpose, board members, authorised signatories, auditors or address publicly available to everyone. Furthermore, the obligation to enter a company in the commercial register entails the obligation to maintain comprehensive accounts in accordance with the rules of the Code of Obligations.

Similar to companies governed by the Code of Obligations, in future all associations that are (already or newly) required to be entered in the commercial register must keep a list of members with their first and last names or company name and address. The register must be kept in such a way that it can be accessed in Switzerland at any time.

In addition, a representative resident in Switzerland must be designated to have access to the membership register. The Swiss residence requirement ensures that at least one person can be questioned in any proceedings against the association without having to rely on international legal assistance.

Pursuant to a new Article 61 paragraph 2ter of the Civil Code, the Federal Council may exempt such associations from the obligation to register if they are exposed to a low risk of misuse for money laundering or terrorist financing due to the amount, origin, purpose or intended use of the assets collected or distributed.

This provision makes it possible to react to changing circumstances at ordinance level and to ensure that associations with an obviously low risk of money laundering or terrorist financing do not fall under the obligation to register. In its draft of the revised Commercial Register Ordinance, the Federal Council refrained from formulating an exception on the grounds that at the present time no circumstances are known in which an association is covered by the scope of application, but there is obviously no increased risk of money laundering or terrorist financing.

Existing associations that are already subject to registration must implement the requirements regarding the list of members and representation in Switzerland within 18 months of the entry into force of the amendments of March 19 2021. Existing associations that are newly required to register must register in the commercial register, keep a register of members and designate a representative in Switzerland within 18 months.

For an effective implementation of the new transparency requirements for associations, a new Article 327b will be introduced in the SCC, which punishes intentional breaches of the duty with regard to the register of members and representation in Switzerland with a fine. The intentional violation of the duty to register in the commercial register already falls under the existing Article 153 of the SCC (false statements to commercial register authorities) and is punishable by imprisonment of up to three years or a fine.

Outlook

On October 1 2021, the Federal Council initiated the consultation on amendments to the Anti-Money Laundering Ordinance and other ordinances. The proposed amendments provide more detail on the measures in the revised Anti-Money Laundering Act. The consultation will last until January 17 2022.

In particular the rejection of new rules for lawyers, notaries and other consultants gave rise to significant criticism remarking that loopholes for lawyers and other advisors to the wealthy are still prevalent. For example, Transparency International said in a statement that Switzerland still has troubling loopholes and remains behind minimum standards internationally, because unlike other countries it does not subject services fraught with risk like lawyers and notaries to the same laws.

Thus, although the final version of the revised AMLA is more in line with international practice, Switzerland is likely to continue to face pressure to tighten money laundering rules in the near future.

BANKING & FINANCE
DIGITAL FINANCE

CBDCs are spearheading cross-border payments innovation

Daniel Eidan at the **Bank for International Settlements** explains how the organisation is making headway in the latest central bank digital currency projects and the challenges that lie ahead

The rate of digitisation the world has experienced in just the past 24 months is truly astounding. It seems like every pre-pandemic trend has been accelerated ten-fold and everyday there is a new digital buzzword we need to come to terms with. Social media is transforming into the metaverse, crypto markets are being overtaken by NFTs (non-fungible tokens) and billionaires are launching themselves into space. With so many flashy headlines and fancy buzzwords it's easy to lose sight of the silent and steady innovation that doesn't get as much time in the limelight. How we store, move and interact with money is changing from the ground up as our financial infrastructure evolves. This process is relevant to all economies and social classes, and its impact will be measured in years and decades to come. Money is one of humanity's greatest inventions and its innovation is essential in shaping our future.

There are many innovations happening in financial technology, but payments seem to be leading the way. Faster retail payment systems are enabling cheaper domestic solutions, cross-border services are becoming more integrated and an overwhelming majority of the world's central banks are researching, designing and experimenting with a new form of money: central bank digital currencies (CBDCs). Commercial banks, payment providers and big techs are also in the game, adding capacity to leverage digital assets, cryptocurrencies, and stable-coins. It seems like a reasonable prediction that our financial infrastructure of today will be stashed away in a drawer like an old mp3 player to make way for the never-ending stream of high-definition audio straight into our Airpods. But this sizable shift does not come without its risks and challenges.

The catalyst for this transformation is novel technology proposing solutions that highlight the inefficiencies of our existing system. The best example of this is Facebook's announcement of its own form of payment called Libra, now

"Most users don't know when they click pay at the end of a ride that there can be up to six intermediaries between them and their Uber driver. Each one of them coming with a delay and a cost, hidden within the transaction settlement"

renamed Diem. The proposition of a private sector actor with 2.3 billion users providing this type of the service was a wake-up for policymakers and central banks. While at first a compelling proposition, this private walled garden may end up benefiting some but excluding a great many others, ultimately leading to fragmentation of the monetary system. Today's monetary system is a patchwork of solutions built over decades that are tied together through jurisdictional legal frameworks. Although complex, these systems have worked well keeping up with users' demands. But most users don't know when they click pay at the end of a ride that there can be up to six intermediaries between them and their Uber driver. Each one of them coming with a delay and a cost, hidden within the transaction settlement.

When these payments cross borders, the number of intermediaries goes up and so do the costs. International transactions are generally slow, expensive and opaque, due to foreign exchange conversions, compliance with regulatory frameworks in different jurisdictions, and various points of settlement along the way. Small value remittances payments suffer most with, according to some estimates, average fees of 6.5%. When considering the $540 billion worth of remittance flows sent in 2020, it's quick to see that a reduction of a few percentage points would put hundreds of billions of dollars into the hands of people who need it most. Wholesale cross-border payments are more efficient, with an estimate average cost of 1%, but this is still sizable when considering the approximate $36 trillion moved across borders in 2021 alone.

To better understand cross-border payments, one must consider the underpinning role of correspondent banking. Correspondent banking is an arrangement whereby one correspondent bank holds deposits owned by another respondent bank and provides those banks with payment and other services. By doing so, banks can provide services in jurisdictions where they don't have access to the central bank balance sheets or provide access to banks that want access. Critically, correspondent banking is a private function and is driven by commercial motivations. And while overall cross-border payment volume and value are increasing, correspondent relationships are in steady decline, leaving entire regions without access to competitive cross-border services. The result is that often the countries that need the funds most pay the largest fees.

Due to these issues, the G20 has made enhancing cross-border payments a priority and has provided an action-oriented road map comprised of 19 building blocks. The BIS Innovation Hub is at the forefront of this innovation. By building hands-on technical solutions for the global central banking community, the BIS Innovation Hub is promoting novel ways to improve cross border payments, advancing the public sector's technical capacity and empowering policy and decision-makers to fulfil their mandates in increasingly digital frontiers. Our work in this area consists of building new payment systems using CBDC and improving existing ones. Multiple-CBDC is a form of new payment system and combines the objectives of two of those G20 building blocks, CBDC (block 19), and new multilateral platforms and arrangements for cross-border payments (block 17). Our mCBDC work is comprised of three main projects: mBridge, Dunbar and Jura, developed in cooperation with 10 central banks around the world. Work on improving existing systems is currently being done primarily through interlinking existing payment systems for cross-border payments (block 13) and can be seen in project Nexus.

1. The mBridge is one of the first of such projects led the Hong Kong SAR centre. It started with Project Inthanon-Lionrock, a joint initiative between the Hong Kong Monetary Authority and the Bank of Thailand to enable cross-border payment vs payment (PvP) of wholesale settlement between the two jurisdictions. PvP is a mechanism in a foreign exchange settlement system which ensures that a final transfer of one currency occurs if and only if a final transfer of the other currency or currencies also takes place. After two

successful prototypes, the project expanded its membership to include the Central Bank of the United Arab Emirates and the Digital Currency Institute of the People's Bank of China. Moving forward the focus will include more advanced topics, like improving the efficiency of foreign exchange mechanisms, multi-currency liquidity, imbedded compliance, capital controls and privacy preserving transactions.

2. Project Dunbar, led by the Hub's Singapore centre, includes the Monetary Authority of Singapore, Reserve Bank of South Africa, Bank Negara Malaysia, and the Australian Reserve Bank. The focus of this project is similar to mBridge but a different set of participants, technology choices and jurisdictional circumstances is producing different outcomes.
3. Project Jura, recently concluded, was led by the Swiss centre jointly with the Banque de France, the Swiss National Bank and a private sector consortium. A continuation of another experiment, Project Helvetia, it shows that CBDC can provide advantages for securities settlement by providing delivery versus payment (DvP). DvP is a mechanism that guarantees the final transfer of securities occurs if and only if a final transfer of the payment takes place. This work was extended and enabled cross-border interoperability between different networks in different jurisdictions, including Euro CBDC, Swiss franc CBDC and digital assets in the form of French tokenised commercial paper.
4. Project Nexus is enabling cross-border retail payments in under 60 seconds across disparate faster payment systems. Because Project Nexus fits into existing regulatory frameworks, it has the potential to provide real world benefits faster than CBDC alternatives. Nexus has already published detailed technical documentation and will be building out the Nexus Gateway in 2022.

The BIS Innovation Hub work shows that new payment solutions can substantially increase cross-border transfer speed from days to seconds, reduce by up to half several of correspondent banking's core costs and reduce overall settlement risk. These benefits can be even more significant for jurisdictions without access to adequate correspondent banking networks.

"Innovation that attracts the most attention is often not the one that matters most. Innovation is therefore not about just a big idea but the ability to deliver it"

But there are many challenges in building these solutions that need to be overcome before these benefits are brought to bear in a large-scale environment. Each jurisdiction comes with a different domestic context that prioritises different use cases, has different legal systems and monetary and fiscal policy considerations. For example, in many countries, cash is in decline, but in others, its usage is increasing. In a declining cash environment, a central bank might be motivated to serve the public interest by providing a cheap and accessible digital public alternative in an otherwise private player dominated market. Or in the latter case, a central bank might be motivated to provide a digital alternative to cash while ensuring that protections are in place to prevent terrorist financing, money laundering and tax evasion.

Regulatory requirements coordination between jurisdictions is also a challenge for those at the forefront of the design of new alternatives. For example, know your customer (KYC), anti-money laundering (AML) and counter terrorism financing (CFT), and necessary prerequisites for payments will need to be harmonised to enable interoperable solutions across jurisdictions. Central bank demands for a high degree of autonomy and control over payment data is often at odds with the shared infrastructure that supports these solutions. Legal constructs are inherently domestic and sometimes fall short on fundamental topics, like issuance of legal tender and settlement finality in these new digital formats. To make this more complex still, new capabilities introduced by technology raise significant questions around monetary policy that need to be carefully considered by governments and policy makers. Lastly and potentially most challenging is the governance of shared projects, a delicate task especially when the project stakeholders are self-sovereign central banks.

Innovation that attracts the most attention is often not the one that matters most. Innovation is therefore not about just a big idea but the ability to deliver it. By virtue of its disruptive nature, failure is always looming. But this process is cyclical and failed innovation inspires more promising alternatives. The challenges in this process should not be a deterrent, rather a guide to improve upon and a yard stick for progress. In financial innovation and payments in particular, the road to delivery is long but incredibly rewarding. The digital acceleration we are living through presents a rare opportunity to engage and improve our financial infrastructure. So do not be distracted by flashy headlines or overwhelmed by technical buzz words. If there is one thing I have learned, it is that steady innovation is the most likely to last the test of time and the most probable to have beneficial impact on the lives of many for years and decades to come.

Daniel Eidan
adviser at the Bank for International Settlements' Innovation Hub in Hong Kong SAR

CORPORATE

CORPORATE GOVERNANCE

Financial institutions grapple with the great data divide in Asia

ASIFMA's MJ Park and Matthew Chan explain how financial institutions are steering through an increasingly fragmented data protection landscape

Financial institutions (FIs) are finding themselves navigating an increasingly fragmented landscape of data protection regimes, not only in relation to their home jurisdictions vis-à-vis other markets but also between other markets they operate within across Asia – a region that is especially prone to market fragmentation at the best of times given its significant diversity.

The result is a 'transnational data governance problem', referring to the fragmentation of international data flows and related governance frameworks due to evolving divergences between major economies, heightened by technological and geopolitical competition.

With the rise in such divergent approaches, an uncertain and constantly shifting regulatory climate is affecting FIs operating across borders in the interconnected global digital economy, throwing a spanner not only into their external market activities, but also into their inner operations and processes, ranging from customer data and risk management to regulatory compliance.

Stuck in the crossfire: increased regulatory burden for the financial sector

Data flows across firms and between intra-group branches are a fundamental building block for the capital markets, where banks responsibly collect, use, process, transfer, dispose of and share financial data, including personal data, in the ordinary course of business. Financial regulation dictates this be done in a safe and responsible manner. The ability to share data between operations is essential to the efficiency, security, and resilience of these organisations, in addition to know you customer (KYC)/anti-money laundering (AML) compliance, monitoring for counter-terrorism financing and fraudulent transactions. Over many years, modern FIs have become accustomed to managing these critical uses of data sensitively and securely, in line with tightly defined financial regulation and international requirements aimed at the protection of clients, and more importantly, in maintaining the integrity and stability of the broader financial system.

Financial regulators ensure that financial services institutions and markets are efficient, stable, secure and serve the best interests of both users of the financial system and the broader economy. Yet, we see some policymaking working in the opposite direction – restricting data flows, decoupling standards from international norms, and introducing regulatory fragmentation that hinders investment flows, operational efficiency, and the financial system's integrity more broadly. This fragmented approach between regulators and policymakers within the same jurisdictions has been a growing concern of the financial industry for a number of years, and continues to be a high priority for the Asia Securities Industry and Financial Markets Association (ASIFMA) and its members.

The financial services industry, already subject to stringent rules on information security, is increasingly being caught in the crossfire between policymakers and concerns with other sectors, often emerging, which are not subject to the high standards on client data and privacy with which banks must already comply. In some jurisdictions, such as India, policy targeting e-commerce and social media is grouping all industries together, resulting in perverse outcomes from a financial system perspective. This not only adds to the regulatory burden on globally operating FIs, but also discourages the entry and continued operation of foreign FIs within jurisdictions that take such a broad-brush approach, particularly where these requirements disaggregate their ability to call on internal global expertise and centralised infrastructure, risk and control functions. It also confuses those using onshore data partners, sometimes the intended beneficiary of policymaking to keep data within borders.

To mitigate such coordination problems, a lead financial regulator is best placed to coordinate with national privacy authorities (as well as among other financial regulators if there are multiple) to ensure consistency and legal certainty, and reduce the likelihood of regulatory arbitrage. The lead coordinating agency can also ensure regulations applicable to the financial sector prevail over conflicting data requirements. Further, with a better understanding of existing regulations with which FIs must already comply, a lead financial regulator can minimise duplication and inconsistency between data and financial stability requirements.

Is data really the new oil?

Increasingly more nationalised approaches to data, privacy, cybersecurity, and technology continue to inform regulation in some APAC jurisdictions, at a time when capital markets and FIs need to operate in an increasingly interconnected global economy. Against such a backdrop, we see an interplay between geopolitics, law, and national economic agendas tying national security agendas with data protection, and calls to ringfence data flowing across a country's borders. From an economic development perspective, we also hear governments and policymakers calling for treatment of data as the 'new oil'.

While compelling in consumer marketing, the 'data-as-oil' analogy is, at its core, erroneous and problematic for policymaking. The finite nature of oil, in contrast to the inexhaustible replicative capacity of 'data', renders this metaphor as ill-suited from the get-go. In fact, treating data like a one-off consumable – stockpiled behind national borders – reduces its usefulness and value which, frankly, relies more on how it is used, moved around, reconfigured, and combined to innovate new uses and efficiencies in an increasingly interconnected world that runs on data flows, not data stores.

Plurilateral approach to resolving cross-border data challenges

In contrast to approaches taken elsewhere, we can observe positive developments taking place in some APAC jurisdictions such as Singapore, Japan, and Australia. The US-Japan Digital Trade Agreement of October 2019 ensured that data can be transferred across borders, by all suppliers, including financial service suppliers. Singapore's joint statement with the US, and agreements with the UK and Australia on financial services data connectivity, are also forward thinking, allowing financial services firms to transfer data across borders while opposing data localisation requirements, provided that financial supervisors can access required information on request. This represents thoughtful inter-governmental collaboration geared to the current operation model of modern financial systems.

Although not a silver bullet, a plurilateral framework – coalitions of jurisdictions based on sector-specific areas created with the intent of having more consistent legal and

> ***"Increasingly more nationalised approaches to data, privacy, cybersecurity, and technology continue to inform regulation in some APAC jurisdictions, at a time when capital markets and FIs need to operate in an increasingly interconnected global economy"***

"To achieve efficiencies while catering for the needs of society and commerce, modern FIs deploy state-of-the-art processes to consolidate their infrastructure globally and achieve operational scale and resilience"

regulatory treatment for sector-specific matters – may be a way forward. A plurilateral framework recognises and legitimises the existence of multiple data governance regimes, yet acknowledges common principles for managing and supervising secure cross-border data flows critical for the financial system,. Such a framework could help minimise fragmentation, supporting cross-border flows of data, international economic trade, and increasingly become an enabler of emerging areas of finance, such as green and transition finance. Notwithstanding, it is also critical that conventional trade agreements not exclude financial services, given the important role capital markets play in fostering economic development and integration.

There also needs to be stronger global coordination on standards and approaches, in line with international developments. As a general principle, international standards with respect to cross-border data transfers should be taken into account when designing cross-border data controls to facilitate the secure flow of data. Existing international fora provide a solid starting ground for alignment and coordination on data driven policies and oversight for financial services, while not limiting further collaboration. Global standard setting bodies, such as FSB and IOSCO, have released statements supporting cross-border data flows, and have launched exercises to further understand how existing national and regional data frameworks interact with and affect cross-border data flows.

Other notable international efforts include the Osaka Declaration on Digital Economy, which seeks to standardise rules in global data flows, with better protection for personal information, intellectual property and cybersecurity; international best practices such as BCBS 239 and ISO/IEC 27701 (2019) which could also pave the path forward to harmonising and strengthening data standards; and the Financial Services Sector Coordinating Council's standardised Cybersecurity Profile which offers a common approach to cybersecurity and assessment.

Meanwhile in Asia, APEC's Privacy Framework provides a set of principles and implementation guidelines to establish efficient privacy protections that mitigate barriers to information flows in Asia Pacific under the Cross-Border Privacy Rules System (CBPR), and most recently, ASEAN released a set of Contractual Clauses for Cross Border Data Flows.

Lessons learned

Free flow of data is key in the creation of competitive digital economies, ensuring a more secure financial system, effective risk management, and the facilitation of global participation in innovation and entrepreneurship. To achieve efficiencies while catering for the needs of society and commerce, modern FIs deploy state-of-the-art processes to consolidate their infrastructure globally and achieve operational scale and resilience, while maintaining secure and robust protocols and systems to meet the stringent needs of financial regulators.

Rulemaking on a cross-sectoral basis, however, can undermine such arrangements – often requiring discrete technological builds in specific jurisdictions, segregating local systems from global hubs – which is a long way back from how the modern global financial system has evolved. This creates significant, often counterproductive, friction in financial markets and exposes market participants and end users to increased cybersecurity risk by creating additional interfaces, and therefore vulnerabilities in the system

At the same time, regulators rightfully want FIs to think more strategically and holistically about operational resilience, particularly in light of lessons from Covid-19. Ironically, it was often cross-border systems and data connectivity that enabled key staff within many FIs to work from home (and abroad in some cases) throughout the pandemic so far, which, in large part, helped keep markets open and properly functioning, ultimately preserving the stability of the financial system throughout the last two years.

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CAPITAL MARKETS

EQUITY CAPITAL MARKETS

India's equity capital markets emerge into the international spotlight

Linklaters lawyers Amit Singh, Joseph Wolpin and Kundhavi Suresh Kumar
unravel the challenges that lie ahead for the Indian IPO market as it continues to heat up amid a tech boom

Amid a backdrop of unprecedented globalisation and technological advancement, the Indian stock market has witnessed a historic number of initial public offerings (IPOs). Indian companies raised approximately $15 billion in IPOs throughout December 2021.

While the increase in Indian IPOs coincides with a global uptick, the Indian market, in particular, has captured the attention of international investors, with tech unicorns occupying centre stage. As with any burgeoning market, challenges remain, but many signs point to an Indian equity capital market (ECM) that is primed to show similar promise to the Chinese and Russian booms of decades past.

The IPO wave

Together, the Bombay Stock Exchange and the National Stock Exchange of India, the country's two largest exchanges, now rank 7th globally by number of IPOs, according to Ernst and Young. Once largely off global investors' radars, Indian equities have emerged as a leading product largely due to the maturity of local corporates and growing investor awareness of the underlying fundamentals of the Indian economy. Technology companies in the country have dominated the current IPO wave, as post-pandemic players in the retail, e-commerce and service sectors have taken advantage of the rapidly expanding online marketplace both globally and domestically. As deal sizes, valuations and international interest in Indian corporates grows, regulatory uncertainty in China, with respect to technology companies, has further accelerated growth for Indian ones, driving investors towards the market.

At the same time, Indian issuers have become increasingly interested in listing at home. Choosing a listing venue depends on several factors, but an IPO is a major milestone for founders and issuers alike, and historically

> *"In addition to traditional IPOs, infrastructure investment trusts (InvITs) and real estate investment trusts (REITs) have also contributed to the Indian ECM pipeline"*

there has been a certain cache to listing in the US or Europe. But with the Indian stock market maturing, and the recent listing of Zomato, the first true Indian unicorn of 2021, several other leading Indian companies have followed suit, drawn by the promise of a successful valuation combined with a hometown listing. Indian companies are also increasingly finding comfort with the chief regulator, the Securities and Exchange Board of India (SEBI).

This 'Zomato effect' is a contrast to the historical Indian market, when established corporate multinationals were viewed as the only potential high profile IPO targets that could attract significant international interest. In 2021, as the shift in IPOs to early stage and tech companies went into full swing in India, international investors quickly began to take note. A testament to this trend was the successful IPO of insurance platform PolicyBazaar.Its stock price experienced a significant 'pop' from its IPO price, before falling victim to the downward pull of the Paytm listing that hampered the Indian markets in late 2021.

In addition to traditional IPOs, infrastructure investment trusts (InvITs) and real estate investment trusts (REITs) have also contributed to the Indian ECM pipeline. Fuelled by the increasing capital needs of the infrastructure and real state sectors, and leveraging supportive government initiatives and policies, InvITs and REITs have become attractive investment vehicles, providing investors with options for growth through long-term capital assets, stable returns, and beneficial tax planning.

Recent deals include India's largest road monetisation project made through an initial placement of units in an InvIT by National Highways Authority of India, the first private placement of units by a regulatory authority in India; the PowerGrid InvIT sponsored by the Power Grid Corporation of India, the first InvIT by a public sector undertaking; and Brookfield India Real Estate Trust REIT, India's first publicly traded REIT.

The road that lies ahead

Going forward, the scale of the Indian unicorn opportunity appears vast: a recent Credit Suisse report suggested that approximately 100 unicorns in India could come to market in the near term, a figure that would surely solidify India into the Pantheon of mainstream markets.

Following the listings of Zomato, Paytm, PolicyBazaar and Nykaa, several other companies have also filed draft red herring IPO prospectuses with SEBI, such as Dehlivery and Pharmeasy, while a plethora of other Indian companies are rumoured to be mulling an IPO as well. Furthermore, the central government of India has formulated the "National Monetisation Pipeline", which aims to partially privatise certain core assets currently held by the government, which will likely be another source of Indian listings in the near-term that will draw international interest.

In addition to the market forces underway, SEBI and other regulators have played a proactive role in designing a long-term platform and regulatory framework for Indian companies to access the capital markets without leaving home. SEBI, in particular, is a relatively young regulator of the securities market, but its experience and sophistication have been steadily growing. For example, in August 2021, SEBI eased rules for start-ups by reducing the lock-in period for selling shareholders and refining the definition of 'promoter groups'.

Despite the positive trends of the Indian IPO market, debates around pricing, valuation and other systemic risks associated with the boom have emerged, especially following recent significant declines in the stock market. As the Indian market experiences these growing pains, further probing into loss-making companies seeking to list and their IPO valuations, an increasingly cautious approach by regulators, analysts and investors is likely to follow.

Investment by retail investors, thus far propelled by the general bullish sentiment, and high returns of the equity market and the interest rate environment, will likely also draw greater attention to risks involved. Moreover, SEBI is already examining ways to tighten certain IPO regulations, and recently released a discussion paper on various issues, including the requirements of specific targets for future acquisitions and strategic investments, conditions for offers by significant selling shareholders, lock-in period for anchor investors, and monitoring of general corporate purpose proceeds.

Ultimately, the key question on the minds of issuers and investors is whether 2022 and beyond will witness an even higher number of listings in India than 2021. With investors, regulatory authorities and Indian corporates maturing at the same time, a virtuous circle is being created that likely will encourage more IPOs. Fast-maturing Indian markets have a knock-on effect of providing companies and investors with a viable alternative for listing venues.

Although ringing the bell of the New York Stock Exchange or appearing in the FTSE 100 will continue to hold allure for some companies, listing abroad, particularly in the US, remains difficult for many issuers, with the need to comply with rules designed by foreign regulators, including numerous onerous obligations post-listing. As India emerges as a viable, credible and attractive option, the diversity of choice and broadening of horizons is a welcomed change, having long-term positive effects for all stakeholders.

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CAPITAL MARKETS
IPOs

Discovering the South Korean IPO market

Myoung Jae Chung, Teo Kim and **Steve Song** of **Kim & Chang**
discuss the trends and issues in the South Korean IPO market, including increased investment and ESG factors

According to the report '2021 EY Global IPO Trends' a total of 547 companies worldwide went public in the third quarter of 2021, raising $106.3 billion (approximately KRW 126 trillion) – this is an increase of 11% from 2020.

South Korea has been no exception to this global boom in initial public offerings (IPO) deals, with Krafton and Kakao Bank spearheading the mega IPO deals in the Korean market. Krafton raised $3.8 billion in August while Kakao Bank raised $2.2 billion, ranking second and fourth, respectively, among global IPO deals that took place in the third quarter of 2021.

One of the notable trends of the Korean IPO market is the increase in the proportion of individual investors participating in IPOs. Until 2021, individual investors would generally apply for subscription of 100 to 200x of the number shares to be offered through an IPO. That ratio increased sharply during this year reaching 450x in the third quarter of 2021, marking the highest participation of individual investors in the past 10 years.

With the proportion of individual investors growing along with the booming IPO market, financial regulations are also tightening. For example, the Financial Supervisory Service (FSS) has been requesting amendments to securities registration statements at a substantially higher rate since last year. Also, the emphasis on environmental, social and governance (ESG) is becoming more pronounced in the South Korean IPO market.

The key characteristics of the South Korean IPO market and related regulatory trends are discussed below.

Increase of individual investors

There are several reasons a growing number of individual investors are showing interest in IPOs: First of all, many South Korean companies that went public have recently shown very high returns on their first day of listing, raising

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the expectations of individuals for investment in IPOs who had little experience in the stock market.

In addition, not only is there a greater number of individual investors who have newly entered the stock market since the Covid-19 pandemic, but the size of each investors' investment in the stock market has also increased significantly.

While an expanded investor base certainly has contributed to vitalising the stock market, unrealistic expectations on their return on investments have also brought adverse effects, such as inflating the initial offering price of the issuer's shares well above its fair value and causing their share price to crash when investors who wish to realise their profit sell their shares at once.

As it happens, there are more and more cases where IPO share prices had plummeted after setting a high initial price on the first day of listing. As individual investors account for a significant portion not only in the subscription of publicly offered shares, but also in post-listing trades, the stock market has become more susceptible to the sentiment of individual investors.

As various problems arose due to the increasing number of individual investors in the IPO market, financial regulators announced measures to improve the IPO framework in November 2020. Such measures include increasing the number of shares offered to individual investors, and an 'equal allocation' of subscription shares for at least half of the shares offered to individual investors so that individual investors who may have difficulty in paying the subscription deposit may nonetheless have access to the IPO market compared to the conventional method of allocating shares in proportion to the number of shares each individual investor applies for subscription.

However, there are ongoing debates as to whether increasing individual investors' access to IPOs is desirable, and in particular, there is a concern that greater participation of individual investors in the IPO market may lead to greater suffering in their investment because investing through an IPO is primarily to invest in the issuer's potential growth, which may or may not be realised.

"One of the notable trends of the Korean IPO market is the increase in the proportion of individual investors participating in IPOs"

FSS review of IPO securities registration statements

As the number of individual investors newly participating in the IPO market increases, the financial authorities' review process is also becoming more stringent in line with investor protection. In South Korea an IPO generally takes the following steps: (i) mandating lead managers; (ii) due diligence of the issuer; (iii) preliminary screening process for listing by the Korea Exchange (KRX); (iv) FSS' review and approval of the issuer's securities registration statement; (v) conducting marketing towards investors through roadshows or other means; (vi) bookbuilding and pricing process; and (vii) subscription of shares and payment.

As a securities registration statement is the basis for investors' investment decision, the issuer could be held liable for misstatements therein if the securities registration statement or a prospectus contains any untrue statement of a material fact or omits to state a material fact necessary in order to make the statements therein not misleading. In addition, the FSS may also require an amendment if the securities registration statement contains any misstatement. Whenever the FSS requests an amendment, the issuer must file an amendment to the securities registration statement, which may delay the overall IPO timeline.

The FSS has been demanding amendments for a greater number of securities registration statements. As of July 2021, 9 out of 54 companies (16.7%) that submitted securities registration statements to the FSS in 2021 were subject to amendment, up by approximately 50% from 2020. This is quite remarkable given that among the 283 companies that were listed between 2017 and 2019, the FSS had never requested an amendment to their securities registration statements.

Meanwhile, three companies that filed an amendment to the securities registration statements in 2021 lowered their expected offering price range, which suggests that although the FSS's requests for amendment were made in the name of investor protection, there is some speculation that it was actually targeted to lower the offering price after some controversy regarding overvaluation.

While some criticise the financial authorities' intervention in the IPO market, especially when there are procedures such as a bookbuilding process to help reasonably find the right offering price, others agree that the financial authorities must take stronger measures to protect investors given that a large number of individual investors are entering the market. Despite such ongoing debate, the financial authorities will likely continue to apply heighted scrutiny. Therefore, adequately responding to the regulators' request is becoming more and more important in the context of an IPO, and the role of legal counsels in this regard will also continue to grow.

More stringent listing eligibility review from KRX

The KRX has the authority to conduct quantitative and qualitative review regarding the listing eligibility of applicants before listing and to approve the IPO. In November 2021, the KRX announced a stricter guideline on its listing eligibility review process to (i) set forth in more detail the qualitative review standards so that issuers would have greater clarity and visibility on the likely outcome of the KRX's review and (ii) prevent any misconduct that may harm the investors.

According to the guideline, the KRX will monitor (i) whether excessive dividends were paid out immediately before the application for review was filed; (ii) whether the offering price was reasonably calculated in light of fair market value; (iii) whether the issuer merged with another non-listed company immediately prior to listing, and inflated the merger value and whether the application was filed shortly after the merger; and (iv) whether the issuer was acquired through leverage buyouts (LBO) and attempts to transfer the burden of repaying the acquisition financing to the issuer.

The above KRX guidelines aim to prevent the booming IPO market from overheating and to strengthen the protection of individual investors through stricter IPO reviews by the KRX as a gatekeeper. However, it is still unclear as to how the KRX will determine and the reasonableness of offering price calculations, and whether or not dividend payments were excessive. Therefore, companies that are currently considering an IPO should carefully analyse the impact of paying out dividends or acquiring other companies.

IPO and ESG

ESG has now become a global megatrend. Global asset management companies and large pension funds in South Korea have brought ESG into their main investment standards, and this has led to a growing interest in ESG also in the IPO market.

Foreign institutional investors are making more and more ESG-related inquiries at Investor Relations (IR) sessions of companies wishing to go public, such as asking the gender ratio of the company's executives and employees and its current and future plans on social contribution. Some major South Korean institutional investors are differentiating their subscription levels according to a company's ESG ratings, cutting down their subscription of shares if the issuer's ESG ratings are low.

In a recent IR session, institutional investors showed a strong interest in the issuer's ESG factors and were checking the ESG status of the issuer, reflecting their strengthened stance on ESG investment. In response, some companies that plan on going public are using ESG management as a strategy to attract greater investor interest. As such, the ESG focus in South Korean IPOs is expected to continue to grow.

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Cyprus tightens measures to combat internet fraud in the digital era

The rapid expansion and use of the internet, the digitalisation of almost every available piece of information on the planet, as well as the enormous increase in the volume of transactions taking place electronically on a daily basis during the last two decades, have also brought about an increase in internet fraud cases. The term 'internet fraud' generally covers cybercrime activity that takes place over the internet or via email, including crimes like phishing, impersonation, credit card and identification theft, and other hacking activities designed to swindle people or businesses out of money.

The online dependency of businesses and people worldwide is creating new opportunities for cybercriminals. According to Interpol officials, since the pandemic outbreak, cybercriminals have been developing and boosting their attacks at an alarming pace. Nowadays, the internet has become one of the most popular tools used to commit fraud. Internet scams that target victims through online services account for millions of dollars' worth of fraudulent activity every year and this figure will continue to increase as internet usage expands and cybercriminals become more sophisticated. Given that cybercriminals operate with stolen identities and bank account details (names, addresses, credit card numbers) they are often hard for the authorities to trace. Obviously, such stolen data is used by them for the planning and realisation of further crimes.

In Cyprus, the Ministry of Justice and Public Order together with the Cyprus Police are the authorities responsible for the prevention and combating of cybercrime. There is a special cybercrime subdivision in the police which is responsible for the effective investigation of cybercrime. However, the specialised body in the Cyprus Police for cybercrime investigation is the Office for Combating Cybercrime (OCC) which is responsible for the investigation of crimes committed via the internet or via computers. The OCC cooperates closely with EU authorities and third countries on the basis of bilateral and multilateral agreements including, inter alia, the Europol (EC3), Interpol, the European Network and Information Security Agency (ENISA), the European Commission and many others.

The relevant legal framework

There is an extensive legislative framework in the field of cybercrime in Cyprus.

Law 22(III)/2004

This legislation ratifies the Budapest Convention on Cybercrime and covers hacking, child pornography and fraud committed via electronic communication and the internet. The convention is the first international treaty on crimes committed via the internet. Its main objective is to pursue a common criminal policy aimed at the protection of society against cybercrime, especially by adopting appropriate legislation and fostering international co-operation.

Law 147(I)/2015

This law implements Directive 2013/40/EU on attacks against information systems. The objectives of the directive are to converge the criminal law of the member states in the area of attacks against information systems by establishing minimum rules concerning the definition of criminal offences and the relevant sanctions and to improve cooperation between competent authorities, including the police and other specialised law enforcement services of the member states, as well as the competent specialised union agencies and bodies, such as Eurojust, Europol and its European Cyber Crime Centre, and the European Network and Information Security Agency (ENISA).

Further legislation

Other pieces of legislation in the field include:

- The Law on the Retention of Telecommunication data for the investigation of serious offences (Law 183(I)/2007);
- Law 26(III)/2004 which ratifies the EU Directive 2011/93/EE which covers, inter alia, child pornography;
- Law 112(I)/2004 which regulates electronic communication.

The role of the Cyprus courts

There has been an increase in the number of new internet fraud cases brought before the Cyprus civil courts in recent years and it is encouraging to note that the civil courts in Cyprus have shown their readiness to adapt and to keep the pace with the cybercriminals. This is heartening because it is of the utmost importance for the courts to contribute to the fight against cybercrime. Otherwise, the scammers who tend to hide behind a veil of anonymity or false identification will always be one step ahead and the imbalance that exists between the victims and the cybercriminals will never be tackled.

Having handled numerous internet fraud cases for clients (usually for large corporations who fell victims of hackers, impersonation and the like), it can be observed that it is very common for stolen funds to be transferred immediately to multiple bank accounts (owned usually by foreign entities) in various jurisdictions around the globe. In such situations the courts can assist by granting freezing orders in order to ensure that the stolen funds are not further alienated, as well as Norwich Pharmacal relief against the banks in order to learn the identity of the account holder(s). In situations where the funds have already been further alienated, the courts can grant tracing orders in order to follow the money.

In a recent internet fraud (impersonation) case, the District Court of Nicosia granted ex parte a freezing order as well as a gagging order against the Bank whereas the Norwich Pharmacal type orders were left to be examined inter partes. The Cyprus courts have also acknowledged the difficulties in serving by conventional means anonymous defendants or defendants who do not want to be found.

Recently, the District Court of Limassol on the basis of O.5R.9 of the Civil Procedure Rules granted a novel form of alternative service, i.e. that of service via Facebook Messenger, which is definitely a step in the right direction. This is because in injunction applications made without notice the general rule is that the proceedings and the order must be served on the respondent as soon as practicable.

This type of alternative (electronic) service is not so uncommon in the UK where, for example, in LJY v. Person(s) Unknown [2017] EWHC 3280 (QB), the court deviated from the general rule and permitted the claimant to serve the defendant by text.

It remains to be seen who the ultimate winner shall be in the fight against cybercrime. So far, both the authorities and the courts have shown good reflexes in assisting corporations and private individuals who have fallen victims of cybercriminals. However, in response, the cybercriminals have always been able to develop even more sophisticated cybercrime techniques.

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JAPAN

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Japan's Ministry of Justice begins study on proposed amendment of security legislation

Prompted by concerns that Japan's current laws and regulations may not be considered business friendly, a subcommittee of the legislative branch of the Ministry of Justice recently commenced a study to determine whether establishing a new type of security right – which is to be granted to a creditor to secure performance of obligations over the debtor's all assets (the Comprehensive Security Right) – would be appropriate.

Directive from the Minister of Justice

On February 10 2021, the Minister of Justice, Yoko Kamikawa, addressed the Legislative Council of the Ministry of Justice regarding Japan's laws on security or collateral rights, which is not fully exhaustive and sometimes filled by court decisions, and not business friendly, stating as follows:

> "In light of the current situation of transactions using property other than real estate as collateral, such as the expansion of the use of financing secured by movable property and claims, it seems necessary to review the legislation on security from the perspective of clarifying legal relationships between the creditors and debtors and ensuring stability."

In response, the Security Legislation Subcommittee of the Legislative Council has been studying the revision of the security legislation at a pace of about once a month since April 13 2021.

Basis for the study to be conducted by the subcommittee

The basis of this study is the report of the 'Study group on security legislation focusing on movable property and claims', sponsored by the Commercial Law Study Group, a public interest incorporated association. From March 4 2019 to March 2 2021, researchers of civil law and insolvency law, lawyers, and people in charge of legal departments of companies discussed the revision of security laws and regulations in this study group.

In this report, the following statements are made, especially regarding comprehensive security rights (described below):

> There might be a need to develop a comprehensive security right that collectively targets and enforces the entirety of property used for a certain business by the debtor, including intangible property rights as well as rights to movable property and claims.
>
> In such case, this could be done through a review of the existing foundation mortgage (Zaidan Teitou) system and corporate collateral laws (Kigyo Tampo Hou), as well as the creation of a new security right.
>
> With regard to a comprehensive security right, given that there are several options, it is necessary to consider what needs cannot be covered by existing security rights for individual movables and claims, and for collective movables and claims, and what specific situations can be envisioned for the use of the new security right. It is also necessary to further examine whether or not it is necessary to establish such a new right, and if so, what specific measures should be taken.

Japan's low rating for ease of doing business

The above statement derives from the fact that Japan was disgracefully ranked 29th in the Doing Business 2020 published by the World Bank, which ranks countries according to the ease of doing business in each country in light of the regulatory or legal environment.

In particular, Japan was given a low rating in the area of credit provision, and one of the elements in that area, "Does the law allow businesses to grant a non-possessory security right in substantially all of its assets?" – which right could allow businesses to raise funds more easily – received a score of zero. In response to this report, the Prime Minister's Office has mentioned the need to review the security law system in its policy announcement.

Opposition to a comprehensive asset securitisation

The study by the Security Legislation Subcommittee of the Legislative Council has just begun, and it is not yet clear whether a new comprehensive security right will be established or not and the specific content of such comprehensive security right.

In particular, lawyers who specialise in the field of bankruptcy law have expressed their opposition to the establishment of a comprehensive security right one after another. They have stated that the comprehensive security right would lead to an excessive influence of creditors (mainly financial institutions) who are granted the comprehensive security right in insolvency proceedings and destroy the existing bankruptcy practice, which has been operating stably for a long time.

The future development of the Security Legislation Subcommittee of the Legislative Council will be closely followed in the coming months.

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A revamped Macau SAR Tax Code and further steps in financial diversification

During the third quarter of 2021, Macau SAR was flooded with news of the much touted 'financial diversification' of the Special Administrative Region (SAR) with a number of government initiatives being prepared for it.

In October, the Executive Council (EC), an advisory body to the Chief Executive, announced that it had completed and finally delivered the draft of what is to be the future Macau SAR Tax Code (MTC) to the Legislative Assembly (LA). This came after the draft laws submitted to public consultations in both 2011 and 2016 never managed to reach the LA.

More than a just simple compilation of the separate tax laws passed during the 1970s and currently still in force, the MTC's aim is to revamp and update the local tax system, finally introducing concepts that are already commonly used in other jurisdictions such as those of 'tax resident' and 'tax residence'. Drafted as a true broad tax code, its acknowledged objectives are "to better comply with the SAR's international tax obligations" and "better attract foreign investment".

Another noteworthy initiative was the launch of the Central Securities Depository (CSD), with its final design and test phase being almost complete according to the Macau Monetary Authority (AMCM).

Designed in collaboration with the stated-owned China Central Depository & Clearing Co, Ltd, the CSD will provide securities account opening services and centralized securities depository services and is considered to be a financial infrastructure crucial to strengthening the integration of Macau SAR's financial market with those overseas.

On December 6 2021, the AMCM also announced the launch of a new trial fast interbank transfer service for small amounts, named 'easy transfer', supported by a 'fast payment service' (FPS) platform. This service will be available for local bank accounts in Patacas (MOP). After signing up for the service through their banks and receiving an 'FPS ID', users may transfer small amounts to other bank accounts in real-time and round the clock using only their mobile phones.

The transfer is made by introducing the telephone number of the intended beneficiary, who must also be registered as a user of the platform. The FPS interbank platform will also accept telephone numbers from mainland China and Hong Kong and transfers made using this service will be completed in 30 seconds, according to the AMCM.

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A closer look at Portugal's private equity transactions in 2021

Portugal has been feeling the repercussions of private equity's (PE) spectacular success as an investment asset class during the past decade and in particular during the last few years.

On the demand side, the paradigm of low interest rates and capital shortfalls suffered by traditional Portuguese industrial groups have led the way for several high-profile buyouts of key assets and enterprises by international buyout shops, pension funds and other institutional investors; on the other hand venture capitalists, buoyed by schemes to deploy European structural and investment funds in 'new economy' ventures, are taking advantage of the country's sophisticated start-up ecosystem.

As for the supply side, there has been a recent flurry of fund raising in the mid-market segment, focusing in particular in venture capital investments, technology companies and tourism and hospitality assets. Companies with resilient business plans proved to be particularly attractive.

However, the path was not strewn with roses. Deals took longer than usual to complete even though private equities had a 'license to invest' because of hesitations on the buy-side, more aggressive negotiations around asset valuation and consequently pricing arrangements (earn-outs, claw-back clauses, deferred prices), longer and more thorough due diligences, especially on the financial side and contract drafting misalignments on material adverse effect clauses, indemnities on Covid-19 related contingencies. Some deals also evolved from typical sale and purchase to cooperation models.

Going to the numbers and the deals, the volume of buyout and growth (i.e. more 'traditional' PE) transactions has decreased significantly compared to the previous year (the Covid-19 pandemic being often cited as the main reason why). Until November 2021, PE transactions represented a total volume of €2.169 billion, which represents a 68% drop compared to the same period in 2020 (Source: TTR – Iberian Market Monthly Report, November 2021).

Major PE deals in 2021 included the acquisition of a 25% minority stake in big-box retailer Sonae MC by CVC Capital Partners (with an implicit equity value of €2.4 billion), and the acquisition, by Ontario Teachers' Pension Plan, of the US PE firm Carlyle Group's majority stake in Logoplaste, one of the world's leading plastic packaging design and manufacturing companies for around €1 billion.

In venture capital, however, the market's upward trajectory has not been interrupted by the pandemic (rather to the contrary) and transaction volume actually increased by 87.6% compared to 2020 levels, rising to €1.542 billion (Source: TTR – Iberian Market Monthly Report, November 2021).

Relevant venture capital transactions include Series B and Series C rounds (aggregate €168 million) of Sword Health (one of the fastest growing MedTech companies internationally) and the Series D investment (€200 million) in Feedzai (leading provider of cybersecurity solutions for financial crime) led by buyout powerhouse KKR.

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Executive payroll in Switzerland – the details matter for employers

Switzerland is an attractive venue for skilled foreign workers. In addition to establishing a domestic employment relationship with a foreign national employee residing in Switzerland, other forms of employment may be considered, such as cross-border assignments, domestic employment contracts with foreign residents or engaging external consultants.

The Covid-19 pandemic has greatly accelerated the already pre-existing trend towards other modern forms of employment, such as home-office working in particular.

Whilst the trend towards more flexible work set-ups has many advantageous aspects, employers' duties and liability exposure in the fields of payroll should not be underestimated.

Tax withholdings, certifications, social security contributions, pension payments, coverage for accidents and related topics may, in negotiations with candidates, be a lesser priority but should be addressed early in the process. Doing so will help to: (i) ensure a compliant set-up for the company and the executive/board member; (ii) properly define functions and places of work; (iii) avoid tax exposures at a corporate level; (iv) ensure adequate coverage of the executive/board member in case of accidents, death, disability and sickness; and (v) avoid liability exposure for the company and its corporate bodies.

Taxation of executive compensation/board members

In view of its wage withholding tax liability exposure, it is crucial for a Swiss employer to clarify an employee's residence status in the context of the first payroll:

- A person residing in Switzerland and intending to stay permanently, or a person present in Switzerland for a mostly uninterrupted stay of 30 days with gainful employment establishes a personal tax residence. Such person has an unlimited tax liability in Switzerland and is liable to Swiss taxes on their worldwide income and wealth, subject to applicable double taxation treaties. Such treaties typically allocate the unlimited tax liability to the country where such person has his/her centre of vital interests. International weekly commuters typically do not have their unlimited tax liability in Switzerland if they have their centre of vital interest, i.e. their family, in another country. Where a person is considered a Swiss tax resident, tax withholdings on compensation may be required for non-Swiss nationals, depending on their marital status and type of permit.
- A tax limited to Swiss sourced income may, for example, arise due to the exercise of a professional activity in Switzerland or due to membership of the board of a Swiss company. Non-resident employees and board members are, by default, subject to Swiss wage withholding tax, i.e. the company is liable to deduct the tax directly from the gross amount of compensation paid. Whilst tax withholdings on board fees are levied at a flat-rate tariff and apply even if no physical work is performed in Switzerland, withholdings on employment compensation will be levied at progressive rates and will only be due on gross compensation relating to work physically performed in Switzerland.

In light of the above, a Swiss company needs to assess the tariff and the basis of assessment on a case-by-case basis in order to be able to carry out any tax deductions from the salary accurately. The Swiss company is liable for the correct tax withholdings and is also obliged to issue an annual salary certificate reflecting gross compensation and any deductions made. Non-compliance may be punished by a fine, and the recharge of omitted tax withholdings to employees can prove complicated or even impossible.

Individuals who are taxed at source may, depending on meeting certain thresholds or trigger events, be required also to file an ordinary tax declaration in Switzerland. Under certain conditions, such ordinary taxation can also be requested voluntarily although the conditions to do so have been loosened through a recently enacted wage withholding tax reform which came into force as of January 1 2021. As a result of this reform, the system is also more uniformly applied in Switzerland. It is essential to evaluate whether ordinary taxation compares favourably with the wage withholding tax.

Last but not least: the place of work of executives and board members not only has payroll and income tax ramifications but may also affect the corporate tax sphere. If a foreign company has staff and facilities at its disposal in Switzerland, it may be considered as operating a permanent establishment in Switzerland for Swiss and international tax purposes. A share of the profits of the company may then be attributed to Switzerland for taxation purposes.

In addition, when it comes to employing senior employees and members of the board of directors in an international context, further questions have to be raised regarding where the company is effectively managed.

Social security and pension aspects

The social insurance obligation of senior employees and members of the board of directors must also be assessed on a case-by-case basis. Swiss social security contributions are generally triggered when an employee resides and/or works in Switzerland.

To coordinate or harmonise contribution duties in cross-border cases, Switzerland has concluded bilateral social security regulations with a number of states. The regulations with and within the EU provide that social security contributions are due in one state only, this typically being the place of performance of work, if no specific secondment rules apply. Where more than 25% of working time is carried out in Switzerland and/or a member state where an individual also resides, the individual is typically subject to the social security legislation of that state. The treaties with other countries, such as the US, provide for different mechanisms in that social security contributions can be triggered in both states.

In any event, the international social security affiliation rules can lead to unexpected social insurance consequences in Switzerland (or abroad). It should also be noted that, from a Swiss social security perspective, senior employees and members of the board of directors are considered to be employed. This may lead to mismatches with foreign countries where such functions might be treated as self-employment.

Where the compensation payable to senior executives and board members is subject to Swiss social security contributions, Swiss pension fund contributions are typically also triggered. It is necessary to review whether any exceptions apply, e.g. for part-time employment. If pension contributions indeed apply, the insured compensation may differ from the salary applicable for social security and tax purposes.

Non-compliance in connection with social security and pension contributions not only leads to gross-up calculations but the recharge of omitted withholdings to employees can also prove burdensome or even impossible, and a lack of social security or pensions coverage in cases where a benefit would become payable can lead to a company having liability exposure.

Recommendations

When a Swiss company employs executives or board members, it is important for the company to keep (or have that individual keep) reliable documentation such as a comprehensive employment / mandate agreement in writing, a running calendar with days of work in Switzerland as well as an updated certificate of coverage or form A1 for social security purposes and to issue annual salary certificates.

From both a tax and social security perspective, further complexities can arise if net salary agreements or fringe benefits are implemented and where benefits are paid in other jurisdictions or by other group companies under certain employee participation plans or pension schemes.

Any such benefits will need to be reviewed from a Swiss perspective to assess their tax and social security treatment, the correct quantification, the potential need for gross-up calculations and will have to be duly reflected in the annual salary certificates provided by the Swiss employer. It is advisable to involve an experienced local payroll provider – especially when there are not enough resources available in Switzerland to cover this in-house.

Further to the liability risk for the company overall, it is often awkward for the company to request additional amounts to be paid as wage withholding tax or social security/pension contributions from employees who ultimately turn out to have had insufficient withholdings from their salaries.

Furthermore, other usual work-related compliance aspects must be considered and, if necessary, require timely filing such as the necessary applications for a work permit.

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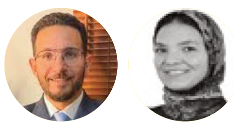

Mohamed Abdelrehiem and Salma Barakat

A closer look at judicial fees in the UAE

Whilst some corporates/individuals may have valid claims to pursue before the UAE courts, many may feel trapped for not knowing the applicable court fees and other hidden expenses involved in the litigation process. Some may not even receive a proper explanation of what the applicable court fees are, what is refundable and what is not.

This article provides a comprehensive overview of all types of courts costs, litigation expenses, and hidden expenses that any litigants could come across during the litigation process and, therefore, can outweigh the financial risk involved.

At the outset, there are two critical rules based on which the courts fees are estimated in the UAE:

- First, the court fees are usually calculated based on a percentage of the claim amount in the statement of claim; and
- Secondly, once the claim amount exceeds a specific amount, the court fee is usually capped to a maximum amount regardless of the percentage rule.

Background to the UAE judicial system

The UAE is a federation of seven emirates. All emirates, except for Abu Dhabi, Dubai, and Ras Al Khaimah, are part of a federal judicial system and the federal supreme court based in the capital. Abu Dhabi, Dubai, and Ras Al Khaimah have their own independent judicial systems. In every emirate, the court system consists of three levels: court of first instance (CFI), court of appeal (COA), and court of cassation or supreme court (COC).

The court fees are usually divided to each court level, and each become due and payable at the relevant court level of the case.

Court fees (at each level) are usually paid in advance, otherwise, the court does not accept the registration of the case at the specific level. If fees are not paid on time this, in most cases, will have a negative effect on the case being accepted and may lead to the time bar of certain legal procedures, hence, waiver of the litigants' rights.

How judicial fees are calculated

Similar to any governmental service in the country, to file a case before a court in the UAE, the Ministry of Justice imposes a fee covering the judicial service per stage. The table below provides a summary of the court fees and how they are calculated at different levels of litigation before the UAE courts in three different jurisdictions (see table above)

In addition to the above table of court fees, it is very important to take into consideration the below hidden expenses that litigants come to know only after the case is filed:

Expert fees

In most cases, the court appoints an expert with a specific mandate to review and prepare a report of the case's facts, documents and financials/amounts in claim. The court usually directs the plaintiff to pay the expert fees within a week time of its

Court level	Dubai	Abu Dhabi	Ras Al Khaimah
Court of first instance (CFI)	6% from the claim amount up to a maximum amount of: • AED 20,000 if the claim is less than AED 500,000 • AED 30,000 if the claim is more than AED 500,000 to 1,000,000 • AED 40,000 for claims exceeding AED 1,000,000	5% of the claim amount up to a maximum amount of AED 40,000	10% of the claim amount up to a maximum amount of: • AED 30,000 for claims up to AED 1,000,000 • An additional 5% for any amount exceeding AED 1,000,000
Court of appeal (COA)	50% of the fee paid to court of first instance	5% of the claim amount up to a maximum amount AED 10,000	5% of the fees of the appeal up to a maximum amount of AED 30,000
Court of cassation (COC)	• AED 3,000 as a deposit • AED 2,000 fixed fees • AED 1,000 for staying execution request	• AED 3,000 as a deposit • AED 2,000 fixed fees • AED 1,000 for staying execution request	• AED 3,000 as a deposit • AED 5,000 fixed fees • AED 1,000 for staying execution request
Appeal insurance	AED 1,000	AED 2,000 insurance	AED 1,000 deposit.
Payment order cases	6% of the claim amount up to a maximum amount of AED 40,000 For any claim below AED 500,000 the plaintiff pays only AED 5,125	6% of the claim amount up to a maximum amount of AED 40,000 For any claim below AED 500,000 the plaintiff pays only AED 5,125	N/A
Execution courts	2% of the claim amount with a minimum amount of AED 200 and up to a maximum amount of AED 5,000	2% of the claim amount with a minimum amount of AED 100 and up to a maximum amount of AED 3,000	1/3 of the proportional fee up to a maximum amount of AED 3,000
Dubai settlement dispute centre	3% of the claim amount anticipated values up to a maximum amount of AED 20,000 For unevaluated claims a fixed fee of AED 6,000	N/A	N/A
Employment dispute	5% of the claimed amount up to a maximum amount of AED 20,000	Free of cost regardless of any claim amount	Free of cost regardless of any claim amount
Dubai rental dispute	3.5% of the tenancy contract value up to a maximum amount of AED 20,000	N/A	N/A

decision. Expert fees range between AED 5,000 for small cases up to AED 90,000 for complex construction disputes. Expert fees are refundable, in case of winning the case as the court directs the losing party to pay such expert fees, in addition to the full amount of the judgment.

In some emirates like Abu Dhabi, it is a prerequisite to submit an independent expert report alongside your case's documents for the court to accept the case registration. Of course, that is an extra layer of cost most of the plaintiffs get to know only at the time of claims registration.

Legal translation

Given that the official language of courts in the UAE is Arabic, the relevant court requires that any document to be submitted must be translated into Arabic. Hence, translation budget should also be considered prior to filing any case and all documents should be relevant and substantial to the case in question to avoid any unnecessary cost.

Conclusion

Whilst the general rule is that the losing party is the one paying the court fees (including the expert fees), the plaintiff should be very careful at the time of calculating its claim amount. The court has a discretionary power to direct the winning party to pay a share of the fees equivalent to the difference between the amount of the final judgment and the original claim amount made by the plaintiff.

For example, in the CFI if the claim amount is AED 1,500,000 the court fees would be AED 40,000 as per Dubai rules. If the final judgment awards the plaintiff AED 500,000 only, the plaintiff may end up, although winning the case, paying 6% of the part not awarded of its claim amount i.e. AED 1,000,000 which gives rise to the maximum court fees of AED 40,000 as per Dubai rules.

The key point here is that litigants should carefully consider the strength and legal merits of their case to avoid unnecessary legal costs.

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