Summer 2022

IFLR

Crimes against the planet

Sharpened regulatory and litigation focus on the environment will help ensure firms are held accountable for their actions

US crypto regulation | GMRA turns 30 | Garuda Indonesia restructuring | Ashley Alder interview

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IFLR

Summer 2022 Vol 94

SUBSCRIPTIONS

UK/Asia hotline
Tel: +44 20 7779 8999

US hotline
Tel: +1 212 224 3570

Email: hotline@euromoney.com

“"These are massive steps that show an increased prioritisation of environmental crimes, when previously it wasn’t a key issue at all”

EDITORIAL

On the edge of the precipice

CONTRIBUTING EDITORS

Amanda Baker
Mayer Brown

Geoffrey Belsher
Blake Cassels & Graydon

Vanessa Blackmore
Sullivan & Cromwell

Tim Bratton
Euromoney Institutional Investor

Harry Broadman
Berkeley Research Group

Melissa Butler
White & Case

Rodrigo Castelazo
Creel García-Cuéllar Aiza y Enríquez

Lewis Cohen
DLx Law

Berkeley Cox
King & Wood Mallesons

Antony Dapiran
Davis Polk & Wardwell

Jeremy Duffy
White & Case

Sui-Jim Ho
Cleary Gottlieb Steen & Hamilton

Joel Hogarth
Reliance Group

Posit Laohaphan
Latham & Watkins

Ward McKimm
Shearman & Sterling

Jeffrey Singer
Stikeman Elliot

As we pass the halfway point of 2022, it is hard to imagine what more could happen to impact the financial markets. War in Europe, a cost-of-living crisis reaching unprecedented levels, populations of entire sub-continent sized countries confined to their homes in the quest to prevent the spread of a virus much of the rest of the world has learned to live with, and an abundance of governmental meltdowns and resignations across Europe.

In addition, recession looms and inflation continues to swell.

Yet, against this backdrop, regulators continue to hammer out rules at near record pace. In the US, the Securities and Exchange Commission continues to push for increased oversight on SPACs, crypto, ESG, stablecoins and swap executions. Calls for the Commission to slow down and consider the impact of its actions have been constant and have come from all areas of the financial sector.

In the UK, the new chancellor of the exchequer Nadhim Zahawi confirmed the government's commitment to repealing EU law and tailoring financial regulation to UK markets, confirming plans to "repeal hundreds of pieces of retained EU law" and "create a coherent and agile approach to financial regulation".

In the EU, negotiations on the Markets in Cryptoassets Regulation (MICA) came to a close with the ruleset expected to bring a unified to approach to the bloc so that cryptoasset service providers will only need one passportable licence to work across the whole of the EU, rather than requiring separate licences in each nation.

When NBER eventually calls a spade a spade and decides the US is in a recession, which will likely spiral across the world, it will come as very little surprise to anyone. Given this inevitability, it might be sensible to curb the rate of regulatory imposition across the world's most significant financial hubs – and elsewhere, frankly – to try and prevent an economic freefall akin to 2008. While loose regulatory regimes arguably caused that particular financial crisis, the following years saw an unparalleled level of rulemaking that introduced significant protections across multiple sectors.

As I wrote two years ago in the midst of a lockdown, the Covid-19 pandemic proved that Dodd-Frank was working in the US, and while the economic backlash has been hard for many – the financial system remains steadfast. Introducing swathes of new regulation at this stage of a crisis is probably too little too late and should be reconsidered. Regulatory action might be necessary, and global coordination continues to be a must, but pushing things through the system simply for the sake of getting it done is a bad idea.

This edition has all the usual features you have come to expect, and features a cover story from senior writer Thomas Helm on environmental crime, on page 6. It's a great issue with some fascinating content, including Americas editor Alice Tchernookova's in-depth interview with IOSCO chair Ashley Alder, ICMA's article on the history and future development of the GMRA, and Ropes & Gray's discussion of liability management techniques.

It's going to be a tough summer for everyone, and an even harder winter. By then, at least, we should know where we stand.

Until then, enjoy the issue.

John Crabb, Managing Editor
@johncrabb_

IFLR

4 & 8 Bouverie Street, London EC4Y 8AX
Email:
[firstname].[surname]@euromoneyplc.com
Customer service: +44 20 7779 8610

EDITORIAL
Managing editor John Crabb
john.crabb@euromoneyny.com
+1 212 224 3402
Commercial editor Alice Jones
alice.jones@euromoneyplc.com
+44 20 7779 8324
Asia editor Karry Lai
karry.lai@euromoneyasia.com
+852 2842 6927
Americas editor Alice Tchernookova
alice.tchernookova@legalmediagroup.com
+44 20 7779 8106
EMEA reporter Lucy Frost
lucy.frost@euromoneyplc.com
+44 20 7779 7204
Senior journalist Thomas Helm
thomas.helm@euromoneyplc.com
+44 20 7779 8063

Global head of sales, LMG Richard Valmarana
MD, market intelligence Timothy Wakefield
UK production manager Luca Ercolani
Production editor Josh Pasanisi

ADVERTISING
Publisher
Emily Kyriacou
emily.kyriacou@euromoneyplc.com
+44 20 7779 8696
BD Manager, Americas
Chris Edouard
chris.edouard@legalmediagroup.com
+1 212 224 3494
BD Manager, Asia
Anicette Indiana
anicette.indiana@euromoneyasia.com
+852 2842 6966
BD Manager, EMEA
Sanawa Mtalo
sanawa.mtalo@iflr.com
+44 207 779 8339

SUBSCRIPTIONS
Subscriptions hotline
Hussein Shirwa
Tel: +44 20 7779 8626
hussein.shirwa@legalmediagroup.com

CUSTOMER SERVICES
Tel: +44 20 7779 8610

International Financial Law Review is published four times a year by Euromoney Institutional Investor PLC, London.

Directors Leslie Van De Walle (Chairman), Andrew Rashbass (CEO), Wendy Pallot, Jan Babiak, Colin Day, Imogen Joss, Lorna Tilbian, Tim Pennington

Printed in the UK by Buxton Press, Buxton, England

International Financial Law Review 2021
ISSN 0262-6969

QUOTES
OF THE MONTH

"There is a proliferation of legislation in the US suggesting how to best regulate cryptocurrency markets, and there are efforts to coordinate across our fragmented federal regulatory landscape within the US and also across branches of government"

CFTC commissioner Kristin Johnson, speaking at the FIA international derivatives expo in London

"Faced with an operating environment where disclosures are required, our priority is to ensure that the disclosure is as good as it can possibly be"

Constantinos Kleanthous, director at CSC, on the EU's Securitisation Regulation

"The market quickly popped, but the bloom may already be off the rose"

Brock Silvers, chief investment officer at Kaiyuan Capital, on China's tech regulatory ease off

"The process is very difficult, so many of those involved are not very hopeful about the working group finding a breakthrough"

Nicolas Véron, senior fellow at Bruegel and the Peterson Institute of International Economics (PIIE), speaking about the EU's Banking Union implementation

ASIA-PACIFIC

Bridging the gender gap through bonds

Despite the boom in sustainable finance focused on addressing environment-related issues, debt capital market flows addressing social issues – particularly gender inequality – have much catching up to do.

While sustainable bonds made up 11% of the global bond market in 2021, less than 1% of these were aligned with sustainable development goal five: to achieve gender equity and empower all women and girls. There is, therefore, much room for gender bonds to grow – especially in Asia, where gender inequality issues are especially acute.

Gender bonds and sustainability-linked bonds (SLBs) are the two main channels through which debt capital markets can provide financing to address gender inequality issues. While the use of proceeds for gender bonds are ringfenced to align with gender equality, SLBs are broader and can include gender equality elements when sustainability performance targets (SPTs) are set, and proceeds can be used for general purposes.

Issuers of a use-of-proceeds bond can either opt for gender equality objectives to be incorporated as the sole objective – maintaining it as a gender bond – or they can choose to include these alongside other social objectives – therefore making it a social bond – or alongside green objectives, which would make it a sustainability bond.

SLBs also offer more flexibility for issuers as gender equality objectives can be incorporated as part of a funding programme. However, if an issuer does not achieve the SPTs it set out, the coupon is negatively affected.

Examples of gender equality objectives include improving the gender diversity of an issuer's leadership and management positions, setting targets for the percentage of female-owned businesses in an issuer's supply chain, and developing products that can have positive social impact for women.

There has been a lot of innovation happening around gender bond issuances, as exemplified by B3 in Brazil, which in 2021, was the first stock exchange globally to issue a gender bond as well as the International Finance Corporation, which invested in Asia-Pacific's first private-sector gender bond to increase loans for women-led SMEs.

However, more work needs to be done to direct more financing towards gender equality. Governments and the public sector have an important role to play. For instance, there is yet to be a sovereign gender bond - although though UN Women has been working with governments in Asia, Africa and Latin America to develop gender bond frameworks.

In the private sector, commonly cited challenges include a perceived lack of interest from investors in getting involved in such initiatives, and the fear of being accused of "pinkwashing". But with the help of transparent and concrete frameworks and action plans, issuers would do well to gain first-mover advantages in the gender bond space. Improving gender equality within their operations, supply chains and communities, can only have a positive impact on their businesses.

AMERICAS

Crypto regulation momentum must be exploited

As the financial world finally makes headway on digital asset regulation, regulators should maximise this moment and continue to plough ahead with any outstanding items.

It only took them so long to get here. Over the course of the past couple of weeks, some landmark developments have occurred in the US and EU on cryptoasset regulation.

In the US, the Lummis-Gillibrand draft bill formulated the basis of what will hopefully become a strong regulatory framework for digital assets, introducing a new concept to differentiate between securities and commodities.

Meanwhile, an agreement was finally reached between the EU Council presidency and the European Parliament on the Markets in Cryptoassets (MICA) proposal, which will bring cryptoassets, issuers and service providers under a single regulation for the first time. The framework also covers stablecoins, as well as crypto trading venues and wallets.

Although these are major developments on the path to regulating digital assets and should be recognised as such, now is no time for policymakers to rest on their laurels. Instead, they should use the momentum created by this progress and press on with settling the many outstanding questions still surrounding this area of regulation.

The Lummis-Gillibrand bill is welcome news and has put a partial end to months of

OFF THE
RECORD

"As there is no bright line test, some financial institutions have taken a more liberal view when it comes to frequency of providing targeted marketing to PRC clients"

A Hong Kong SAR-based private practice lawyer speaking on China's Futures and Derivatives Law

"In my experience, the private market is used mostly for newer asset classes and new originators, which may not yet be fit for the public markets"

A EU-based private practice lawyer speaking on the EU's Securitisation Regulation

"What we want to avoid is having three standards that are so different and require disclosures that aren't comparable, and that larger corporates operating cross-border have to deal and comply with three competing standards"

A regulator sharing views on global green regulatory standards

"Japan should avoid making the domestic crypto asset market isolated from the rest of the world by introducing the world's first stablecoin regulations with excessive requirements"

Head of a cryptocurrency exchange operator in Japan on the country's stablecoin law

debate on which US regulator – the Securities and Exchange Commission (SEC) or the Commodity Futures Trading Commission (CFTC) – is more suited to regulating the space, but the road ahead is still long. It could be months, if not years, before a final text is agreed on and implemented.

Meanwhile, in the UK, a proper regulatory framework for digital assets is yet to emerge – although the country has vowed to position itself as a global cryptoasset hub. However, the Bank of England's deputy governor Jon Cunliffe announced that legislation on stablecoins could be introduced by August.

In the US, too, a new federal law on stablecoins could be passed by year-end, lawmakers recently said. The collapse of crypto entities such as TerraUSD and Luna is said to have spurred movement in that direction.

The ongoing discussion on central bank digital currencies (CBDCs) and whether or not to introduce them, also remains an open debate in most jurisdictions.

In Europe, a targeted consultation on the digital euro was circulated between April and June this year, and explored subjects such as the needs and expectations around a digital currency, its role for the EU's retail payments and the digital economy.

In the US, the Federal Reserve issued a paper called Money and Payments: The US Dollar in the Age of Digital Transformation as a first step in fostering a broad and transparent public dialogue about CBDCs, and the potential risks and benefits of a digital dollar. However, the Fed said it would not proceed with issuing a CBDC without clear support from the executive branch and from Congress – ideally in the form of a specific authorising law.

In a day and age where digital transformation runs at the speed of light, regulators across the globe would be well-advised to settle these questions sooner rather than later.

EMEA

EU taxonomy will damage impact investing if used incorrectly

The green taxonomy was created to provide a clear and standardised framework so that investors could have reliable information over the sustainability credentials of their investments and avoid greenwashing. However, the collective market view of the taxonomy has shifted from a niche of best-practice, data-backed investments to the more problematic view that taxonomy-compliant investments are good and non-compliant ones are bad.

This mindset has encouraged policymakers to push for nuclear and gas to be included in the EU's regulation through the concern that if these asset classes are not included in the taxonomy, investment will dry up.

Such energy sources have a role to play in the transition and may still need investment now. However, labelling them as the crème-de-la-crème among the green is clearly not the answer to this concern. The binary approach of the EU taxonomy, unlike the multi-tiered ASEAN approach, seems to have promoted such concerns.

On the other end of the scale are the investments which are impactful from an ESG perspective but for one reason or another may not fit the remit of the green taxonomy, for example, projects by multilateral development banks. Many of these projects fall outside the EU's green taxonomy because they take place outside of the EU where the data is not readily available and they do not see the same benefits that EU-based projects might see, such as exceptions for companies that are part of the EU's energy saving schemes.

If we take the green taxonomy as the 'be all and end all' of green and socially-good investments, the sustainable finance efforts will be shooting themselves in the foot.

This wouldn't be the first time that sustainable finance initiatives have been misused and warped to apply in a way they were not intended. The EU's Sustainable Finance Disclosure Regulation (SFDR) was intended as a disclosures framework but is now regularly used as a labelling device for asset managers to help sell a fund that complies with the Article eight or nine disclosure requirements. In the rush for ESG investments, it won't be a surprise if taxonomy is picked up with similar vigour.

Now the taxonomy has been used to help create the EU Green Bonds Standard and will likely be used as a guide more broadly, it's even more important that the industry and regulators view the taxonomy for what it is: a niche and data-backed list of the best practice of green investments. Nothing more, nothing less.

COVER STORY

Tackling green crime

The rise of environmental crimes in global regulatory agendas will come hand in hand with increased litigation

By **Thomas Helm**

The combination of stricter regulations and enforcement and more litigation will likely lead to a tightening of capital flows related to environmental crimes.

Major drivers include the 6th Anti-Money Laundering Directive (AMLD6), which is the first time an EU anti-money laundering law specifically targets environmental crime, and the Financial Action Task Force's (FATF) prioritisation of the subject. New due diligence laws, such as the EU's Due Diligence Directive, explicitly target environmental crimes, such as illegal deforestation, in the supply chains of large firms.

With initiatives such as the EU taxonomy, tighter ESG-related disclosures, and a more general regulatory emphasis on combatting greenwashing, firms have to be extra carefully about the ESG claims they make – or face legal consequences and even litigation.

The meteoric rise of carbon markets has also helped highlight the importance of protecting biodiversity-rich carbon sinks, such as the Amazon rainforest, in the fight against climate change and the fulfilment of net-zero ambitions. Regulators are now focused on standardising those markets to make sure the credits live up to their claims.

Never has environmental crime been so high on the regulatory agenda.

"The rapid introduction of laws that focus on environmental crimes are forcing the legal departments of financial institutions (FI) to sharpen their pencils," said Andrew Mitchell, founder of Global Canopy, one of Taskforce on Nature-related Financial Disclosure (TNFD)'s founding partner organisations and vice-chair of TNFD's stewardship council.

Anti-money laundering

AMLD6, which came into force last year, prohibits the importation of goods associated with deforestation and illegal fishing. These offences are also reportable under the revised FATF guidelines.

FATF is a global money laundering and terrorist financing watchdog with over 200 member states. Its main task is setting international standards and helping to generate the necessary

> ***"The rapid introduction of laws that focus on environmental crimes are forcing the legal departments of financial institutions to sharpen their pencils"***
>
> – Andrew Mitchell, founder of Global Canopy and vice-chair of TNFD's stewardship council

political will to bring about national legislative and regulatory reforms.

"About four or five years ago, we noticed that countries weren't following the money for environmental crimes," said Ailsa Hart, analyst at FATF. Since then, FATF has prioritised the issue, producing two global reports on how money related to environmental crimes is moving. Each report has specific risk indictors and recommendations for countries.

FATF then realised that jurisdictions lacked a common understanding of what constitutes an environmental crime. In October last year, the inter-governmental watchdog published a document that aimed to standardise the terms.

"This is a long-overlooked issue, but we're now starting to see some signs of progress, especially at the European level, with AMLD6's specific mentioning of environmental crimes," Hart continued. "Moreover, individual countries are changing their laws. For example, one large European country recently criminalised environmental crimes as predicates for money laundering. We're also seeing increasing risk assessments from European countries."

Meanwhile, both the G7 and the G20 have stepped up their efforts to bring environmental crime to the forefront of the global agenda, especially in the context of voluntary carbon markets and the fight against climate change, according to Hart. In the private sector, the United for Wildlife taskforce aims to strengthen the controls that monitor for capital flows related to wildlife trafficking and counts 50 global FIs among its signatories.

"These are massive steps that show an increased prioritisation of environmental crimes, when previously it wasn't a key issue at all," she added.

The FATF standards provide a toolkit that helps financial firms assess their financial flows across different kinds of environmental crime. Customer due diligence and transaction monitoring are areas that need special attention. When financial firms open a business relationship with a client, they need to be able to determine where the money comes from and whether the profile is suspicious.

One key compliance challenge involves identifying the ownership of land and other resources, especially in developing countries. This has led FATF to work with the broader global network of standard setters to strengthen record keeping practices.

"The main problem isn't a shortcoming in domestic laws but a lack of prioritisation given to the issue," Hart added. "For example, many countries have tended to think of environmental crime as another country's problem. That's also why the FATF has picked this up."

The momentum appears to be building. EMPACT (European Multidisciplinary Platform Against Criminal Threats), for example, has identified financial crimes and environmental crimes as a priority enforcement area for the next three years.

Loopholes in AML

Simon Zadek, chair for Finance for Biodiversity (F4B) Initiative, was less sanguine on the impact of anti-money laundering regulation.

"The AMLD6 won't have much of a real-world impact on nature crimes," he said. "This is mainly because the AML community is focused on catching criminals, not preventing crime or protecting nature." This means that other, less direct forms of profiteering from environmental crimes are able to continue without falling into the scope of the AML rules. It is the subject of F4B's recent report.

For example, an FI can still make a perfectly legal investment in a company that has benefited from an environmental crime, such as rearing cattle on illegally deforested land. "Although the FI may have perfect sight on the problem, unless illicit financial flows cross the FI's balance sheet, it does not become an AML event," he said. "In other words, an illegality in the financing value chain is completely disconnected from the AML mind-set. That's the big problem."

Global Witness's Deforestation Dividends report found that FIs made an estimated $1.74 billion in deforestation-adjusted proceeds from deals with some of the world's most harmful deforesters in the five years following the Paris Climate Agreement. The NGO estimates the total value of the deals with deforesters at $157 billion.

Closing the AML loophole would require changing the definitions of what constitutes money laundering. F4B's argument is that if an FI has increased risk-adjusted returns as a result in investing in a company that has profited from environmental crimes, then that should count as money laundering. "The illicit flow doesn't need to come through some other route," he said. "You're translating the proceeds of a crime into clean money called profit and that's money laundering."

Unfortunately, Zadek continued, the financial crime community tends to think that this solution is unworkable, even if many agree that the logic is sound. F4B's recommendation to the UK government states that it should be illegal for financial institutions to have nature crimes in their financing value chains. "That could be achieved through the development of a due diligence mechanism in the AML framework, either through AML rules or a standalone mechanism," he said. "Conflict diamonds or modern slavery, for example, have due diligence mechanisms that sit separately from AML. The important thing is to make financial institutions prove that their financing value chain is nature-crime free."

Currently, the likelihood of fixing the AML rules is small, since the process would be complex, slow-moving and require the co-ordination of diverse actors, according to Zadek. That means the option of the standalone mechanism could be the most preferable route.

"AMLD6 doesn't consider that profitability through nature crimes is money laundering," he said. "That's its biggest flaw."

To give a sense of the scale of the problem, Zadek pointed to the recent Blackrock scandal, in which the American giant was found to be among the shareholders of a palm oil company that had benefited from illegal deforestation in Liberia.

Under current AML rules, Blackrock's investment was perfectly legal. "Unless those who pulled down the forest put their money into a Blackrock bank account, Blackrock's not liable," said Zadek. "The only risk is if the palm oil company gets fined. But that figures as a credit risk, not a liability risk. And in Liberia, the truth is, they will be unlikely to be fined, and even if they were, it would be small change compared to their balance sheet. That means investment companies like Blackrock can decide there is effectively no risk, apart from the reputation risk."

The irony here is that Blackrock's chairman Larry Fink has made combatting climate change a focus for the $9.5 trillion of assets his firm manages.

In addition to the time-consuming nature of changing the rules, regulators are also concerned about serious pushback from the FIs themselves. Nevertheless, despite the current stasis, Zadek was confident that progress is on its way.

Reputational risk

The reputational risk for firms implicated in environmental crimes will also increase. This is especially true for financial firms complying with new sustainable financial disclosures regimes, which will increase transparency and place stricter criteria on what constitutes a sustainable business decision.

For example, the most significant consequence of the Blackrock case is reputational in nature, since the company has not broken any laws. Reputational risk could, however, be quite severe, especially for large investor like Blackrock, which has, under Larry Fink's auspices, attempted to position itself as an ESG leader.

Zadek said the "good guys" in the financial community will, at some point, want to join some form of voluntary initiative that will require them to have a mechanism in place to prove they are not benefiting from environmental crimes. "This will begin as a voluntary coalition," he said. "Then, over time, regulation will appear in one form or another."

ESG litigation is also expected to make waves. "We're at a moment in history where the outrageousness of FIs benefiting directly from environmental crimes not only makes good press, but will lead to litigation," he said. "In the same way we've seen litigation in relation to climate change, we will see litigation emerging around the links between FI activity and illegal deforestation and the degradation of nature. That wave of litigation is still to come."

"Although the FI may have perfect sight on the problem, unless illicit financial flows cross the FI's balance sheet, it does not become an AML event"

– Simon Zadek, chair for Finance for Biodiversity Initiative

Litigation

Litigation is likely to focus on a mixture of areas, including breaches in new supply chain due diligence legislation that is being rolled out across Europe, securities claims, and broader greenwashing claims in which firms are caught mis-selling products labelled as ESG-compliant "I expect to see a rise in biodiversity-related litigation going forward," said Alex Cooper, a lawyer at the Commonwealth Climate and Law Initiative, a charitable organisation which analyses companies and securities laws and sustainability risks. "The cases will be different to climate change ones, but likely to be similar in terms of the popularity and uptake."

Thanks to the Network for Greening the Financial System (NGFS), Dutch Central Bank, and World Economic Forum reports, Cooper said biodiversity risk has reached a level of awareness similar to that of climate change five years ago. More awareness, regulatory scrutiny, and biodiversity-focused legislation will ultimately result in more litigation.

"Increased regulatory scrutiny helps clarify what corporates and financial firms should consider a risk," he added. "If serious authorities are highlighting that biodiversity loss is a systemic risk, then that makes biodiversity a risk management and compliance issue, with potential consequences for breaches."

The on-going Casino case, which is currently being played out in France, is a good example of the kinds of cases that are likely to appear in the future. Aided by a coalition of NGOs, Amazonian groups allege that Casino failed to do adequate due diligence in its supply chain (which is required under French law), resulting in the sale of beef linked to deforestation and human rights abuses in the Amazon.

It is the first time a French supermarket chain has been taken to court over deforestation and the loss of land and livelihood under the 2017 law in France called Devoir de Vigilance (Duty of Care). The law holds companies accountable for human rights and environmental violations.

In addition to implementing Task Force on Climate-Related Financial Disclosures (TCFD), France has also made biodiversity

"ESG as an area is ripe for collective claims and class action"

– Nikolas Ireland, senior counsel at Macfarlanes

reporting compulsory, which shows how seriously the jurisdiction considers the impact of biodiversity loss.

Cooper also mentioned the possibility of biodiversity litigation being brought against governments. For example, five French NGOs have recently sued the French government for using a fertiliser that has had an impact on biodiversity.

While France is a frontrunner when it comes to ESG-related due diligence laws, the EU is following suit with its new Due Diligence Directive. Similarly, the UK's Environmental Act will make it illegal for larger businesses operating in the UK to use key forest risk commodities produced on land illegally occupied or used.

"Due to growing awareness and the new laws, supply chain litigation is an emerging area," Eleanor Reeves, an environmental focused partner at Ashurst said. "It is one of the next frontiers of ESG litigation."

Biodiversity and climate change differences

Sources said legislation to mitigate the risks associated with biodiversity loss will follow a similar path as climate change. For example, biodiversity is already mentioned in the International Sustainability Standards Board (ISSB) disclosure standards, and various EU directives, such as the Sustainable Finance Disclosure Regulation (SFDR), as well as the aforementioned due diligence laws. The key takeaway here is that firms are under increasing pressure to implement robust supply chain policies that monitor, manage, and disclose the related risks.

"Biodiversity loss tends to be a lot more localised than climate change, which means measuring and reporting it comes with an extra set of complications, especially considering the global nature of many supply chains," Commonwealth Climate and Law Initiative' Cooper said.

In addition to deforestation, other environment-related litigation could revolve around waste management and use of plastics, Cooper continued. For example, cases have recently been brought before the UK Advertising Standards to contest claims that plastic bottles are 100% recycled. A class action suit on a similar issue is being brought against Coca-Cola in the US.

"Similar strategies are being translated in different jurisdictions for different sustainability issues," Cooper added. "It means the whole field of ESG litigation, although broad, operates under similar principles."

Hopes of high returns

Adding to the dynamic is a healthy appetite for ESG litigation funding that has been growing in recent years, as various buyside firms look for profitable ways to enter the ESG space. Litigation typically carries high risks, but also high returns, and traditional funders tend to prefer cases whose defendants have deep pockets, according to the Macfarlanes litigation finance team.

That said, NGOs and charitable arms of litigation funds may also take on cases without any expectation of returns.

"Litigation and litigation funding are the pointy end of the enforcement spear," said Neil Purslow, chief investment officer at Therium, a litigation fund active in the ESG space. "It will be aimed at both corporates that break environmental laws and funds that turn out not to be as ESG-compliant as they claim."

Therium's litigation strategy often involves securities fraud, where it funds claims for stock drops resulting from a breach in ESG compliance. Such cases make use of already existing legislation that aims to protect investors against the inaccuracy of a firm's statements to the market.

"Such cases won't require new legislation," he added. "They will be based on existing corporate governance requirements being played out in the spirit of ESG."

Greenwashing is already high on the regulatory agenda – with for example the SEC's probe against Goldman Sachs' asset management division and Germany's recent raid on DWS – which means funds could also be targeted by civil lawsuits if they fail to deliver on their promises. As regulatory scrutiny increases, the lines as to what constitute acceptable behaviour in the eyes of the law will become even sharper.

Regarding specific environmental crimes, Purslow said the still nascent space is likely to follow a similar path as other forms of securities litigation. For example, Danske Bank became the subject of litigation after revelations that the bank was running a money laundering operation in Estonia. A similar situation could occur in the ESG space, albeit with environmental crimes as opposed to financial crimes being the focus of a legal breach that results in a stock drop.

From low enforcement to expensive litigation

The reality though is that fines meted out for environmental crimes had historically been low in the UK, Ashurst's Eleanor Reeves said. For example, water pollution fines rarely used to exceed a few thousand pounds, which some might say is hardly a sufficient deterrent for criminal activity. In 2015 new sentencing guidelines and case law said fines for very large organisations could reach up to 100% of a firm's profits. The change has helped hammer home to shareholders the regulatory message that corporate criminal damage to the environment is unacceptable.

That said, generally there has been a lack of enforcement action for environmental crimes in Europe. "In cases where there hasn't been any enforcement, it will be interesting to see whether civil claims will step in to fill the gap," she said.

"ESG as an area is ripe for collective claims and class action," said Nikolas Ireland, a senior counsel at Macfarlanes. "A large group in aggregate may translate as a large claim, thus creating a sufficiently strong economic incentive for the funder."

Malcolm Hitching, partner at Macfarlanes, stressed the strong appetite for ESG litigation, and especially climate litigation, among funders. However, he also said such cases may not always result in economic damages substantial enough to warrant their involvement.

"The claim might help change behaviours, and do a lot of good for society, but not result in economic gain," he said. "For more conventional funders to invest in cases, there has to be a significant economic incentive."

That said, some funders are looking closely at ESG litigation as part of an ESG strategy and are prepared to fund for little to no financial return, he continued. One fund with which the Macfarlanes litigation finance team works with has recently set up a separate charitable arm to enable it to work on low-return, ESG-related cases, a move that represents a growing interest in the space. "Many litigation funds and lawyers are focused on ways in which they can provide legal support for ESG cases," he added. "That trend is likely to continue, especially in the UK."

Thomas Helm
IFLR senior journalist

INTERVIEW
ESG

Q&A with Ashley Alder, IOSCO chair and CEO of Hong Kong SAR's SFC

Alder discusses with **Alice Tchernookova** about the ongoing efforts of global market regulators to address the risks presented by climate change and the rapid evolution of digital assets

Ashley Alder talked about global regulators' key priorities during this eventful time. He emphasises the importance of the effort by the new International Sustainability Standards Board (ISSB) to create a global baseline for corporate climate disclosures. This will be a major advance to improve transparency, help achieve net zero targets and address significant concerns about greenwashing in the financial industry. The second part of the interview features Alder's remarks on the regulation of crypto-assets and digital currencies.

What are IOSCO's main priorities and key areas of work for the coming year?

There are three major areas. First is sustainable finance, and specifically climate. This mainly relates to the ISSB and the role of the International Organization of Securities Commissions (IOSCO) in potentially endorsing the ISSB's new standards. The second area, which is accelerating fast, is crypto. And the third is about policies to address issues with non-bank financial intermediation—in other words, the financial sector outside traditional banking. That piece is complex, and we have been working on it together with the Financial Stability Board (FSB) since the March 2020 dash-for-cash episode, which exposed some vulnerabilities in the non-bank sector.

How has the Russian invasion of Ukraine and its consequences for the global economy shaped IOSCO's agenda?

A lot has been said about deglobalisation and reducing external dependencies, and there are other drivers towards more dependable supply chains. But when it comes to the movement of capital, the situation is less clear. More

importantly, when it comes to the community of regulators—both market regulators and central banks—the way we interact and cooperate has never been better. Our ability to work together to address cross-border, global issues is of a very high order.

By way of example, we held frequent calls after the invasion of Ukraine to discuss financial markets and the potential financial stability vulnerabilities that might arise. Everyone was contributing—which is partly because we all know each other well, across countries and organisations. The political fragmentation people claim to be seeing is not reflected in the way regulators have been cooperating.

You recently said this year would be "crunch year" for the ISSB and the evaluation of standards for endorsement by IOSCO. Can you expand on that?

The ISSB's exposure drafts were issued in March of this year. This is the first time the ISSB put out something which needs to be assessed by the financial community as a whole, and IOSCO's evaluation work continues. It is also crunch year in the sense that we always knew that the details of the standards, and implementation in particular, would be challenging and require a lot of work. At the same time, the US Securities and Exchange Commission is consulting on its proposals for corporate-level disclosures and the EU is also consulting on its own regulations.

What we obviously want to avoid is having three standards which are so different that disclosures are not comparable, and larger corporates operating cross-border would have to comply with three competing standards. We have made clear from an IOSCO perspective the need for the ISSB to operate as the global baseline which is sufficiently interoperable with the EU and the US approaches. That is essential, not least because the ISSB standards will be extremely important for emerging markets. We have to make sure this knits together to create an overall disclosure picture which is sufficiently comparable on a global basis.

There is also the question of implementation, which boils down to practicalities—including not just interoperability, but also data availability and proportionality. Climate disclosure depends on various categories of data being available and how the data is interpreted. Access to data is as important as the standards, which would be difficult to comply with if there is no existing data to inform the required disclosures. And an associated issue is proportionality. Smaller companies, in aggregate, may be significant in terms of climate impact and risk. What do they need to do? Is there a subset of standards or phase-in for them? These questions are equally important.

Implementation is always the hard part. That is what I meant by "crunch year". We are now looking at how the ISSB might provide implementation guidance to sit alongside the standards. This would be more about the "how" of the way in which corporates comply. And then IOSCO may consider guidance to our membership on how regulators could phase in the standards. These are all under discussion at the moment.

How do you tackle the issue of different jurisdictions progressing at different speeds when it comes to climate initiatives?

> ***"Asia accounts for 50% of global greenhouse gas emissions, but so far emerging economies in Asia have not developed proposals for climate disclosures which are close to those being pursued in Europe"***

Asia accounts for 50% of global greenhouse gas emissions, but so far emerging economies in Asia have not developed proposals for climate disclosures which are close to those being pursued in Europe. There is a great deal of willingness, but the question is to what extent can they look to a global baseline to accelerate the process. That is why the ISSB standards are important.

Corporate disclosure standards are critical for sustainable finance. Without them, it is very difficult for asset managers, banks and corporates to assess risks and fold climate issues into their strategies. As regulators, our position is that this information is certainly important in the context of net zero targets and transition: you cannot manage what you cannot measure. But in the broader context, our prime concern is about greenwashing. One of our major motives here is to make sure we have something similar to the traditional view, which is that you disclose what is material for investors and do not misrepresent your disclosures.

Finally, has there been much progress around a common ground taxonomy?

The second version of the International Platform on Sustainable Finance's common ground taxonomy was released in early June. Basically, it takes what is common between the Chinese and European taxonomies for environmentally sustainable activities, and works out how that can be used as a baseline for other jurisdictions. This initiative was the result of a conversation we kicked off in Hong Kong about three years ago, with the overarching aim that aligning taxonomies as much as possible would provide a starting point for other countries. Of course, each country's economy is different and may require modified taxonomies.

In part two of the interview, Alder provides an update on what global standard setters are doing to heighten regulatory oversight of crypto-assets and digital currencies.

Crypto regulation is a big subject at the moment. Can you expand a bit on some of the work that IOSCO has been doing on that?

Until about mid-last year, the view amongst regulators globally was that crypto activity was not sufficiently large in scale to pose a significant financial stability risk. The view now is that it still does not, but could end up doing so—particularly when we look at the growing connections between the crypto world and traditional finance. Secondly, given what we have seen, there is now a view that a regulatory approach to crypto is needed.

That is not to say we need a brand-new regulatory framework. If you unpack what crypto does, from individual crypto products through to crypto trading platforms, the way investors access crypto and how it intersects with the traditional financial sector in terms of advice and distribution, you see that fundamentally these activities are not that different from traditional financial services. Of course, some rules need to be adapted for crypto and there are regulatory perimeter issues which need to be addressed, but the overall approach is "same activities, same risk, same rules."

What are some other parts of IOSCO's work around crypto?

We are looking carefully at decentralised finance (DeFi) and recently published a diagnostic report with a view to reaching some policy conclusions sometime next year. We mainly consider this from an investor protection and market integrity point of view, but we also work closely with the Financial Stability Board, which looks at it more from a financial stability perspective, as well as other standard setters. Of course, there is an intersection between these different perspectives.

A good example is the work of IOSCO and the Committee on Payments and Market Infrastructures (CPMI), who jointly issued the Principles for Financial Market Infrastructures (PFMI), the post-financial crisis set of principles for clearing and payment systems. Last October, CPMI-IOSCO produced a consultative report looking at stablecoins through the lens of their payment function and systemic importance, and we are now heading toward publication of final guidance. This guidance should read across to non-systemically important stablecoins.

A key aspect is that there should be an identifiable and accountable human (or humans) with whom regulators can interact and who is able to intervene in the functioning of algorithms and smart contracts if necessary. DeFi claims that these humans are absent, which is not true. Defi is not as decentralised as people like to make out—and if it were, it would simply not comply with the PFMI. We are effectively going down the path where we apply our principles to ensure financial stability, market integrity and investor protection, and in the end the industry needs to adapt to that.

Do you believe that there should be a global effort to coordinate rules for crypto?

There are two "big Cs" at the moment—climate and crypto. In the climate world, numerous global initiatives and platforms are already well developed. There is the ISSB, the International Platform on Sustainable Finance, the G20 working group co-chaired by the US and China, and the FSB and its roadmap—among many others. There is a lot of activity, and the challenge is to coordinate it.

In contrast, that has not been the case in the crypto world, where there are no equivalents to the international climate platforms. What is starting to happen now in crypto, possibly a little bit late in the day, is the development of mechanisms to coordinate and develop policies—within IOSCO and the FSB in particular, but also within the Basel Committee. As I already mentioned, we are picking things up on stablecoins with CPMI. The degree to which we need to coordinate on crypto is very important and urgent, and it is happening.

There's a big scramble to find the most suitable way to regulate crypto – including in the US. Do you believe regulators are approaching this in the right way?

These are still early days. For some regulators, there is a remit issue and a question as to whether they need to extend their regulatory perimeter. To illustrate, in Hong Kong, we decided to approach this through two intersection points between regulators and the industry. The first is crypto platforms. The SFC's remit only covers platforms which trade securities, but not those that only trade more familiar cryptoassets such as Bitcoin. We are now going through the legislative process to extend our remit and require any platform which trades any type of cryptoasset to be licensed with us. The second intersection is traditional financial services firms, and for those we set out expected standards when they advise on and distribute cryptoassets.

There are a few missing pieces, of course. We are not yet directly regulating crypto issuers or custody services. The CPMI-IOSCO report on stablecoins is a bit agnostic as to how you do it, saying only that a stablecoin of this type needs to comply with these sorts of principles. From a regulatory perspective, that would intuitively drive us down the path of having a regulatory handle on the issuer of the asset and also the administrator.

Finally, can you tell us what has been keeping the SFC busy lately?

We spent a lot of time thinking about how to focus our efforts on the largest risks, which led to a major reset of how we conduct operations such as surveillance, enforcement, and supervision. These are now fundamentally risk-based. On the policy side, climate is a top priority, in particular corporate-level disclosure of climate risk and opportunities as well as expectations of asset managers. We will probably start looking at ESG ratings, too.

Overarching all of that is the fact that capital markets have had bouts of high volatility and there is a lot of uncertainty around COVID-19, supply chains, economic growth, commodities and the potential delisting of Chinese companies in the US. Our priority is to ensure that all the elements of the market that we supervise are sufficiently resilient to manage any future volatility. We stress test all the firms that we regulate and work closely with our local stock exchange around the way it manages its clearing and settlement system. This also extends to funds—particularly funds invested in illiquid assets—to stay on top of potential redemption pressures. Our job is to make sure that market functioning remains orderly, fair and with high integrity. That is the number one priority right now.

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BANKING & FINANCE
DIGITAL ASSETS

RFIA proposals introduce innovative digital asset regulation through ancillary assets

The Lummis-Gillibrand Responsible Financial Innovation Act has reset the discussion for the regulation of digital asset business in the US

On June 7 2022, US Senators Cynthia Lummis (R-WY) and Kirsten Gillibrand (D-NY) announced the anticipated introduction of the bipartisan Lummis-Gillibrand Responsible Financial Innovation Act (RFIA). If enacted in its current form, the RFIA will be the first comprehensive federal legislation to tackle the most significant issues arising at the intersection of traditional financial regulation and digital assets across all aspects of the regulatory spectrum, including tax, securities, commodities, banking, and consumer protection. Even though it is unlikely that the RFIA will become law in the current Congress (now winding down in anticipation of the US midterm elections in November), the bill nonetheless introduces a variety of innovative solutions to the issues affecting the digital asset and blockchain sectors that are likely here to stay.

Perhaps of greatest importance to transactional attorneys, the RFIA provides an answer to the most foundational question affecting clients in the digital asset space – When is activity involving digital assets governed by the federal securities laws and when do the federal commodities laws properly apply? To answer this question, the RFIA adopts a novel approach, addressing the concerns raised by the US Securities and Exchange Commission (SEC) by imposing disclosure obligations on companies that raise funds through the sale of digital assets, even where the funds were raised in private placement transactions.

The RFIA introduces a new term, "ancillary asset" and various additional related provisions to what would be a new Section 41 of the US Securities Exchange Act of 1934 (the Exchange Act) to create a disclosure regime tailored to the needs of users of digital assets. The term ancillary asset in the RFIA is used to describe a fungible intangible asset that is offered, sold or otherwise provided to a person in connection with the purchase and sale of an "investment

> ***"The RFIA adopts a novel approach, addressing the concerns raised by the SEC by imposing disclosure obligations on companies that raise funds through the sale of digital assets"***

contract" , but does not provide the holder of the asset with: (i) a debt or equity interest in that entity, (ii) a profit or revenue share derived from that entity, (iii) an entitlement to an interest or dividend payment from that entity, (iv) a profit or revenue share in that entity derived solely from the entrepreneurial or managerial efforts of others, or (v) any other financial interest in that entity.

Background

The purported applicability of the federal securities law to transactions involving digital assets has been the subject of extensive discussion among regulators, academicians, practitioners and entrepreneurs. Initially, much of this attention focused on the many transactions (often styled as "initial coin offerings" or "ICOs") in which newly minted digital assets were sold or otherwise distributed, usually to the general public, as part of the process of creating a new "decentralised" blockchain-based protocol.

For those seeking to create these decentralised projects, the use of a finite or provably scarce number of unique but fungible digital assets was essential to facilitating the economic incentives needed to drive engagement with the new platform. The alternative – fundraising for the development of the protocol through the sale of traditional equity in a company – would usually mean that the value of the network would be owned and controlled by the founding company seeking to recover value for its shareholders (the "web 2.0" business model), rather than by the network users themselves (the hallmark of "web3"). However, when the solicitation of funds in exchange for digital assets was made to the general public without any registration or disclosure, it was quickly recognised that the supposedly commercial sale transaction was in "economic reality" more akin to a securities transaction and should, in the US at least, be treated as an "investment contract" – best understood as a constructive securities offering.

Without either regulatory or market-based constraints, the ICO market based around frothy (often fraudulent) sales of new digital assets imploded. Along the way, though, an examination of the legal nature of the digital assets, as separate from the fundraising transactions pursuant to which they were sold or distributed, was blurred or lost entirely. Instead, many regulators and other commentators asserted that "most" digital assets were themselves securities simply due to having been sold in a securities transaction. Project developers responded by ensuring that any fundraising was done in compliant "private placement" transactions. However, this left a cloud hanging over third-party users of the digital assets – persons who were many steps removed from the original investment contract transaction. Were these users, investors and dealers involved in securities transactions solely by virtue of engaging with the assets?

It is broadly recognised that most digital assets themselves do not fall within any of the main categories of assets enumerated in the definition of "security" in the US Securities Act of 1933 (Securities Act), focusing the analysis on the catch-all provision in the definition – "investment contract". In elucidating the meaning this otherwise undefined term, the U.S. Supreme Court in the seminal case of SEC v. W.J. Howey Co., 328 U.S. 293 (1946) found that an investment contract had to involve a contract, transaction, or scheme, placing the focus squarely on whether a given transaction would be considered a "securities" transaction (not on whether an asset would be a type of "security"). A longitudinal review we conducted across all 259 federal appellate and Supreme Court decisions following Howey confirms that the judicial focus is inevitably on transactions potentially triggering securities law compliance, not on the assets being sold (which have not otherwise been themselves considered "securities" solely by virtue of having been sold as part of an investment contract transaction).

The distinction between "transactions" and "assets" in this context would however be largely academic unless the assets sold in an investment contract transaction retained value and were transferred among persons not related to the original investment contract transaction (as is often the case with digital assets). With an apparent impasse among different regulatory bodies and with market participants, the climate for cooperation in the US has deteriorated in the last 12 months, with increasingly

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entrenched positions on all sides of the question of where and when securities laws should apply to secondary transactions in fungible digital assets. It is this issue that the RFIA seeks to address.

Towards codification – ancillary assets

The concept of "ancillary assets" in the RFIA allows statutory law to align better with existing Howey jurisprudence by providing a clear way of distinguishing between assets sold investment contract transactions which are not otherwise "securities", and the transactions by which these assets are sold, which sometimes are. Focusing specifically on digital assets, the large majority of these assets currently in the market will likely be considered "ancillary assets" under the RFIA, since very few of these assets provide the holder with equity or debt-like rights in a separate "business entity" – they simply allow for instructions to be given to a network of computers.

To resolve the status of these assets, the new Section 41 of the Exchange Act introduces a presumption that ancillary assets as so defined are not "securities". For a seller of ancillary assets (and certain of its affiliates) this presumption is conditional – for those persons to benefit from it, the seller must be in compliance with the above-mentioned tailored disclosure requirements, to the extent that they are applicable. On the other hand, persons simply using the relevant assets and not otherwise affiliated with the asset seller are provided with an unconditional presumption that the ancillary asset is not a "security", promoting liquidity but also bringing these assets within the newly expanded jurisdiction of the US Commodities Futures Trading Commission (CFTC), which is given jurisdiction over spot markets in fungible digital assets. With a tough federal regulator (CFTC) now in charge of secondary markets in most digital assets and the SEC charged with overseeing the disclosure regime applicable to sellers of digital assets, the RFIA balances the competing policy concerns in a way that provides much enhanced protections to the market while allowing offering technologists seeking to build new projects in the US a viable path forward.

At the same time, the RFIA recognises that there is a broad design space available when digital assets are created. Where a digital asset does create (or at least purports to create) actual legal rights that can be enforced in a traditional judicial proceeding (as would be the case with equity or debt rights), then the parties would need to carefully consider whether a "security" had been created. This determination is left to existing Howey and related jurisprudence.

In addition, far from being blind to the real concerns associated with the information asymmetries that can arise between entities that create and deploy digital assets and subsequent digital asset owners, the RFIA imposes new disclosure obligations on the companies that fundraise through the "investment contract" sales of ancillary assets – even where the deemed securities offering was validly conducted as a private placement.

In this respect, if a company with jurisdictional ties to the US offers, sells, or otherwise executes investment contract transactions that provide their counterparty with an "ancillary asset", that company will be subject to the periodic disclosure requirements targeted at the asset sold and the involvement of the seller beginning on the date that is 180 days after the first date on which the investment contract is offered, sold, or otherwise provided by the company. However, the disclosure is conditional upon there being an active trading market for the asset and the seller (or certain affiliated entities) remaining the driving force in determining the value of the relevant assets. Said differently, the disclosure obligations under the RFIA continue until the project to which the relevant assets relate is "sufficiently decentralised". Every six months this is tested again and when the seller entities are no longer actively involved, the requirement for them to provide disclosure to the market ceases.

One online observer noted that the RFIA "elegantly deals with requiring the disclosures necessary for consumer protection, without taking the untenable position that tokens themselves are securities". We tend to agree. By distinguishing between the contract, transaction, or scheme, and the digital asset sold, the RFIA correctly seeks to codify existing jurisprudence while balancing the real need to protect consumers through disclosure. This novel solution to a very real and expensive problem, both for companies and consumers, represents the very best of legislative thought – and we look forward to seeing its principles permeate throughout the regulatory community as the RFIA itself begins the process of becoming law.

Lewis Cohen
co-founder at DLx Law

Freeman Lewin
attorney at DLx Law

Initial litigation token offering: a look at the digitised future of litigation funding

Julien Chaisse of **City University Hong Kong** discusses how tokenisation will revolutionise litigation and where its risks lie

An initial litigation offering (ILO) is a blockchain-enabled payment offering used to fund individual litigation. This financial product is available under Regulation Crowdfunding in the US, and practically all investors, regardless of accreditation status, are eligible to participate, as long as they are over 18 years old. In civil disputes when a plaintiff or a plaintiff's counsel wishes to raise funds to lessen the financial demands of litigation, ILOs tokenise the funding required to pursue litigation. Investors in an ILO will receive a token in the amount of their investment, with one token often equaling one US dollar.

If the action is finally successful, investors will get a multiplier based on the number of tokens they own and the length of time it takes to resolve the dispute. However, ILOs have historically had drawbacks. Due to the hefty legal costs, it is only available to wealthy investors and high-net-worth institutions. This makes it impossible for regular investors to invest in lawsuits. Furthermore, ILOs necessitate a multi-year capital commitment. This is why investors who want to generate money quickly become discouraged.

Simply defined, ILOs function as a form of litigation investment. It serves as a new financial approach in which investors risk their money in exchange for a profit. The investor becomes a third-party financier for persons who cannot afford to pay their legal fees and receives a portion of the financial outcome depending on how the process proceeds, comparable to IPOs.

Third-party funding on the rise

With escalating arbitration costs and corporate legal budgets being cut, it's no surprise that demand for third-party funding (TPF) has skyrocketed in recent years. Furthermore, as access to justice improves, businesses are less hesitant to pursue valid claims while still need financial flow to conduct

"With escalating arbitration costs and corporate legal budgets being cut, it's no surprise that demand for third-party funding has skyrocketed in recent years"

their operations and manage risks. Individual citizens are also becoming more interested in the idea of filing a case on a "no-win, no-fee" basis.

To put it another way, TPF is not only for people who are financially poor. As a result of the rising demand for TPF, a flurry of new funders have entered the global litigation finance market, demonstrating the industry's rapid expansion, which is expected to continue with tokenisation. With arbitration costs rising and business legal budgets shrinking, it's no wonder that demand for TPF has risen in recent years. Furthermore, as access to justice increases, businesses are less hesitant to pursue legitimate claims while still need money flow to operate and manage risks. Individual citizens are also getting more interested in the concept of bringing a "no-win, no-fee" case.

TPF has also received significant recognition, notably in international arbitration, and its participation is mandatory. As a result, governments should view donors as partners rather than adversaries. Furthermore, institutions should evaluate whether proposals to control TPF through national legislation or investment arbitration are based on sound information and a commitment to fair and balanced procedures - or are motivated by a desire to gain an unfair advantage and discourage or prohibit parties from enforcing their rights.

TPF's success has been primarily due to its ability to widen access to justice, i.e., by allowing lawsuits that would otherwise have gone dormant to be initiated or maintained.

How tokenisation works

Tokenisation serves three purposes: it promotes the acquisition of funds by issuers, the acquisition of investments by investors, and the fractionalization of assets. A tokenised litigation finance fund would not have the same operational overhead as a regular pool, allowing investors to focus their contributions more narrowly on legal case funding. Furthermore, a tokenised fund would spread the risk of supporting failure situations, allowing investors to profit from overall gains rather than losses due to poor performance. Furthermore, by developing a token that is freely available and tradeable on exchanges, more people will be able to participate in this lucrative asset class without continually verifying their credentials as an approved investor.

When considering TPF, legal experts usually debate active versus passive TPF. A passive TPF pool is one in which participants 'merely donate money,' but an active TPF pool is one in which investors also provide ideas to assist in the safeguarding of their own assets and increasing the pools' overall success. In practice, active TPF pool investors can vote on litigation settlement, appeal, or withdrawal.

However, with the advent of tokenisation, there is a significant opportunity to operate active TPF pools more efficiently, i.e., security tokens can easily be embedded with voting rights, and thus decision making can operate in a far more straightforward and in real time. Tokenisation is the next boon for TPF is because it investigates the role of trustworthy third-party authority in decentralised networks as link builders between the on- and off-chain worlds, as well as the need for a tokenised form of central bank digital currency or stablecoin for the payment leg of security settlements on distributed ledger technology-based trading platforms.

Risks to consider

Tokenising TPF carries with it a moral hazard. For starters, security token issuers have a motivation to skew signals of venture quality to their advantage. There is currently no method for an investor to determine the quality of the underlying assets in tokenised TPF pools. This means that the average investor cannot distinguish between high-quality and rogue funds. Secondly, the tokenisation of $20 billion (and probably much more) risks raising the uncertainty and volatility of global capital markets.

More importantly, there are still gaps in the regulation of security tokens in the primary jurisdictions where securities token offerings take place. While differences in token and platform standards allow a competitive economy to thrive, they also increase uncertainty, especially for TPF pools wishing to tokenise in a straightforward manner. Dispute resolution is a problem in the context of security tokens, and one solution that has been explored is to embed dispute resolution instructions in the smart contract at the time of token acquisition. This will circumvent questions of jurisdiction and the existing dispute resolution system's technological capabilities.

Julien Chaisse
Professor of Law at
City University of Hong Kong
and president at the
Asia Pacific FDI Network

CAPITAL MARKETS
DEBT

Lender-on-lender violence: a European perspective

Ropes & Gray lawyers discuss liability management techniques typically used in the US and whether they could be applied in the European market

What is lender-on-lender violence?

Lender-on-lender violence refers to a type of liability management transaction through which a company gives an advantage to a subset of its creditors at the expense of another subset. These transactions are often referred to as "priming" deals, whereby a participating subset of creditors will, post-execution, have some form of priority ranking in relation to the non-participating creditors.

In recent years, variations of these transactions have been relatively commonplace in the US market, but we are yet to see the relevant techniques widely used in Europe. As we will discuss, such deals are more challenging in the European market, but are not impossible. Given the increasing global macroeconomic pressures due to, amongst other things, supply chain disruption, high levels of inflation, increasing interest rates and geopolitical instability, we expect distressed European companies without easy access to vanilla refinancing options to consider the viability of these techniques over the coming months.

Dropdown transactions

A well-known technique is the dropdown or "J-Crew" transaction (eponymous with that company's 2017 liability management deal). A dropdown transaction involves the transfer of previously encumbered assets outside the restricted group to an unrestricted subsidiary that is not subject to the restrictive covenants in the existing credit documents without equivalent (or any) value being received for such transfer, a release of any liens or guarantees relating to such assets, and the subsequent raising of new financing secured against those assets. This can be effected by aggregating express permissions for investments, restricted payments or unrestricted subsidiary baskets or using loopholes in the documents (including the relatively uncommon "J-Crew trap door", consisting of: (i) an investment basket allowing loan parties to invest in non-loan

> *"Dropdown transactions and uptiering transactions have been successfully implemented in the US, although these have been the subject of extensive litigation"*

party restricted subsidiaries; and (ii) an investment basket allowing a non-loan party restricted subsidiary to invest in an unrestricted subsidiary using the proceeds from other permitted investments).

Importantly, sizeable restricted payment, investment and unrestricted subsidiary permissions and baskets are often already included in the existing credit documents and, where they are, no creditor consent is typically needed to effect a transaction in reliance on such provisions. Instead, the debtor would work with a subset of existing creditors or a new creditor, and offer them the opportunity (not open to other creditors) to participate in the new secured financing outside the restricted group. Aside from J-Crew, other notable examples were effected by Neiman Marcus in 2017, Petsmart/Chewy in 2018 and Envision Healthcare in 2022.

In light of such dropdown transactions, creditors entering into new credit documents now often seek protection from such transactions at the outset, such as by prohibiting the transfer of material intellectual property or other valuable assets to an unrestricted subsidiary. However, this provision is still subject to extensive negotiation and far from universally accepted.

Uptiering transactions

In an uptiering transaction, participating creditors exchange existing debt (typically at a premium to the trading price but at a discount to the par value) for debt in a new, super senior instrument. Participating creditors must constitute a group large enough to reach the thresholds required to provide any consents necessary to effect the transaction. Notable examples (in the US market) include Serta Simmons, Boardriders and Trimark, each in 2020, and Wesco Aircraft/Incora in 2022.

An uptiering transaction is characterised by:

a) Majority consent: majority consent may be needed for new super senior debt. A group of participating creditors constituting a majority under the existing credit documents will form and consent to amendments to terms to permit the creation of a new super senior debt instrument in the capital structure, on the condition that they then participate in the new super senior instrument (this is sometimes known as an "exit consent"). Some transactions might go further and use exit consents to remove certain protections from the existing credit documents to the detriment of non-participating creditors (i.e., covenant strip), although such an aggressive approach is unlikely to be required unless the debtor is looking to maximise participation.
b) Open market repurchase provisions: the debtor will make use of open market repurchase provisions under the existing credit documents to repurchase the debt of the participating creditors on a non-pro rata basis, in consideration for a participation in the new super senior instrument.

Could these controversial structures be brought to Europe?

Dropdown transactions and uptiering transactions have been successfully implemented in the US, although these have been the subject of extensive litigation. The key differences between the US and European markets that impact the ability of debtors in Europe to implement dropdown and uptiering transactions are: (i) less flexible credit documentation; and (ii) for uptiering transactions, unfavourable case law that casts doubt on the ability to make use of aggressive exit consents in English law credit documents. The feasibility in each case is considered below with respect to English law credit agreements versus European-issued New York law high yield bonds.

Dropdown transactions

The ability to implement a dropdown transaction in Europe will depend on the permissions in the relevant credit documents in each case. A dropdown transaction can be structured based on the relevant permitted investment baskets, restricted payment baskets or asset disposal baskets and, if the basket capacity is sufficient, then no additional consent is required to implement the dropdown transaction. If amendments to documentation are required, and only certain creditors are to be offered the chance to participate in the new instrument, then some of the concerns described below in relation to the seeking of consents will apply.

Uptiering transactions

Majority consent for the new super senior debt

a) English law credit agreements: It may be possible to amend the relevant documents to permit super senior debt with majority consent. To the extent that consent is needed, English case law has held that consent payments for supporting creditors are permissible (*Azevedo & Anor v Imcopa Importacao, Exportacao E Indústria De Oleos Ltd & Ors* [2013] EWCA Civ 364), provided that the offer is open to all creditors equally. However, English case law may make an exit consent transaction relating to an English law credit agreement challenging. *Assenagon Asset Management S.A. v. Irish Bank Resolution Corporation Limited* (2012) held that the use of an exit consent was an abuse of power, as the power to approve the exit consents was not exercised in the best interests of the class of creditors as a whole and did not benefit the creditors as a class. Given the decision in *Assenagon*, the purpose and effect of a proposed exit consent under English law would need to be considered very carefully, as would the treatment of creditors as a class.

b) European-issued New York law high yield bonds: It may be possible to amend the relevant documents to permit super senior debt with majority consent. Unlike with respect to English law credit agreements, the use of exit consents is well established. European-issued New York law high yield bonds sometimes contain a "payments for consent" covenant that requires the same consideration to be offered and paid to all holders that consent to an amendment, although this creditor protection has suffered significant erosion in recent years. However, indentures that include the "payments for consent" provision may restrict the ability to pay consideration for consent to only certain holders without making the offer available to all holders who consent on the same terms, subject to limited exceptions. This could prevent a transaction that offers an exchange of existing debt for a new super senior instrument to only a subset of holders in "consideration" for the participating holders providing the relevant consents.

c) Intercreditor agreements: The consent thresholds for amending the ranking or subordination provisions in an intercreditor agreement are generally agreed in the underlying credit documents and will typically be one hundred per cent. under a credit agreement, as opposed to a bond indenture, where the relevant threshold is more likely to be majority consent. As a result, in a capital structure with credit facilities (whether a revolving facility or a term loan), an uptiering transaction will usually be very difficult to execute. In certain cases, the intercreditor agreement may itself require all adversely affected lender consent to amend the ranking or subordination provisions. However, some credit documents and intercreditor agreements do allow such amendments to be made with a lower voting threshold, and some documents include a "hollow" super senior tranche built into the intercreditor agreement that could be used, in which case an uptiering transaction may be permitted under the terms of the existing documents.

Open market repurchase provisions

d) English law credit agreement: Debt repurchase provisions tend to require an opportunity for all lenders to participate, and a requirement to accept offers in inverse order of the prices offered (with the offer or offers at the lowest price being accepted first) and if there are two or more offers at the same price they can only be accepted on a pro rata basis (without exceptions for "open market repurchases" in advance of such a process), although such requirements could potentially be amended with majority or supermajority consent.

e) European-issued New York law high yield bond: Most bonds of this type will permit debt repurchases through a private exchange with a subset of bondholders. However, such a private exchange will need to be structured to avoid being deemed a "creeping tender offer" under US tender offer rules, which introduce certain procedural protections for bondholders (such as a minimum tender offer period). The relevant listing exchange may also have "equal treatment" or analogous rules, which would also need to be taken into account when structuring a private exchange.

What strategies can investors employ to gain an advantage?

There are several strategies that investors can employ to improve their likelihood of having an influence on any liability management transaction. These include:

a) engaging in dialogue with all stakeholders and maintaining close contact with the debtor, the sponsor and other creditors;
b) conducting thorough documentary due diligence as early as possible to understand the ability to implement such liability management transactions under the credit documentation;
c) acquiring cross-holdings, which provide the benefit of a seat at multiple tables, making it easier to keep abreast of the dynamics between creditors in different parts of the capital structure; and
d) building up a substantial position, as investors with a significant stake in the debt are more likely to be included early in discussions relating to potential liability management transactions and to be part of the critical majority needed to effect such a transaction.

What are the alternatives?

Each situation is different, and the options available will vary depending on the terms of the existing credit documentation, stakeholder dynamics and the holdings and/or cross-holdings of specific investors.

The closest alternative to a US-style uptiering transaction in the European context would be a bilateral elevation. To allow for such a transaction, the existing credit documents would need to include:

a) the ability to carry out open market repurchases on a non-pro rata basis; and
b) appropriate debt and security capacity (or ability to extract value into a joint venture or an unrestricted subsidiary) under the existing credit documentation.

If this flexibility is included in the existing credit documents, the debtor may effect a transaction whereby it repurchases debt from participating lenders or bondholders (typically at a premium to the trading price) in consideration for participation in a new debt instrument, often with its own security package.

Participation in such a transaction could be made contingent on providing new money to the debtor, and it could be sweetened by issuance of an equity-like instrument to participating investors.

Another alternative to differentiating between lenders within the same class is through the use of a "structural adjustment" or "facility change" clause. Such clauses can allow lenders to be moved into a separate facility within the same credit agreement with different terms and economics.

With thanks to Alex Robb, partner at Ropes & Gray and Natalie Raine, associate at Ropes & Gray for their input

Matthew Czyzyk
Partner, Ropes & Gray

Aditya Khanna
Partner, Ropes & Gray

Natalie Blanc
Associate, Ropes & Gray

CAPITAL MARKETS
DEBT

The GMRA: past, present, and future

Mushtaq Kapasi of **International Capital Market Association**
discusses the history of the Global Master Repurchase Agreement and its transformation for the digital age

The repo market is the circulatory system of modern financial markets — the unsung yet indispensable plumbing that channels liquidity, illuminates prices, and allocates collateral and risk across the global system.

Repos are traded every day on a huge scale — with daily turnover estimated at over $2.3 trillion. The repo market is the main way that banks and other financial institutions borrow and lend cash to each other for short periods of time. Repo is also a key monetary policy tool for central banks, who extensively lend cash to other financial institutions through repo. This allows central banks to control interest rates more effectively in the market, while managing their credit risk through the collateral they take.

Transactions in the international repo market are governed by the Global Master Repurchase Agreement (GMRA), which is managed by the International Capital Markets Association (ICMA) and supported by legal opinions relating to its enforceability in nearly 70 jurisdictions. The GMRA is the market standard bilateral umbrella agreement governing multiple transactions between two parties.

First published in 1992, the GMRA has been revised and enhanced with updated versions in 1995, 2000 and 2011.

This year marks 30 years since the first publication of the GMRA, which is established as the foremost agreement for documenting cross border repos. This article looks at the context in which the GMRA was created, and its salient and unique features that have permitted a robust international repo market to develop.

The history

As recalled by Habib Motani of Clifford Chance, one of the original chief architects of the GMRA, its genesis dates back to the UK financial reforms of the late 1980s and the flourishing of a new repo market in London. In these years, investment banking activity in London mushroomed and the city welcomed the presence of increasing numbers of non-UK banks and securities firms. Many of them were US firms already familiar with the repoing of securities as a tool for accessing liquidity in the US. As these firms grew in Europe, they sought to use that tool on the continent as well.

The use of securities as collateral to support liquidity was certainly not unknown at that time in Europe. But in a period that preceded the Single European Market, the laws and financial market infrastructures relating to the use of securities as collateral were fragmented across the various European countries. As a result, repurchase transactions were frequently structured as buy/sell back transactions. These were relatively simple in operation, but largely undocumented. So, they lacked the certainty that documentation provides, including a cross transactional mechanism to address counterparty default and the protections afforded by provisions for marking to market of collateral.

At the same time, bank regulators were focusing on formulating standards for bank credit risk management and supporting regulatory capital through the Basel Capital Accord (Basel 1), and its successors. Crucially, as the bank regulators continued to refine their approach to the measurement of credit risk and the associated capital adequacy requirements in the early 1990s, they came to accept the relevance and benefits of netting.

Standardisation of documentation

The institutions seeking to promote the use of repos in the European markets at that time were familiar with the standard used for repos in the US government bond market, the Master Repurchase Agreement (MRA) published by the Public Securities Association (PSA). In the absence of a standard European repo document, these institutions developed their own house documentation, generally based on the MRA but customised. Their counterparties were therefore faced with individual, customised repo agreements that they were not familiar with and required individual review, a costly exercise, which some counterparties were reluctant to undertake. Parties were used to the simpler undocumented buy/sell back structure. Additionally, these MRA-based documents often contained provisions taken from the MRA which, although appropriate in the US markets, did not transpose easily into the European context.

The more active institutions saw the need for greater consistency, and turned to the PSA and to ISMA, a predecessor to ICMA, to create a standard repo document which could readily be used across borders in multiple European jurisdictions, would facilitate counterparty review, give counterparties the confidence that a market standard document brings, and facilitate dealings among the most active institutions themselves. All of these factors ultimately led to the development of the GMRA.

Title transfer

Many of the provisions in the GMRA reflected the content of the MRA. However, the marking to market structure, the collateralisation mechanism embedded in the agreement, did not always sit comfortably with European collateral laws when used in cross-border transactions. This was solved with *a transfer of title* collateralisation structure. This is a structure where title both to the repoed securities and to collateral securities is transferred, and the right of the original transferor is to receive back equivalent securities or assets. By itself, this does not close the collateralisation circle, but when coupled with a close-out netting mechanism in the event of a default, the economic outcome is as effective as other collateralisation mechanisms. The close-out mechanism involves establishing the values of the repoed securities and collateral, aggregating the repurchase prices payable and any outstanding amounts and combining all these into one overall net figure.

Extensions of the GMRA

The market standard GMRA was drafted with fixed income securities in mind, primarily for transactions involving G10 government bonds and other liquid debt securities. However, the architecture of the GMRA allows it to be adapted through annexes incorporating additional provisions required to cover other types of securities and country or counterparty type specific

"But in a period that preceded the Single European Market, the laws and financial market infrastructures relating to the use of securities as collateral were fragmented across the various European countries"

"Over time, the positive benefits for national financial markets of effective close-out netting, particularly in facilitating access to liquidity, have come to be appreciated in these countries"

requirements. Indeed, ICMA has continually adapted the GMRA by developing annexes which extend the securities, countries and counterparties with which the GMRA can be used, thus expanding its usability.

Netting

At the time the GMRA was being developed, the notion of collateralisation through transfer of title was regarded with caution in some jurisdictions, often being perceived as a device to circumvent security interest laws.

Over time, the positive benefits for national financial markets of effective close-out netting, particularly in facilitating access to liquidity, have come to be appreciated in these countries. Many years of insolvency law reforms in these and other countries has meant that today the collateralisation mechanism and the close-out mechanism of the GMRA are widely accepted across the world.

The practical way in which effectiveness of the collateralisation and close-out mechanism is verified is through the obtaining of legal opinions confirming the legal position for the relevant jurisdiction. ICMA now has an extensive library of legal opinions addressing the enforceability of the agreement, reflecting again the substantial work that has gone into promoting law reforms in many of these countries and now supporting cross-border repo transactions across the world.

Regulatory capital

Around the time the GMRA was being developed, the bank regulators were getting to grips with close-out netting and the contribution it makes to reducing credit exposures and managing the regulatory capital required to support those exposures. Fortunately, these contributions came to be appreciated by the regulators who from the early 1990s began to accept reductions in regulatory capital requirements based on the availability of close-out netting. However, the regulators set out specific criteria to be satisfied before netting could be applied in a regulatory capital calculation: mainly, the use of a binding written agreement between the parties such as the GMRA and verification of the effectiveness of the close-out netting through confirmatory legal opinions.

The future

Both the GMRA and ICMA have now served the market for three decades, not simply in managing credit risks and regulatory capital but in continuing to develop the GMRA as a robust standard cross-border contract for accessing liquidity, a robustness that has been tested in a number of court cases over 30 years. Looking ahead, ICMA will, alongside market participants, continue to adapt the GMRA to the needs of the market and prepare the agreement for use in the digital age.

With this goal in mind, the Common Domain Model (CDM), a digital standard for trade processing, is being developed to effectively enable IT systems across the market to speak the same language as each other. Originally developed by ISDA for the derivatives market, ICMA has extended the use of the CDM to repos and bonds.

CDM seeks to facilitate the translation of existing messaging protocols and data standards used at different stages of the lifecycle and to consolidate the transaction data into a single view, providing the connecting tissue between different applications.

ICMA has also launched a GMRA Clause Taxonomy and Library Project. The ultimate aim of the project is to build an industry-wide classification of the most commonly accepted provisions in actual GMRAs used in today's market. Once in place, the clause library will help both to reduce legal risk and to digitise processes that have been largely analogue up to now.

The GMRA Clause Library together with the CDM can be transformative beyond simply improving efficiencies in repo trades. It can be part of digital automation strategy for existing players, clear the way for new counterparties to join the international market, and remove barriers to development in emerging or frontier markets.

For this article ICMA acknowledges the substantial contributions of Habib Motani, consultant at Clifford Chance, where he was previously a partner and global head of its derivatives group. Motani led the Clifford Chance team that drafted the GMRA in 1992 and has been involved in the development of the agreement since then, including holding the pen on the GMRA 2011.

Mushtaq Kapasi
Managing director and chief representative for Asia-Pacific, ICMA

CORPORATE

RESTRUCTURING & INSOLVENCY

Garuda Indonesia restructuring stands on shaky grounds

Dan Margulies and Dirk Behnsen of Dechert discusses the troubled airline's restructuring history and how its latest approved restructuring proposal could face obstacles

The airline industry: volatile, complicated and a difficult space for investors in any corner of the world. It is therefore unsurprising that Garuda Indonesia, the Indonesian national airline, has experienced the full range of market ups and downs since its first flight in 1949. Though the firm originally enjoyed a monopoly on the Indonesian market, its fortunes turned when the national government opened up the sector to rival domestic airlines, changing the market landscape dramatically and launching what would become a long, bumpy trajectory of woes leading to the present day.

Two-thirds of Garuda Indonesia is owned by the Indonesian government, categorising the airline as a state-owned enterprise (*Badan Usaha Milik Negara*). The airline remains exposed to market forces despite government ownership and has weathered countless commercial and legal challenges over the years, from high aircraft leasing and fuel costs to recent corruption investigations. Garuda has attempted to implement a variety of solutions to its liquidity troubles — the airline is currently in the middle of its third financial restructuring in as many decades. Despite these efforts, Garuda's list of problems has only grown longer and the issues it faces more complex.

1998-2001: first restructuring required

After more than half a decade in operation, by the end of the last millennium Garuda was battered by competitor airlines and was experiencing severe operational issues. Its first restructuring saw the company seek domestic government support via the conversion of government-held debt into equity, a voluntary agreement with certain creditors to term-out the maturity of their indebtedness and the implementation of schemes of arrangement in both England and Singapore.

This occurred before the 2004 implementation of the *Penundaan Kewajiban Pembayaran Utang* (PKPU), a now well-known restructuring mechanism for bankruptcy and suspension of debt payment obligations obtainable in the Indonesian commercial courts. As such, Garuda looked outside of Indonesia for adequate relief. Contractual and commercial touch points in multiple jurisdictions meant the airline could avail itself to mechanisms available in other relevant legal systems, such as a scheme of arrangement under English law. Despite having what might be considered a tenuous connection with England, Garuda found reprieve in the English courts with the express approval of the judges who described the case before them as a "rational commercial decision".

The judges noted that "of course, one would normally expect a corporate entity to look first to the law of the place of its incorporation" – Indonesia, in this case. Despite this, they seemed willing and able to help where they could establish their jurisdiction over the matter and, for all intents and purposes, fill a gap in law in another legal system where that system would have left a complainant's debts unmet.

A combination of domestic government support and recourse to another jurisdiction had helped save the day. The UK scheme of arrangement was successful.

2005-2010 – round two

This happy ending was unfortunately short-lived. With the global financial crisis (GFC) brewing in the background, the company defaulted on scheduled loan repayments, and despite vested interest in the financial well-being of the company, the Indonesian government was not willing to provide further assistance.

By 2010, Garuda had managed to decrease its indebtedness by 45% through a combination of payments, debt buybacks and equity conversions. After an intense five years of negotiations with export credit agencies and more than 20 commercial creditors, and despite the GFC being in full swing, Garuda was still able to conclude a $500 million debt restructuring, clearing the way for a long-awaited and much delayed initial public offering in Indonesia followed by a listing on the Indonesian Stock Exchange in 2011.

The airline once on life support had not only been revived but elevated by an IPO without needing a bailout from the Indonesian government.

After its listing on the Indonesian Stock Exchange, Garuda briefly experienced a few successful years. It made headlines as the first non-sovereign US-dollar-denominated Indonesian sukuk issuer, an issuance which attracted so much attention that it was oversubscribed four times over — despite the airline offering no credit rating nor no credit guarantee, nor was there any guarantee from the Indonesian government. By 2017, however, the company was hit by a raft of issues from corruption investigations to a steep increase in fuel prices hit the industry, forcing it to negotiate with creditors under the once-successful sukuk. By 2019, the good news of earning a net profit was drowned out by cash-flow issues, a failed fundraising attempt via a second sukuk issuance and the spectre of Covid-19 looming large over global travel.

"Questions surrounding the interplay of competent jurisdictions in cross-border restructurings once again came to the fore"

PKPU in 2021: once more unto the breach

While Garuda's attempts to stave off the paralysing effects of the Covid-19 pandemic on its business initially brought some temporary debt relief, it was no surprise when Garuda entered the PKPU process in December 2021, a third restructuring attempt only two decades after its first.

Questions surrounding the interplay of competent jurisdictions in cross-border restructurings once again came to the fore. The company contemplated concurrent Indonesian PKPU and English law scheme of arrangement processes as well as the triggering of the international treaty called the Cape Town Convention, to which both the UK and Indonesia are signatories, which would have added an extra layer of complexity to the handling of Garuda's obligations to creditors.

Eventually, by June 2022 95% of the airline's creditors and lessors agreed to Garuda's restructuring proposal under Indonesian law. In exchange for a 90% debt write-off of $9 billion, creditors received $825 million of bonds due in 2031 and $330 million in equity.

Quo vadis?

Given the current macroeconomic climate, Garuda's creditors may have had little choice but to consent to the restructuring proposal in order to salvage residual value. However, while headlines may give the impression that this is all but a done deal, troubling economic indicators and key legal questions relating to enforcement and extinguishment of debts remain.

The 5% of creditors who had not supported the approved restructuring proposal could still be in a position to take action in the English courts or in another suitable jurisdiction. While the English law "Rule in Gibbs" legal principle might prevent enforcement of English court judgements without a re-trial in an Indonesian court, there may be some assets that could be successfully sought if they fall outside of the jurisdiction of the Indonesian courts, and the dissenting creditors could search for ways to enforce their judgment debt against those assets.

Even without such a dispute, rising interest rates, oil prices and a looming global recession threaten to derail Garuda's plan to return to profitability within a few years despite the huge debt write-off in its PKPU. A new, fourth restructuring may be closer than one might think for the beleaguered airline, and any new shareholders may wish to locate the nearest emergency exit before Garuda hits yet another patch of turbulence.

Dan Margulies
Partner, Dechert

Dirk Behnsen
Counsel, Dechert

CORPORATE

RESTRUCTURING & INSOLVENCY

Embattled Chinese real estate firms turn to the Cayman Islands for debt restructuring

Wenhao Han of **Harneys** explains how restructuring reforms in the Cayman Islands can provide an efficient route for companies struggling with offshore debt repayments

In the past six months, a wave of defaults in China's real estate market has rattled investors and caused concerns about whether they will recoup their investment. On June 24, at the height of the crisis, a winding-up petition was filed in the High Court of Hong Kong SAR against China Evergrande Group, the world's most indebted property developer facing US$300 billion of liabilities. Included in this figure are about US$19 billion in bonds that are denominated in US dollars and issued offshore. It is a larger amount than is outstanding from any other Chinese property development company. The petition is the first known to have been filed against Evergrande which it will fight vigorously in the months to come.

Evergrande is just one of many Chinese real estate developers starved of liquidity. Many Chinese real estate companies have issued high-yield bonds, typically with three to five-year maturities, to offshore investors since 2013. The need to redeem or refinance this debt has squeezed the sector in recent years. Companies that issued bonds with a five-year lifespan in 2017 will come under pressure this year. Fitch-rated Chinese developers have around US$40 billion of offshore public bonds and CNY165 billion ($24.6 billion) of domestic capital market maturing in 2022.

The Cayman Islands' corporate structure is very popular among Chinese real estate companies looking to restructure their offshore debt. It is, therefore, inevitable that entities incorporated in the territory and raising US dollar denominated bonds will need to consider seeking moratoriums on creditors taking legal actions for payments through proceedings there. These might give such companies the breathing space to improve business and restore viability in aid of the overall restructuring plan and avoid liquidation.

Cayman Islands – a new restructuring officer regime

As a jurisdiction, the Cayman Islands has been at the forefront of cross-border insolvency law. The territory has recently announced reforms to Part V of its Companies Act, by way of the Companies (Amendment) Act 2021. When enforced (most likely before the end of 2022), the amendments will allow a company to file a petition to the court for the appointment of a restructuring officer on the grounds that the company is, or is likely to become, unable to pay its debts and intends to present a compromise or arrangement to its creditors. The directors of the company should thus be able to keep it afloat without having to present a winding up petition.

This is an even more user-friendly process than a "light-touch" provisional liquidation in aid of restructuring, which is also available in the Cayman Islands. It creates a new standalone restructuring regime. Once in force, a petition for the appointment of a restructuring officer can be made in connection with a compromise or arrangement pursuant to the law of a foreign country. As such, it will be of interest to wider cross-border restructurings. Unlike the current regime for provisional liquidation, directors will be able to take the initiative in trying to restructure the company's debts, without first needing to seek members' approval or the support of a "friendly" creditor.

As a further advantage, an extraterritorial moratorium will automatically occur as at the time of filing of the petition for the appointment of the restructuring officer. The company will be protected from creditors' attempts to liquidate it in the Cayman Islands or any other jurisdiction.

Parallel schemes and proceedings

Many Chinese real estate business groups listed in Hong Kong SAR and raising US dollar denominated debt agree that the relevant debt instruments are to be governed by New York law or Hong Kong SAR law. For debt restructuring purposes, a common practice is to compromise such debt by introducing a scheme in an offshore jurisdiction where the company is incorporated or where its centre of main interests (COMI) lies. It will then be followed by an application for recognition in the country where the law governing the debt instrument applies.

If the debt instrument is governed by New York law, recognition of such schemes under Chapter 15 of the US Bankruptcy Code ("Chapter 15") only operates procedurally to prevent action by a creditor against a debtor's property in the US. It does not, however, discharge the debt. In other words, recognition under Chapter 15 is limited only to the US. If a company needs to discharge the debt governed by New York law and to prevent creditors who did not participate in the scheme from winding up the company in another jurisdiction, the proper procedure should be an application under Chapter 11 of the US Bankruptcy Code that purports to have worldwide effect.

Similarly, the latest case law in Hong Kong SAR that applies the English law *Rule in Gibbs* shows that in addition to the scheme in the offshore jurisdiction where the company is registered or where the asset holding entities of the business group are incorporated, it may be sometimes also necessary to have parallel schemes in the jurisdiction where the law governs the debt. This is needed to remove the risk of a disgruntled creditor issuing claims against the company in that foreign jurisdiction. In *Rare Earth* [2022], it is made clear that for Hong Kong SAR law governed debt, it is anticipated that a Hong Kong SAR scheme of arrangement needs to be sanctioned in the jurisdiction's court to discharge the debt.

Recognition and assistance of Cayman Islands insolvency proceedings

The owners of many real estate developers in Hong Kong SAR and Mainland China and the businesses they operate have no connection with the Cayman Islands apart from incorporation. The COMI of such companies is likely to be in Hong Kong SAR or Mainland China. As a result, for the cross-border restructuring of their indebtedness, it will inevitably involve the jurisdiction of the Hong Kong court for

> *"For debt restructuring purposes, a common practice is to compromise such debt by introducing a scheme in an offshore jurisdiction where the company is incorporated or where its centre of main interests lies"*

"The upcoming restructuring officer regime in the Cayman Islands will give extra options to Chinese real estate business groups when restructuring their offshore indebtedness"

recognition and assistance of the foreign insolvency proceedings.

Recognition and assistance of foreign insolvency proceedings is a matter of common law in Hong Kong SAR. Traditionally, following the common law in England, recognition of foreign insolvency proceedings in Hong Kong SAR is limited to liquidators appointed in a company's place of incorporation. However, the common law in this area contains sufficient flexibility to be consistent with commercial practice. It is now accepted that there is nothing in principle preventing recognition of liquidators appointed in a company's COMI or a jurisdiction with which it has a sufficiently strong connection to justify recognition. The recent Hong Kong SAR case law shows that the jurisdiction's court will exercise its discretion to wind up a foreign incorporated company if the connection between it and Hong Kong SAR is substantial and other core requirements are satisfied.

There has been a trend for debtors to rely on an offshore restructuring to oppose a Hong Kong SAR winding up. This, however, may not work. In seeking to adjourn an existing winding up petition, a debtor with COMI in Hong Kong SAR must satisfy the criteria by reference to which the Hong Kong court assesses applications on similar grounds by companies incorporated in Hong Kong SAR. The fact that the debtor may have subsequently entered "light-touch" provisional liquidation in its jurisdiction of incorporation may not assist it.

Since *Lamtex* [2021], recognition and assistance provided to foreign provisional liquidators by the Hong Kong court is likely to be subject to more scrutiny. It is anticipated that unless the agreement of petitioner and supporting creditors have been obtained in advance, the Hong Kong court will not deal with recognition and assistance applications made by provisional liquidators on paper, after winding-up petition presented in Hong Kong SAR. If the debtor fails to satisfy the criteria for adjourning the winding up petition, the court will not recognise its offshore "light-touch" provisional liquidation restructuring. This is also likely to apply to the new restructuring officer regime.

More choices ahead

The upcoming restructuring officer regime in the Cayman Islands will give extra options to Chinese real estate business groups when restructuring their offshore indebtedness. For recognition and assistance of a Cayman Islands restructuring in other jurisdictions, the restructuring proposals will have to be credible and supported by detailed information, and the views of local creditors on such proposals will be of heightened importance. To take advantage of the extraterritorial moratorium, it is advisable to start the restructuring proceedings in the Cayman Islands before a winding up petition is presented by the creditors in other jurisdictions.

Last but not least, Chinese real estate business groups with main foreign insolvency proceedings outside the Cayman Islands may also wish to consider using the new restructuring officer regime to ward off predatory creditors. Once the petition is filed, the latter will not be able to take satellite *ex- parte* actions in the Cayman Islands against the local entities within the group to steal a march on other creditors and disrupt any rescue package that might otherwise be available to the company for the benefit of its creditors and contributories.

Wenhao Han
Partner
Harneys

CYPRUS
Elias Neocleous & Co

Xenia Kalogirou

Liquidity management tools in collective investment schemes

The investment fund industry has grown strongly over the past decade, both in the EU and globally. At European level, as reported by the European Fund and Asset Management Association (EFAMA), the net sales of UCITS and AIFs rose to €866 billion in 2021, compared to €650 billion in 2020 while the net assets of European investment funds grew by 17%, to reach €22 trillion.

Low or negative interest rates and balance sheet constraints in the banking sector, enhanced the role of investment funds in financial intermediation which is anticipated to further increase. While, such developments may strengthen the efficiency and resilience of the financial system as a whole, there are concerns that increased financial intermediation by investment funds may cause amplification of any future financial crisis.

Notably, the complex range of potential behaviours of investment funds and the resulting investor redemption requests in reaction to market stress, eventually exacerbate the market shock and contribute to financial instability.

The current regulatory framework governing investment fund liquidity management in the EU includes specific provisions on liquidity management which have been generally adequate so far. However, the results of the surveys of European Systemic Risk Board (ESRB), European Securities and Markets Authority (ESMA) and International Organisation of Securities Commissions (IOSCO) on existing practices, have revealed that there are still some areas in the general liquidity management environment which could be improved.

This article concentrates principally on the liquidity management tools (LMTs) which could ultimately contribute positively to the management of liquidity risk.

Existing regulatory framework for investment fund liquidity

AIFMs

The AIFM Directive (2011/61/EU) (AIFMD), incorporated into the national law by the Republic of Cyprus through the adoption of 'The Alternative Investments Fund Managers Law 56(I)/2013)' as amended, and its implementing acts lay out the liquidity risk management requirements, in particular in the context of the establishment of a general permanent and independent risk management function (Article 15 of the AIFMD and Article 39 of the delegated regulation (No.231/2013) to the AIFMD).

This function shall, firstly, implement effective risk management policies and procedures in order to identify, measure, manage and monitor on an ongoing basis all risks (including liquidity risk) relevant to each AIF's investment strategy, and secondly comply with the obligation to monitor compliance with the above risk limits (Article 44 and Article 48 of the delegated regulation).

In addition to the general risk management requirements, the Article 16 of the AIFMD provides that AIFMs shall for each fund managed which is not a closed-end fund employ an appropriate liquidity management system, including procedures to monitor the liquidity risk of the AIF and to ensure that the liquidity profile of the investments of the AIF complies with its underlying obligations. It is further added that the AIFMs must also ensure that the AIFs' investment strategy, their liquidity profile and their redemption policy are consistent.

Under Article 46(2) of the AIFMD and Article 108(3)(b) of the delegated regulation, the competent authorities and the managers respectively, have the power to require the suspension of the repurchase or redemption of units in the interest of the unit-holders or of the public in terms of management of the AIF's liquidity. Similar provisions are also included in The Alternative Investment Funds Law of 2018 L.124(I) of 2018 (Article 43).

Article 47(1) of the delegated regulation describes the specific details of the liquidity management system and procedures for each AIF. In respect of the LMT, it is specifically provided that the AIFM shall consider and put into effect the tools and arrangements, including special arrangements, necessary to manage the liquidity risk of each AIF under its management.

The AIFM shall identify the types of circumstances where these tools and arrangements may be used in both normal and exceptional circumstances, taking into account the fair treatment of all AIF investors in relation to each AIF under management. The AIFM may use such tools and arrangements only in these circumstances and if appropriate disclosures have been made in accordance with the relevant provisions of the delegated regulation.

UCITS

UCITS have been designed principally for the retail market as open-ended diversified and liquid products.

A key principle of the UCITS Directive (2009/65/EC), implemented in the Republic of Cyprus by the adoption of the Open-Ended Undertakings for Collective Investment (UCI) Law 78(I)/2012 as amended, is the portfolio diversification based on the so-called '5-10-40 rule', set out in Article 52(1) and (2) which refers to maximum permitted exposures per issuer.

Accordingly, the general rule as reinforced by a list of eligible and non-eligible assets under the Article 50, requires that, a UCITS shall invest no more than 5% of its assets in transferable securities or money market instruments issued by the same body. The above 5% limit may be raised to a maximum of 10%, with a further aggregate limitation of 40% of net assets on exposures of greater than 5% to single issuers.

Apart from the above principle which guarantees the liquidity of the UCITS product in line with the general obligation under Article 84(1) of the UCITS Directive, whereby a UCITS shall repurchase or redeem its units at the request of any unit-holder, the UCITS Directive includes liquidity risk management requirements for UCITS management companies corresponding to those under AIFMD.

Specifically, Article 51(1) of the UCITS Directive provides that a UCITS management company shall employ a risk-management process which enables it to monitor and measure the risk of the positions and their contribution to the overall risk profile of the UCITS portfolio at any time.

Article 12 of the implementing Directive 2010/43/EU (as incorporated into national law via the 'CySEC Directive DI78-2012-03 regarding the Conditions for Authorization and Ongoing Obligations of a Management Company and the Agreement between a Depositary and a Management Company of UCITS)' further requires the management company, where appropriate and proportionate in view of the nature, scale and complexity of its business and of the UCITS it manages, to establish and maintain a permanent risk management function which shall be hierarchically and functionally independent from other operating units of the management company. Amongst others, it shall additionally implement the risk management policy and procedures, ensure compliance with the UCITS' risk limits and provide relevant advice and reports to the board of directors and the senior management.

Furthermore, Article 38(1) of the implementing Directive 2010/43/ EU provides that management companies shall address at least the following elements in the risk management policy:

(a) the techniques, tools and arrangements that enable them to comply with their obligations in respect of measurement and management of risk and compliance with limits concerning global exposure and counterparty risk;
(b) the allocation of responsibilities within the management company pertaining to risk management.

By way of derogation from the general obligation under Article 84(1) of the UCITS Directive, a UCITS may, in accordance with the applicable national law, the fund rules or the instruments of incorporation of the investment company, temporarily suspend the repurchase or redemption of its units and its competent authorities may require the suspension of the repurchase or redemption of units in the interest of the unit-holders or of the public (Article 84(2) of the UCITS Directive).

Article 39(1) of the implementing Directive 2010/43/ EU obliges UCITS management companies to assess, monitor and periodically review the effectiveness of their risk management policy, their level of compliance with it and the adequacy of measures taken to address any deficiencies in the performance of the risk management process.

In addition, Article 40(3) of the implementing Directive 2010/43/EU, provides that UCITS management companies shall employ an appropriate liquidity risk management process in order to ensure that each UCITS they manage is able to redeem at any time the investors' units upon their request. Paragraph 4 further adds that UCITS management companies shall ensure that for each UCITS they manage the liquidity profile of the investments of the UCITS is appropriate to the redemption policy laid down in the fund rules or the instruments of incorporation or the prospectus.

Liquidity management tools for redemption

General

Apart from the regulatory requirements under the EU legislation across the AIFM and UCITS regimes as analysed above, there are certain complimentary operational tools recognised and used in many European jurisdictions by management companies for the management of liquidity.

The availability and implementation of LMTs for collective schemes varies significantly across jurisdictions. Thus, there are differences in the availability of LMTs as well as the specific procedures governing the use of a-LMT across jurisdictions as evidenced by the survey conducted by IOSCO, the Recommendation of the European Systemic Risk Board of 7 December 2017 on liquidity and leverage risks in investment funds (ESRB/2017/6) February 2018 (the 'ESBR Recommendations') and the survey of member states conducted by ESMA.

The most commonly available tools in member states are the following: (a) redemption fees; (b) redemption gates; (c) redemptions in kind; (d) side pockets; (e) suspension of redemptions; (f) anti-dilution levy; (g) swing pricing; (h) mandatory liquidity buffers; and (i) side letters.

Available LMTs in Cyprus

LMTs, and the circumstances under which they can be used, must typically be listed in the constitutional documents of the investment fund, which are subject to approval by Cyprus Securities and Exchange Commission (CySEC). These tools are reinforced by the funds' internal risk management and control system, which ensures that material risks are properly identified, assessed, measured, monitored and controlled.

According to the ESBR Recommendations, the regulators are not generally allowed to activate tools. The general exception to this is the suspension of redemptions, which may be imposed by the regulator if it is deemed to be in the public interest. It is further observed that in general the fund managers do not need regulatory authorisation to activate a-LMT.

However, in some jurisdictions including Cyprus, the use of the power to suspend redemptions is subject to previous permission of the regulator which may require more intensive oversight and prescriptive requirements.

In Cyprus, there is a set of a-LMTs which can help to mitigate liquidity risks for open-ended funds. These mechanisms include: (a) ex-ante tools, such as swing pricing and anti-dilution levies, which can be used to mitigate first mover advantage and systemic risk; and (b) ex-post tools, such as gates, side pockets, redemption-in-kind, notice periods and suspension of redemptions, allowing fund managers to manage investment fund liquidity by controlling or limiting outflows.

Ex-ante LMTs

Swing pricing: The purpose of this tool is to protect existing investors from unfavourable price effects caused by transactions executed by other investors.

In practice, a swing pricing mechanism enables a manager to charge, or 'swing', the relevant transaction costs attributed to the net subscriptions, or net redemptions, respectively on the incoming or outgoing investors. Effectively, the NAV of the investment fund is adjusted downwards (upwards) in the case of large outflows (inflows) so that the transaction costs are borne by the investors buying or selling the shares rather than the existing investors.

It is observed that two types of swing pricing exist, being the 'full' and 'partial' swinging. Under full swing pricing, the relative costs are allocated and NAV is adjusted any time there are net inflows or outflows in a fund, hence swing pricing is applied to all subscriptions and redemptions by investors.

Under partial swing pricing, the costs are allocated and the NAV is 'swung' only when net inflows or net outflows exceed a predefined threshold expressed as a percentage of a fund's NAV, hence swing pricing is applied to subscriptions and redemptions beyond a certain threshold.

Anti-dilution levy: The anti-dilution levy is a similar tool to the swing-pricing as it aims to protect existing or remaining investors against the adverse performance impact of new or leaving investors. This tool involves investors paying an additional charge to the investment fund when they subscribe to or redeem investment fund shares, in an attempt to offset any potential effect on the fund's NAV resulting from the additional transaction costs. Compared to the swing pricing mechanism, it does not involve any adjustment to the value of the portfolio (e.g. NAV).

Ex-post LMTs

Redemption gates (deferred redemptions): A mechanism that temporarily defers the right of shareholders to redeem their shares in the fund and gives more time to management companies to permit realisation of assets in a more orderly and controlled manner in order to decrease the risk of fire sales under stressed market conditions.

This deferral may be full, so that investors cannot redeem their shares at all, or partial, so that investors can only redeem a certain portion of their shares.

Redemption gates can also be structured in such a manner that when redemption requests reach a certain threshold, a fund management company can decide to meet on a pro-rata basis any redemption requests and carry forward any residual requests over that threshold to the next dealing period.

Such gates may be imposed either at the fund-level (i.e. prohibition of redemptions if aggregate fund redemptions over a given period exceed certain percentage of the fund's assets) or at the investor-level (i.e. prohibition from withdrawing more than certain percentage of investor's interest in the fund) with differing thresholds.

Side pockets: This mechanism allows the segregation of the illiquid or difficult to value portion of a fund's portfolio from remaining liquid investments of the investment fund via the creation of side pockets classes for the former. While the remainder of an investor's shareholding can be redeemed in the normal manner as described in the fund's constitutional documents, shares in the side pocket class cannot be redeemed until such time as the underlying assets become sufficiently liquid.

Therefore, side pockets are especially suitable whenever a fund has diverging investor interests. In this respect, investors needing liquidity can still cash in the liquid part of the investment fund's investments at, presumably, low liquidation cost while investors who wish to remain in the investment fund are protected since the fund management company is not forced to liquidate assets at or under market prices if faced with high redemption demand.

Redemption-in-kind: Redemptions in-kind (or in specie) consist of non-cash payments (i.e. securities) to the redeeming investor of assets in the fund instead, in whole or in part, of cash. There would therefore be no need to liquidate large amounts of assets in the event of large-scale redemptions, thereby protecting both remaining and redeeming investors from any high transaction costs which might otherwise arise and avoiding any market price impacts.

Due to its operational challenges (such as complex transfer process and valuation procedures) and involved costs, this mechanism may be suitable for large redemption orders from institutional investors and it is generally less suitable for redemptions by retail investors.

From financial stability standpoint, such tool does not necessarily deal with contagion issues as the impact on the market might be the same, irrespective of whether it was the investment fund itself or the investor who sold the underlying assets into a falling market.

Notice periods: This tool provides fund management companies with additional flexibility to manage their liquidity without the need to sell assets at discounted price.

A notice period is stipulated in the constitutional documents of an investment fund and refers to the period of advance notice that investors must give to fund managers when redeeming their investments.

Some managers use a slightly different form of notice period whereby investors are subject to a redemption fee (i.e. a charge that a fund levies to investors when exiting the fund) unless the investor provides notice of the redemption.

Suspension of redemption: An extraordinary instrument of last resort for open-end fund structures, which allows fund managers or regulators to suspend redemptions during a liquidity crisis or for public interest or financial stability reasons, when no other option is available. For instance, a suspension of redemptions may be implemented when the market trading the underlying assets is closed or during exceptional market events affecting a large proportion of the underlying assets or the settlement system for payments (such as TARGET2) is closed on specific public holidays.

There are various reasons to suspend redemptions. Commonly reported reason as identified by IOSCO based on their report on Open-ended fund liquidity and risk management – good practices and issues for consideration, is to prevent a sudden outflow of capital, which may have additional adverse impacts for the fund, such as:

- The compulsory sale of assets at prices that would disadvantage remaining investors;
- A resulting portfolio for non-redeeming investors that is largely concentrated in illiquid assets and falls outside the risk tolerance horizon of the fund; and
- A resulting portfolio that may be too small for the intended strategy of the fund.

EU Commission's proposals to amend AIFMD and the UCITS Directive

On November 25 2021, the European Commission has published its legislative proposal to amend both the UCITS and AIFMD frameworks together with an Annex (together the 'proposal'). The proposal includes significant developments in respect of the LMTs.

Specifically, following the ESBR Recommendations, the European Commission has proposed the harmonisation and convergence of the availability and use of LMTs to UCITS funds and open-ended AIFs in terms of protection of the value of investors' money, reduction of liquidity pressure on funds and mitigation against broader systemic risk implications in situations of market-wide stress.

Minimum list of LMTs

The European Commission further proposed that member states ensure that the LMTs listed below are available to AIFMs managing open-ended AIFs and UCITS management companies:

1. Suspension of redemption and subscriptions;
2. Redemption gates;
3. Notice periods;
4. Redemption fees;
5. Swing pricing;
6. Anti-dilution levy;
7. Redemptions in kind; and
8. Side pockets.

In addition to being able to suspend redemptions as explicitly provided under the current regulatory framework, the management companies would also be required to:

- Choose at least one other appropriate LMT from the points 2 to 4 of the above list which harmonises the minimum list that should be available anywhere in the EU;
- Implement specific policies and procedures for the activation and deactivation of any selected LMT and disclose to investors the specific circumstances in which the relevant LMT can be used; and
- Notify the regulator without delay about activating or deactivating an LMT.

Under the proposal, ESMA is tasked with developing draft Level 2 technical standards (RTS): (a) to define and specify the characteristics of each of the above-mentioned LMTs; and (b) on the selection and suitable use of the LMTs.

Regulatory powers

The European Commission proposed that national competent authorities be empowered to require a fund manager to activate or deactivate an appropriate LMT, subject to prior notification to other relevant authorities, ESMA and ESRB. ESMA is mandated to develop RTS indicating when the competent authority's intervention would be warranted and in which situations a competent authority may exercise its powers in respect of LMTs.

EFAMA's position paper

While EFAMA welcomes the decision of the European Commission to adopt a targeted approach in its review of the AIFMD and UCITS Directive by including a list of LMTs as a means of managing liquidity risks and ensuring the fair treatment of investors, it considers that it is critical that the management of liquidity risk remains the responsibility of the fund manager.

Specifically, the management of liquidity risk as a function is directly linked to the investment strategy of the fund, its underlying assets and nature of its investor base. Removing this function from the manager or introducing automatic or prescriptive triggering of similar LMTs under similar circumstances would give rise to pro-cyclical effects, for example by creating a risk of rush for redemption where the imposition of a particular LMT is expected by investors in the market.

Importantly, EFAMA recommends that NCAs and ESMA be granted the power to request the manager to suspend redemptions or impose redemption gates in exceptional cases where circumstances so require, having regard to the interests of the unit-holders and to any financial stability risks, in consultation with the manager.

Similarly, any specification as to the criteria for the selection and use of appropriate LMTs by managers should adopt a principles-based approach by reference to existing guidance across EU jurisdictions as opposed to setting out prescriptive rules as regards instances where specific LMTs should be triggered.

European Parliament's proposal

On May 16 2022, the European Parliament has issued its draft report on the European Commission's proposals to amend the existing AIFMD framework after discussions and feedback from regulators and stakeholders.

There are three important proposed areas of improvement related to the liquidity management provisions:

- The range of LMTs from which an AIFM must select at least one as part of its liquidity management policy are proposed to be expanded to include swing pricing, anti-dilution levies and side pockets in addition to the original list of redemption gates, notice periods and redemption fees.
- Clarity that the AIFM has primary responsibility for decisions on LMTs. In this respect, ESMA should allow time for the market to adapt before it applies the technical standards on selection and use of LMTs, in particular for existing AIFs.
- Intervention by competent authorities in an AIF's liquidity management is intended to be a last resort and limited to exceptional circumstances and after consulting with the AIFM. Importantly, the report also proposes completely removing the ability for competent authorities to require non-EU AIFMs marketing in the EU to activate or deactivate LMTs.

Although there is still scope for change of the proposed amendments, the report is important in terms of formulating the final text of the AIFMD II.

Concluding remarks

Liquidity risk management has long been an important area of consideration for policy makers and the asset management industry.

Overall, fund managers shall consider the implementation of suitable risk management at the prelaunch (product development) stage and the postlaunch (ongoing management) stage of the product lifecycle taking into account the market conditions and the macroeconomic environment.

Existing regulatory frameworks have improved the functioning of markets, their transparency and ultimately the protection of investors. In the context of heightened attention for fund liquidity risks, questions have been raised regarding the sufficiency of the existing regulatory regime and whether additional rules are required.

Although the proposal does not seek to introduce extensive changes in respect of investor protection and financial stability, it proposes important changes in a number of areas including the LMTs.

In this context, the impact of Covid-19 and the Ukraine war and crisis on financial markets are closely monitored by ESMA in coordination with national competent authorities. The challenge of course is to focus on liquidity issues and the use of appropriate LMTs to ensure the orderly functioning of markets, financial stability and investor protection.

Elias Neocleous & Co
Xenia Kalogirou
Senior associate, Elias Neocleous & Co
E: xenia.kalogirou@neo.law

JAPAN

Nagashima Ohno & Tsunematsu

Reona Okazaki

Japan reviews information disclosure practices

The Disclosure Working Group (DWG) of the Financial System Council of the Japanese Financial Services Agency is considering expanding its rules on the disclosure of information.

This would contribute to a constructive dialogue between companies and investors by giving investors access to more information, such as agreements between a company and its shareholders.

This article examines the recent discussions at the DWG over revising the rules for disclosing "Material Contracts in Management."

DWG's awareness of issues

At the 5th meeting of the DWG, held on January 19 2022, the need to review the disclosure practices of "Material Contracts in Management" in Japan was acknowledged. The practice of disclosing these contracts in Japan is considered insufficient compared with practices in the US and the EU. For example, there are cases where the contracts between a foreign company and a Japanese company are disclosed in detail outside Japan by the foreign company, but not disclosed in detail in Japan by the Japanese company.

In addition, certain agreements between companies and shareholders are usually important for investment decisions, but the DWG has pointed out that the disclosure of these agreements in Japanese annual securities reports, semi-annual securities reports, and quarterly securities reports (collectively, ASRs) is insufficient. The types of agreements are listed below:

1. Agreements on corporate governance such as the following:
   a. Agreements on the right to nominate candidates for directors;
   b. Agreements binding on the exercise of voting rights; and
   c. Agreements on matters requiring prior consent by certain shareholder(s).
2. Agreements regarding shareholdings such as the following:
   a. Agreements prohibiting or restricting the transfer or other disposition of shares;
   b. Agreements prohibiting the purchase of additional shares;
   c. Agreements to maintain shareholding ratios; and
   d. Agreements requiring the sale of shares upon termination of certain agreement.

The DWG also lists the disclosure of loan covenants and other material business contracts among the types of contracts subject to review.

Direction of the review

Based on the awareness of the issues as mentioned above, the DWG is considering measures such as adding items to be stated in the ASRs and publishing a collection of good practices.

While enhanced disclosure is important for making appropriate investment decisions, expanding the items of disclosure also introduces disadvantages such as the burden on companies For example, the DWG's study materials point out that, with regard to a case outside Japan in which the entire contract is disclosed, there are doubts as to whether it is easy for investors to understand if the entire contract, which runs to several dozen pages, is attached to the ASRs.

The DWG also noted the following points to be considered when reviewing the disclosure practices. We look forward to seeing how these points will be taken into consideration in the concrete measures proposed after the disclosure practices are reviewed.

1. Requiring the disclosure of agreements that have already been executed at the time of implementation of the revised disclosure practices should be avoided (although the overall direction of the discussions in the DWG seems to be to include such executed agreements that have already been executed in the scope of disclosure);
2. Only agreements that are legally binding should be subject to disclosure (although, in the DWG, there is an opinion that the need for disclosure should be decided based on the actual impact, regardless of whether the agreement is legally binding);
3. Consideration should be given to the protection of trade secrets; and
4. The shareholding ratio of shareholders in the agreement subject to disclosure should be limited.

Final thoughts

The information above provides an introduction to the DWG's discussion on the disclosure of "Material Contracts in Management."

The DWG has also discussed the timeliness and enhancement of English-language disclosure, with some suggesting that a certain degree of English-language disclosure should be mandatory, especially for TSE "Prime Market" listed companies in Japan.

On June 13 2022, the DWG released a report titled "Toward Building a Capital Market that Enhances Corporate Value over the Medium to Long Term." In the report, the contents of the discussions explained above are basically maintained. From now on, revisions to regulations and guidelines based on this report are expected to bring about substantial impact on disclosure practices in Japan.

Nagashima Ohno & Tsunematsu
Reona Okazaki
Associate, Nagashima Ohno & Tsunematsu
E: reona_okazaki@noandt.com

MACAU SAR

Riquito Advogados

João Nuno Riquito and Belmiro Leong

Constitution of usufruct over shares in Macau SAR

Aside from the traditional or more recurrent financing instruments, the constitution of a usufruct over shares may be a desirable option for shareholders, as it may allow them to maximise their interests by sharing the risks associated with investment without ever actually transferring legal ownership of the shares to a different holder.

As defined in the relevant provisions of the Macau SAR Commercial Code, by constituting an usufruct, the title owner attributes to a third party, on a temporary basis, with or without consideration, the right to receive the dividends declared by the company throughout the duration of the usufruct, as well as both the exercise of the voting rights granted by the corresponding shares and the right to share in the liquidation of the company.

The temporary dissociation between the legal ownership and the beneficial ownership of the shares, the different commercial arrangements which may be agreed in respect of the constitution of the usufruct, its duration, the type or category of shares over which it is created and the conditions associated with their respective remission (i.e. their extinction), among others, often show that this (too frequently ignored) arrangement can be an excellent way for two investors to organise the apportionment of risk and reward to their corporate investment in an optimal manner.

The usufruct of shares further presents a significant advantage over other arrangements serving (at least partially) common objectives (for example, repos or reverse repos) in that it can keep the legal ownership of the shares unchanged, on the one hand and, on the other hand, its main effects are not dependent on the contractual efficacy of shareholders' agreements, whilst still being binding on the company itself.

Riquito Advogados
João Nuno Riquito
Managing partner, Riquito Advogados
E: jnr@riquito.com

Belmiro Leong
Trainee lawyer, Riquito Advogados
E: bel@riquito.com