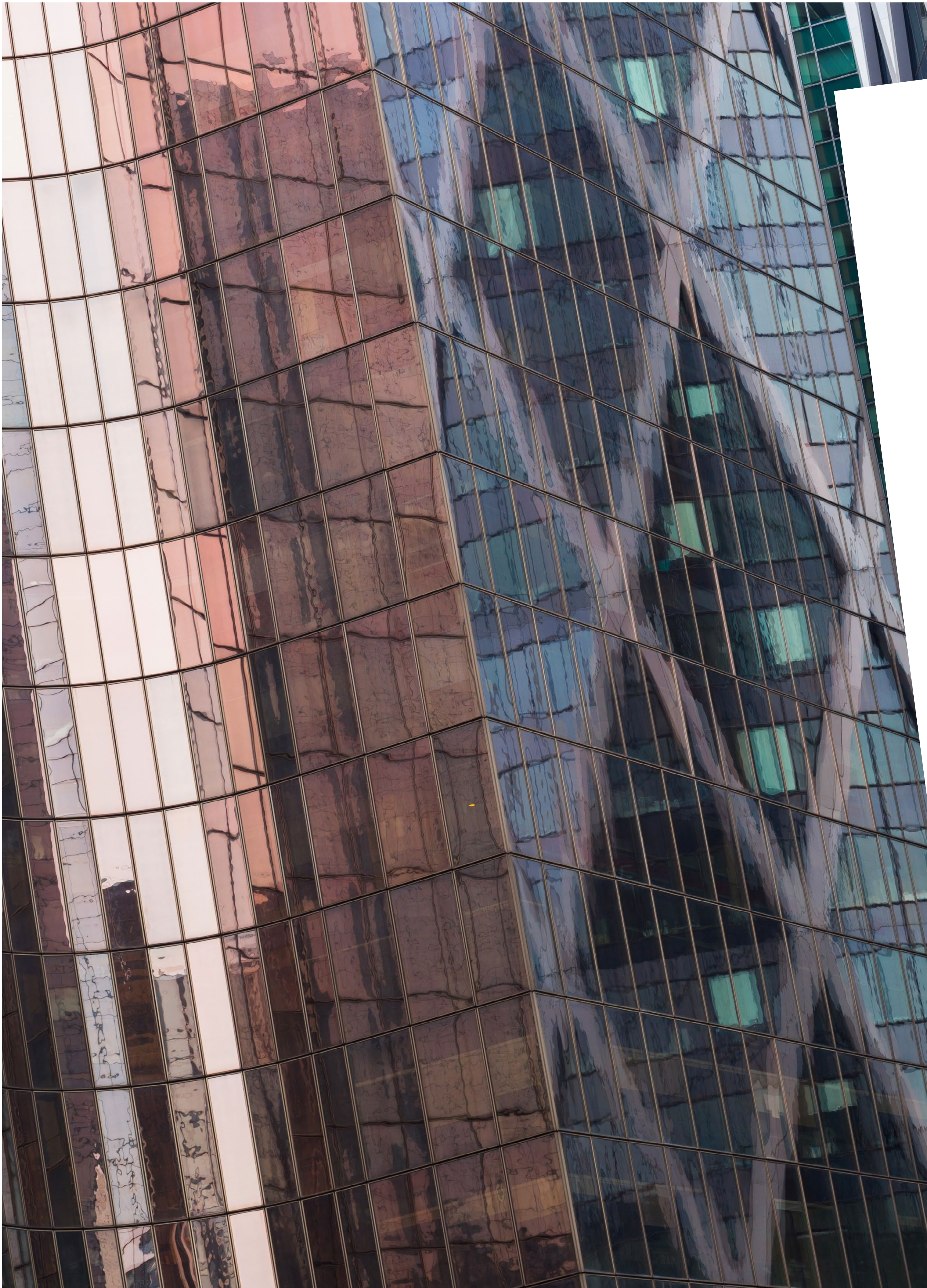
Debt Capital Markets – Global Insights

Summer 2018



Welcome

At Hogan Lovells, we follow industry trends very closely and we take great care to listen to our clients and contacts – to understand the issues they face and how the industry is changing. Our Debt Capital Markets – Global Insights publication reflects this dialogue and brings together a number of different perspectives from around the globe. We are delighted to share our latest issue with you.

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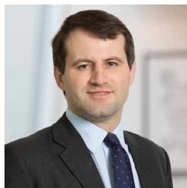

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Cryptocurrencies: What is the applicable regulatory framework in the United States?

According to the unknown person or persons who "invented" cryptocurrencies, cryptocurrencies are "[a] n electronic payment system based on cryptographic proof instead of trust, allowing any two willing parties to transact directly with each other without the need of a trusted third party." This definition sheds very little light on whether they should be regulated and how they should be characterized for purposes of regulation. Any serious discussion of regulation of cryptocurrencies does not start with the premise that they are completely unregulated but with the question of what they are and to what extent they should be regulated. The possible candidates for regulatory categories are securities, money, commodities and swaps/futures. As with most questions of legal characterization, the answer does not depend upon abstract or theoretical concepts but context and a "facts and circumstances" test, which is used frequently by lawyers to articulate a test which relies upon "I know it when I see it." Relevant facts that could be important in this analysis are the motivation or intent of those creating or using the cryptocurrency and their manner of use — in other words, what are they being used for and how are they being used. Applying these factors leads to a conclusion that cryptocurrencies can, depending, upon the context, be all of the above, namely securities, monies, commodities and swaps.

Securities

The Securities and Exchange Commission (**SEC**) has examined the issue of whether and when cryptocurrencies are securities through reports, statements of commissioners and enforcement, particularly in the context of initial coin offerings (**ICOs**). The SEC has used the analytical framework first set forth by the U.S. Supreme Court in SEC v. W. J. Howey Co. (**Howey**) to assess whether an investment in a cryptocurrency is a security. In Howey, the Supreme Court was called to determine whether "an offering of units of a citrus grove development, coupled with a contract for cultivating, marketing, and remitting the net proceeds to the investor" is an "investment contract" and therefore a "security" for purposes of the Securities Act of 1933. The Supreme Court in Howey articulated a four-part test to determine whether an investment is a "security", namely whether there is (a) an investment of money; (b) in a common enterprise; (c) with a reasonable expectation of profits; (d) from the entrepreneurial efforts of others.

In the "Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO", issued July 25, 2017, the SEC indicated that cryptocurrencies can be categorized as securities offerings, and that the DAO, a decentralized autonomous organization, further described as "a 'virtual' organization embodied in computer code and executed on a distributed ledger or blockchain", was a securities offering because it resembled an investment company. The DAO sold so-called "DAO Tokens" to investors in exchange for Ether cryptocurrency, with the proceeds of such sales being used to fund "projects." Investors could vote on what to do with the revenue generated by the "projects" – either to use it to fund new "projects" or to distribute it to the investors as a return on investment. The investors were also able to sell their DAO Tokens in the secondary markets by using electronic platforms. About one-third of the assets of the DAO were stolen in a cyberattack.

Similarly, in the In re Munchee Inc. administrative proceeding, in which the SEC issued an order in December 2017, a business that created an iPhone app for people to review restaurants offered and then sold digital tokens to be issued on the Ethereum blockchain via an "initial coin offering" to the general public. Munchee Inc. described to investors how the tokens would be expected to increase in value and stated that they would be traded on secondary markets. Munchee Inc. started selling the tokens on October 31, 2017, but ceased sales the following day after being contacted by SEC staff. The SEC applied the Howey test in the context where the proceeds of the token offering were used to promote general corporate purposes of the issuer rather than held in escrow or invested in a hedging transaction to provide the good or service that a

buyer can exchange for the token in the future. In such situations, where investors may be motivated more by an appreciation in the tokens rather than their use with respect to a good or service, the tokens are more likely to be deemed a "security."

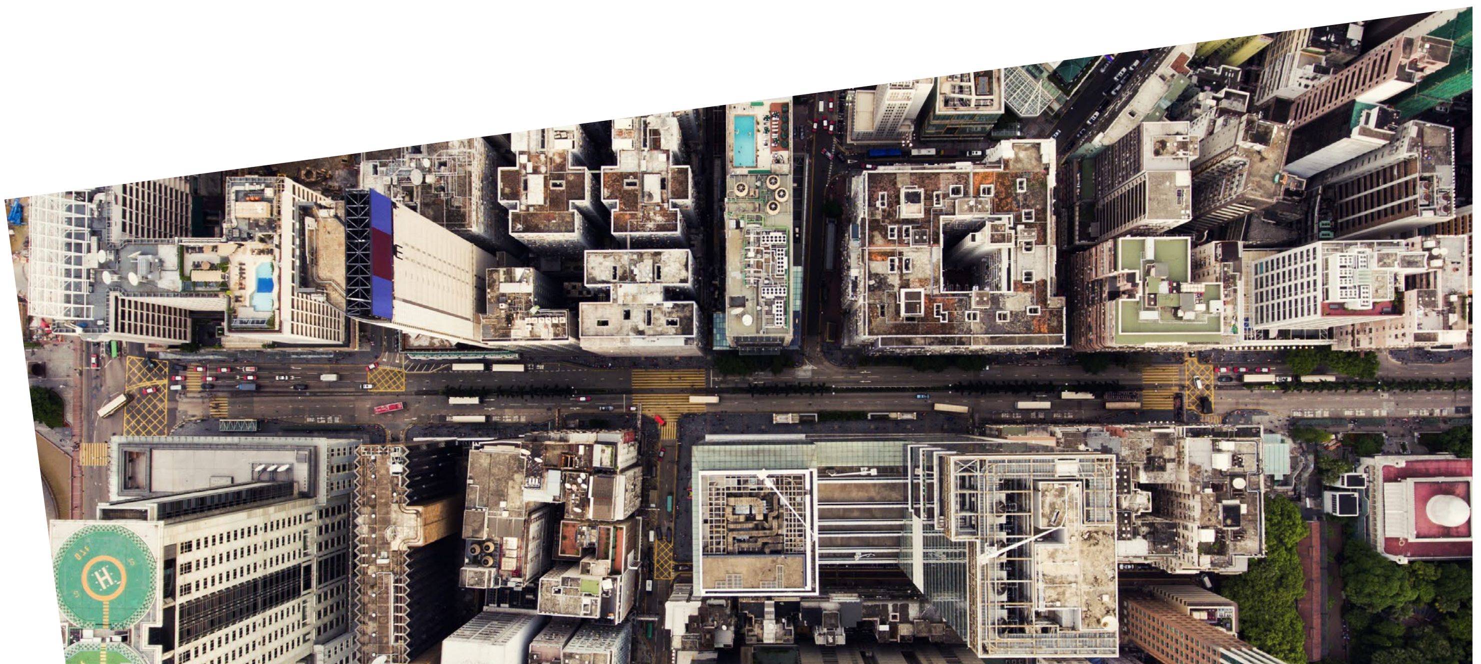
Furthermore, SEC commissioners have issued official statements highlighting their views on whether cryptocurrency products are securities. For example, in a December 2017 statement, SEC Chairman Jay Clayton stated that "[m]erely calling a token a 'utility' token or structuring it to provide some utility does not prevent the token from being a security. Tokens and offerings that incorporate features and marketing efforts that emphasize the potential for profits based on the entrepreneurial or managerial efforts of others continue to contain the hallmarks of a security under U.S. law."

DAO and Munchee did not have an immediate direct connection with the purchase of goods and services, and in DAO included a cyber-attack, and accordingly their characterization as securities were not close calls. Less clear, however, are situations where a cryptocurrency token may have dual purposes, i.e., the promotion of general purposes as well as a method of exchange or where the use may change over time from a "security token" to exclusively a "utility token".

Money

Money transmitters are regulated by both federal and state regulation. The U.S. Department of Treasury Financial Crimes Enforcement Network (**FinCEN**), pursuant to its implementation of the Bank Secrecy Act and the USA PATRIOT Act, requires that "money transmitters" comply with registration, monitoring, reporting and other requirements. Under FinCEN regulations, a "[m]oney transmitter" means "[a] person that provides money transmission services" or "[a]ny other person engaged in the transfer of funds." "Money transmission services" is defined as "the acceptance of currency, funds, or other value that substitutes for currency from one person and the transmission of currency, funds, or other value that substitutes for currency to another location or person by any means." Virtually every state has licensing and/or registration requirements that parallel those of FinCEN.

FinCEN has also issued specific guidance (**FinCEN Guidance**) on the application of its money transmission regulations with respect to cyptocurrencies. According to the FinCEN Guidance, a "user" of cryptocurrencies, i.e., one who uses virtual currency to purchase goods or services on the user's own behalf, is not a money transmitter, while "exchangers" or "administrators" are



properly classified as money transmitters. Further, according to the FinCEN Guidance, an "exchanger" is a person or entity "engaged as a business in the exchange of virtual currency for real currency, funds, or other virtual currency," while an administrator of virtual currency is a person or entity "engaged as a business in issuing (putting into circulation) a virtual currency, and who has the authority to redeem (to withdraw from circulation) such virtual currency." In looking at the questions of motivation and manner of use, therefore, FinCEN focuses on whether the person is engaged in a business (whether as an issuer of virtual currency or as an exchanger) and the manner of use — on an exchange.

Commodities

The term "commodity" is defined broadly in the relevant statute, the Commodity Exchange Act (**CEA**), to mean:

"wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil, and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice, and all other goods and articles, except onions . . . and motion picture box office receipts (or any index, measure, value, or data related to such receipts), and all services, rights, and interests (except motion picture box office receipts, or any index, measure, value, or data related to such receipts) in which contracts for future delivery are presently or in the future dealt in."

This definition encompasses both physical commodities, like agricultural products or natural resources, as well as financial assets, which are included within the definition of "all services, rights, and interests . . . in which contracts for future delivery are presently or in the future dealt in." The Commodity Futures Trading Commission ("CFTC") has taken the view that cryptocurrencies are within the scope of this definition of "commodity."

At least one federal court has agreed with the CFTC. The court in CFTC v. McDonnell held that the CEA has non-exclusive authority to investigate and enforce the CEA as to both virtual currency spot transactions and futures transactions. In McDonnell, the defendant was accused of operating CabbageTech, Corp., doing business as Coin Drop Markets, for the stated purposes of soliciting funds from customers in exchange for providing advice about trading virtual currencies and for trading on behalf of the customers under the defendant's direction. Instead, the defendant was alleged to have misappropriated customer funds. The court examined whether the CFTC had standing to sue the defendant. It should be noted, however, that the defendant in McDonnell was pro se and did not raise available arguments against the court's ultimate interpretation, and accordingly this may not be the final word on this analysis.

Whether cryptocurrency is a commodity or not, however, is only part of the question in assessing the scope of CFTC jurisdiction. Other than anti-fraud enforcement authority, the CFTC and the CEA do not generally regulate "cash" or spot transactions involving commodities such as cryptocurrencies (but they do with respect to "commodity interests" – swaps and futures).

One key exception is if the cryptocurrency transactions utilize margin, leverage or financing – if the transaction does utilize margin or leverage then it is subject to CFTC and CEA oversight in addition to anti-fraud enforcement. Section 2(c)(2)(D) of the CEA grants explicit jurisdiction to the CFTC over "any agreement, contract, or transaction in any commodity that is . . . entered into with, or offered to (even if not entered into with)" a person that is neither an "eligible contract participant" nor an "eligible commercial entity" "on a leveraged or margined basis, or financed by

the offeror, the counterparty, or a person acting in concert with the offeror or counterparty on a similar basis."

An important factor in determining whether cryptocurrencies utilize margin or leverage and the resultant scope of CFTC authority is whether there has been "actual delivery" of the cryptocurrency. Pursuant to Section 2(c)(2)(D)(ii)(III) of the CEA , known as the "Actual Delivery Exception", CFTC authority does not extend to any contract of sale that "results in actual delivery within 28 days or such other longer period as the [CFTC] may determine by rule or regulation based upon the typical commercial practice in cash or spot markets for the commodity involved."

In the context of cryptocurrencies, however, this definition begs the question of the meaning of "actual delivery" in the context of an environment where payments are based upon cryptographic proof reflected on a distributed ledger. The CFTC has attempted to provide guidance on this issue through the issuance of a proposed interpretation (**Proposed Interpretation**) for public comment in December 2017, which has not yet been finalized and which has thus far received more than 90 comments. The Proposed Interpretation defines actual delivery as having occurred when a customer has the ability to "(i) [t]ake possession and control of the entire quantity of the commodity, whether it was purchased on margin, or using leverage, or any other financing arrangement, and (ii) use it freely in commerce (both within and away from any particular platform) no later than 28 days from the date of the transaction" and "[t]he offeror and counterparty seller (including any of their respective affiliates or other persons acting in concert with the offeror or counterparty seller on a similar basis) not retaining any interest in or control over any of the commodity purchased on margin, leverage, or other financing arrangement at the expiration of 28 days from the date of the transaction."

The Proposed Interpretation sets forth four examples of the presence and absence of "actual delivery" in the context of virtual currencies:

Example 1: Actual delivery: within 28 days of entering into an agreement:

- there is a record on the relevant public distributed ledger network or blockchain of the transfer of virtual currency, whereby the entire quantity of the purchased virtual currency, including any portion of the purchase made using leverage, margin, or other financing, is transferred from counterparty seller's blockchain wallet to purchaser's blockchain wallet;
- counterparty seller retains no interest in or control over the transferred commodity; and
- counterparty seller has transferred title of the commodity to purchaser.

When a matching platform or other third party offeror acts as an intermediary, the virtual currency's public distributed ledger must reflect the purchased virtual currency transferring from counterparty seller's blockchain wallet to

the third party offeror's blockchain wallet and, separately, from third party offeror's blockchain wallet to purchaser's blockchain wallet, provided that purchaser's wallet is not affiliated with or controlled by counterparty seller or third party offeror in any manner.

Example 2: Actual delivery: within 28 days of entering into a transaction:

- counterparty seller has delivered the entire quantity of the virtual currency purchased, including any portion of the purchase made using leverage, margin, or financing, into the possession of a depository (i.e., wallet or other relevant storage system) other than one owned, controlled, or operated by counterparty seller (including any parent companies, partners, agents, affiliates, and others acting in concert with counterparty seller) that has entered into an agreement with purchaser to hold virtual currency as agent for purchaser without regard to any asserted interest of offeror, counterparty seller, or persons acting in concert with offeror or counterparty seller on a similar basis;
- counterparty seller has transferred title of the commodity to purchaser;
- purchaser has secured full control over the virtual currency (i.e., the ability to immediately remove the full amount of purchased commodity from depository); and
- no liens (or other interests of offeror, counterparty seller, or persons acting in concert with offeror or counterparty seller on a similar basis) resulting from the use of margin, leverage, or financing used to obtain the entire quantity of the commodity purchased will continue forward at the expiration of 28 days from the date of the transaction.

Example 3: No actual delivery: within 28 days of entering into a transaction, a book entry is made by offeror or counterparty seller purporting to show that delivery of the virtual currency has been made to the purchaser, but counterparty seller or offeror has not, in accordance with the methods described in Example 1 or Example 2, actually delivered the entire quantity of the virtual currency purchased, including any portion of the purchase made using leverage, margin, or financing, and transferred title to that quantity to purchaser, regardless of whether the agreement between purchaser and offeror or counterparty seller purports to create an enforceable obligation to deliver the commodity to purchaser.

Example 4: No actual delivery: within 28 days of entering into a transaction, the agreement, contract, or transaction for the purchase or sale of virtual currency is rolled, offset against, netted out, or settled in cash or virtual currency (other than the purchased virtual currency) between purchaser and offeror or counterparty seller (or persons acting in concert with offeror or counterparty seller).

The CFTC's focus on possession in the Proposed Interpretation, however, has been cast into doubt in another context by a recent U.S. District Court decision that resulted in the dismissal of an enforcement action against a company offering precious metals to customers on a leveraged basis and where the court held that the CFTC lacked regulatory jurisdiction as to alleged commodity fraud under the Actual Delivery Exception. In this case, which does not relate to cryptocurrencies, the defendants offered precious metals on a leveraged, margined, or financed basis, meaning that retail customers purchased the metals by paying a part of the purchase price, with the balance financed. The trading did not take place on a regulated exchange or board of trade, and the defendant was the counterparty to, and set the price for, every trade. The metals were stored at third-party depositories, and customers could only request physical possession of metals upon full payment. The CFTC alleged fraud in violation of the CEA and that these precious metal trades are off-exchange transactions in violation of the CEA. Defendants argued that the CFTC lacked jurisdiction due to the Actual Delivery Exception, and the court agreed. The CFTC is expected to appeal or file an amended complaint.

Since certain cryptocurrencies can only be used on specific platforms, it is difficult to see how the second prong of the Proposed Interpretation with respect to actual delivery — requiring the commodity to be used freely in commerce both within and away from any particular platform — can be satisfied.

Whether there has been "actual delivery" is not just an academic question; rather, absent a new statute, the scope of federal commodities jurisdiction will depend upon how this exception is applied in the commodities context. Accordingly, as with respect to the securities and money transmitter discussion, commodity regulation will depend upon the manner of use — in other words, whether through actual delivery or future delivery.

Swaps/Futures

It is possible, however, that "delivery" or physical settlement of the cryptocurrency will never occur; in other words, that the change in value of a cryptocurrency will be cash-settled in U.S. dollars or another fiat currency. In that case, the cryptocurrency product could be a "swap" or "futures" contract. The definition of "swap" in the CEA is likewise very broad – it includes any contract "that provides on an executory basis for the exchange, on a fixed or contingent basis, of [one] or more payments based on the value or level of [one] or more interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind, or any interest therein or based on the value thereof, and that transfers, as between the parties to the transaction, in whole or in part, the financial risk associated with a future change in any such value or level without also conveying a current or future direct or indirect ownership interest in an asset (including any enterprise or investment pool) or liability that incorporates the financial risk so transferred."

Under this portion of the definition it is possible that contracts for future sale of cryptocurrencies (i.e., ICO pre-sales) that provide the purchaser with a right to transfer the right of future purchase, to book-out or to monetize that right may be considered to be a "swap" and therefore subject to CFTC regulation as a swap. In addition, lack of clarity around the meaning of the phrase "without also conveying a current or future direct or indirect ownership interest" in the context of cryptographic proof or distributed ledger technology where ownership and control have different meanings than in a traditional context may prove problematic and

requires different applications than those based upon exclusive possession and control. If classified as swaps, these products could be subject to a litany of federal swaps regulation, such as reporting, central clearing and recordkeeping requirements, each of which may prove difficult to apply in the context of a distributed ledger.

Conclusion

We are still in the early stages of obtaining clarity with respect to the scope of regulation regarding cryptocurrencies. Part of that may be due to the fact that the early cases testing these issues are usually fraud cases; part of this may be due to the still somewhat limited scope of the use of cryptocurrencies and the fact that it will take some time before more complicated test cases are "ripe" for regulatory review. In any case, it is clear that the regulatory tools for supervision and enforcement exist — and a legislative solution is not necessary — although the application of these tools may require some different approaches in order to take into account technological changes.

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The global march of open banking: the financial technology institutions law in Mexico

Mexico has joined the increasing global trend towards open banking. An ambitious new law aimed at developing innovative financial services and increasing the level of competition and financial inclusion places Mexico at the forefront of the global FinTech industry.

The Financial Technology Institutions Law (the **FinTech Law**) was published in the Mexican Federal Official Gazette on 9 March 2018. It covers a lot more than just open banking though. Here is a quick guide to the key elements of the FinTech Law.

New regulated providers

The FinTech Law introduces two new types of financial technology institutions (FTI) and an innovative model:

- **Crowdfunding Institutions.** Crowdfunding Institutions connect people so that investors can fund investment seekers through mobile applications, interfaces, websites or any other means of electronic or digital communications.
- **Electronic Payment Institutions.** Electronic Payment Institutions offer issuance, management, accountability and transfer of electronic payments services. The funds recorded in an electronic transaction accounting ledger and kept by an Electronic Payment Institution will be considered as electronic payment funds.
- **Innovative Model.** The FinTech Law allows certain FTIs to operate on a temporary basis under an Innovative Model – meaning institutions that provide financial services through technological tools or means with different characteristics to those already available in the market. This type of FTI is eligible for a temporary authorization.

New services: virtual assets

The Law defines 'virtual assets' as account units electronically recorded and used between the public as a payment method for all types of legal transactions and whose transfer can be implemented only through electronic means. This is primarily intended to regulate cryptocurrencies such as Bitcoin, although the broad definition raises concerns that other types of asset could be caught inadvertently.

Banco de México (**Banxico**) will determine, through subordinate legislation, the types of virtual assets that FTIs will be able to use.

Open Banking

In reality, the open access requirements of the FinTech Law are about a lot more than Open Banking; it might be more accurate to call it Open Financial Services, since the law requires all financial institutions (not just banks) to create an application program interface (**API**)s that will allow authorized third parties access to customer data (with the customer's consent). It is hoped that this will lead to the creation of technological tools that improve the experience of financial services users in a more competitive environment.

In relation to Open Banking specifically, account providers will be required to develop and publish APIs giving access both to product data and to customer transactional data. This will support the provision of services such as account aggregation, product comparison, more accurate credit scoring, and services that monitor spending patterns in order to provide 'nudges' to customers about how to make better use of their money.

At present, the FinTech Law does not mandate open access for payment initiation services, as the second Payment Services Directive does in Europe. Given that these services have already started to appear in Mexico, however (facilitated by screen-scraping), it will be interesting to see whether the Mexican government brings them into the fold in a future iteration of the law.

Next steps

The Fintech Law requires the Mexican financial authorities to issue secondary regulations within the deadlines set out below.

Time from the date of publication (is this 9 March 2018?) of the FinTech Law				
	2 months	6 months	12 months	24 months
Ministry of Finance and Public Credit (SHCP)		General provisions to establish procedures and methods to prevent and detect acts, omissions and operations that finance terrorism.	General provisions to establish additional criteria and conditions to grant the temporary authorization for the operation of Innovative Models.	
National Banking and Securities Commission (CNBV)		General provisions to establish the rules related to FTI accounting and business continuity plan.	General provisions related to information accessibility on FTI operations, the use of equipment and technological means, the hiring of services with third parties, and the operation of Innovative Models and self-correction programs by FTIs.	General provisions related to capital requirements and establishing certain bases for data and information exchange.
National Commission for the Protection and Defense of Financial Services Users (CONDUSEF)			General provisions related to the FTI information regarding activities that must be reported to the financial authorities.	
			General provisions to establish additional criteria and conditions to grant the temporary authorization for the operation of Innovative Models	General provisions to establish additional criteria and conditions to grant the temporary authorization for the operation of Innovative Models, as well as self-correction programs by FTIs.
National Commission of the Retirement Savings System (CONSAR) and the National Insurance Commission (CNSF)				General provisions to establish the basis for the exchange of the data and information that may be shared.
Banxico		General provisions relating to the operations carried out by Electronic Payment Institutions, as well as activities linked to payment systems, and limits for the resources that may be maintained on behalf of their clients or which a costumer may use	General provisions regarding the virtual assets with which FTIs may operate, as well as the operations that may be carried out with said assets, the information related to their activities that shall be reported to the financial authorities, the additional criteria and conditions for the granting of the temporary authorization for the operation of Innovative Models, as well as regulation for the self-correction programs.	General provisions to establish the rules for the exchange of the data and information that may be shared.
CNBV and Banxico jointly	General provisions regarding the data security of Electronic Payment Institutions as well as the third-party services that they will be able to hire, and the equipment and technological means that they may use to carry out their operations.		Collaboration agreement that will establish the form and terms for supervising FTI compliance, as well as the enforcement procedures that may be adopted by the corresponding authorities in exercise of their duties.	

The Fintech Law also provides for the formation of a Committee of Financial Technology Institutions, which will be composed of six members, with two representatives from each of the following authorities: the SHCP, the CNBV, and Banxico; each one of them designated by the respective heads of those financial authorities.

Such inter-institutional Committee and the CNBV will be responsible, amongst other things, for discretionally granting the necessary authorizations in accordance with the Fintech Law so that FTIs operate correctly within Mexico.

Grandfathering

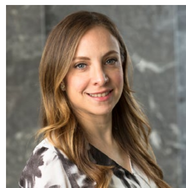
Anyone currently carrying out the activities newly regulated by the FinTech Law will have up to 12 months from its publication date in the Federal Official Gazette to request authorization from the CNBV.

In the meantime, they may continue to carry out such activities until the CNBV approves or denies their request, but until they receive the relevant authorization they must publish on their website that the authorization to carry out such activity is in process and therefore is not an activity supervised by the authorities. Failure to comply with this obligation will result in automatic denial of authorization.

Final Thoughts

The next couple of years look set to be pivotal both for financial services and for the wider Mexican economy. It will be interesting to see how the Mexican FinTech industry evolves under the direction of the FinTech Law, and whether it will achieve at least some of what it promises in terms of addressing financial exclusion and gender inequality, as well as paving the way for the wider economic benefits to be realized.

Contacts



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Compliance due diligence in the context of securities offerings by Brazilian issuers

Introduction

Despite the economic and political crises that have gripped Brazil in recent years, the Brazilian sovereign's loss of its investment grade rating, and the prevalence of Operation Carwash (*Operação Lava Jato*)[1], debt and equity securities issued by Brazilian issuers have been attractive to foreign investors. A recent increase of capital markets activity by Brazilian issuers indicates that foreign investors continue to look to Brazil for investment opportunities.

As a result of the widespread reporting of corruption and the ongoing Operation Carwash investigations in the national and international press, one of the first red flags raised by foreign investors and banks when deciding to invest in securities issued by Brazilian companies is the results of the compliance and anti-corruption due diligence undertaken with respect to such potential issuers. Even prior to the Operation Carwash investigation, investment banks and institutional investors involved in securities issuances exhibited great concern in connection with compliance policies and risk assessment with respect to Brazilian entities which, in part, lead to the enactment of Law No. 12,846, dated August 1, 2013 (Brazilian Anticorruption Law) (as further described herein).

The main purpose of this article is to describe the importance of conducting effective compliance due diligence to address applicable laws such as the **Brazilian Anticorruption Law**, the U.S. Foreign Corrupt Practices Act (**FCPA**) and the Bribery Act 2010 of the United Kingdom (**UK Bribery Act**), as well as risk mitigation and reputational concerns, all in the context of securities offerings by Brazilian issuers into the international capital markets.

Overview of International Placement of Securities Offerings by Brazilian Issuers

In Brazil, securities offerings are subject to a number of rules and regulations that have been enacted by the local securities regulator, the Brazilian Securities Exchange Commission (*Comissão de Valores Mobiliários*) (**CVM**). From a U.S. law perspective, international placements of securities issued by a Brazilian issuer are typically offered and sold under the exemptions from registration required pursuant to the U.S. Securities Act of 1933, as amended (**U.S. Securities Act**), such as those provided by Rule 144A of the U.S. Securities Act (**Rule 144A**) as well as the exemption provided for non-U.S. persons under Regulation S of the U.S. Securities Act (**Regulation S**).

In respect of offerings of equity securities, which typically are undertaken by means of an initial public offering (**IPO**) or follow-on offerings, applicable Brazilian laws require that an offering prospectus containing the terms of the securities in question and related matters (prospecto) and a disclosure document containing detailed information with respect to the issuer (*Formulário de Referência*) are filed with the CVM. The content and format of such disclosure are governed by a fulsome set of rules and regulations. A key requirement is that the documentation filed with the CVM must be in Portuguese. For the purposes of securities offered to investors outside of Brazil, typically an offering memorandum is also prepared in English containing the terms and conditions of such equity securities and related matters, as well as disclosure regarding the issuer, utilizing the disclosure standards applicable to transactions undertaken pursuant to the exemptions from registration available under Rule 144A and/or Regulation S.

1 In March 2014, while conducting a small investigation involving a local gas station/carwash in the city of Curitiba (state of Paraná, Brazil), the Brazilian Federal Police and the MPF uncovered evidence of a much larger corruption and bribery scheme involving Brazil's state run oil company, Petrobras. Shortly after Brazilian authorities became aware of the scheme, a federal investigation, dubbed Operation Carwash (Operação Lava Jato), was initiated and is being conducted by Federal Prosecutors and the Federal Police with the support of a Federal Judge, Sérgio Moro. Operation Carwash was initially thought to involve high-ranking employees of Petrobras and several of the country's largest construction companies. However, after the arrest of certain key individuals, such as Petrobras' former Director of Refining and Supply, Brazilian authorities became aware that the scheme was a billion-dollar operation involving numerous politicians and political parties. Operation Carwash is still ongoing and it has spread around other sectors of the Brazilian economy.

Therefore, Brazilian qualified lawyers prepare the local offering disclosure and other documents required for filing with the CVM and otherwise execute the offering to investors in Brazil, with the input of the other parties to the transaction, which should include foreign underwriters or placement agents and counsel (which are typically U.S. qualified lawyers) retained for the international leg of an equity offering, such as an IPO with sales of shares to investors outside of Brazil.

With respect to offerings of debt securities by a Brazilian issuer, the debt securities are typically offered and sold in private placements pursuant to an exemption from registration under the U.S. Securities Act, in many cases by using the exemptions under Rule 144A and Regulation S, as described above. Unlike equity securities offerings by Brazilian issuers listed in Brazil, debt securities offerings by Brazilian issuers do not need to be filed with the CVM. Thus, only an offering memorandum in English containing the terms and conditions of such debt securities and disclosure regarding the issuer need to be prepared for the purposes of providing the requisite information to potential investors, as required by the U.S. Securities Act, Rule 144A and Regulation S.

While Rule 144A contains less fulsome disclosure requirements when compared to an offering registered with the U.S. Securities Exchange Commission (**SEC**) under the U.S. federal securities laws, market practice and general U.S. anti-fraud considerations have developed to the effect that U.S. investors in offerings made pursuant to Rule 144A expect disclosure standards similar to what would otherwise be required for transactions subject to SEC registration. Thus, the relevant SEC disclosure standards are used as guidance by international counsel in preparing the offering documents (with some exceptions).

However, a misstatement or omission of fact in the applicable disclosure document could open parties involved in the securities offering (including the investment banks, the issuer's shareholders, officers, and directors, as applicable) to legal proceedings instituted by investors and in some instances, enforcement actions by U.S. and European regulators. In order to mitigate this risk, the drafting process, business due diligence, bring down due diligence and compliance due diligence must be carefully managed by the parties involved in the respective securities offering.

Compliance Due Diligence

Under Brazilian law, compliance is a set of measures to prevent or mitigate the risk of violation of laws in connection with an activity carried out by a person (e.g., shareholder, officer, director, employee or a third party service provider contracted by the issuer). In addition, compliance strengthens the internal controls of the issuer, mitigating risks to the issuer's reputation and reflecting transparency and high ethical standards, generating more value and credibility for its shareholders and investors.

The need for conducting an in-depth compliance due diligence in the context of securities offerings by Brazilian issuers cannot be analyzed without further observation of the Brazilian political and macroeconomic scenario. A turbulent political and economic environment, coupled with popular protests in June 2013, lead to the legislative action needed to cause the enactment of the Brazilian Anticorruption Law, which was approved in 1 August 2013, by the then President Dilma Rousseff. The Brazilian Anticorruption Law became enforceable in January 2014 and further regulations were issued in March 2015 which imposed the need for Brazilian companies to have an effective compliance program.

Three years later, on 31 August 2016, the then President Dilma Rousseff was found guilty in an administrative proceeding conducted by the upper house of the Brazilian legislature during an impeachment procedure. As a consequence, President Dilma Rousseff was impeached and removed from office and Vice President Michel Temer became President for the remainder of Ms. Roussef's term, which ends on 1 January 2019.

Considering the political scenario described above and the ongoing Operation Carwash, their ramifications in other sectors of the economy and the involvement of large Brazilian companies, politicians and their political parties, undertaking compliance due diligence has become an essential requirement to executing securities offerings by Brazilian issuers in order to prevent, or mitigate, the risks of legal proceedings to be brought by the investors and regulators, as well as reputational risks to institutions involved in such transactions (including investment banks involved in the marketing and/or underwriting of such securities).

Despite the political scenario in which the Brazilian Anticorruption Law was enacted, this legislation was considered innovative in imposing liability on companies and their officers, directors, and shareholders. Strict liability applies to the company in question, as no intent to commit corruption needs to be found in order for a company to be convicted under the Brazilian Anticorruption Law. The law may also allow for the piercing of the corporate veil in order to reach shareholders of the company in question. In addition, should the company interfere in public biddings, including the competitive nature of such biddings, it could be found guilty under the new Brazilian Anticorruption Law.

In the context of securities offerings by Brazilian issuers, a compliance due diligence is a prior investigation conducted to identify any potential liability of the issuer before the launch of the offering, in order to prevent risks involved in the offer for underwriters. It may also involve setting out a strategy to mitigate liability of the parties involved in the offer. How thorough a compliance due diligence is undertaken will very much depend on the issuer's circumstances and the risk perception by the underwriters. It therefore varies from a set of tailored questions addressing all aspects of the issuer's compliance policies and procedures, coupled with media review of the company, its shareholders and directors, and judicial searches, to a complete due diligence which mirrors an internal investigation.

A fulsome compliance due diligence will contain the following elements and work product:

- document review;
- background check of key individuals;
- fact interviews with officers, directors and key employees of the issuer; and
- an analysis of internal practices, policies and relevant information, which should include, among other things, (a) a description of the business activities and where such activities are conducted; (b) information about political exposed persons and interactions with government officials; (c) accounting and finance controls; (d) off-balance sheet transactions; (e) relationships with external auditors; (f) charitable and political donations; (g) gift policies; (h) third-party intermediaries; (i) policies and procedures with respect to commercial bribery; (j) policies and procedures with respect to participation in public biddings; (k) policies and procedures with respect to conflicts of interest; (l) policies and procedures with respect to sanctions and embargoes; (m) policies and procedures with respect to privacy and cyber security; (n) judicial and administrative proceedings; (o) permits and licenses; and (p) compliance with the Brazilian Anticorruption Law, the FCPA and the UK Bribery Act, as applicable. Depending on the applicable company's exposure to the FCPA or UK Bribery Act, other activities can be undertaken.

Upon conclusion of an effective compliance due diligence, it should be possible to identify the contingencies (whether or not such contingencies have materialized), that may result in risks to the offering and to the issuer, and also some strategies may be proposed by the counsels to resolve or mitigate risks that could impose liability on or reputational harm to parties involved in the securities offering. In addition, compliance due diligence process serves as a great opportunity for the issuer to verify that all internal practices and policies are being conducted in compliance with applicable laws and market practice, thereby reducing the possibility of judicial and administrative procedures being brought by applicable regulators or investors.

One of the strategies to mitigate the risk of a class action brought by future foreign investors arising from a corruption scandal that becomes public after the settlement of the securities offering, is the proper disclosure of the potential acts of corruption in the applicable offering disclosure, disclosing the current status of ongoing investigations and, as the case may be, the dismissal of the persons involved in the respective corruption by the issuer. Compliance due diligence will assist in identifying any such risks so that proper disclosure can be included in the applicable offering memorandum.

In addition, the representations and warranties made by the issuer under the placement facilitation agreement or underwriting agreement (in offerings of equity securities) or the note purchase agreement or subscription agreement (in offerings of debt securities), as applicable, should include an issuer's statement or selling shareholders' statement in respect of such entity or individual's compliance with the Brazilian Anticorruption Law, the FCPA, and the UK Bribery Act, as applicable. Undertaking a fulsome compliance review is necessary in order to allow for the individual or entity making such representations to be in a position to accurately make the requisite declarations or otherwise address the subject thereof with the other parties to the proposed securities offering (such as the investment banks). These representations are of critical importance to investment banks involved in the marketing and/or underwriting of securities, given the risks inherent in participating in offerings in the current environment.

Conclusion

Due to the current national political and economic scenario, Brazilian companies are incorporating the compliance culture into their own daily practices, observing and respecting investors' requirements of undertaking compliance due diligence as part of an international offer of securities. This measure has become essential to companies that want to receive foreign investments and compete for funds in the international capital markets. Given that there is international interest in eradicating corruption around the world, it is no longer acceptable for companies who wish to tap the market not comply with the demands of the Brazilian Anticorruption Law and the standards set by the FCPA and the UK Bribery Act.

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The development of the ABS market in China and latest market trends

Introduction

Asset-backed securitization (**ABS**) - the process of taking an illiquid asset, or pool of assets, and transforming it (or them) into tradable securities, first emerged in the U.S. in the 1970s and has developed into a mature market in both U.S. and Europe. The ABS market in People's Republic of China (**PRC**) , however, is relatively new and still evolving.

History: 2005 - 2009

Securitization was officially established in China after the launch of the credit asset securitization pilot program in 2005, pursuant to a set of administrative regulations promulgated by the China Banking Regulatory Commission (**CBRC**) the main regulator of the banking industry in China and the Chinese central bank, the People's Bank of China (**PBOC**)[1]. These regulations comprise primarily of: (i) The Administration of Pilot Projects for Securitization of Credit Assets Procedures (April 2005); and (ii) The Measures for Pilot Supervision and Administration of Securitization of Credit Assets of Financial Institutions (November 2005).

At the same time, the China Securities Regulatory Commission (**CSRC**), the main regulator of the securities industry in China, also launched its first securitization scheme pursuant to administrative regulations entitled Interim Measures on Managing Client Assets by Securities Firms (August 2005). Under the CSRC's 2005 regulations (which were seen at the time to rival the CBRC regulations), securities companies could apply to the CSRC for approval to establish a "selective asset management plan" (**SAMP**). However, neither program continued indefinitely. The CSRC SAMP program was soon discontinued as the structure relied heavily on third party guarantees due to perceived difficulties with legal isolation. The onset of the 2007 global financial crisis led to the suspension of the securitization program supervised by the CBRC in 2009.

The current view of securitization in China

In 2012, securitization re-emerged in China after the PBOC, CBRC and the Ministry of Finance jointly issued a notice to expand the credit asset securitization pilot program. Since then, the securitization market in China has grown very rapidly. Securitization is viewed by the PRC government as an alternative funding source and balance-sheet-management tool to help alleviate China's shadow banking problems.

We'll talk about the different structures below and then talk about what is happening in the market at the moment.

The securitization regimes in China

There are two regulatory regimes in China for securitization: the Credit Asset Securitization (**CAS**) and Asset-Backed Specific Plan (**ABSP**) Schemes, and we discuss each of these below. There is currently no consolidated securitization statute or law in China, although there are general PRC laws which are applicable to securitizations, including PRC Contract Law, PRC Property Law, PRC Enterprise Bankruptcy Law and the Measures on the Administration of Bond Transactions in the Inter-bank Bond Market.

What is China's shadow banking problem?

Since the 2007 global financial crisis, China has invested huge amounts into its economy. As well as formal bank loans, money has also been funneled into the economy through a variety of other channels, including shadow banks. Chinese officials are keen to bring this under control and are focusing on channeling assets towards the real economy. To this end, alternative funding sources and balance-sheet-management tools such as securitization are appealing.

1 For the purpose of this article, PRC does not include the Hong Kong Special Administrative Region, the Macau Special Administrative Region or Taiwan.

CAS Scheme

The CAS Scheme (sometimes known as **CASS**) is specifically for financial institutions and uses the special purpose trust (**SPT**) structure under the PRC Trust Law.

Key features to note are:

- The CAS scheme is regulated by the CBRC and the PBOC.
- Under the CAS Scheme, banks and non-bank financial institutions licensed by CBRC may entrust loan receivables comprising "credit assets" to a CBRC-licensed trust and investment company as trustee.
- Under a SPT, the receivables typically securitized are credit assets of the originator, including consumer auto loans, infrastructure project loans, agriculture-related loans, qualifying loans to financial vehicles of local governments, loans related to strategic emerging industries, residential mortgage loans and loans related to affordable housing projects.
- In practice, the asset classes most frequently securitized under SPTs are residential mortgage loans, corporate loans (including non-performing loans) and auto loans.

ABSP Scheme

The ABSP Scheme is used by all non-financial institution issuers and therefore dominated by corporate issuance where such securities are listed either on the Shanghai or Shengzhen Exchange or private issuances over-the-counter.

Key features to note are:

- The ABSP Scheme is regulated by the CSRC.
- The ABSP Scheme uses the SAMP structure, which is set up by a securities company as an asset management scheme (not a trust) to acquire the underlying assets from the originator (usually a cooperation).
- The legal basis for the SAMP stems from the CSRC Securitization Measures.
- The ABSP market consists of a broad range of assets, including securitized assets issued by state-owned enterprises (SOE), corporate receivables, creditors' rights under leases, credit assets, beneficial interest in trusts, profits from infrastructure projects and commercial real estate and other assets or property rights.
- According to one source[2], SOE restructuring is high on the agenda of many local governments and as part of the restructuring, local governments are supporting the securitization of SOE assets. For example, the East China's Shandong province recently released guidelines to support securitization of SOE assets and by 2020, it plans to bring at least three SOEs or their core businesses onto the capital market and raise the securitization rate of provincial-level SOEs to more than 60 percent.

Asset-backed notes

Another form of securitized product in China is the asset-backed note (**ABN**). This structure is similar to a loan secured by assets of the issuer (being a non-financial institution), or a "covered bond" structure. However, there is an important distinction: there is no supporting legislation allowing for the segregation of the assets backing the note from the issuer's other assets. Therefore, an ABN issue is sometimes referred to as a "quasi-securitization".

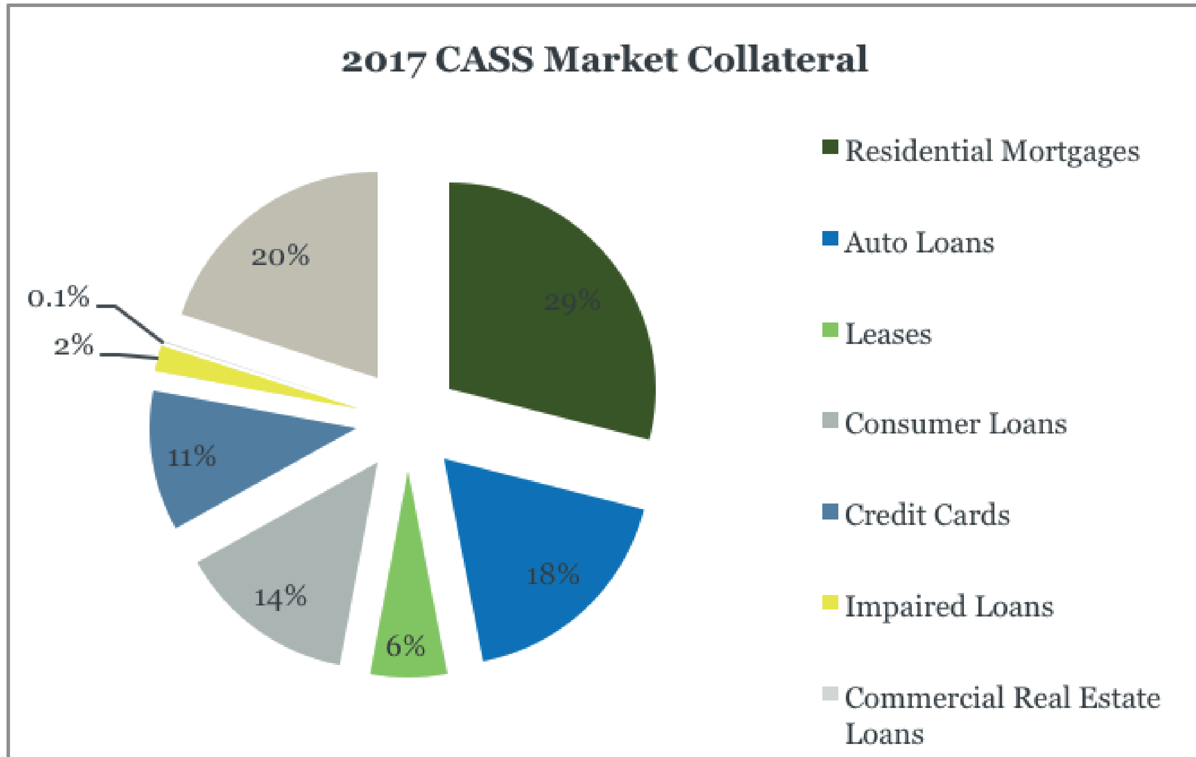
Developments in the securitization market in China

Since its revival, the securitization market in China was initially slow during 2012-2013 but picked up steam in the second half of 2014 and has been on a rapid growth trajectory ever since. In 2017, the total volume of issuance of asset-backed securities (**ABS**) in China reached US$230bn, marking a 65.86% increase compared to 2016. The total outstanding volume of ABS by the end of 2017 stood at US$326bn, a 66.41% increase from 2016.[3]

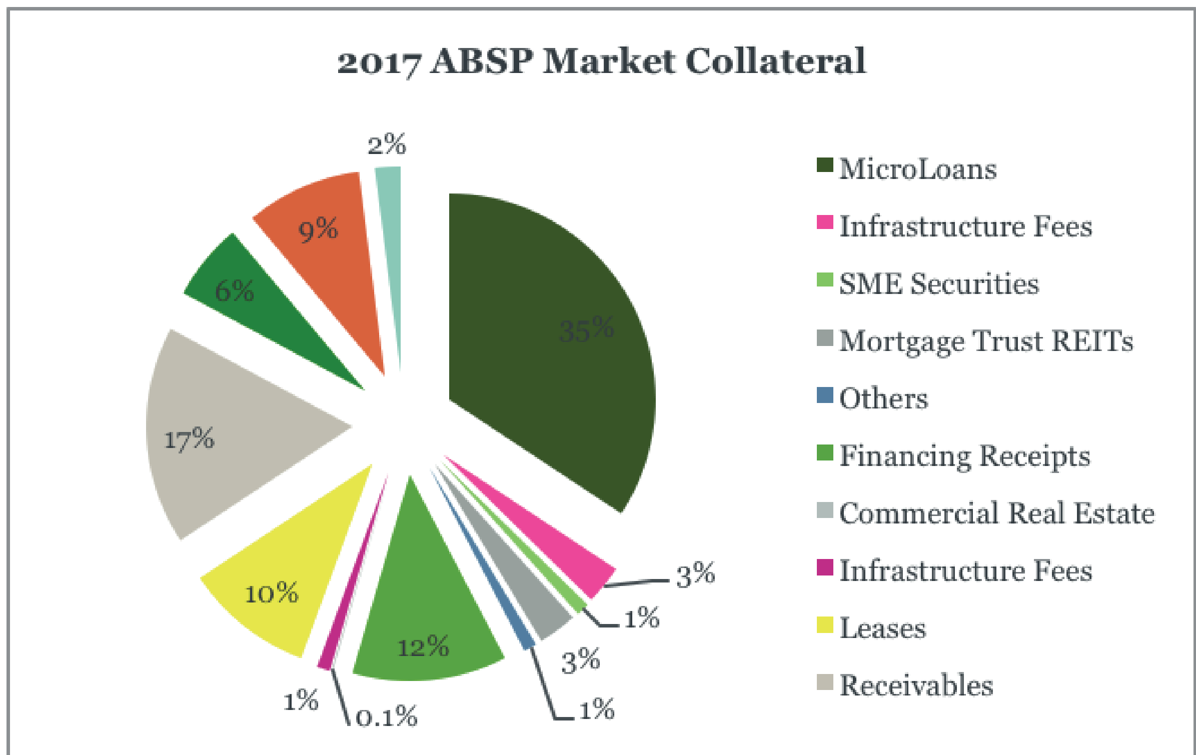
2 China Daily – "China SOE reform set to accelerate", 26th October 2017

3 Figures in this paragraph are taken from the 2017 Asset-Backed Securities Development Report, published by the China Central Depository & Clearing Co., Ltd., pg.6 (2017年资产证券化发展报告)

As can be seen from the charts below, a wide range of assets have been used in securitization deals in each of the CASS and ABSP markets.



CASS Market Collateral, 2005-2015 (Wind, January 2018)



ABSP Market Collateral, 2005-2015 (Wind, January 2018)

Property ABS market in China

One area where there is reportedly a lot of growth in China at present is the property ABS market. This market includes residential mortgage-backed securities (**RMBS**) and commercial mortgage-backed securities (**CMBS**) issued under the CAS Scheme or the ABSP Scheme. Property ABS are becoming more popular as an alternative funding solution in light of the lower funding costs compared to loans due to the Chinese government tightening their policy and imposing high thresholds and costs for securing bank loans and issuing corporate bonds.

Property ABS can also help banks to transfer some of their liquidity risks to investors and free up cash flows of long-term loans for other investments.

As insurance companies are expressly allowed to invest in property and ABS products pursuant to the Measures for the Administration of the Utilization of Insurance Funds (which came into force on 1 April 2018), we anticipate that Chinese insurance companies will increasingly invest in property ABS products. The lower interest rates in the domestic loan market and a need for portfolio diversification will make this product attractive.

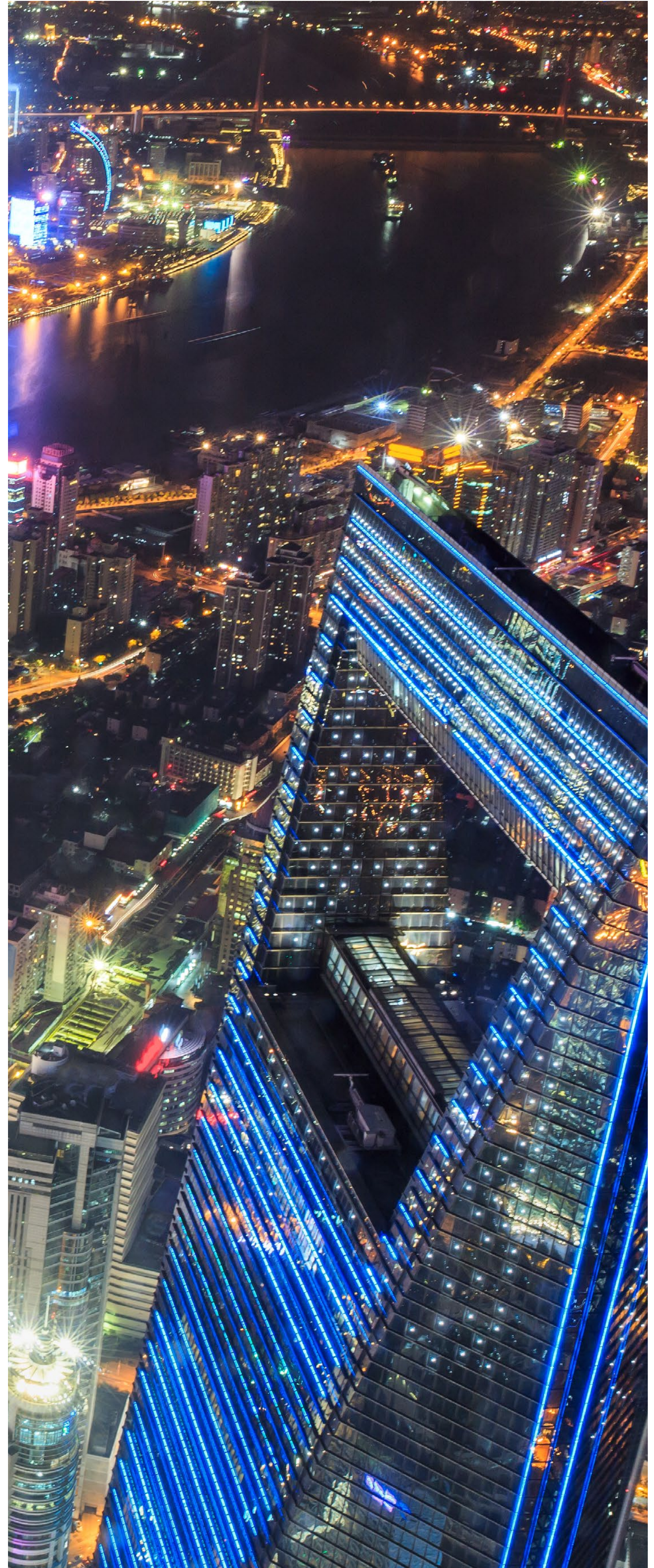
How the China property ABS market compares to ABS in developed markets

The property ABS market in China has developed rapidly in recent years. However, it is still at a nascent stage compared to developed markets and there are several reasons for this.

First, given the complexity of the property ABS products and lack of retail participants, there is no secondary market for property ABS in China.

Secondly, stringent financial regulation means there is a lack of origination of securitized assets.

Finally, the issuance of RMBS is limited due to incomplete individual credit data.



Legal issues

Whilst the ABS market continues to grow in China, there remain a number of legal issues which need to be addressed. We highlight some of these below:

- One fundamental issue is that the CAS and ABSP Schemes are fairly new, and as such are untested (or inadequately tested) in PRC courts. Even if an insolvency of a key securitization party or participant (e.g. the sponsor or the manager) were to occur that was adjudicated by a PRC court in favor of the integrity of the securitization scheme, there is no precedent in the PRC.
- Furthermore, both the CBRC and CSRC regulations are not statutory law. Being a civil law jurisdiction, it is important that the securitization schemes in the PRC are codified in statute, in order to create clarity and certainty for market participants.
- Another issue is that under the Security Law and Property Rights Law, mortgages over "immovable" (e.g. real estate) require registration to create the mortgage whereas mortgages over "movables" (e.g. motor vehicles) are created by contract and require registration only to perfect the mortgage. This could pose a challenge, especially for RMBS where there would be a large number of re-registrations involved. The Ministry of Housing and Urban-Rural Development issued a notice (as a trial) to facilitate the efficient registration of any change to the underlying residential mortgage loans of RMBS by allowing the originator to file with the registrar any mortgage associated with residential mortgage loans in bulk and to notify all the debtors in bulk by way of disclosure of the mortgage transfer using specified media. ABS transactions involving mortgage-secured auto loans, on the other hand, may be more feasible in terms of transferring rights in collateral.
- Under the Security Law and Property Rights Law, it is not technically possible to create a security interest over a bank account. The "lock-box" account concept is not available in the PRC as a way for buy-side parties to control cash so other arrangements must be made, such as diversions of funds paid by obligors on day one.

Future outlook

The ABS market in China has been highly successful to date. The legal and regulatory challenges remain (and we have only highlighted a few examples of these).

According to a report by Pengyuan International, a credit rating agency, demand remains strong: the issuance of transactions backed by commercial real estate assets will continue to increase, driven by favorable policies in the housing rental market and property developers' incentives to diversify their financing channels.

Certainly its importance as an alternative funding source and balance-sheet-management tool is something that should not be forgotten and it is an important arrow in the Chinese government's quiver.

The recent trend of tightening regulations and increasing enforcement actions (such as the new regulations on capital, liquidity and risk management for banks issued by the CBRC) may continue and we expect that China's ABS market will continue to grow in 2018 and into 2019, albeit at a more moderate pace than in the last couple of years.

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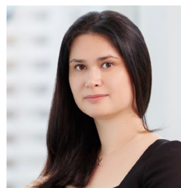

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Securitization of income contingent student loans – breaking new ground

Overview and background

In December 2017 we acted for the UK Government on its first securitization of income contingent student loans (**ICR Loans**), which involved the largest ever sale of student loans in the United Kingdom. As the amount of public student loan debt in the UK rapidly approached £100bn, the UK Government has been seeking to sell some of that loan book to the private market. This process began in 2010 but took almost seven years to complete, given the complexity of the asset and intervening events.

The transaction was designed to take the relevant loan book off the public balance sheet by transferring risk in the loan book to the private sector. The proceeds of the sales will go towards reducing public sector net debt, which as at the end of October 2017 stood at approximately £1.8tn.

Summary of the Transaction

As a part of the transaction, approximately £3.7bn of ICR Loans were sold by the UK Government to an orphan special purpose vehicle (the **Issuer**). The Issuer issued four tranches of notes backed by the pool of ICR Loans, the junior-most of which (i) bear interest at a fixed interest rate and (ii) include an entitlement to collections remaining available after all other costs of the transaction have been paid.

How is the Transaction different from previous UK Student Loan Securitisations?

The UK Government has previously sold portfolios of student loans which were then securitized by the private sector purchasers (including the "Honours" and "Thesis" transactions). There are two principal differences between the securitization of ICR Loans and these earlier transactions. These differences relate to the underlying asset class as well as the post sale servicing arrangements.

The types of loans securitised in Honours and Thesis are significantly different from ICR Loans. Honours and Thesis were backed by "mortgage style" loans (**MSL**), which are repayable over a fixed number of instalments irrespective of the amount the borrower is earning. In contrast, repayments under ICR Loans are calculated at a repayment rate multiplied by earnings above a repayment threshold. This results in a more flexible "loan" product for the borrower under which repayments are adjusted depending on employment status and earnings of the borrower.

The other key difference is that repayments for the loans securitized as part of the Honours and Thesis transactions were collected directly by the Student Loans Company (**SLC**) prior to the sale through direct debit and other standard payment channels. The servicer appointed by the buyer took over this function after completion of the sale. Unlike Honours and Thesis, repayments of the ICR Loans are (and continue to be after sale) collected by HM Revenue and Customs (**HMRC**) and Student Loans Company (**SLC**). Consequently borrowers are unaffected by the sale and continue to deal with SLC in relation to their loan account. In addition, the investors in the loan portfolio have the benefit of the majority of collections being made directly through the UK tax system by HMRC.

Key features of the Transaction

As with many "first-of-its-kind" transactions there were many challenges which required new and innovative solutions to be developed to achieve a successful completion.

Permission to sell

At the time the UK Government decided to sell the book of ICR Loans, there was no legislative framework under which the ICR Loans could be transferred. The Education (Student Loans) Act 1998, pursuant to which MSLs had been sold was repealed when MSLs were

replaced by income contingent repayment loans in 1999. The UK Government relied on a specific Act of Parliament to enable the sale; the Sale of Student Loans Act 2008 (the **SSLA**).

The UK Government can adjust loan terms

The UK Government retained the right to adjust the terms of the ICR Loans following the sale. This could potentially have an adverse impact on the return to the investors. Accordingly, pursuant to its powers under the SSLA, the UK Government agreed not to make certain changes to the loan regulations (including amendments which cause a reduction to the interest rate, an increase to the repayment threshold, a reduction in the repayment rate and a change to the write-off date) unless the UK Government compensated the Issuer for any material losses caused as a result of such amendment. Various other key amendments also trigger payment of compensation. The way in which compensation is to be calculated means that compensation should only be payable by the UK Government where it has made a specified amendment to the loan terms and that there is a difference between actual collections on the loan and what those collections would be if the amendment had not been made. This gives investors certainty as to the terms of the ICR Loans. For the UK Government the compensation provisions allowed it to ensure that all borrowers (whether or not their loan has been sold) will continue to be treated in the same way.

Collections of receipts

As with any other loan portfolio, the performance of the servicer is a key factor in the performance of the ICR Loans and investors would usually expect to have a right to replace the servicer for breach of its obligations under the relevant transaction documentation. Repayments on the ICR Loans are largely collected through the UK tax system and continue to be so

collected following the securitisation. Given the unique position of HMRC as an entity collecting repayments through the UK tax system and given the policy of treating borrowers of sold and unsold ICR Loans equally, it would not be possible for a private entity to replicate or be involved in the collection of repayments of the ICR Loans. To deal with the practical inability of investors to replace the UK Government as master servicer even if it breaches any of its obligations (which in another asset class would be a servicer termination event) the master servicer must, in those cases, prepare and implement a remedial plan. The remedial plan would set out the way in which the master servicer proposes to remedy the breach or for the master servicer to indemnify the Issuer. This would help the Issuer compensate the investors for any loss caused to them as a result of breach of the master servicer's obligations in relation to the ICR Loans.

The transaction also maintains collections of repayments on the ICR Loans through the UK tax system and servicing of the loans by SLC broadly to the standards which those parties collect and service unsold loans. In this way HMRC and SLC could maintain "business as usual" processes in relation to the sold loans (as well as the unsold loans).

Risk Retention

As well as being structured to comply with EU risk retention requirements under Article 405 of the CRR, Article 51 of the AIFMR and Article 254 of the Solvency II Regulation, the risk retention needed to be compatible with the UK Government's objective of achieving off-balance sheet treatment for the UK Government accounting rules. This was achieved through the UK Government retaining a randomly selected pool of loans equal to at least 5% of the securitised portfolio which would have otherwise been eligible for sale into the securitisation.

Matching Adjustment

To encourage investment in the transaction by insurance companies, certain classes of the notes issued by the Issuer were structured to support insurance company investors allocating the notes to their "matching adjustment" portfolio under the Solvency II Regulation

What next?

- This was the largest ever sale of student loans in the UK. It was also the first time anywhere in the world ICR loans have been securitised creating an entirely new asset class – notes backed by income contingent loans.
- The successful conclusion of this transaction has opened the door for the UK Government to continue its commitment to, subject to market conditions, sell further portfolios of Plan 1 (pre-2012) student loans over the following four financial years, and indicates that the securitisation market remains open to new and innovative asset classes.

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European Non-Performing Exposures are running out of time

On 15 March 2018, following a public consultation which ran from 4 October 2017 to 8 December 2017, the European Central Bank (the **ECB**) published the "*Addendum to the ECB Guidance to banks on non-performing loans: supervisory expectations for prudential provisioning of non-performing exposures*" (the **Addendum**)[1]. The Addendum supplements the "*Guidance to banks on non-performing loans*" (**ECB Guidance**)[2] released by the ECB on 20 March 2017 and is applicable to all significant institutions supervised by the ECB. The ECB Guidance is a tool which clarifies supervisory expectations regarding identification, management, measurement and write-offs of non-performing exposure (**NPEs**)[3] to foster more timely provisioning practices for NPEs in the context of existing regulations, directives and guidelines.

In particular, such supervisory expectations are deemed complementary to a proposal (adopted by the European Commission on 14 March 2018 (the **Proposal**) in line with the aim of tackling the high number of NPEs in the European Union) for a Regulation amending the Capital Requirements Regulation (the **CRR**) as regards minimum loss coverage for non-performing exposures. The Proposal provides for a statutory prudential backstop against any excessive future build-up of NPEs without sufficient loss coverage on banks' balance sheets in order to ensure that credit losses on future NPEs are sufficiently covered.

Scope of application

In line with the ECB Guidance, the Addendum specifies the ECB's supervisory expectations from the Banks when they assess their level of prudential provisions for NPEs management. It applies to NPEs which are classified as such from 1 April 2018 onwards and the results of the supervisory dialogue relating to its provisions will be incorporated, for the first time, in the 2021 Supervisory Review and Evaluation Process (**SREP 2021**).

The Addendum's main criteria

The prudential expectations set out in the Addendum consider:

- the length of time an exposure has been classified as a non-performing loan; and
- the collateral held (if any) in relation to any such loan.

With regards the length of time, the Addendum uses an "NPE vintage" concept (specifically, the number of days from the date on which an exposure was classified as non-performing) so that the compliance with the supervisory expectations depends on the length of time a loan has been classified as NPEs.

In respect of collateral, on the basis of the distinction between secured and unsecured exposures as described below, the Addendum applies prudential principles to define the eligibility criteria for credit protection which are used to determine which parts of NPEs are to be deemed secured or unsecured and, consequently, whether to consider supervisory expectations for secured or unsecured exposures. The aim is to avoid an excessive build-up of non-covered aged NPEs on banks' balance sheets in the future.

Secured and unsecured exposures

As indicated, the supervisory expectations distinguish between secured and unsecured (parts of) NPEs in accordance with the existence of certain form of credit risk protections. Specifically, the Addendum recognizes as potential collateral (a) all types of immovable property collateral; and (b) other forms of credit risk protection meeting the criteria of credit risk mitigation set out in the CRR.

1 Please see https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.npl_addendum_201803.en.pdf.

2 Please see https://www.bankingsupervision.europa.eu/ecb/pub/pdf/guidance_on_npl.en.pdf.

3 According to paragraph 145 of Annex V of the EBA Implementing Technical Standard (ITS) on supervisory reporting "non-performing exposures are those that satisfy either or both of the following criteria: 1) material exposures which are more than 90 days past-due; and 2) the debtor is assessed as unlikely to pay its credit obligations in full without realisation of collateral, regardless of the existence of any past-due amount or of the number of days past due."

Accordingly, the Addendum divides the NPEs into the following main categories:

Fully unsecured exposures: if no types of credit risk protection covers the exposures.

Fully secured exposures: if the exposure's amount is fully covered with collateral or any other form of credit risk protection.

Partially secured exposures: if the exposures are partially collateralised so that they may be further split into secured balance and unsecured balance which, then, shall be assessed in line with the relevant supervisory expectations outlined above.

The prudential provisioning expectations

The Addendum sets out an expectation that new unsecured NPEs will be fully covered after a period of two years from the date of their classification as NPEs (i.e. a loan that is classified as an unsecured NPE on 1 September 2018 should be fully provisioned for by September 2020).

For new secured NPEs, the provisioning of the exposures will take longer so a certain level of provisioning is expected after three years of being classified as a NPE which would then increase over time until the seventh year (i.e. it would be expected that a secured loan classified as an NPE on 1 September 2018, would be at least 40% provisioned for by September 2021 and totally provisioned by September 2025). Hence, secured loans should be fully provisioned for after 7 years and banks are expected to review the value of collateral on a regular basis.

However, as the supervisory expectations are non-binding, the ECB will discuss with each Bank eventual divergences from the prudential provisioning expectations laid out in the Addendum (the so-called "comply or explain" approach). The results of such supervisory dialogue will be included for the first time in the SREP 2021 which, among the others, will also take into consideration the linear path in implementing the above-mentioned prudential provisions.

What about Italy?

On 30 January 2018 (after a consultation phase which started in September 2017), in line with the ECB's approach, the Bank of Italy published specific guidelines applicable to so called "less significant" institutions ("*Linee guida per le banche Less Significant italiane in materia di gestione dei crediti deteriorati*" – **BoI Guidelines**).

Scope of application

The BoI Guidelines set out the Bank of Italy's expectations and best practices on the management of NPEs by Banks to which the ECB Guidance does not apply (Less Significant Institution (**LSI**)). The BoI Guidelines (like the ECB Guidance) are non-binding in nature. They will not apply where other European or national laws and regulations already exist. Non-complying Banks may be required by the supervisory authorities to account for any failure to comply with the BoI Guidelines.

Main actions to be taken

The BoI Guidelines require the Italian LSI Banks to take certain actions, including:

NPEs strategy: to adopt a clear strategy for the management of the NPEs and to maximise the value of the recoveries. In particular, LSI Banks need to prepare operational plans for both short term (approximately 1 year) and medium/long-term (approximately 3/5 years) horizon, setting out the objectives to be achieved and the best combination of recovery actions (such as, inter alia, internal or externalized NPEs management, restructuring and forbearance measures, securitisation or other form of NPEs assignment resulting in the derecognition of the assigned assets). For such purpose, the LSI Banks shall fully involve the strategic supervising body (organo di supervisione strategica) in the implementation, update and assessment of the relevant plans.

Mitigation of the conflict of interests: to establish measures aimed at mitigating any conflict of interest which may arise in granting credit and managing NPEs.

Internal organisational measures: to put in place the relevant organisational measures for the classification, valuation (including write-off policies and collateral valuations) and management of NPEs (such as, inter alia, establishing internal procedures and early warning systems, reporting and monitoring systems, internal audit assessment).

Database: to manage and record material information from NPEs in a dedicated database, in order to allow timely management decisions and assist the decision-making process.

During the course of 2018, the Bank of Italy may supplement the BoI Guidelines to take into account any analogous initiatives which may be adopted within the context of the "*Council conclusions on Action plan to tackle non-performing loans in Europe*" published on 11 July 2017 and later approved by the ECOFIN Council.

Final thoughts

The Addendum's prudential expectations are all non-binding in nature and will serve as a starting point for a supervisory dialogue with each individual Bank on the adoption of adequate and timely provisions for NPEs.

As mentioned above, the Addendum applies only to new NPEs so the exact impact of its prudential provisioning expectations upon each Bank will mainly depend on the amount of NPEs' inflows which, actually, have been reducing across the EU in recent years. Nevertheless, given that managing NPEs by means of sales is expressly indicated as one of a number of possible tools to address high levels of NPEs, it is expected that one potential impact of the Addendum will be a further boost of the secondary NPE market activities (i.e. securitizations).

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Discontinuation of LIBOR: How documentation in securitizations and other debt capital markets transactions is responding to the development

Issues

Market participants should not rely on the London Interbank Offered Rate (**LIBOR**) being available after 2021. That was the message delivered on 27 July 2017 by Andrew Bailey, chief executive of the United Kingdom Financial Conduct Authority (the **FCA**). This approach stems from the FCA's concern that it is potentially unsustainable and undesirable for market participants to rely on reference rates such as LIBOR that do not have active underlying markets to support them. Accordingly, the FCA proposes to transition to alternative reference rates that are firmly based on transactions.

LIBOR's administrator, ICE Benchmark Administration Ltd., has said that it intends to continue to produce LIBOR after 2021 because it believes that in accordance with the Wheatley reforms it has modified the index into a sustainable, modern part of the financial system. LIBOR's survival, however, cannot be guaranteed as the FCA has said that it will not compel or persuade LIBOR panel banks to continue to submit quotes after 2021 and so in practice they may be unlikely to do so.

There are three main issues that are thrown up by the planned discontinuation of LIBOR:

1. What will replace LIBOR?
2. How do current transactions in the market address the fact that LIBOR could potentially be discontinued during the term of the transactions?
3. How do we deal with transactions that have already been entered into with maturities that extend to beyond 2021?

This article looks at each of these issues in turn.

What will replace LIBOR?

The long term issue is obviously the development of a robust and feasible alternative to LIBOR. Although there is no official definition of "robust", the International Swaps and Derivatives Association, Inc. (**ISDA**) have stated that it is important that any rate designed to replace LIBOR is not susceptible to manipulation and is based on liquid transactions.

The FCA has said that market participants should take primary responsibility for the development and transition to alternative reference rates, although it is ready to support and coordinate efforts. There is no replacement already available.

In the UK, in April 2017, the Bank of England Working Group on Sterling Risk-Free Reference Rates (which was set up to recommend a near risk-free reference rate and promote its adoption as an alternative to sterling

LIBOR) selected SONIA as its proposed benchmark for use in sterling derivatives and relevant financial contracts. The group published a White Paper in June 2017 on the adoption of SONIA in sterling markets and sought feedback on the appropriate scope of adoption of the risk free rate across broader financial markets beyond derivatives, such as loan or bond markets and the substitution of SONIA into legacy contracts referencing LIBOR. SONIA is an overnight unsecured rate produced by the Bank of England, backward looking and fixed daily so it will not reflect the dependence of rates on the term of a loan. On the other hand with LIBOR, a borrower knows the interest rate payable for the relevant period. The Bank of England is looking to develop SONIA for different terms – three, six and twelve months. However, no concrete steps have been taken in this regard.

In the US, in June the Alternative Reference Rates Committee announced its choice of a broad US Treasuries repo financing rate as a replacement for USD LIBOR. It is worth noting that this rate is not yet being published.

The FCA notes that both of these benchmarks benefit from more active underlying markets than LIBOR and neither involves expert judgment although they are backward looking as they report the rate for past transactions.

ISDA has also been working on long-term alternatives to LIBOR (and indeed to other benchmark rates) for some time and has set up working groups to address the following:

- suggestion of a fallback rate, or if determined necessary, fallback rates and/or other fallback mechanisms, that would apply if LIBOR (or any other applicable interbank offered rate) is permanently discontinued;
- amendments to the ISDA 2006 Definitions to add selected fallbacks that would apply upon any such permanent discontinuation; and
- development of a proposed plan to amend legacy contracts referencing the applicable interbank offered rates to include the amended definitions, including potential development of a protocol mechanism to facilitate multilateral amendments.

Given the inter-connectivity of the markets and the importance of ensuring matching cashflows between bonds and swaps, the bond market and other markets will need to be guided by the derivatives market to establish benchmark rates fall backs and alternatives. It is crucial that the relevant working groups consider the financial markets as a whole and the full spectrum of products utilising benchmark rates as a reference rate when determining the appropriateness of alternative rates.

Given that the work on replacing LIBOR with a more robust, risk free rate which is less susceptible to manipulation is still ongoing and there is little clarity of what LIBOR will be replaced with, it is difficult for market participants to pre-judge the outcome of the on-going work on the risk-free rates to produce an interim or long-term rate as any alternative to LIBOR. Flexibility and ease of amendment in deal documents will therefore be critical.

European Benchmark Regulation

Separately the EU Benchmark Regulation (Regulation (EU) 2016/1011) (the **BMR**) applied in the European Union from 1 January 2018. The BMR aims to provide a framework for benchmarks to be produced in a transparent and reliable manner.

While the BMR itself is not discussed in this article, it would be useful, in this context, to note the requirement under Article 28(2) of the BMR pursuant to which supervised entities (regulated firms including EU credit institutions, investment firms, insurers or reinsurers, pension funds, AIFs, UCITS, central counterparties and trade repositories) must produce and maintain "robust written plans" detailing what they would do if a benchmark materially changes or ceases to be produced, which must be made available to their competent authority upon request and included in the relevant contractual documentation. The plans should, where feasible and appropriate, nominate one or several alternative benchmarks that could be referenced to substitute the benchmarks no longer provided, indicating why such benchmarks would be suitable alternatives.

In addition, the BMR requires that prospectuses published under the Prospectus Directive which relate to an offer of transferable securities that reference a benchmark, are required to include clear and prominent information stating whether the benchmark is provided by an administrator included in the ESMA register. Prospectuses approved prior to 1 January 2018 need to be updated by 1 January 2019. Supervised entities can continue to use "existing' benchmarks until 2020.

How do current transactions in the market address the fact that LIBOR could potentially be discontinued during the term of the transactions?

Until a robust alternative to LIBOR that works for the financial markets as a whole is put in place, parties will need to consider whether transactions with maturities beyond 2021 should include provisions addressing a potential scenario where LIBOR is discontinued on a permanent basis. Although there is currently no consistent market-wide approach, considerable efforts are being made in this regard. The interests of lenders in the loans market, investors in the debt capital markets and of market participants in derivatives (including interest rate swaps) will all need to be considered. Within specific markets, there are also divergent views on what a robust alternative to LIBOR could be - for instance in the loans market, regulated banks fund themselves differently to non-bank lenders, thereby resulting in differing cost of funds (and potentially, differing interests).

In the absence of any guidance and divergent approaches being considered to address the discontinuation of LIBOR, it is likely that transactions will continue to be based on LIBOR as documentation can be adapted only when market thinking is more developed (and this may vary from jurisdiction to jurisdiction).

In the meantime, documentation is being designed to provide flexibility to make amendments to interest rate determination provisions that may be required as a result of the discontinuation of LIBOR.

Loans

Loan documents based on the current LMA forms and many U.S. forms typically have one or more fallback positions to cover a situation in which LIBOR is unavailable. The LMA and market participants in the loans market have expressed concerns about the suitability of risk free rates (**RFRs**) for the loans market and have expressed a preference for a more backward looking "term rate" alternative to LIBOR. The LMA (and their US counterpart, the Loan Syndications & Trading Association (the **LSTA**) is also working with the relevant regulators to make suitable for the loan markets. In the meantime, new transactions will continue to be based on the existing wording, including the existing fallback provisions. These include the standard "unavailability of screen rate" provision pursuant to which parties can choose to have recourse to the Reference Bank Rate and/or to lender actual cost of funds. One of the main issues with the fallback provisions under the LMA form loan documentation is that they have been developed primarily to address temporary unavailability of LIBOR. They are not designed for where LIBOR has been replaced by a totally different rate with a different methodology for calculation. Using the fallbacks as a long-term solution may be difficult and more costly to administer in the long term. It is also likely that Reference Banks would simply not provide quotes after LIBOR ceased to exist and the documentation would usually not compel them to do so. Mechanisms such as fallbacks to the last available LIBOR might result in a floating loans note being effectively converted into fixed rate loans, which is unlikely to be acceptable to lenders.

The LMA form loan documentation also includes an optional "Replacement of Screen Rate" clause, which is designed to make it easier for the parties to amend the facilities agreement to incorporate an alternative rate in place of LIBOR. The provision enables the loan documentation to be amended to incorporate an alternative rate provided that the borrower obtains the consent of the Majority Lenders to do so (as opposed to a more typical amendment clause which would require the consent of all lenders). The issue with this approach is that while it may facilitate the amendment being made, the provision may not be acceptable to all lenders on certain transactions as it would mean that fundamental changes in the loan's rate of return could be forced upon any minority lender.

One potential fallback that has been subject of extensive discussions is the introduction of a provision that, if LIBOR is unavailable, the reference rate will be the rate as determined by the lenders/agent. The concern that has been raised with this fallback is that it places too much discretion in the hands of the entity tasked with determining the alternative reference rate.

The LMA announced that, with effect from 22 December 2017, they have updated their secondary trading documents, being their standard terms and conditions, the user's guide and the trade confirmations for bank debt, claims and risk participation to address the discontinuance of LIBOR. The definition of "Relevant Benchmark Rate" (used for the purposes of calculating the Relevant Rate in respect of the cost of carry element of Delayed Settlement Compensation and the sell-out element of the buy-in/sell-out provisions) has been amended to include, where the specified screen rate is not available and where it is not possible to calculate the interpolated rate, any rate specified by the Seller, acting reasonably. It remains to be seen how the difference in approach between the loan documentation and the secondary trading documentation will be dealt with.

Pending the adoption of new rates across financial products, the focus in the loans market is on being able to amend loan documentation to reflect the relevant changes as and when these are adopted. In this regard, there are divergent approaches being adopted. In the UK, EU and the APAC markets, the documentation is being drafted to amend the interest rate provisions with less than unanimous lender consent (with the agreement of the borrower). In the US, whilst there has been no consistency in approach, market participants are leaning towards giving the agent discretion to, on behalf of lenders, agree amendments to interest rate provisions in documentation.

Debt Capital Markets

The discontinuation of LIBOR could potentially have implications for all types of debt capital markets transactions including bonds and securitisations. While long term floating rate notes are not very common in the plain vanilla bond markets (most have between 18 months to 3 years maturity); they are more common in bank and insurance regulatory capital issuances, corporate hybrid issuances and securitisation transactions.

Bonds

Though, unlike ISDA or LMA documentation, there is no "master" or "standard" form for terms and conditions of notes in the bond market, the terms and conditions of most bond documentation typically contain limited fallback options if LIBOR is unavailable. These are (i) screen rate determination (if the relevant screen rate comprising LIBOR is not available, the provisions provide for a successor or replacement screen, an alternative fallback to rates to be determined by a number of reference banks who lend in the relevant interbank market and an eventual fallback to rates determined at the discretion of a given party (typically the cash manager or the calculation agent)) and (ii) ISDA determination (which typically refers to calculation on the same basis as the floating rate leg for an interest rate swap for the relevant designated maturity determined by the calculation agent on the basis of ISDA definitions).

While prospectuses and offering documents in plain vanilla bond transactions have begun to include a risk factor relating to the discontinuation of LIBOR, in the absence of any certainty as to when LIBOR will be discontinued and what rate will replace it, the approach is very much to "wait and watch" until further clarity is achieved in this regard and no provisions are being included in the bond documentation itself to address the likelihood or LIBOR being discontinued.

Securitizations

In relation to securitisation transactions, it has become commonplace for bond documentation to include provisions that will allow the parties to make amendments to the interest rate determination provisions if LIBOR is discontinued. Recognising that amendments to bond documentation could be time consuming and expensive (due to the nature of the consents provisions typically included in securitisation transactions), provisions are now being included in documentation to "simplify" the consent process in circumstances where the issuer proposes to amend the reference rate. The simpler process requires the note trustee to agree to amendments to the reference rate (and other amendments which are necessary or advisable to facilitate such change) without the consent of noteholders or other secured creditors if the note trustee is provided with a certificate by or on behalf of the relevant issuer that the amendment is being made solely for the purposes of enabling the issuer to amend the reference rate. In order to provide maximum flexibility and permit issuers to carry out the amendments in good time before any discontinuation kicks in, the trigger for the issuers to request that the note trustee consent to amendments to the reference rate is not the discontinuation per se of LIBOR but any steps that would indicate that LIBOR is likely to be discontinued.

Whilst the provisions enabling a simpler consent process to be followed for the amendment of the reference rate are commonplace in securitisation transactions, there had been no consistent approach in new transactions and decisions to include fallback language in relation to replacement of LIBOR were being made on a case-by-case basis. The Association for Financial Markets in Europe (**AFME**) has produced model wording to include in documentation which (i) sets out the grounds on which the simplified amendment procedure would apply to amendments to references rates (ii) lists out the possible alternatives to reference rates and (iii) sets out the procedure to be followed for the simplified amendment procedure to be applicable to amendments to reference rates, which model wording is now in final form. The model wording includes the following as circumstances which would trigger the simplified consent process to be followed in relation to the modification of a benchmark/ reference rate (including LIBOR):

- a material disruption to LIBOR, a material change in the methodology of calculating LIBOR, LIBOR ceasing to exist or be published, or the administrator of LIBOR having used a fallback methodology for calculating the LIBOR for a period of at least 30 calendar days;
- the insolvency or cessation of business of the LIBOR administrator (in circumstances where no successor LIBOR administrator has been appointed);

- a public statement by the LIBOR administrator that it will cease publishing LIBOR permanently or indefinitely (in circumstances where no successor LIBOR administrator has been appointed that will continue publication of LIBOR) with effect from a date no later than 6 months after the proposed effective date;
- a public statement by the supervisor of the LIBOR administrator that LIBOR has been or will be permanently or indefinitely discontinued or there will be a material change in the methodology of calculating LIBOR with effect from a date no later than 6 months after the proposed effective date of such modification;
- public statement by the supervisor of the LIBOR administrator that means LIBOR will be prohibited from being used or that its use is subject to restrictions or adverse consequences with effect from a date no later than 6 months after the proposed effective date of such modification; or
- a change in the generally accepted market practice in the publicly listed asset backed floating rate notes market to refer to a benchmark rate endorsed in a public statement by the Bank of England, the Financial Conduct Authority or the Prudential Regulation Authority or any relevant committee or other body established, sponsored or approved by any of the foregoing despite the continued existence of LIBOR; or
- it having become unlawful and/or impossible and/or impracticable for any paying agent, calculation agent, the issuer or the cash manager to calculate any payments due to be made to any noteholder using LIBOR; or
- it being the reasonable expectation of the issuer (or an entity such as the servicer or the cash manager on its behalf) that any of the events specified in sub-paragraphs (i), (ii) or (vii) will occur or exist within six months of the proposed effective date of LIBOR.

Given the considerable uncertainty around the nature of the reference rate that would replace LIBOR, the AFME model wording also includes the following parameters for determining a new reference rates:

- any benchmark rate with an equivalent term to LIBOR as published, endorsed, approved or recognised as a replacement to LIBOR by the Bank of England, the Financial Conduct Authority or the Prudential Regulation Authority or any relevant committee or other body established, sponsored or approved by any of the foregoing;
- a benchmark rate with an equivalent terms utilised in a material number of publicly listed new issues of asset backed floating rate notes denominated in the same currency in the six months prior to the proposed effective date of such modification; or

- such other benchmark rate as reasonably determined by the issuer (or an entity such as the servicer or the cash manager on its behalf).

The parties that will ultimately be affected if LIBOR or any other reference rate is unavailable would be the noteholders. In order to protect their rights, the noteholders have, in recent transactions, been given the right to veto any amendment relating to LIBOR by way of a "negative consent" provision. Under this provision, in order to veto the proposed amendment, noteholders representing at least a specified percentage (in most recent cases and in the AFME model wording, this has been set at 10%) of the principal amount outstanding of the notes should have notified the relevant issuer that they do not consent to the proposed amendments. Approaches as to which class(es) of noteholders have the negative consent right vary from transaction to transaction. In certain transactions, the negative consent right has been given to the most senior class then outstanding and in other transactions (where the floating rate notes are not the most senior class) to either the class(es) of floating rate notes or class(es) of notes that rank senior to such affected class).

Any modification to the reference rate will also need to satisfy other conditions including consent of all parties to the transaction documents that are proposed to be amended and a confirmation from the rating agencies rating the notes that such amendments would not cause a downgrade of the rated notes. Although rating agencies are often sensitive to such provisions.

Any amendments to the benchmark rates would need to ensure that various issues including the following (some of which have been identified by AFME) are addressed:

- in transactions that involve interest rate hedging relating to a floating rate, care should be taken to ensure that any amendments are followed through in the swap documentation so that there are no unhedged mismatches.
- any relevant asset-specific swaps will also need to be amended.
- where the transaction documentation involves definitions such as "basic terms modifications", "reserved matters" or similar formulations, the definitions of such terms should be expressed to exclude modifications to the reference rate made in accordance with the terms above.
- would it be sensible to introduce a put option for noteholders/call option for the issuer in case the reference rate modification cannot be agreed?
- if so, what should be the exact circumstances in which any such options can be used (e.g. only if there is no LIBOR screen rate and fallbacks have been followed to apply a fixed rate)?
- should there be a time limit for use of any such option after those circumstances exist?

In addition to the flexible amendment language described above, prospectuses and offering documents in relation to securitisation transaction have also begun to include additional risk factor language in offering documents to highlight any risks arising as a result of the discontinuation of LIBOR.

Derivatives

As with debt capital market transactions, derivatives transactions are also likely to continue to refer, where relevant, to LIBOR until other options are more developed. ISDA has set up working groups to develop fallback provisions if LIBOR or any other reference rates were to be permanently discontinued. ISDA is also looking to develop a protocol to provide for amendments to existing contracts for those that elect to adhere to the amendments. During the time that the fallbacks and the protocol are being developed, no language is currently being used in documentation to address the potential of LIBOR being discontinued.

A principal risk in relying on the short term solutions described above is that the entire market does not move to new fallbacks, resulting in different issuers/transactions/markets amending reference rate provisions at times or only some contracts move to new fallbacks. Therefore it is essential that a "permanent discontinuance" is clearly defined. The various bodies working on fallback provisions will have to ensure that fallbacks put in place will be suitable for the entire market.

What about existing transactions?

In terms of legacy transactions that continue to reference LIBOR, market participants would need to evaluate the fallback provisions in agreements that refer to LIBOR and consider how to amend those agreements to specify a replacement reference rate when necessary.

As mentioned above, the ISDA is looking to develop a protocol to provide for amendments to existing contracts for those that elect to adhere to the amendments.

Unlike in the derivatives market, changes to pre-existing bond terms and conditions and loan agreements cannot be made via a protocol mechanism. Amendments to legacy bond terms and conditions would typically require a liability management exercise such as a consent solicitation. In the case of loan agreements, each loan agreement may need to be amended and the borrower will need to meet the requisite lender consent threshold in order to make that change in accordance with the requirements of the loan documents.

Both the process relating to amendments of bond documents and loan agreements would be time consuming and expensive. The issuer/borrower will also run the risk of the requisite conditions for the amendments not being met. This may result in many legacy loans or bonds being prepaid or refinanced in advance of establishment of a new benchmark (which might also prove to be costly and time consuming or these instruments reverting to a fixed rate equivalent to the last available LIBOR rate. An alternative mechanism could be some form of coordinated statutory measure in the main jurisdictions. It is difficult to assess, at this stage, what form the statutory measures (if any) can be put in place.

Next steps

Whilst it is clear that various industry bodies and market participants are being proactive in taking steps to address the discontinuation of LIBOR (and other benchmark rates), the processes have raised more questions than answers at this stage. Whilst any development of market standard approach to address the discontinuation will take some time, it is important that these issues are addressed in a manner that works for market participants across the various markets and recognises the inter-connectivity between these markets.

This article is an updated version of the article published in the Debt Capital Markets – Global Insights Spring 2018 brochure, following the finalisation of the AFME modification wording in April 2018.

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European Commission proposal for a regulation on the law applicable to assignment to third parties – how will this impact your business?

Overview

On 12 March 2018, the European Commission (**EC**) published a proposal for a new Regulation on the law applicable to the third-party effects of assignments of claims (the **Regulation**), which involves issues of uttermost importance for businesses and banks engaged in cross-border financing in order to reduce existing legal uncertainty through the adoption of EU-wide, uniform conflict-of-laws rules. The proposal, setting out a high-level framework especially for those working in the fields of factoring, collateralization and securitization, is linked to the 2015 Action Plan on Capital Markets Union (**CMU**) and the EC's Mid-term Review of June 2017. The CMU is set to be enacted with the objective of removing barriers to cross-border investments and lowering costs of funding; the EC is committed to put in place all the building blocks by mid-2019. Completing the CMU is an urgent priority.

The Regulation, as part of the CMU and the Mid-Term Review, seeks to deal with one of the glaring omissions in the existing EU conflict-of-law rules relating to the contractual assignments found in the Rome I Regulation (593/2008). Currently, national securities laws are not harmonized at EU-level, this is why conflict-of-laws rules determine which national law applies in cross-border transactions. While the contractual element (i.e. the contractual relationship between the assignor and the assignee as well as the effects of the assignment on the relationship between the assignee and the debtor) of securities transactions is already regulated at EU level by the Rome I Regulation, the proprietary element which refers to the transfer of rights in property and affects third parties, is yet to be standardized. The Regulation therefore intends to fill the gap left by the Rome I Regulation by creating a parallel regulation on third-party effects of assignment of claims.

Certainly, the Regulation identifies differences in the national treatment of third-party effects of assignment of claims as one of the obstacles that stand in the way of cross-border investment in the Single Market and furthermore, envisages a targeted action in this area by rendering cross-border transactions less risky and boosting cross-border investment.

Scope of the new Regulation

With the increasing interconnectivity of national markets, a company can often assign a claim to an entity in another EU country which can lead to a conflict of applicable laws. For cross-border situations, a number of Member States do not have clear rules on third-party effects of assignment of claims. The current uncertainty as to the applicable law creates a higher legal risk in cross-border transactions compared to domestic transactions. The EC's solution is a general rule that in conflict situations the law of the assignor's habitual residence applies. The law of the assignor's habitual residence is easy to determine and most likely to be the place in which the main insolvency proceedings with respect to the assignor will be opened. The proposal is particularly suitable for bulk assignments (i.e. parties should enable to assign a portfolio of claims without being faced with many different laws) and assignments of receivables under future contracts (as a crucial source of finance for SMEs). However, special rules are needed to cater for sectors which may not be well served by the rules of the law of the assignor. This is why the two types of specific claims are exempted from the general rule: (a) cash on the account of a credit institution and (b) claims derived from financial instruments. In addition, for securitization transactions, the EC proposes a choice between the law of the assignor and the law of the assigned claim. Key parties benefitting from legal certainty are borrowers, financial institutions and financial intermediaries which transact in securities and claims as well as end investors.

Background

Substantively, there exists no harmonization in the fields of the assignment of a claim at EU level. The third party effects relate to who has ownership rights over a claim, especially in relation to: (i) which requirements must be fulfilled by the assignee to ensure that he acquires legal title over the claim as a consequence of the assignment; and (ii) how to resolve priority conflicts between the assignee and third parties.

These issues must be resolved by national conflict-of-law rules on third-party effects of assignment of claims at a Member State level. The Member States have conflict rules that diverge substantially: for example the law governing the assigned/pledged claim, the law governing the assignment/pledge contract or the law of the habitual residence of the assignor/pledger. Given the inconsistency in these rules, uncertainty as to which law applies leads to the need of formal requirements to recognize third-party effectiveness.

Currently, article 14 of the Rome I Regulation (entitled 'voluntary assignment and contractual subrogation') contains uniform conflict-of-laws rules determining the law applicable to the contractual relationships relating to a contract of assignment. However, the proprietary element or third-party effects of such an assignment of claims is not covered by the Rome I Regulation. Those elements include questions as to who has ownership rights over a claim and in particular to (i) what requirements must be fulfilled by the assignee in order to ensure legal title over the claim after an assignment (e.g. by providing written notice to the debtor or registration in a public register), and (ii) how priority between several competing claimants can be resolved, including those which arise in circumstances where there have been several assignments of the same claim or the question of priority over the rights of the assignor's creditors arises, as well as the rights of the assignee over the rights of the beneficiaries of a transfer of a contract in respect of the same claim, or the novation of contract against the debtor in respect of an equivalent claim.

An attempt concerning these issues during the negotiations for the Rome I Regulation to create an appropriate framework failed. Consequently, the new Regulation aims to cure this omission instead of simply being amended to Rome I.

Final thoughts

An – admittedly ambiguous – harmonization of conflict-of-laws rules at EU-level on the law applicable is very desirable to increase legal certainty. By introducing legal certainty in this area, the new rules will indeed promote cross-border investment, enhance access to credit and contribute to market integration. It will, in particular, enhance the quality of cross-border securitisation transactions by reducing their legal complexity.

Although the Rome I Regulation did not manage to address this issue, it still required the EC to prepare a report on the matter with a view to completing the gap. The new Regulation complements the existing rules in the Rome I Regulation.

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Green Finance: Drivers, challenges and developments

What is Green Finance?

"Green finance" broadly covers the financing or re-financing in full or in part of a wide range of new and existing public and private investments with environmental objectives such as renewable energy, conservation, carbon capture and storage, energy efficiency, industrial pollution control, land management, green buildings, green products and materials, transport, waste management, processing and recycling and water sanitation. Such financing can take many different forms, including by way of bond or loan.

Green Bonds v Green Loans

Green bonds are debt capital market instruments. To date, they have tended to be medium-term and highly-rated instruments ranking pari passu with the issuer's conventional senior vanilla bonds.

Green loans are loan facilities such as term loans, (including those structured on a corporate or project finance basis), revolving credit facilities and working capital facilities. There are a range of lenders in the market offering these loan facilities, including commercial banks, development banks, multilaterals, institutional lenders and funds.

While green bonds and green loans are different financial products, their common aim is to finance sustainable environmental development.

Drivers and Challenges

The green finance market and particularly the green bond market have experienced significant growth and development in recent years; this has been facilitated by the development of ICMA's Green Bond Principles (GBP), discussed below.

According to the Climate Bonds Initiative (CBI), the green bond market doubled to almost US$83bn in 2016 (up from US$42.4bn in 2015). Issuance in 2017 reached US$160.8bn[1]. The CBI has estimated that the green bonds market has capacity to reach US$1tn by 2020[2]. Therefore, while green bonds still account for a very small proportion of the total bond market, the demand for and supply of green investments is increasing rapidly.

Following the entry into force of the Paris Climate Agreement (COP 21) in 2016, there has been increasing international and governmental recognition that green finance is fundamental to the long-term growth of the global economy and the need for decreased dependency on fossil fuels. According to the European Commission[3], Europe alone has to close a yearly investment gap of almost €180bn to achieve the EU's climate and energy targets by 2030.

Some countries, such as China, have already developed ambitious green financing action plans providing preferential lending rates for green investments and there are also proposals to introduce tax incentives for green financing, allow green loans/bonds to be eligible for use as collateral in central bank operations and implement preferential risk-weightings for green assets and reduce liquidity constraints for medium-long term green funding. The European Commission has recently published its action plan for sustainable finance (discussed further below).

In addition, in the last couple of years, there has been a push from the world's largest investors, central banks, regulators and market organizations for new frameworks setting out market terms and standards for green finance to be developed. While the green bond market is considered to be fairly advanced in terms of the development of definitions and tracking, as a consequence of the development of ICMA's GBP, it is apparent that action is needed at an international level to develop standardized policies for the regulation and evaluation of and infrastructure for green bonds and other green financial instruments in order to make the market more readily accessible to a wider range of investors.

1 https://www.climatebonds.net/resources/reports/green-bonds-market-summary-q1-2018 .

2 Address by Climate Bonds CEO Sean Kidney to Luxembourg Stock Exchange: https://www.climatebonds.net/address-climate-bonds-ceo-sean-kidney-luxembourg-stock-exchange

3 EC's Action Plan: Financing Sustainable Growth published on 08 March 2018.

Current Market Standards

Although various market standards have been developed defining what constitutes a green bond or a green loan, these guidelines currently have no legislative or regulatory backing or authority.

The most widely recognized green financing principles are ICMA's GBP which seek to enhance transparency and integrity in the green bond market. The GBP have four key components:

- **Use of proceeds:** proceeds must be used for green purposes with clear environmental benefits, which must be specified in transaction documentation.
- **Process for evaluation and selection:** the issuer must disclose its green objectives and the process determining eligibility for green finance as well as its environmental risk management processes.
- **Management of proceeds:** the issuer must implement a formal tracking and attestation process linked to the issuer's green lending and investment operations to ensure ring-fencing of the proceeds.
- **Reporting:** the issuer must maintain up-to-date information on the use of proceeds and the GBP recommend reporting against qualitative and quantitative performance indicators.

The GBP have been typically updated annually since their introduction in 2014 to reflect the development and growth of the global green bond market.

The Climate Bond Initiative has also developed its own certification that is available for assets and projects that meet the requirements of the Climate Bonds Standard. The Climate Bond Standard allows certification of a bond prior to its issuance, enabling the issuer to use the Climate Bond Certification mark in marketing efforts and investor roadshows. The latest version of the Climate Bonds Standard is fully aligned with ICMA's GBP.

It is recommended in the GBP and required by the Climate Bond Standard that green bond issuers use external reviewers or verifiers to confirm alignment with the key features of green bonds; this review can be carried out by various specialist external green assessors including rating agencies, which have now developed criteria for green bonds assessment.

In addition, some countries, such as China, India and France[4] have developed national green bond principles which are largely aligned with those published by ICMA and the CBI's Standard.

In relation to the loan market, the Loan Market Association published on 21 March 2018 its Green Loan Principles (**GLP**). The GLP build on and refer to ICMA's GBP with a view to promoting consistency across the financial markets. They incorporate the four GBP core components outlined above.

All published standards to date focus on use of proceeds rather than the general "greenness" of a corporate issuer/borrower and none provide for contractual consequences (such as acceleration or coupon step-up) in the event of a failure to maintain green eligibility.

Recent Developments

There are now a significant number of green finance initiatives at an international and European level in addition to the national and market initiatives (a few of which are mentioned above); these include the work of the G20 Green Finance Study Group which is currently looking at ways to mobilize private capital for green investment, specifically focusing on banking, the bond markets, and institutional investors, the FSB Task Force recommendations on climate-related financial disclosures and ISO's guidelines on climate finance and the first internationally accepted certification of climate performance.

4 France has implemented its "Transition Energetique Climat" label

On 8 March 2018, the European Commission published its Action Plan for Sustainable Finance which is based on the recommendations of the High-Level Expert Group on sustainable finance established by the Commission in 2016 and sets a range of goals for sustainable finance for 2018 and 2019. Most of these will, subject to consultation processes, result in some form of legislative proposal being published by the Commission. The Commission considers the Action Plan instrumental in helping to deliver on the Paris Climate Agreement and the Sustainable Development Goals set out in the Commission's Communication on 'Next steps for a Sustainable European future: European actions for sustainability'. The Commission intends to report on the progress of the Action Plan on sustainable finance in 2019. Among other measures, the Commission's Action Plan proposes to establish a common taxonomy for sustainable finance, create EU labels for green financial products (including in all likelihood a green bond standard), incorporate sustainability into prudential requirements, enhance transparency in corporate reporting and support investment in sustainable infrastructure projects.

It is also worth noting that as part of the new European framework for securitizations applying from 1 January 2019, the EU's Securitization Regulation[5] requires issuers seeking the simple, transparent and standardized (STS) label for a transaction to disclose available information on the environmental performance of any underlying residential mortgage and auto loan assets being securitized. A CBI article[6] reports that the OECD has estimated that between US$280-380bn of green asset-backed securities could be issued by 2035 for renewable energy, energy efficiency and private electric vehicles, with US$84bn of that being issued in the EU alone[7].

A number of institutions have created indices to exclusively cover green bonds as well as various indices which capture the development of China's fast growing green bond market. Stock markets which have developed specialist green bond markets include Luxembourg, London, Oslo, Stockholm, China and Mexico.

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5 Regulation (EU) 2017/2402

6 CBI Briefing Paper " Green Securitisation: unlocking finance for small-scale low carbon projects" February 2017

7 CBI and CCCEP Policy Paper: Stimulating private market development in green securitisation in Europe: the public sector agenda: April 2017

2018 ISDA Choice of Court and Governing Law Guide: What you need to know

On 27 February 2018 the International Swaps and Derivatives Association, Inc. (**ISDA**) published the *2018 ISDA Choice of Court and Governing Law Guide* (the **Guide**). This follows a consultation in 2017 where it was felt that revisions to the jurisdiction and governing law clauses were necessary to take account of recent developments such as the 2005 Hague Convention.

Most OTC derivatives are governed by either the ISDA 1992 Master Agreement (the **1992 Agreement)** or the ISDA 2002 Master Agreement (the **2002 Agreement**), which contain standard jurisdiction and governing law clauses (based on English or New York law), which were first published in 1987 and then revised in 2002.

The Guide provides optional model forms of non-exclusive and, for the first time, exclusive jurisdiction clauses as alternative governing law clauses. This reflects the increased move in favor of exclusive jurisdiction clauses.

When entering into new transactions, parties to an ISDA Master Agreement may choose between these new model clauses or the current jurisdiction and governing law provisions contained in Section 13 of the 2002 Agreement and 1992 Agreement. The new model clauses do not amend any existing jurisdiction agreements contained in the 1992 or 2002 Agreements.

The Guide takes into account the latest regulatory changes since 2002 (in particular, the 2005 Hague Convention, which promotes the use of exclusive choice of court agreements and the 2012 Brussels I Recast, which governs jurisdiction issues within the European Union).

In addition, the Guide provides non-binding comprehensive guidance on these new model clauses, which is supplemental to the existing 1992 and 2002 ISDA User's Guides.

Governing Law

The Governing Law clauses in both the 1992 and 2002 Master Agreement state that the Agreement shall be governed by and construed in accordance with the law specified in the Schedule (English or New York Law) as non-exclusive choices save for certain exceptions. The current Governing Law clauses only cover contractual obligations.

However, the new Governing Law model clause in Appendix D of the Guide expressly offers to cover non-contractual obligations as well:

The following provision should be included in Part 4 (Miscellaneous) of the Schedule:

Section 13(a) – Governing Law shall be deleted in its entirety and replaced with the following:

"Governing Law. This Agreement and any non-contractual obligations arising out of or in connection with it will be governed by and construed in accordance with the law specified in the Schedule."

ISDA states that these drafting changes are for clarification only and should not be taken to imply that the current language in the 1992 or 2002 Agreements should be construed narrowly.

The model governing law clause in Appendix D is for use where parties have selected either English law or New York law as the governing law.

Choice of court

A dispute resolution clause is a provision by which the parties elect, in the ISDA Schedule, which courts should hear their disputes in order to avoid uncertainty.

The existing jurisdiction clauses in the 1992 and 2002 ISDA Agreements provide:

- a non-exclusive jurisdiction of the English Courts for ISDA Master Agreements governed by English law;
- a non-exclusive jurisdiction of the New York Courts for ISDA Master Agreements governed by New York law.

A non-exclusive jurisdiction may allow another judge to exercise jurisdiction in certain circumstances.

ISDA provides for the first time, in this Guide, the following new exclusive jurisdiction model clauses:

- one in favor of the English Courts (in Appendix A);and
- the other in favor of the New York Courts (in Appendix B).

In response to comments from ISDA members regarding the ambiguity of the existing non-exclusive jurisdiction clause, the Guide also provides, in Appendix C, a new and simplified non-exclusive jurisdiction model clause.

The new model jurisdiction clauses in the Guide contain wording that can be used to replace the existing jurisdiction clause (in section 13 of the ISDA Master Agreement). Parties wishing to amend existing agreements will need to include the additional wording in an amended Schedule to incorporate the new clauses, deleting the existing provision.

The Guide also provides a new definition of "Proceedings" (namely, "*any dispute, claim, difference or controversy arising out of, relating to or having any connection with this Agreement…*"), which incorporates pre- or non-contractual matters.

Final thoughts

Whilst this Guide was not developed as a direct result of the UK's anticipated withdrawal from the EU (Brexit), the greater clarity and legal certainty that it offers is a helpful development.

ISDA is currently also working on adding in EU Member State (namely French and Irish) governing law and jurisdiction provision options to its documentation, in light of Brexit.

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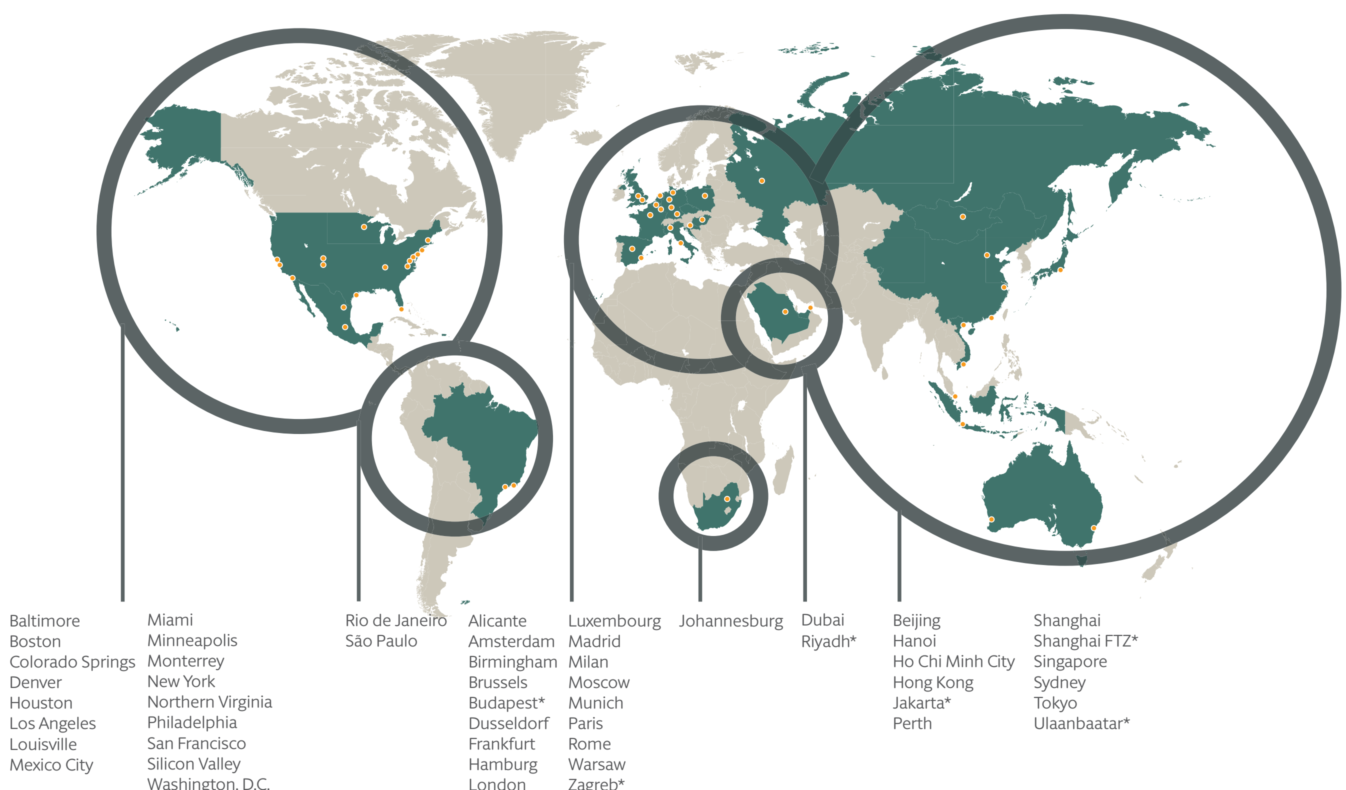
Change is happening faster than ever, and to stay ahead, you need to anticipate what's next. Legal challenges come from all directions. We understand and work together with you to solve the toughest legal issues in major industries and commercial centers around the world. Whether you're expanding into new markets, considering capital from new sources, or dealing with increasingly complex regulation or disputes, we can help. Whether change brings opportunity, risk, or disruption, be ready by working with Hogan Lovells.

Straight talking. Understanding and solving the problem before it becomes one. Delivering clear and practical advice that gets your job done. Hogan Lovells offers extensive experience and insights gained from working in some of the world's most complex legal environments and markets for corporations, financial institutions, and governments. We help you identify and mitigate risk and make the most of opportunities. Our 2,500 lawyers on six continents provide practical legal solutions wherever your work takes you.

A fast-changing and inter-connected world requires fresh thinking combined with proven experience. That's what we provide. Progress starts with ideas. And while imagination helps at every level, our legal solutions are aligned with your business strategy. Our experience in cross-border and emerging economies gives us the market perspective to be your global partner. We believe that when knowledge travels, opportunities arise.

Our team has a wide range of backgrounds. Diversity of backgrounds and experience delivers a broader perspective. Perspectives which ultimately make for more rounded thinking and better answers for you.

Giving back to communities and society is fundamental to good business. And, it's part of our core. We are advocates of justice, equality, and opportunity. Everyone at Hogan Lovells is asked to volunteer at least 25 hours a year as part of their normal work duties. Around the world, our people are making a difference through pro bono activities, community investment, and social justice.



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Our International Debt Capital Markets practice

Debt Capital Markets - General

Are you looking for capital to grow your business, expand into new markets, or strengthen your balance sheet? We advise clients on all aspects of international debt capital markets transactions including corporate, financial institution and sovereign bonds. Our clients include arrangers/underwriters, corporate, financial institution and sovereign issuers, and transaction services providers.

We have a global practice with lawyers in the major jurisdictions of Europe, the United States, Latin America and Asia. Our size, experience and specialization enable us to offer expert and competitive advice on a full range of capital markets transactions. We also have considerable experience in emerging markets economies.

Our strong restructuring practice means that we are well positioned to react to distressed market conditions and we are a leading provider of legal services to trustees and other relevant market participants.

We are consistently ranked in the world's leading legal directories for our international debt capital markets practice and we are one of the leading players in the numerous capital markets disciplines.

Areas of focus

- corporate debt and equity-linked securities offerings
- sovereign debt
- establishment of, updates to and drawdowns under debt issuance programmes
- tender offers, exchange offers and other liability management transactions
- promissory notes (schuldscheine)
- debt restructurings
- subordinated debt as part of prudential capital for financial institutions
- credit-linked and loan participation note offerings
- islamic finance transactions.

Structured Finance and Securitization

Hogan Lovells Structured Finance and Securitization practice handles every aspect of structured finance transactions. Our global team has handled deals with assets originating in more than 30 countries. We help issuers and originators of securitized assets, underwriters, managers and arrangers, trustees, investors, and collateral and portfolio managers.

We advise on the financing of a wide range of classic and innovative asset types, both as public and private stand-alone issues, master trusts, programs, and through conduit structures. In addition, we run one of the few practices able to offer dedicated and knowledgeable advice to capital markets trustees.

Our team is involved in issues regarding the changing regulatory environment relating to structured finance, Dodd-Frank legislation in the US and the relevant EU directives and regulations, including, compliance counselling, disclosure and advocacy relating to the legislation. We also advise clients on issues relating to derivatives related infrastructure, including clearing, data repositories, broker-dealer matter and exchange execution.

Areas of focus

- ABCP
- auto and consumer loan and lease
- CLOs
- commercial mortgage backed (CMBS)
- covered bonds
- equipment leases and operating assets
- future flow securitizations from emerging markets
- infrastructure
- insurance
- market place lending
- residential mortgage backed (RMBS)
- trade receivables
- whole business.

Derivatives and Structured Products

Hogan Lovells advises clients across the world on a complete range of derivative and structured product transactions across all asset classes.

Our practice is truly global. With dedicated derivatives and structured products lawyers in Europe, the United States and Asia and capital markets lawyers across our global network of offices, we have one of the most integrated teams in the market.

We understand the considerable and complex legal, regulatory and tax implications of these products, including the cross-border implications of their use. Working closely with lawyers in our renowned finance, disputes, tax, regulatory and insolvency departments, we provide our clients with practical, timely advice on all aspects of their business. We have significant experience in advising clients on various regulatory matters applicable to derivatives across the world: from the United States under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), the European Union under the European Market Infrastructure Regulation ("EMIR") to the local regulations in various jurisdictions across Asia. In addition, our team is particularly strong in structured finance and structured finance-related derivatives, having established and updated many securitization and repackaging programs that contain swaps and repos.

Our clients include major financial institutions, funds, government sponsored entities, asset managers and commercial end-users. Our size, global reach, experience and specialization enable us to provide clients with a competitive, knowledge-based service for all derivatives and structured products transactions.

Areas of focus

- energy and commodities
- regulatory matters
- securitized derivatives and repackaging programmes
- soft commodities and metals
- equity derivatives
- credit derivatives
- fund derivatives
- portfolio acquisitions and disposals
- structured finance, securitization-related, fixed income and other treasury related matters
- longevity and insurance linked derivatives
- distressed derivatives.

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