Hogan Lovells

Debt Capital Markets – Global Insights

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Welcome

We live in interesting times. Whilst the financial crisis of 2008-9 is beginning to fade into the distance, its effects are still being felt. We have witnessed almost continual change in relation to the regulation of the debt capital markets, and now the industry faces very significant political and economic uncertainty with Brexit, the result of the U.S. election, the prospect of a slowdown in China and the continued weakness of fragile European economies. On top of that, there are both opportunities and challenges to market participants, including those arising from new technology, changing investor expectations and the desire of financial institutions (and their regulators) to continue cleaning up balance sheets by disposing of non-performing loan portfolios.

As a practice, 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. This brochure reflects this dialogue and brings together a number of different perspectives from around the globe, ranging from views on how regulators are engaging with disruption in the debt capital markets, potential changes to the Dodd-Frank Act as a result of political change in the US and how key legal judgments are affecting the markets in which we participate. There are also new hurdles to be faced with new regulation around covered bonds and the modernisation of laws around the issuance of securities. Finally new markets are developing and existing markets evolving, for instance in the FinTech space or with the launch of green bonds.

Our vision is to be a bold and distinctive law firm that creates valuable solutions for clients. We hope that this brochure illustrates our commitment to this vision and our engagement with the industry across the wide range of markets which we service.

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No ordinary debt claim

When Russia calls and asks you to get its money back from Ukraine

Summary

On 29 March 2017, the High Court handed down its judgment in *The Law Debenture Trust Corporation P.L.C. v Ukraine [2017] EWHC 655* (Comm) (the **Ukraine Case**) which considered a summary judgment application by The Law Debenture Trust Corporation P.L.C. (**Law Debenture**) in respect of the non-payment of US$3bn of Eurobonds (the **Notes**) by the State of Ukraine (**Ukraine**). Law Debenture was trustee of the Notes and was directed to bring proceedings by the Russian Federation (**Russia**) which was the sole holder of the Notes. Although Mr Justice Blair commented that the background to the case was "extraordinary", he held that the Trustee was entitled to summary judgment as there were no valid reasons under English law to suppose that Ukraine has a real prospect of successfully defending the claim brought by Law Debenture.

Geopolitical tensions had emerged between Russia and Ukraine over the latter's proposed signature of an Association Agreement with the European Union in November 2013. Ukraine claimed that Russia had exerted unlawful and illegitimate political and economic pressure on it in order to compel it to accede to Russian financial support instead of signing that agreement. The US$3bn Notes represented the first part of Russian financial support. Despite Russia's alleged annexation of the Crimean Peninsula and allegations of general interference in Ukraine's domestic political affairs, Ukraine made three interest payments under the Notes in 2014 and 2015 before Ukrainian Ministers approved a moratorium on 18 December 2015 to suspend payment of the Notes shortly before the Notes were due to be repaid.

Ukraine's defence

Ukraine provided four grounds of defence to the claim for payment of the Notes:

- **Capacity**: Ukraine claimed that it did not have the capacity to issue the Notes because the debt issuance contravened its own Budget Law limit and because Ukrainian Ministers were not provided with a mandatory opinion on the borrowing.
- **Duress**: Ukraine argued that Russia's behavior, which included threats to enforce protective tariffs against Ukrainian goods and to end co-operation between the countries in a number of industries, constituted duress under English law. As a result Ukraine claimed the Notes were voidable, and were in fact avoided by the moratorium of 18 December 2015.
- **Implied Terms**: Ukraine claimed that contractual terms should be implied into the Trust Deed to the effect that Russia would not deliberately interfere with or hinder Ukraine's ability to repay under the Notes and that Russia would not demand repayment if it breached well-established principles of international law - and that in turn Russia was in breach of those implied terms.
- **Non-Payment as a Countermeasure**: Ukraine argued that under public international law it was entitled to decline to make payments to Russia under the Notes as a proportionate "countermeasure", taking into account the impact of Russia's activities on its economic and territorial integrity.

It is fair to note that these are among the more unusual defences that have been raised to a claim for non-payment of a debt.

The Court's reasons for dismissing the defence

Mr Justice Blair rejected all four grounds of defence. Ukraine is a sovereign state which had entered into a debt contract governed by English law. Mr Justice Blair found that as a matter of international law, sovereign states had an unlimited capacity to borrow and that English law duly recognized such capacity. Further, the Ukrainian Minister of Finance through his governmental position had usual authority to enter into the transaction on behalf of Ukraine. The fact that the Minister of Finance was the signatory on all 31 debt issuances by Ukraine in which Law Debenture had acted as trustee between 2000 and 2013 established "such authority beyond doubt".

Mr Justice Blair commented, obiter, that a defence of duress should not in principle be blocked off to an issuer where the transactional structure incorporates a trustee. However, Mr Justice Blair considered that the English courts did not have the competence to adjudicate either on transactions entered into between states "on the plane of international law" or on international treaties and conventions which have not become part of domestic law. Similarly, the English courts were not competent to rule on questions of aggression or armed conflict among states. In these circumstances, he held that the allegedly coercive measures by Russia relied upon by Ukraine in its defence of duress fell within the foreign act of state doctrine and were therefore not capable of being determined by the High Court. They were in that sense "non-justiciable".

Ukraine's third defence failed because Mr Justice Blair held that the test for the implication of terms was not satisfied on these facts. This was primarily because, even if in some circumstances the Court will imply a term that neither party will prevent the other party's performance, such an approach was not appropriate in a case like this where transferrable instruments such as the Notes were involved. The Judge noted that potential transferees of Notes have to be able to identify the rights which they are acquiring from the relevant contracts themselves, and that implication of the sorts of terms suggested by Ukraine would risk the Notes becoming unworkable and untradeable. Although Russia was unlikely to have intended to transfer the Notes at any point before the due date, this was not legally relevant because the test for the implication of terms is determined at the time of contracting. It is also worth noting that recent case authority on transferable debt instruments has given prominence to the express wording of contracts for similar reasons to those considered by Mr Justice Blair.

Ukraine's argument that non-payment constituted a legitimate "countermeasure" under public international law was rejected because English courts are not competent to consider such measures.

Conclusion

In one respect the Ukraine case represents a simple debt claim under English law. As trustee of the Notes, Law Debenture was owed the debt obligation. The relevant transaction documents, including the Trust Deed and the Agency Agreement, were governed by English law. However, as Mr Justice Blair acknowledged in his judgment, the complex geopolitical backdrop to the case meant that Ukraine's four main defences in fact raised "legal questions of considerable difficulties". The length of the judgment (107 pages) speaks to these difficulties. Mr Justice Blair also took the relatively unusual step of annexing the factual sections of Ukraine's defence to his judgment so that readers are able to appreciate the context in which the court was asked to consider these matters.

As the UK forges a new relationship with its neighbors, the case reminds us that English law is the choice of many involved in cross border investment, and that the English courts will apply consistent legal principles even in the most unusual of circumstances. The case also illustrates the fact that trustees cannot choose their beneficiaries, and can find themselves fighting some unusual corners.

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Modernization of Bond Issuance

One week after the publication of ordinance n°2017-748 dated 4 May 2017 regarding the role of security agents, the modernization of French law continues with an in-depth reform of bond issues with ordinance n° 2017-970 dated 10 May 2017.

The current system dating back to a decree-law of 1935 and a reform in 1966 does not match the current standards of the bond market. Therefore a reform is necessary especially as regards bond issues offered to institutional investors.

The reform comes with ordinance n° 2017-970 dated 10 May 2017 which aims to reinforce the attractiveness of French law relating to the framework for bond issuance. The ordinance has immediate effect. Certain provisions will entail implementing decrees (*décrets d'application*).

Clarification of the status of the representative of bondholders

Without involving major changes, the measures regarding the representative of the bondholders mainly aim to clarify the method of appointment of the representative and his role.

The appointment of the representative of the bondholders

The provisions relating to the appointment have been clarified. It is now expressly specified that the representative of the bondholders is appointed either in the issue agreement, at the general meeting, or failing that at the request of any interested person. In the case of a public issue, the initial representatives are appointed in the issue agreement.

Since institutional investors tend to invest in securitized bonds the new provisions also specify that a future representative of the bondholders can be named in the securities agreement (*l'acte constituant les sûretés pour le compte de la masse des obligataires*).

Finally, for the sake of compliance with European law the representative can be a person who is a national of, or a permanent resident in, any European Union member state. It is no longer limited to French residents.

The role of the representative of the bondholders' group

Concerning the role of the representative of the bondholders' group (known as *la masse*), the ordinance grants him (or it) the ability to delegate his power to a third party subject to the same restrictions. This will enable the representative of the bondholders' group to delegate the management of securities to a security agent.

Furthermore the representative's powers of representation before the courts are listed in Article L. 228-54 of the French *Code de Commerce* and are now to be recognized by the court.

The Bond market's modernization

The measures regarding bond markets mainly aim to adapt the current system to market conditions. The idea is to grant more flexibility in the relationship between the issuer and the institutional bondholders. These provisions affect the issue as well as the life of the bonds.

Issue of the bonds

The ordinance expands the circle of people who can be granted a delegation of power by the board of directors of the issuer so he or she is able to issue the bonds. The new provision refers to "anyone" being a possible delegate of the powers so the list is no longer limitative. Accordingly the delegate will be able to take faster decisions about the issue having regard to market conditions.

The ordinance facilitates the use of the bond market for financing subsidiaries in a group. The subsidiary which is to issue bonds will no longer have to file two years' audited accounts if the company acting as guarantor of the issue (usually its parent company) files the guarantor's accounts. Issuers who are in a group may therefore issue bonds at less cost by avoiding the need to have their assets and liabilities fully audited.

Life of the bonds

The ordinance distinguishes between retail issues, offered to the public (where the nominal value of the bond is less than €100,000) and wholesale issues, offered to institutional investors (where the nominal value is €00,000 or more).

In the case of issues (not involving an equity option) and where the nominal value of the bond is not less than an amount to be fixed by a decree of the *Conseil d'Etat* (which will be €100,000), the parties are free to negotiate the issue contracts which they wish. The same principle applies to issues where trading in the bonds is required in a minimum aggregate nominal value of the same amount.

In this context new provisions allow the parties to define the conditions of majority and quorum of bondholders required to make decisions in accordance with market standards. For example, day to day decisions could be taken with a simple majority while some more important questions could be decided by enhanced majority.

Moreover, since institutional investors do not need the same protection as the general public the creation of a group representing bondholders is not automatic when the issue is localized in France. The issuer will also be able to correct unilaterally a material error in the documentation without asking for bondholders' approval or request all bondholders' consent.

Where the issue is not a public offering, the issue contracts and related documents, including for paying agency and hedging, can be in English. For all bond issues, the ordinance provides that decisions of the bondholders may be taken by written resolution including electronically.

The position has also been clarified where an issuer wishes to issue bonds secured on assets (*Obligations assorties de sûretés réelles*). The issuer is required to convene a bondholders' meeting if the benefit of this security is not to be extended to existing bondholders.

In conclusion, the ordinance has removed the formal requirement in the case of underwritten issues to have a notarial deed declaring the result of subscriptions.

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New covered bond framework based on minimum harmonization principle

Background

On December 20 2016 the European Banking Authority (**EBA**) published a report on covered bonds, following up on its July 2014 report. Where the 2014 report identified a series of best practices with a view to ensuring robust and consistent covered bond frameworks in the European Union, the 2016 report goes further, proposing a three-step approach to the harmonization of covered bond frameworks in the European Union. The covered bond framework currently relies on principle-based EU regulation to address the key technical issues of regulatory treatment of covered bonds, leaving the implementation of such core elements at an individual member-state level and thus allowing for the diversity to arise between national laws. The harmonization of the EU covered bond framework forms part of the Capital Markets Union (**CMU**) project, an initiative of the European Commission. To assess the merits of a possible integrated EU covered bond framework, the European Commission published a consultation paper on EU covered bonds in September 2015. The 2016 report provides recommendations which the European Commission will take into consideration in the process of furthering the CMU project.

This update summarizes the EBA's three-step plan to a harmonized covered bond framework in the European Union, as set out in the 2016 report, and comments on the likely impact of such a proposal on EU covered bonds.

Diversity in existing national covered bond frameworks

The 2016 report summarizes the results of the EBA's assessment of the functioning of – and developments in – national covered bond frameworks, which was conducted pursuant to the 2012 Recommendations of the European Systemic Risk Board on funding of credit institutions.(1) The assessment included a comprehensive analysis of the regulatory developments in EU member states and considered the alignment of national frameworks with the EBA's best practices laid down in the 2014 report, as well as providing an analysis of market trends and EU-wide developments.

The assessment covered 22 EU member states, including those with the most active covered bond markets, such as Germany and France. The EBA's analysis shows that the best practices in the 2014 report are somewhat devoid of substance. Only 10 jurisdictions have amended their covered bond frameworks since publication of the 2014 report. The remaining 12 jurisdictions have taken no action to amend their covered bond frameworks or actions to implement the best practices has been put on hold, pending completion of the European Commission's review of the EU covered bond framework.

Active covered bond markets exist in almost all EU countries. In the 2016 report, the EBA concludes that while most national frameworks adhere to the same core principles (eg, dual recourse and coverage principles), there is also substantial diversity among the legal, regulatory and supervisory covered bond frameworks across the EU member states. This diversity is due to, among other things:

- the different systems of law applied by the relevant EU countries;
- the different approaches taken in formulating national covered bond laws; and
- the different structures of covered bond programs applied for regulatory, civil law or insolvency law reasons, or otherwise.

Such diversity does not contribute to maintaining a well-functioning EU covered bond market, which is important given that covered bonds are seen as a key funding instrument of the EU economy.

Favorable regulatory recognition

The 2016 report highlights the continued trend for a favorable regulatory recognition of covered bonds. Favorable regulatory recognition of covered bonds is evidenced by the following measures, among others:

– In September 2014 the European Central Bank announced the launch of the third covered bond purchase program causing an increased share of central banks' investments in covered bonds.

– Covered bonds are included as a liquidity buffer (level 1 and level 2A assets) under the EU liquidity coverage ratio, incentivizing credit institutions to invest in covered bonds.

– The EU banking recovery and resolution framework exempts covered bonds from the scope of the bail-in instrument, making them the only wholesale funding instrument exempt from bail-in.

However, the 2016 report also concludes that covered bond instruments with different quality characteristics are subject to the same EU regulatory rules and, therefore, all benefit from such far-reaching favorable regulatory recognition, irrespective of the EU member state in which they are issued.

The EBA's aim in proposing a harmonized EU covered bond framework is to ensure that only those financial instruments that are compliant with the requirements set out in the framework could qualify as 'covered bonds' and thereby benefit from the preferential prudential and risk-weight treatment for EU covered bonds in the mid-to-long term.

Three steps to a harmonized covered bond framework

The 2016 report contains a detailed proposal for a three-step approach to the harmonization of covered bond frameworks in the European Union. The EBA attempts to ensure more consistency in the definition and regulatory treatment of EU covered bonds, while building on the strengths of the existing national covered bond frameworks and maintaining the flexibility and specificities of such frameworks. The three-step approach consists of:

– an EU Covered Bonds Directive;

– amendments to the EU Capital Requirements Regulation (575/2013); and

– a voluntary convergence.

Step 1: EU Covered Bonds Directive

EU covered bond regulation is laid down in several directives and regulations, of which the most important are considered to be:

– Article 52(4) of the Undertakings for Collective Investment in Transferable Securities Directive (2009/65/EC); and

– Article 129 of the Capital Requirements Regulation.

The Undertakings for Collective Investment in Transferable Securities (**UCITS**) Directive defines the core characteristics of covered bond instruments and the Capital Requirements Regulation (**CRR**) sets out preferential risk-weight treatment for covered bonds, as referred to in the directive, which meet specified conditions. Other EU legislation sets out specific treatment for covered bonds compliant with either the UCITS Directive or the CRR.

The EBA recommends developing an EU covered bond framework through the implementation of an EU Covered Bonds Directive. The proposed directive would apply across different financial sectors and be based on the minimum harmonization principle.

The EBA also recommends that the covered bond framework establish a definition of the term 'covered bond' that will serve as a baseline for prudential regulation purposes. Reference to the definition of 'covered bond' in the EU Covered Bonds Directive should be used in all EU regulations that include specific treatments for covered bonds.

The EBA further recommends that the covered bond framework replace the existing principle-based provisions in the UCITS Directive with a more detailed set of existing and additional requirements, applicable to all EU covered bonds and covering a wide range of areas necessary to preserve the covered bond brand.

The areas that should be covered in a proposed EU covered bond framework are:

- the dual recourse of a covered bond, segregation of cover assets and bankruptcy remoteness of a covered bond;
- the coverage principle, liquidity risk mitigation and cover pool derivatives;
- a system of special public supervision and administration; and
- transparency and disclosure.

Step 2: amendments to Capital Requirements Regulation

Step 2 is closely related to Step 1 of the proposed three-step approach. However, it relates to preferential capital treatment, focusing on specific amendments to provisions of the CRR. Covered bonds that meet the definition of 'covered bond' as formulated in the covered bond framework (Step 1 above) are not automatically eligible for preferential risk-weight treatment. As under the current applicable rules, the additional criteria for eligibility for preferential risk-weight treatment will be set out in the CRR. In addition to the existing provisions, new conditions for access to preferential risk-weight treatment of investments in covered bonds will be included. The EBA considers that the CRR should clarify that only covered bonds meeting the requirements stated in both the proposed EU Covered Bonds Directive and the amended CRR will be eligible for preferential risk-weight treatment.

In addition to the requirements under Step 1's proposed covered bond framework, the areas that should be covered under Step 2 include, among other things:

- requirements for eligible cover assets and loan-to-value limits for mortgage cover assets, and limits on substitution assets;
- requirements for minimum over-collateralization.

With respect to the requirements for eligible cover assets, the EBA recommends that the scope of covered assets not be widened and that small and medium-sized enterprise loans, infrastructure loans and additional non-public debtor loans are excluded as eligible cover assets for such preferential treatment. The EBA suggests that the eligibility of shipping loans should be considered further before determining their treatment.

Step 3: voluntary convergence

Step 3 covers areas that have less material impact on the protection of quality of the covered bond product and areas where convergence is considered beneficial, but where (binding) minimum harmonization could have disruptive effects on national covered bond markets.

The EBA considers that convergence between national frameworks should be emboldened on a voluntary basis through non-binding instruments. According to the EBA, such non-binding measures should provide for additional rules on, among other things:

- the composition of cover pools;
- the treatment of cover pools with assets or obligors located in non-EEA jurisdictions;
- asset valuation and monitoring (eg, loan-to-value thresholds); and
- stress testing in relation to the coverage requirement.

In the 2016 report, the EBA suggests that voluntary convergence issues are secondary to the measures proposed in Steps 1 and 2 above. It therefore recommends that non-compliance with these recommendations should not affect the eligibility of a covered bond for preferential regulatory or risk-weight treatment.

Key considerations

The EBA's three-step approach makes sense in an attempt to harmonize covered bond frameworks across the European Union. Given the diversity of the existing legal, regulatory and supervisory covered bond frameworks, and the strength of existing national covered bond frameworks, a minimum harmonization measure is probably the most realistic method of creating effective harmonization that defines and preserves a quality covered bond product for EU financial regulation purposes and justifies a preferential prudential and risk-weight treatment for EU covered bonds.

It should be relatively straightforward for most EU member states to implement a number of the EBA's recommendations at a national level (if this has not already been done). However, some recommendations – as acknowledged by the EBA – require careful consideration before they become detailed legislative requirements, in order to preserve well-functioning markets, existing legal structures of covered bond programs and the economic rationale of using covered bonds as a funding tool.

At a broader level, it is worth considering the potential interaction between the proposed EU covered bond framework legislation and other existing EU legislation, such as the European resolution and recovery framework established under the Bank Recovery and Resolution Directive (2014/59/EU) (**BRRD**) and the Single Resolution Mechanism Regulation (806/2014). Further analysis is required to avoid uncertainty, at both an EU and national level. This issue is relevant to the proposed EU covered bond framework in terms of:

- step 1 – the system of special public supervision and administration relating to covered bonds in the event of an issuer's resolution or insolvency; and
- steps 1 and 2 – coverage requirements and minimum over-collateralization.

Step 1: system of special public supervision and administration in the event of resolution or insolvency

An untested area remains between the interactions between:

- the duties of the competent authority and the independent special administrator responsible for supervision and administration (respectively) of cover pools and covered bonds of an issuer in resolution;
- the duties and rights of the resolution authority relating to resolution tools provided under the Bank Recovery and Resolution Directive and, where applicable, the Single Resolution Mechanism Regulation.

The same concern applies in the event of an issuer's insolvency and a receiver or administrator's appointment.

The scope of duties and responsibilities should be clearly defined to ensure that the cover pool can be managed in the interest of the covered bondholders without at the same time affecting the tools and rights available to the resolution authority under the Bank Recovery and Resolution Directive and the Single Resolution Mechanism Regulation, but without prejudice to the protected position of covered bonds under such legislation. The scope of duties and responsibilities of the competent authority should also be sufficiently clear to avoid conflicts of interest in its functions as supervisor of the covered bonds and regulator of the issuer credit institution, both in going-concern and gone-concern situations. Further, detailed analysis will be required to address asset encumbrance issues and to strike a balance between the interests of the covered bondholders and those of unsecured creditors of the issuer credit institution.

Steps 1 and 2: coverage requirements and minimum over-collateralization

The EBA's recommendations include proposals for:

- the calculation of cover assets;
- eligibility criteria applicable to cover assets;
- minimum over-collateralization requirements to ensure that there is sufficient coverage for the covered bonds and related liabilities.

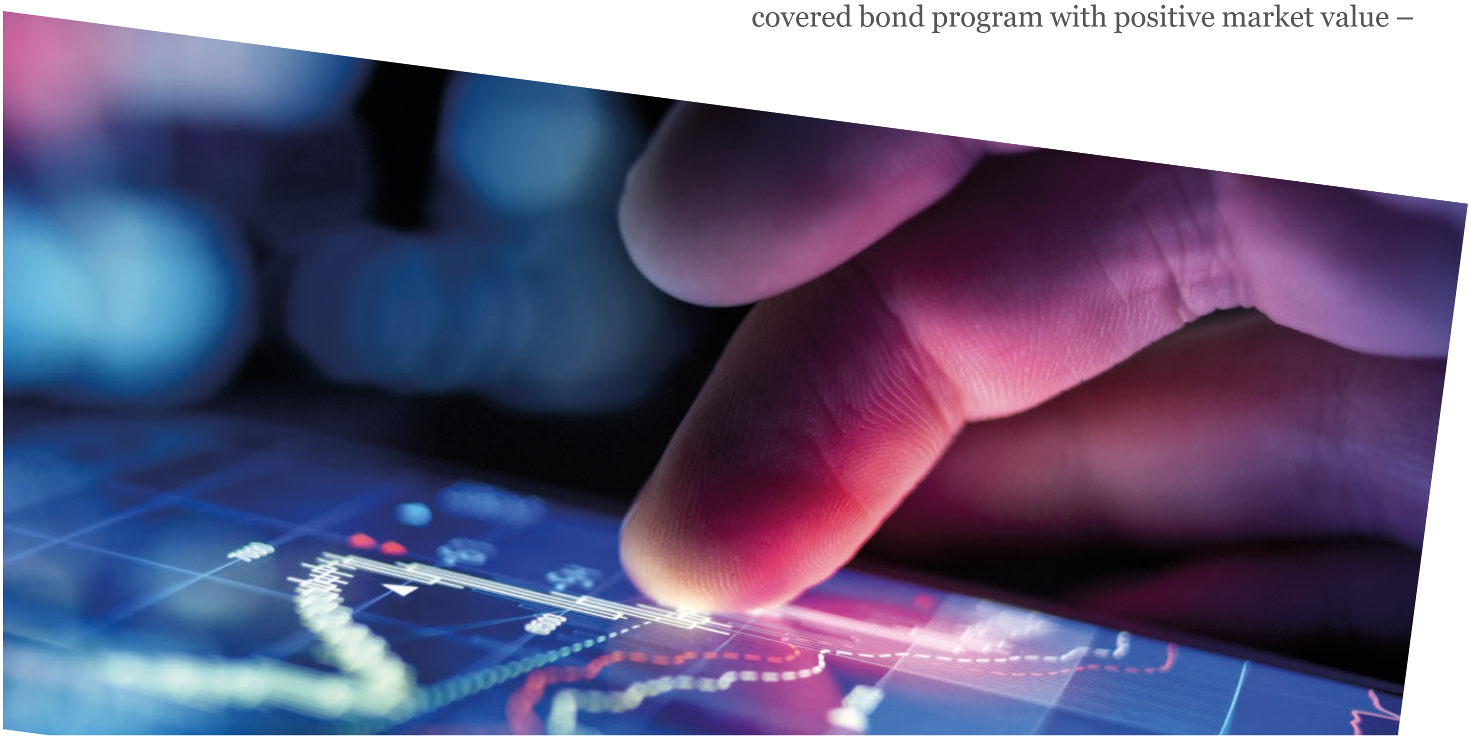
Pursuant to Article 27(3)(b) of the Single Resolution Mechanism Regulation and Article 44(2)(b) of the BRRD, covered bonds are excluded from the applicability of the write-down and conversion powers laid down in the BRRD and the Single Resolution Mechanism Regulation. This means, in principle, that covered bonds cannot be written down following a bail-in intervention by the relevant resolution authority in relation to an issuer. However, such write-down powers can be used in cases where the liabilities from the covered bonds exceed the collateral. It is unclear how and when, during any such bail-in intervention, the value of such collateral is determined and how voluntary over-collateralization is treated. This could affect the preferential interests of covered bondholders. It would be sensible for the EU resolution legislation to clarify this issue and other points relating to safeguards available for covered bonds under the resolution framework (e.g., in the context of a partial transfer of assets and liabilities as a resolution tool).

In addition, without purporting to be complete, it is understood that in determining whether the cover assets provide sufficient coverage to pay all liabilities of, or related to, the covered bonds (ie, the coverage requirement is complied with), the value of cover pool derivatives as a component of such cover assets (expressed as a positive or negative amount) must be taken into account. Such value is determined by:

- calculating the cash in and outflows under all cover pool derivatives entered into under a market-standard master derivatives agreement (e.g., International Swaps and Derivatives Association) on an aggregate basis – a so-called ‘aggregate cash-flow amount’;
- comparing such amount with the close-out amount determined under such master agreement in respect of such derivatives.

The smaller amount will be taken into account as a component (expressed as a positive or negative amount) for determining the value of the cover pool assets.

In the current low-interest climate, determining the value of cover pool derivatives for the purpose of calculating the cover pool assets as part of the coverage requirement could negatively impact covered bond structures in EU jurisdictions which use ‘basis swap’ or ‘total return swap’ derivatives (e.g., under which the rate of interest received on the primary assets is swapped for a basis reference rate) to mitigate interest rate risk between the cover pool assets and covered bonds, if the negative market value of such derivatives – even if determined on a net basis, taking into account other cover pool derivatives for the same covered bond program with positive market value –



exceeds the aggregate cash-flow amount referred to above. This could be particularly relevant to structures with high over-collateralization. The EBA's proposed recommendation could be expanded on to clarify the process of determining the value of cover pool derivatives as part of the coverage requirement.

Finally, it remains to be seen how requirements are actually implemented in the EU covered bond framework to preserve the strength of the covered bond brand, and how much flexibility will be created to cater for innovative covered bond structures such as (conditional) pass-through covered bonds with long maturity extension options.

Grandfathering

Following the 2016 report, the EBA recommends that existing covered bonds issued before the new EU covered bond framework's entry into force and benefiting from the existing preferential (risk weight) treatment not be affected by the new framework, and thus continue to benefit from such preferential treatment until their maturity.

Next steps

Following publication of its consultation paper on EU covered bonds in September 2015, the European Commission recently announced that – as part of its CMU mid-term review – it will set out which legislative changes may be needed to support the development of EU covered bond markets. The European Commission will likely take account of the recommendations contained in the EBA's 2016 report when finalizing its proposals, and has announced that it intends to complete the CMU mid-term review in June 2017.

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Emergency liquidity assistance: Italian state guarantee for newly issued liabilities

On 23 December 2016, the Italian government issued Law Decree No. 237 (the "Decree") which sets out "urgent measures to protect public savings in the credit market" in order to prevent or remedy serious turbulence in the economy and preserve financial stability.

The Decree has since been converted into law by Law No. 15 of 17 February 2017 and applied from 23 December 2016 (and from 22 February 2017 with respect to the provisions of the Decree amended by the conversion Law).

What is the new state guarantee?

The Decree authorizes the Italian Minister for Economic Affairs and Finance (the **MEF**) to grant a state guarantee (the **Guarantee**) in respect of newly issued liabilities of banks that have a registered office in Italy (**Italian Banks**). The state guarantee is available until 30 June 2017 although this period may be extended by up to 6 months by the MEF, subject to the approval of the European Commission.

The Guarantee is an unconditional, irrevocable and first demand guarantee and covers both capital and interest. It is only available to banks that meet certain capital requirements and in relation to certain debt instruments that have specific structural features.

What types of instruments are eligible for the Guarantee?

Debt instruments issued by Italian Banks that have the following features may be eligible for the Guarantee:

- issued after 23 December 2016 or, in respect of existing issuance programs, subject to specified terms of duration;
- principal amount to be repaid in full;
- fixed rate interest;
- denominated in Euro;
- no subordination;
- that are not structured securities, complex products or instruments which incorporate a derivative component.

What are the capital requirements that banks need to meet?

General Aid Regime: In order to qualify for the Guarantee, a bank must meet the following capital requirements:

- full compliance with the requirements relating to own funds referred to in Article 92 of EU Regulation No. 575/2013; and
- evidence that no stress test has shown any current or future failure of its own funds.

Compliance with these conditions is checked by the Bank of Italy or, if a significant bank, the European Central Bank, in accordance with the Single Supervisory Mechanism.

If a Bank receives a Guarantee in respect of instruments that have a nominal value greater than €500m and 5% of its total liabilities, it will need to submit a restructuring plan to confirm its profitability and long-term funding capacity without recourse to public support, within two months of receiving the Guarantee.

Individual Aid Regime: If a Bank does not meet any of the above requirements, a Guarantee will only be available if a Bank urgently needs liquidity support and the following conditions are met:

- the Bank has positive net assets; and
- the European Commission takes a positive decision in light of European legislation on state aids applicable to liquidity measures in the context of a financial crisis.

Under the Individual Aid Regime, for the entire period of effectiveness of the Guarantee, the bank must not:

- distribute dividends;
- make discretionary payments on Additional Tier 1 capital instruments;
- buy-back its own Core Tier 1 capital and Additional Tier 1 capital instruments, without prior authorisation from the European Commission; and
- acquire new shares, except for acquisitions compliant with European legislation on state aids.

A Bank will also need to submit, within two months of receiving a Guarantee, a restructuring plan to confirm its profitability and long-term funding capacity without recourse to public support.

Emergency liquidity assistance guarantee

In addition to the above guarantee regime for newly issued liabilities, the Decree also authorizes the MEF to issue a State guarantee to integrate collateral, or its realizable value, allocated from Italian Banks to secure funds disbursed by the Bank of Italy where they are facing a liquidity crisis (emergency liquidity assistance).

A Bank in receipt of this guarantee will need to provide, within 2 months, a restructuring plan to confirm its profitability and long-term funding capacity without recourse to public support.

Final thoughts

This Decree is designed to help Italian banks in need of additional capital and unable to raise capital on their own. The capital injection will alleviate the problem for some weak banks and help the whole system achieve more stability, enhance the Italian economy and strengthen the investors' trust in the Italian banking system.

General market conditions in the EU may entail systemic risks for a single Member State or for the whole European economic area and therefore setting up of public financial support tools (such as these) which may be utilized if and when needed may preserve financial stability and avoid market turmoil.

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Green bonds – More than a fashion trend?

COP21 and its consequences

Since the historic COP21 agreement, which seeks to make a transition towards renewable and more sustainable energy, interest in green finance and securities has increased dramatically. With studies showing that more than US$1tn annually will need to be spent each year in order to support low-emission projects, this former "niche" has now become a sector which offers numerous opportunities for the green securities market, and in particular the green bond market, to grow.

Background

Climate finance through the green bond market has grown substantially in 2016 with issuances having almost doubled since 2015. This growth has been driven by government action and substantial issuances in China, which is soon to be the world's largest green bond market. It is worth examining the reasons behind investors' appetite for green bonds compared to other emerging markets.

What are the Main drivers for the issuance of green bonds and the development of green bond market?

– **Satisfy investor demands for responsible business practices**: Investors are increasingly demanding socially responsible investment (**SRI**) opportunities. Consequently, issuances of green bonds have been repeatedly oversubscribed. Conscious retail investors are looking to invest in sustainable investments, increasingly demanding such products from their brokers. On the other hand, institutional investors, coming under scrutiny by having to comply with best practices and corporate social responsibility, are using green bonds to satisfy ESG (Environment, Social and Governance) requirements, something that had been difficult to address with more traditional financial instruments in the pre-green bond era. As a result, green bond issuances have attracted new types of investors, providing a potential audience for future issuances.

– **Securing project finance**: Green bonds are an attractive means of financing large environmental investment projects, such as wind and solar development which often require a large capital investment. This is thanks to the larger audience that green bonds attract, the lower costs of raising capital (as opposed to traditional funding) and the use of proceeds in sustainable and environmentally conscious projects.

– **Reputational advantages and differentiation**: With the press generally covering green bond issuances favorably, green bonds provide issuers, regardless of whether they are corporate or public entities, with an opportunity to differentiate themselves from their competitors and promote them as conscious, innovative and sustainable.

General features of green bonds

How does a "green bond" differ from a regular bond?

Like other bonds, a green bond is a financial instrument for raising capital from investors on the debt capital market, repaying the capital when the bond matures and distributing a set amount of interest during the life-span of the bond.

By labeling the bond as "green", the issuer commits to using the proceeds of the bond in a transparent manner and exclusively to support climate-related or environmental projects.

This specific use of the funds raised distinguishes green bonds from regular bonds. Therefore, in addition to assessing the financial characteristics of the financial instrument (such as price, credit rating of the issuer or maturity), investors also assess the specific purpose of the projects which the bonds intend to support.

There is however, not yet a single set of globally-agreed criteria to which a green bond must conform. The principal markets are actively working towards developing an agreed set of criteria. The two sets of standards which are widely followed by investors and issuers alike are:

– the Green Bond Principles (**GBP**), published by the International Capital Markets Association (**ICMA**), which recommend transparency and promote integrity.
– the Climate Bond Standard (**CBS**), a set of best practice recommendations published by the Climate Bonds Initiative.

Luxembourg as pioneer in green bonds

– **The Luxembourg Green Exchange**: In September 2016, the Luxembourg Stock Exchange (**LuxSE**) added, in addition to its two existing markets, a new platform for securities: the Luxembourg Green Exchange (**LGX**).

  LGX is the first "green" platform and currently is the exchange with the highest number of listed green bonds worldwide, listing currently more than 50% of all listed labeled green bonds. The value of green bonds on the LGX has already passed €50bn, in the first six months of its existence.

– **LGX entry requirements**: Once listed on one of the LuxSE's two markets, issuers must self-label their security as "green" by disclosing the green nature of the use of proceeds, providing an independent pre-issuance external review and committing to regular post-issuance reporting. These details will then be assessed by the LGX admission team before the security can be listed on the LGX. Both the GBP and the CBS are recognized by the LGX.

– **On-going obligations and fees**: Once listed on the LGX, LuxSE will conduct an annual review to ensure the issuer complies with its commitment to disclosure and transparency. While no standards or rules on documentation for post-issuance reporting are imposed by LGX, there is a discretionary right of withdrawal of the security from LGX if its requirements are not fulfilled.

No additional fees or costs, other than those levied for admission to one of LuxSE's markets and those associated with additional reporting obligations will apply for admission to the LGX.

– **Excluded project categories**: Clearly Securities whose proceeds will be invested in projects such as nuclear power production or fossil fuels (specifically oil, gas and coal, including so-called "clean coal") will not be admitted to LGX.

– **Notable admissions**: Since the listing of the world's first green bond by the European Investment Bank on the LuxSE in 2007, other notable issuances have followed. The Bank of China has issued four green bonds with a total issue amount of US$2.8bn, which have been listed on the LGX, making it the first Chinese bank to list a green bond on LuxSE Furthermore, the world's first sovereign green bond, issued by the Republic of Poland, was listed on the LGX in December 2016.

Outlook: Exciting times ahead

With green bond markets currently enjoying tremendous success, it remains to be seen whether they will eventually be able to develop and diversify. This may be achieved by entering emerging or developing markets where significant green investment is needed or by unlocking the green bonds market to other groups of investors, in particular through high yield green bonds.

From a legal perspective, it will also be interesting to see whether the standards which are currently prevailing on the green bond market and which seem to enjoy a high rate of acceptance amongst market participants may eventually translate into binding legislation.

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Investments of Money Market Funds

in Securitizations and ABCPs under upcoming EU Regulation

Background

In response to the effects the financial crisis had on Money Market Funds (**MMF**), in 2013 the European Commission (**Commission**) proposed a regulation on MMF. On 20 April 2015 the European Parliament adopted amendments to the Commission's proposal and on 15 June 2016, the Council of the EU agreed its "general approach". Trilogue negotiations concluded on 7 December 2016, when the Permanent Representatives Committee approved, on behalf of the Council, an agreement with the European Parliament on the proposed regulation (the **Regulation**). The Regulation was adopted by the European Parliament on 5 April 2017 and by the Council on 16 May 2017. The Regulation is now due for publication in the Official Journal of the EU. The Regulation will enter into force on the twentieth day following that of its publication in the Official Journal.

The Commission's intention in proposing a regulation was to improve MMFs' ability to weather stressed market conditions. The financial crisis in 2008 highlighted several weaknesses of MMFs, in particular issues relating to instantaneous redemption and value preservation when the prices of assets in which MMFs are invested start to decline. Large redemption requests could force MMFs to sell some of their investment assets in a declining market, potentially fuelling a liquidity crisis. This could lead to wider consequences for financial institutions or the economy because of money market issuers struggling with funding difficulties.

The Regulation tries to reduce these risks mainly through establishing a capital buffer, introducing conditions on portfolio structure, addressing over-reliance on external credit rating agencies and improving their internal risk management, transparency and reporting.

This article discusses investments of MMFs in securitizations and ABCPs.

Investments in Securitizations and ABCPs

The Regulation gives specific guidance on the circumstances under which future investments in securitizations and ABCPs will be permissible for an MMF.

An MMF is generally entitled to invest in a securitization or ABCP if several conditions are met. A securitization or an ABCP has to be sufficiently liquid, it must have received a favourable credit quality assessment and must meet requirements relating to maturity. A securitization must also comply with the Level 2 B requirements for highly liquid securitizations as set out in Article 13 of Commission Delegated Regulation (EU) No 2015/61. ABCP can be an eligible asset if it is issued by an ABCP program are also which is fully supported by a regulated credit institution, is not a re-securitization and the exposure underlying the securitization at the level of each ABCP transaction does not include any securitization position and does not include synthetic securitizations. Simple, transparent and standardized (**STS**) securitizations and ABCP are also classified as eligible assets under the Regulation.. The text of the regulation which contains the framework and criteria for STS securitizations (including ABCP) is still being negotiated under the trilogue procedure (the **Securitization Regulation**). The Regulation provides for an amendment to be made to the provisions detailing the requirements for eligible securitizations and ABCP by way of a delegated act (the **MMF Delegated Act**) once the Securitization Regulation has been finalised to incorporate appropriate cross references to the STS criteria.

The Regulation distinguishes between "Short-term MMF" and "Standard-MMF". This distinction is relevant tor permitted investments in securitizations and ABCP.

A short-term MMF is only entitled to invest in securitizations or ABCP if the legal maturity is less than or equal to 2 years and the time remaining until the next interest rate reset date is less than or equal to

397 days, the residual maturity or the legal maturity at issuance is 397 days or less and if the securitization is an amortizing instrument and has a weighted average life of less than or equal to 2 years. Whilst such rules in general also apply to a Standard MMF, a Standard MMF is not entitled to invest in securitizations the residual maturity or legal maturity of which is at issuance 397 days or less.

Although the initial proposal of the Commission did not prohibit investing in securitizations or ABCPs, the ability to actually invest in a securitization or ABCP was rather limited due to restrictive provisions prescribing the nature of the underlying assets and their maturity. However, following their discussions with the industry, the European institutions acknowledged that the focus on the legal maturity of an instrument does not appropriately match the risk profile of an amortizing securitization. Such a difference is also of importance for investments of an MMF. A MMF is generally intended to invest in short-term finance instruments. However, the legal maturity of a securitization is usually five years or more. During the trilogue process, the European institutions realized that strict adherence to the legal maturity falls short of the actual risk profile of a securitization. One has to take into account that the weight average life (**WAL**) of a securitization with a legal maturity of five years is in the area of 1.2 years. Such WAL actually determines the point in time when the substantial part of the risk associated with a securitization has disappeared. Therefore the WAL is the correct figure to determine whether a securitization is suitable for an investment by an MMF. Accordingly, the Regulation now sets out two thresholds on WAL for permitted investments by MMFs in securitizations. Firstly, the WAL of the securitization itself will be crucial going forward, due to the fact that an MMF is only entitled to invest in securitizations with an WAL of less than or equal to two years. Secondly, a portfolio of a Short-term MMF shall have a WAL at all times of no more than 120 days and a portfolio of a Standard MMF a WAL at all times of no more than 12 months.

The Regulation includes limits on the percentage of assets that a MMF may invest in securitizations and ABCP. Until the MMF Delegated Act comes into effect (which depends upon when the Securitization Regulation is finalised), the aggregate of all exposures to securitizations and ABCPs must not exceed 15% of the assets of a MMF. After that date, the aggregate of

all exposures to securitizations and ABCPs shall not exceed 20% of the assets of a MMF whereby up to 15% of the assets of a MMF may be invested in securitizations and ABCPs not compliant with the criteria for the identification of STS securitizations and ABCPs.
The Regulation also contains provisions detailing diversification requirements and concentration limits for investments of MMFs. A MMF must invest no more than 5% of its assets in money market instruments, securitizations and ABCPs issued by the same body and may not hold more than 10% of the money market instruments, securitizations and ABCPs issued by a single body.

Future prospects

With this new Regulation, investment by a MMF in a securitization or ABCP is still possible in a broad way. For those corporations that fully supported ABCP programs being excluded from the securitization limits to ensure better investment opportunities, the Regulation is a suitable compromise between the EU institutions desire to further regulate the financial markets and the need of MMF to invest in highly rated securitizations and ABCP.

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MAS Asian Bond Grant Scheme

The Monetary Authority of Singapore (MAS) launched its new Asian Bond Grant Scheme (the Scheme) on 9 January 2017 with the stated aims of strengthening the Asian bond market and encouraging Asian issuers to raise international capital in Singapore.

The Scheme aims to broaden the issuer base in the Singapore bond market by co-funding up to 50 per cent. of Eligible Expenses attributable to the issuance of certain Asian bonds listed in Singapore. The Scheme runs for three years and is available to first-time Qualifying Issuers on a one-time basis.

Key criteria of the scheme

- **What types of issuers are eligible for the Scheme?** Issuers eligible for the Scheme (**Qualifying Issuers**) are first-time issuing Asian companies and non-bank financial institutions with their global headquarters in an Asian country (ASEAN members, China, India, South Korea, Japan, Australia and New Zealand, together, the **Qualifying Jurisdictions**)).

  Non-bank financial institutions include policy banks (such as export and import banks).

  First-time Qualifying Issuers may also include issuers who have not filed a Return on Debt Securities[1] in the 5 years before 1 January 2017.

  Deposit-taking banks or entities licensed as a "bank" by the relevant authority are specifically excluded.

- **What type of bonds will qualify for the Scheme?** Bonds issued by Qualifying Issuers and denominated in USD, EUR or any of the local currencies of the Qualifying Jurisdictions will be eligible for the Scheme provided certain conditions are met, including:

  a) the issue is declared to be a Qualifying Debt Security (**QDS**) under the relevant Singapore regulations;

  b) for example, the bonds must be, among other conditions set out in the Income Tax (Qualifying Debt Securities) Regulations[2], substantially arranged by a financial institution in Singapore to qualify as a QDS;

  c) the principal amount of the issue is at least SGD200,000 (or its equivalent);

  d) the bonds must have a non-redeemable tenor of at least 3 years (with limited exceptions[3]);

  e) the bonds must be listed on the Singapore Exchange (**SGX**);

  f) more than half of the gross revenue from arranging[4] the issue must be attributable to FSI companies in Singapore; and

  g) if the bonds are denominated in SGD, they must be rated by any of Standard and Poor's Financial Services LLC (**S&P**), Fitch Ratings Inc. (**Fitch**) or Moody's Investor Services (**Moody's**).

1 This form is to be completed and submitted to the MAS within one month from the date of issue of all debt securities. (http://www.mas.gov.sg/~/media/MAS/News%20 and%20Publications/Surveys/Debts/RODSMar%202015%20onwards.docx)

2 Clause 4 (Arrangements for qualifying debt securities): http://statutes.agc.gov.sg/aol/search/display/view.w3p;ident=f5d0fdfe-ed68-43d2-ba00-f0134f439f4e;page=0;query=Id%3A%22978dafa7-2359-4845-9c2a-ec53a269d9e9%22%20Status%3Ainforce;rec=0#pr4-he-

3 http://statutes.agc.gov.sg/aol/search/display/view.w3p;ident=b937aa64-f4a4-42d0-b491-edd152d2fd4d;orderBy=relevance;query=DocId%3A4d18a35a-ef3a-427a-b86d-cebc4be10966%20Depth%3A0%20Status%3Ainforce;rec=0#pr4A-he-.

4 "Arranging" includes securing the mandate, originating and structuring the bond issuance, documenting and preparing the offering circular and related transaction documents, and distributing and selling of the issuance.

– **Who can be a Lead Arranger?** A Qualifying Issuer must appoint a Lead Arranger to carry out due diligence (including having consultations with MAS) to determine whether the issuer is eligible for the Scheme. The Lead Arranger must be a bank, licensed as a Financial Sector Incentive (**FSI**) Company[5] in Singapore.

– **What expenses are reimbursable?** Expenses of a Singapore-based provider which are incurred by a Qualifying Issuer and are directly attributable to a Qualifying Issuance, are eligible for co-funding under the Scheme. **Eligible Expenses** include arranger fees, auditor's fees, credit rating fees, legal fees and listing fees.

There is a cap on per-issuance expenses: Qualifying Issuers can only apply for up to 50 per cent. of the total Eligible Expenses per issuance, subject to a cap of (i) SGD400,000 where the Qualifying Issuance is rated by any of S&P, Moody's and Fitch; and (ii) SGD200,000 where the Qualifying Issuance is not rated. This can be done once per Qualifying Issuer.

Certain expenses (such as printer's fees, trustee fees, paying agent fees, roadshow and marketing fees, Goods and Services Tax (GST) and certain other taxes) are specifically excluded.

Where the criteria are met

Where the above criteria are met, the Lead Arranger will submit, on behalf of the Qualifying Issuer, a completed application form to MAS, together with the relevant invoices for reimbursement of Eligible Expenses no later than 3 months after the issuance date of the relevant bond.

Summary and observations

This is a positive move by MAS to strengthen the Asian bond market in Singapore and to increase the volume of SGX-listed bonds. The Scheme is specifically aimed at first-time Asian bond issuers and will also be of interest to banks licensed as FSI companies arranging and selling such issuances. If an issuer is of the view that it could benefit from the Scheme, it is encouraged to seek legal and tax advice pre-issuance and to consult with the MAS prior to applying.

It remains to be seen how the Scheme will be implemented in practice and how successful it will be in increasing Asia's share of the global bond market over the next three years.

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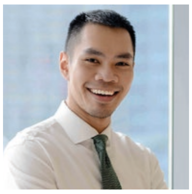

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5 Financial Sector Incentive Scheme applies to licensed financial institutions and seeks to encourage the development of Singapore's financial services sector.

Investment Partnership Program

Is Brazilian infrastructure spending back on track?

The year 2016 proved to be a very difficult one for the Brazilian economy. Along with a presidential impeachment and on-going high profile corruption scandals, Brazil is in the midst of a financial crisis, a byproduct of which has been a lack of spending on infrastructure and infrastructure projects. Brazil is in need of new infrastructure investment in order to help lift it out of its current recession. To that end, one of the key issues on Brazilian President Michel Temer's agenda is to promote the expansion of infrastructure investment and encourage private sector in the country's infrastructure development.

On September 13, 2016 Brazil enacted Law No. 13,334 (the **PPI Law**), which introduced a new Investment Partnership Program (Programa de Parcerias de Investimentos, or the **PPI**), which seeks to prioritize infrastructure projects and increase and strengthen the role of the private sector in infrastructure projects.

Traditionally, the primary source of infrastructure funding in Brazil has been the Brazilian National Development Bank (**BNDES**), a financing vehicle for the Brazilian federal government which focuses on economic development. However, the levels of funding traditionally provided by the BNDES are expected to significantly decrease and this will need to be offset by alternative sources of funding. According to a recent study[1] published by IBMEC (Instituto Brasileiro de Mercado de Capitais), a leading institution in researching capital markets in Brazil, there has been a significant reduction in financing provided by the BNDES to companies seeking funding for infrastructure projects in Brazil. This reduction reflects recent revisions to the institution's credit policies with respect to approving financing. In addition, the Brazilian federal government recently announced a reduction in public funding available to the BNDES which has resulted in a significant reduction in the transfer of funds from the Brazilian treasury to the BNDES.

The PPI focuses on facilitating collaboration between the public and private sectors. The Brazilian federal government has initially pledged R$30bn to support the long term financing of projects, of which R$18bn will be provided by the BNDES, through investments in debentures and traditional loan financing. Funding will also be provided by other state-controlled banks and investment funds.

The Investment Partnership Program

The PPI's main goal is to "expand and strengthen the interaction between the Government and the private sector through the conclusion of partnership agreements for the implementation of public infrastructure projects and other privatization measures."

The PPI Law aims to facilitate the planning and development of infrastructure projects by creating a centralized monitoring mechanism. The two bodies responsible for the implementation of the PPI are: (i) a committee (the **PPI Committee)** to assist the Brazilian President in his decision-making concerning projects and to monitor their development; and (ii) a secretariat to assist relevant authorities (at federal and local levels) to get projects included in the scope of the PPI.

The "centralized monitoring mechanism" was created to promote coordination between the different governmental authorities involved in infrastructure projects. The PPI Law provides for important additional structural measures to facilitate private participation in infrastructure projects, reducing government intervention in the design of the projects and avoiding frequent delays in obtaining the licenses and authorizations required under Brazilian law, which has traditionally been an impediment to infrastructure development in Brazil.

1 Nota CEMEC – 09/2016 - Relatório Trimestral De Financiamento Dos Investimentos No Brasil; December 2016

The PPI Law provides that both current and future federal and local infrastructure projects can be included as priority projects under the PPI, which allows for a more expedited process with respect to obtaining the requisite licenses and permits needed for the implementation and operation of the projects in question. Some of the first projects within the PPI have already been commenced and have attracted a high level of interest from the international private sector. For example, the concessions for the operation of four major airports (Porto Alegre, Salvador, Florianópolis and Fortaleza) have already been granted to European airport operators, who paid premiums over the prices originally established by the Brazilian federal government in order to win the respective bidding process[2], which bodes well with respect to how operators are viewing the new infrastructure project concession model adopted in Brazil.

Currently, another 37 projects are being structured and awaiting implementation under the PPI, including new projects as well as existing projects[3].

In order to encourage international participation, the PPI Committee now publishes tender documents in both Portuguese and English. Perhaps more importantly, and in order to address a longstanding concern with respect to foreign investors, Brazilian granting authorities have focused on devising hedging mechanisms with respect to concessions (which, by law, are denominated in Brazilian Reais), in order to mitigate foreign currency risks. These mechanisms have been applied in the airport concessions mentioned above and take into account currency variations, on the one hand, and the project's risk of return, adjusted by inflation, on the other, for the adjustment of the variable installments to be paid by foreign investors to the applicable granting authority.

2 http://www1.folha.uol.com.br/mercado/2017/03/1867000-grupos-levam-4-aeroportos-em-leilao-com-oferta-de-r-37-bilhoes.shtml

3 For a description of the current PPI projects, please refer to http://www.ppi.gov.br/projects

Practical Effects

One of the positive consequences of the BNDES reducing its participation in funding infrastructure projects, coupled with the gradual recovery of the Brazilian economy, is increased financing opportunities through the domestic and international capital markets. According to ANBIMA[4] (Associação Brasileira de Entidades dos Mercados Financeiro e de Capitais), the leading financial institutions industry group in Brazil, Brazilian companies raised R$52.2bn in the domestic and international capital markets during the first quarter of 2017, an increase of 139% when compared to the same period in 2016. This increase was mainly driven by issuances in the international markets that reached US$10bn[5] during the quarter.

The PPI may prove to be a vehicle that can be used by investors to foster private sector participation in infrastructure funding to supplement the reduced availability of public sources of financing. Through such programs, increased foreign capital and participation could be a significant driving force behind infrastructure development.

The PPI Law is a positive step in the direction of attracting private investment in Brazilian infrastructure. In addition to the hedging mechanisms and dual language versions of tender documents, Brazilian authorities have indicated a willingness to provide realistic rates of return with respect to investments in infrastructure projects. These measures, coupled with the potential recovery of the Brazilian economy and other legal and market developments, should provide for increased opportunities for financing of infrastructure projects in the international capital markets.

4 The Brazilian Financial and Capital Markets Association – Associação Brasileira das Entidades dos Mercados Financeiro e de Capitais.

5 http://www.anbima.com.br/pt_br/imprensa/volume-de-captacoes-das-companhias-brasileiras-cresce-139-no-primeiro-trimestre-de-2017.htm

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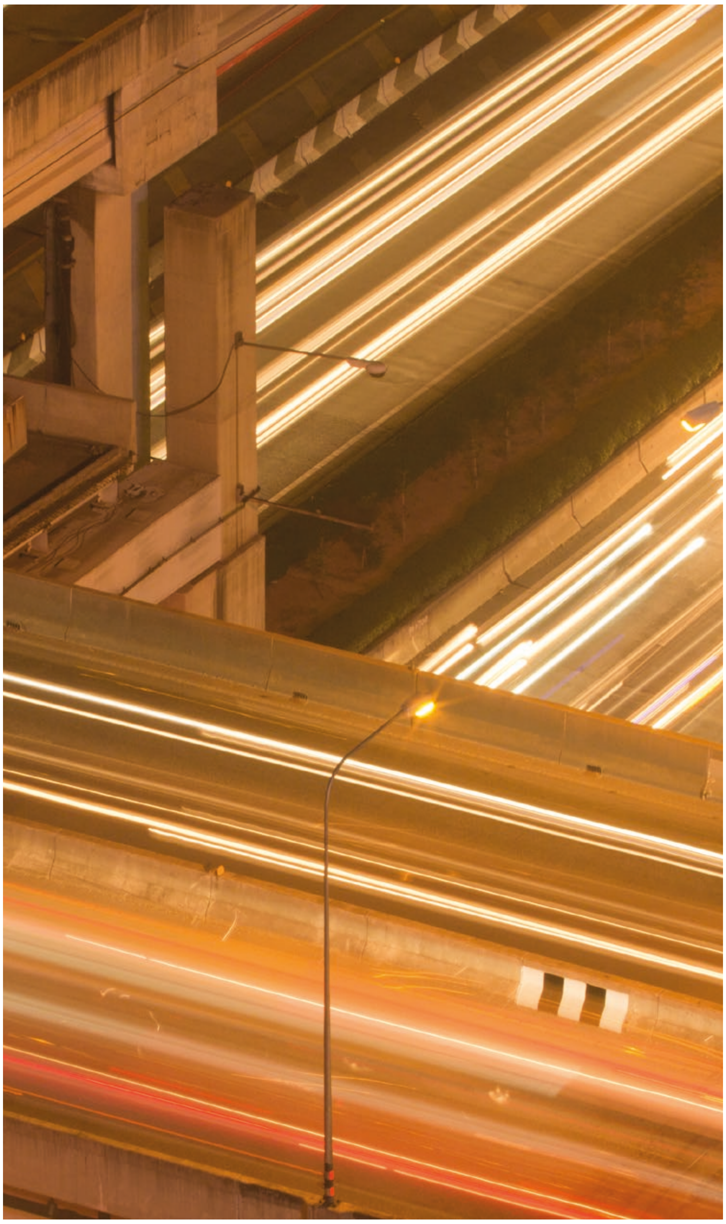


Mexico's Fintech Law initiative: What you need to know

On March 23 2017, the draft bill of the Financial Technology Law (the Law) was published in Mexico. Comments were invited by the Ministry of Finance and Public Credit (known by its Spanish acronym SHCP) from the Mexican banking and financial industry. The bill will also amend other existing financial services laws.

The Law will regulate the organization, operation, functioning and authorization of companies that offer alternative means of access to finance and investment, the issuance and management of electronic payment funds and the exchange of virtual assets or cryptocurrency (the **Financial Technology Institutions**, or **FTIs**).

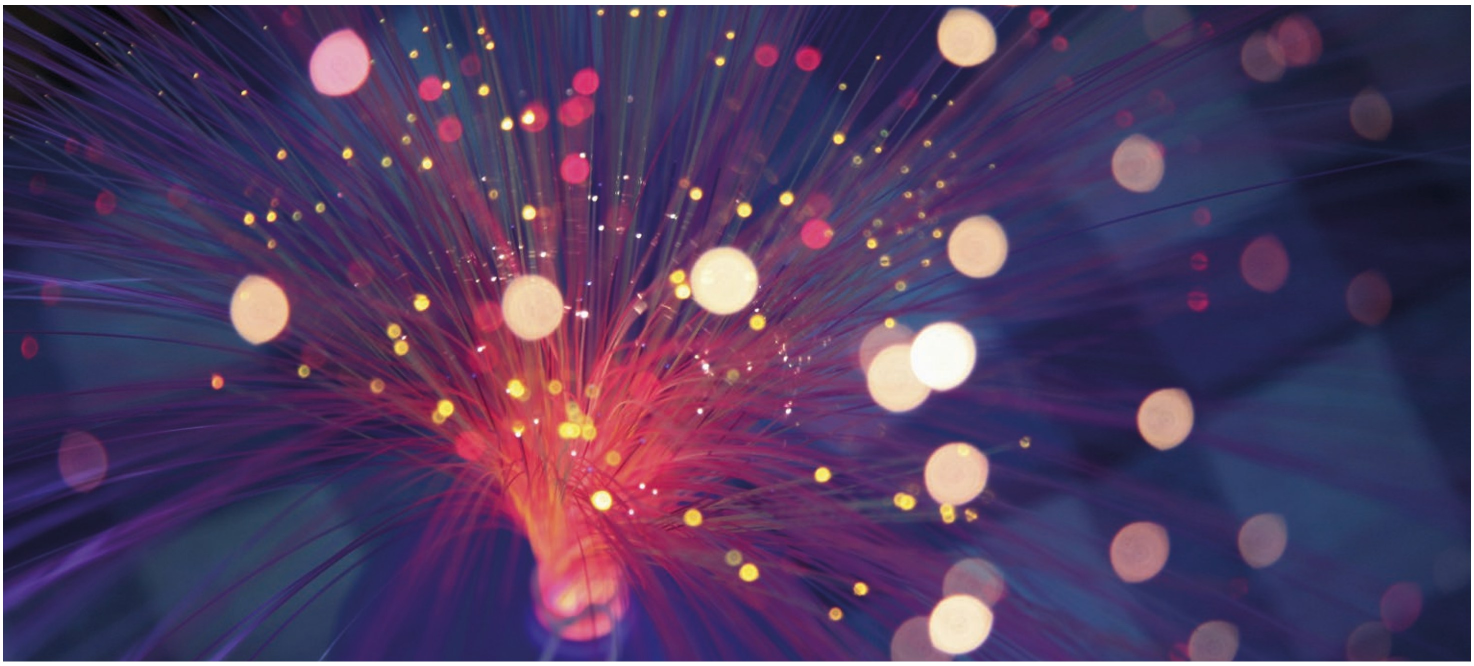
This FinTech initiative formally introduces several widely used concepts that are in the industry to the regulatory framework, such as big data, crowdfunding, cryptocurrency, e-money, regulatory sandboxes, robo advisory and application programming interface (**API**).

Why are Mexican authorities taking steps to incorporate FinTech regulation into the legal framework?

Mexico is leading the way in Latin America to implement regulation in this area for several reasons. By establishing the basis for regulation and development of the FinTech industry, Mexican regulators are looking to give legal certainty to industry participants. They are also hoping to take advantage of the opportunity to expand the financial market by covering segments of the market not covered by traditional banking institutions due to limitations in their infrastructure, cost of services and operational structures. The intention is to encourage products and services that are practical, easy to access and close to the client.

Another objective of this initiative is to provide financial stability, by providing prudential rules in financial risk, operational, technological, marketing, corporate governance and accounting rules, as well as establishing limitations and maximum amounts for transactions. Encouraging healthy competition is also important for the regulators, in order to have greater diversity and reduced costs in the provision of services and new distribution channels for financial services consumers.

Finally, this initiative intends to provide the basis for preventing the use of FinTech activities for purposes of money laundering and terrorism financing, as well as protecting the users of financial services.



How does this FinTech initiative address money laundering and terrorism financing risks, and consumer protection?

To mitigate the risks of using FinTech companies for money laundering and the financing of terrorism, this initiative proposes establishing both client and investor identification standards, which it considers essential for the integrity and correct functioning of the financial system. Companies that wish to participate in this industry must use bank accounts maintained in authorized financial institutions; the use of cash in transactions is limited only to specific situations as permitted by the authorities.

Without any regulation in place, FinTech operations currently fall outside of the scope of the protection of Mexican authorities. However, by introducing a FinTech regulatory framework, the authorities will supervise the authorized companies and their activities, and establish much-needed defence mechanisms.

To further protect FTI investors and clients, FTIs will not be allowed to make any guaranteed returns on investment, or guarantee the result or success of investments. Also, the initiative prohibits related persons, or those with the power to direct or control an FTI's management or resolutions, from applying for crowdfunding financing, as well as those officers, partners, board directors, managers and other individuals imprisoned for over one year for a financial crime.

Relevant FinTech authorities

The Law establishes the **SHCP**, the National Banking and Securities Commission (**CNBV**) and the Bank of Mexico (**Banxico**) as the main authorities in the financial technology field.

In addition, it provides that the CNBV, the National Commission for the Protection and Defense of Financial Services Users (**CONDUSEF**), the National Commission System for Retirement Savings (**CONSAR**), and the National Insurance and Bond Commission (known by its Spanish acronym **CNSF**) will have supervision and surveillance powers, and must operate within the scope of their jurisdictions.

The Law also proposes that a Committee on Financial Technology Institutions (the **Committee**), which will be set up, consisting of two representatives from each of the SHCP, the CNBV and Banxico.

The Committee, together with the CNBV, will be responsible for granting the necessary authorizations so that the FTIs can correctly operate within the national territory.

What types of institutions will be regulated by the Law?

The following institutions that undertake financing, investment, savings, payments or transfer activities through interfaces, the internet or any other means of electronic or digital communications will be considered FTIs pursuant to the initiative:

- **Crowdfunding Institutions:** These serve as mediators to investment seekers and potential investors through digital platforms such as websites or mobile applications, so that prospective investors can fund applicants through such digital platforms.
- **Electronic Payment Institutions:** These offer the services of issuance, management, accountability and transfer of electronic payments. Electronic payment funds include, but are not limited to: (i) the amounts or units of an asset that can be assigned a monetary value and are recorded in an electronic transaction accounting ledger; and/or (ii) those

amounts that are accepted by a third party as receipt of an amount of money or respective virtual assets.

- **Virtual Asset Management Institutions:** These contact third parties through digital means in order to buy, sell or dispose of their own or a third party's virtual assets, and receive virtual assets to make transfers or payments to a person, including another Virtual Asset Management Institution. Virtual assets are those digital units that have similar uses to that of the Mexican peso, as determined by Banxico under certain criteria it will take into consideration.

What does the enactment of the Law mean for future FTIs, and those FTIs already in existence?

If the Law comes into force in its current form, FTIs will have to be incorporated as a Mexican corporation (sociedad anónima de capital variable) or limited liability company (sociedad de responsabilidad limitada de capital variable) in order to provide services in Mexico. This is something all interested parties from outside Mexico must take into consideration.

All FTIs must obtain prior authorization from the CNBV, together with an opinion from the Committee. FTIs that are already providing services in Mexico will have to obtain the CNBV's authorization in order to continue operating.

To be authorized as FTIs, companies must certify to the CNBV that the transactions they wish to carry out are expressly indicated in their bylaws; (i) that they have the appropriate governing bodies and corporate structure to carry out their operations; and (ii) that they have the necessary infrastructure and internal controls such as operating, accounting and security systems, offices, as well as the respective manuals. The CNBV will publish the authorizations it grants on a public registry and on the CNBV's website.

An important point to keep in mind for both existing and future FTIs is that if a FTI fails to comply with the minimum operating requirements or any of the other conditions established in the Law, the CNBV has the authority to revoke its authorization to operate.

Introduction of innovative companies (regulatory sandboxes)

Modeled after the regulatory sandboxes in the UK, this initiative enables innovative companies to operate dedicated to using technological tools, models, services or other means through innovative methods or processes.

Innovative companies must obtain a temporary authorization (of not more than two years), during which time they can provide their services to a reduced number of clients. This will be a trial period in which innovative companies can test out their business model. During this time, they must take all necessary steps in order to obtain permanent authorization, registration or concession to continue operating.

Creation of a FinTech Council

The Law also provides for the creation of a FinTech Council, which shall act as a means of consultation, advice and coordination. The Council's purpose is to create a space for exchanging opinions, ideas and knowledge between the public and private sector, in order to learn about the innovations in the field of financial technology and plan their development and regulation. The Council will be composed of individuals from the public and private sectors.

Next steps

Once the finance and banking community has provided its feedback on the initiative, the draft bill will be introduced to Congress who of Congress will make any adjustments and if passed, the bill will be enacted. It is therefore important to note that the bill is still in draft form and the proposal may change.

If the draft provisions are enacted without any amendments, as proposed existing FinTech companies will have a six months from the date the Law comes into force, within which to request authorization from the CNBV in order to continue operating. In the meantime, they will need to disclose to the public that the FinTech activities they perform are pending authorization from the CNBV, and are not supervised.

It is expected that the issuance of secondary regulation would be enacted and would cover general provisions such as regarding FTIs acting as attorneys-in-fact or agents of their clients, requirements and methodologies to report client risk and payment behavior to investors, technological infrastructure provided by financial entities with interests in an ITF, the creation of a specialized office for attending claims, and the use of robo advisory.

The Hogan Lovells team will closely monitor the continuing developments regarding this groundbreaking initiative.

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Dismantling Dodd-Frank: The Road Ahead

Among the many campaign promises of the 45th President of the United States, the repeal of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank or DF) may not have captured the popular imagination as firmly as his undertakings to build the wall or to bring manufacturing jobs back to America did. Nevertheless, for structured finance lawyers it is the promise that is most anxiously monitored with mixed degrees of concern and anticipation. Concern, because of the confusion and uncertainty that even a carefully orchestrated repeal will inevitably entail; anticipation, because of the work volumes that such confusion and uncertainty will hopefully spur.

The chart below summarizes some of the main Dodd-Frank provisions affecting securitizations, and examines some potential avenues for reform or repeal. Before getting into the specifics of the chart, however, a few high-level thoughts may be helpful.

First, It would be a mistake to assume that a simple repeal of Dodd-Frank (whether in part or in its entirety) would suffice to restore the regulatory regime in effect at the onset of the financial crisis. For example:

– In situations where Dodd-Frank repealed a pre-existing regulation (e.g., former Rule 436(g), promulgated by the Securities and Exchange Commission (the **SEC**) under the Securities Act of 1933, as amended (the **Securities Act**), which protected rating agencies from being regarded as "experts" for purposes of the liability provisions of the federal securities laws), a repeal of Dodd-Frank itself would not automatically revive the repealed regulation. Instead, further regulatory action would need to be taken.

– In addition, when Dodd-Frank added new language to a pre-existing statute (e.g., the addition of a new Section 13 to the Bank Holding Company Act of 1956, which mandates the enactment of the Volcker Rule regulations, or the insertion of new language in Section 15(d) of the Securities Exchange Act of 1934, which eliminated the automatic suspension of on-going reporting obligations under that statute for asset-backed issuers), the effect of a repeal of Dodd-Frank on the amended pre-existing statute is less clear.

– Finally, in instances where Dodd-Frank required federal agencies to adopt regulations that those agencies could arguably have adopted in exercise of their pre-Dodd-Frank regulatory powers (e.g., SEC regulations requiring securitizers to perform a review of the assets being securitized), these regulations would survive a simple repeal of Dodd-Frank. However, in instances where federal agencies relied solely on the authority granted by Dodd-Frank to adopt regulations, these regulations may no longer be enforceable following a repeal of Dodd-Frank.

Second, in certain instances it may be possible to obtain relief from the regulatory constraints introduced by Dodd-Frank through more than one avenue (e.g., amending or repealing legislation, amending existing regulation, or agency interpretive action). The selection of the course of action to be pursued in a particular instance will involve multiple considerations, including:

– Under the appropriate circumstances (i.e., when Democratic support can be enlisted to foreclose the potential for a filibuster in the Senate, and the House radical conservatives can be appeased), legislative relief could potentially be obtained significantly faster than any of its regulatory alternatives since the legislative process is not subject to the lengthy notice and comment period requirements that surround most agency action.

– Depending on the subject matter involved, however, it may be more appropriate to pursue individual regulatory reforms with the relevant departments or agencies (particularly in circumstances where an alternative regulatory regime is sought to be adopted to replace repealed provisions of Dodd-Frank). As the experience under Dodd-Frank demonstrated, when intricate subjects are involved or politically charged, there may be a preference within Congress to not prescribe detailed statutory specifics, but rather to delegate to the relevant agencies the substantive content and mechanics of implementing the policy objective. Unfortunately, this can result in a lack of meaningful guidance as to the intended parameters of the enacted law (and resulting regulation).

– A corollary of the foregoing is that technical matters are more likely to be addressed by lobbyists directly to the agency in charge of the corresponding regulation.

Third, in most instances where legislation is not possible or appropriate and changes are needed to existing securitization regulations, under the Administrative Procedure Act (**APA**) the process of amending or repealing regulation is treated identically to origi nal rule-making for purposes of the required notice and comment process, unless either (i) the proposed changes consist of interpretative rules, general statements of policy, or rules of agency organization, procedure, or practice or (ii) the relevant agency for good cause finds that notice and comment on such amendment or repeal are impracticable, unnecessary, or contrary to the public interest (in which case the APA allows the rele vant agencies to dispense with notice and comment requirements).

Given this framework, a combination of fast-paced legislative repeal followed by slow-moving regulatory replacements of the discarded regime could lead to several years of uncertainty and confusion.

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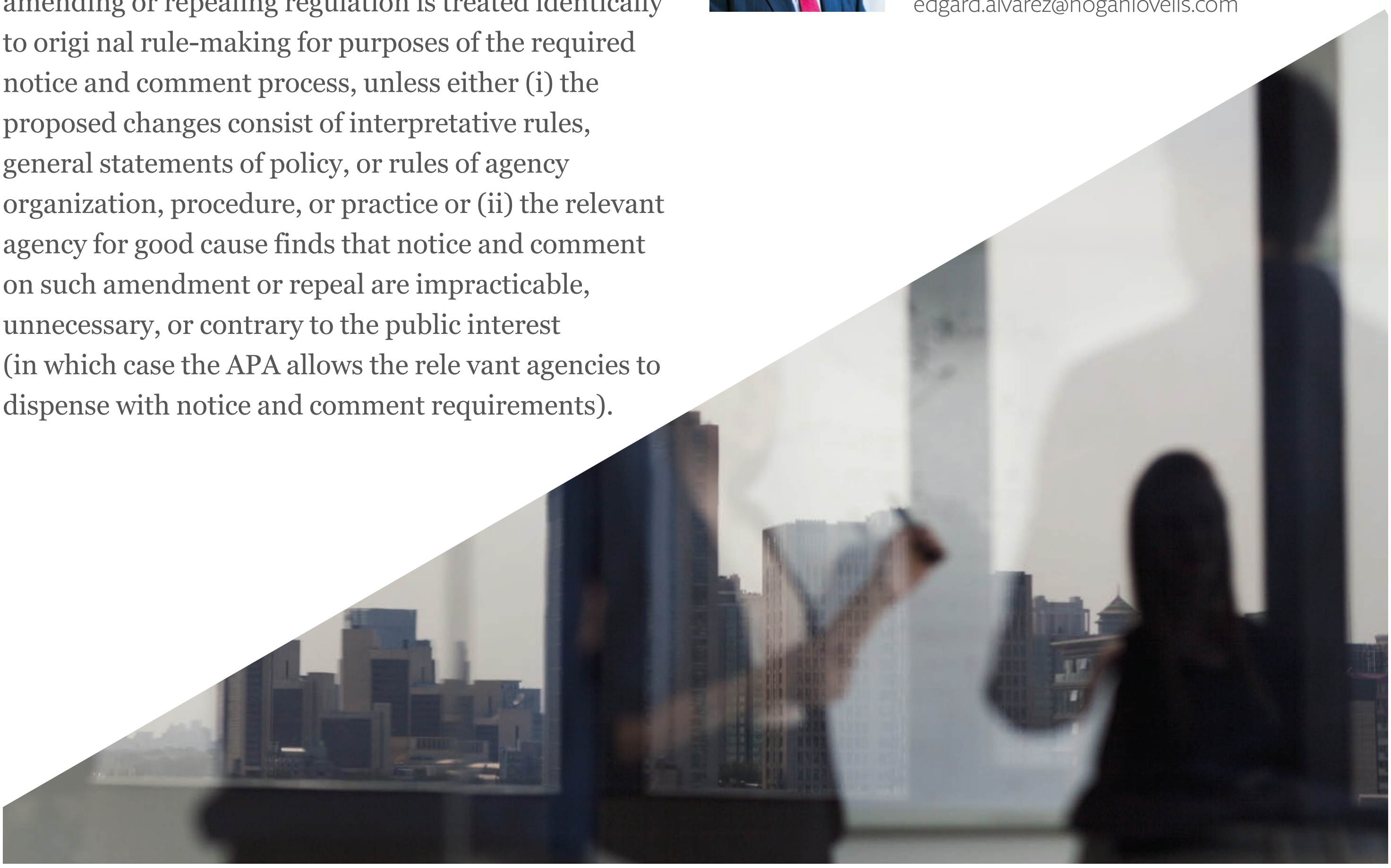

Appendix

Securitization regulation reform avenues

Provision	Potential Reform Avenue(s)	Observations
Dodd-Frank Required Regulations		
Title IX, Subtitle D (Improvements to the Asset-Backed Securitization Process)		
Conflicts of interest regarding certain securitizations (DF § 621) (prohibiting underwriters, placement agents, initial purchasers and sponsors of ABS from engaging in transactions that would result in material conflicts of interest with respect to any investor in such ABS for a period of one year following the closing date):		
– Rule 127B (proposed on September 19, 2011; not yet adopted).		Given that this rulemaking was mandated by Congress, a withdrawal of the proposed rule (without further rulemaking on this issue implemented or at least planned) may be inappropriate. A repeal of this section of Dodd-Frank would remove any urgency that the SEC may have to complete this rulemaking process (although the SEC probably has inherent authority to adopt the proposed rule even in the absence of a DF-based mandate).
Credit risk retention (DF § 941) (requiring issuers and sponsors of ABS to retain an economic interest in a material portion of the credit risk for any asset that, through the issuance of an asset-backed security, they transfer, sell, or convey to a third party):		Given the important and widely-acknowledged policy drivers behind the risk retention requirements, coupled with the international commitment of the U.S. in the wake of the financial crisis to implement some form of risk retention, complete repeal of the requirement is likely neither appropriate nor probable.
– Regulation RR adopted on October 20, 2014 by the six federal agencies subject to the mandate.	– Legislation to repeal or amend Exchange Act § 15G. – Joint agency rulemaking to revise existing regulations in order to address industry-identified pain points.	Paragraph (e)(1) of § 15G appears to require that any "exemptions, exceptions or adjustments" to the rules adopted thereunder need to be jointly adopted by all the agencies involved in the initial rulemaking. If this interpretation prevails, any effort to seek regulatory amendments would be more challenging. As of the date of this writing, the staff of the SEC has issued two no-action letters regarding requirements of Regulation RR. In both instances, the staff indicated that it had consulted the positions taken with colleagues at the other agencies.
		While a complete overhaul of the current Risk Retention regime may be difficult to achieve and time consuming to undertake, some specific revisions that directly affect securitization may be more easily achievable. For example:
		– The agencies could revise the criteria for Qualifying Automobile Loans to be more consistent with the auto finance business, as provided in comments to the proposed rule.
		– With respect to externally managed CLOs, there may be lender and investor support for the legislative removal of the Risk Retention Requirement.

Provision	Potential Reform Avenue(s)	Observations
		– A simple legislative amendment would suffice to ensure that offshore transactions that meet the risk retention guidelines of the European Union are entitled to claim substituted compliance when sold in the U.S.
Suspension of Exchange Act on-going reporting obligations for ABS issuers (DF § 942(a)) (carving out ABS from the suspension of on-going reporting obligations for issuers of securities with less than 300 holders):		
– Rules 12h-3, 12h-6 and 15d-22 and Form 15 amended on August 17, 2011.	– Legislation to amend Exchange Act § 15(d). – SEC rulemaking to change the current regime.	Because § 942(a) of Dodd-Frank amended § 15(d) of the Exchange Act to carve out ABS issuers from the general provision allowing issuers with less than 300 holders to suspend their reporting obligations, a repeal of Dodd-Frank § 942(a) that does not expressly restore 15(d) to its pre-Dodd-Frank language may not automatically bring back the old regime (in which case, additional rulemaking would be required).
ABS loan-level data disclosure (DF § 942(b)) (requiring the adoption of rules to (i) set asset-level disclosure requirements to enable investors to perform due diligence on assets and (ii) set standards for the format of data provided by ABS issuers):		
– Items 1111(h) (Asset-Level Information) and 1125 (Schedule AL) of Regulation AB added on September 4, 2014 as part of Regulation AB II.	– SEC rulemaking to repeal or amend current regime. – No-action relief or interpretive guidance may be available to address more targeted industry-identified pain points.	Items 1111(h) and 1125 of Regulation AB would survive a repeal of Dodd-Frank § 942(b) since they were not adopted exclusively under the authority of § 942(b). Prior to Dodd-Frank, the SEC had the authority to require asset-level disclosure (and had, in fact, proposed such a requirement for all assets in its 2010 proposal to amend Regulation AB).
Representations and Warranties in ABS Offerings (DF § 943) (requiring promulgation of rules directing (i) rating agencies, to describe transaction representations, warranties and enforcement mechanisms and their differences with those in other transactions involving similar securities; and (ii) securitizers, to disclose fulfilled and unfulfilled repurchase requests):		
– New Rules 15Ga-1 and 17g-7 and amendments to Item 1104 (Sponsors) and 1121 (Distribution and Pool Performance Information) of Regulation AB adopted on January 20, 2011.	– SEC rulemaking to repeal or amend the current regime. – Congressional hearing to re-evaluate efficacy of rulemaking under DF §§ 932(a), 943, and 945.	Rules 15Ga-1 and 17g-7 would survive a repeal of Dodd-Frank § 943 since they were adopted, not only under § 943, but also in reliance on the SEC's general rulemaking authority under the Exchange Act.
		Now that there are several years of practical experience with these rules, it may be appropriate to revisit them through a public hearing or other method to analyze whether the investor protection provided is worth the cost to the industry (and, indirectly, to the cost of credit in the real economy) of complying with these regulations.

Provision	Potential Reform Avenue(s)	Observations
Due diligence analysis and disclosure in ABS issues (DF § 945) (requiring promulgation of rules directing issuers of ABS to perform a review of the underlying assets and disclose the nature of such review to investors):		
– Rule 193 and amendments to Item 1111 of Regulation AB adopted on January 20, 2011.	– SEC rulemaking to repeal or amend the current regime. – See above with respect to rules adopted under DF §§ 932(a), 943, and 945.	Rule 193 and the amendments to Item 1111 would survive a repeal of Dodd-Frank § 945 since they were adopted not only under § 945, but also in reliance on the SEC's general rulemaking authority under the Exchange Act.
Title VI (Improvements to the Regulation of Banks)		
Volcker Rule (DF § 619) (prohibiting banking entities from proprietary trading and from sponsoring, owning or retaining an ownership interest in covered funds):		
– Final joint rule adopted on December 10, 2013. – Final Commodity Futures Trading Commission rule adopted on January 31, 2014.	– Legislation to amend or repeal Section 13 of the Bank Holding Company Act of 1956, as amended (the **BHC**). – Rulemaking to revise existing regulations. One potential solution would be simply to exclude any entity that exclusively issues securities meeting the Exchange Act definition of "asset-backed security" from the definition of "covered fund" in the Volcker Rule. This would clarify the common-sense position that the purpose of the Volcker Rule was not to deter securitization activity.	The OCC, the FDIC, the SEC and the Commodity Futures Trading Commission ("CFTC") adopted the Volcker Rule solely on the authority of Section 13 of the BHC. With respect to these agencies, a repeal of Section 13 would appear to make the corresponding regulations unenforceable. The FRB, on the other hand, adopted the Volcker Rule not only on the authority of Section 13 of the BHC, but also relying on its regulatory authority under the Federal Reserve Act, the Federal Deposit Insurance Act and the International Banking Act of 1978, as amended. A repeal of Section 13 of the BHC alone would leave doubts as to which provisions of the Volcker Rule would survive under the authority of these other statutes.
		If Section 13 of the BHC is not repealed, amendments to the Volcker Rule regulations may be complicated. Because the existing regulations were simultaneously adopted by four federal agencies, there is a question as to the different agencies' ability and willingness to independently revise their own regulations. Further questions are raised as to how the separate CFTC rule will complicate any revisions to the existing regulations.
Title VII, Part II (Regulation of Swap Markets)		
Margin (DF §§ 731 and 764) (requiring implementation of rules establishing capital requirements and initial and variation margin requirements for swap entities on all non-cleared swaps and non-cleared security-based swaps):		
– Final Rules adopted by the OCC, the FRB, the FDIC, the Farm Credit Administration and the Federal Housing Finance Agency published on November 30, 2015 (80 FR 74840).	– Rulemaking to revise existing regulations. – No action or exemptive relief.	
– Final Rules adopted by the CFTC on December 18, 2015 (81 FR 636). – SEC proposed rules (October 18, 2012)		

Provision	Potential Reform Avenue(s)	Observations
Title IX, Subtitle C (Improvements to the Regulation of Credit Rating Agencies)		
Disclosure of Third-Party Due Diligence Services (DF § 932(a)) (requiring third-party due diligence providers for ABS to provide written certification to rating agencies and requiring that these reports be made publicly available):		
– Rules 15Ga-2 and 17g-8 to 17g-10 adopted on August 27, 2014.	– SEC rulemaking to repeal or amend the current regime. – See above with respect to rules adopted under DF §§ 932(a), 943, and 945.	Rules 15Ga-2 and 17g-8 to 17g-10 would survive a repeal of Dodd-Frank § 932(a) since they were adopted not only under § 932(a), but also on reliance on the SEC's general rulemaking authority under the Exchange Act.
Study and Rule-Making on Assigned Credit Ratings (DF § 939F, also known as the Franken Amendment) (requiring that the SEC carry out a study of (i) the credit rating process for structured finance and related conflicts of interest and (ii) the feasibility of establishing a program in which a third party assigns rating agencies to determine the credit ratings for structured finance products).		The study was submitted to Congress in December 2012. In 2014 when the final rules on rating agencies were announced, no reference was made to forthcoming rules under § 939F. As the SEC has not yet taken action to propose a rule, it seems unlikely that a rule will be proposed; however, it is unclear whether this may be a part of the SEC rulemaking agenda going forward.

Distributed ledger technology and derivatives

Is the FCA looking to regulate innovation?

Distributed ledger technology – The FCA discussion paper

The Financial Conduct Authority (**FCA**) in the UK published a discussion paper[1] (the **FCA Discussion Paper**) on 10 April 2017 to gauge market participants' views on how the future development of distributed ledger technology (**DLT**) should be regulated by the FCA in FCA-regulated markets.

Background

What is DLT?

The FCA Discussion Paper describes DLT as:

"a set of technological solutions that enables a single, sequenced, standardised and cryptographically-secured record of activity to be safely distributed to, and acted upon by, a network of varied participants. This record could contain for example, transactions, asset holdings or identity data."

There is therefore no need for a central trusted authority or intermediaries and the technology is "immutable" so records cannot be amended except through agreed protocols by the participants (or a subset of the participants) with this being known as theconsensus protocol.

The record itself is either private or public (i.e. only available to be viewed by certain parties or anyone) and permissioned (i.e. where only participants with specific rights can add or change the record or unpermissioned (i.e. where anyone can make such additions or changes). We believe that a permissioned system of DLT with authorised participants only is most likely to be used in financial markets.

A commonly known form of DLT is Blockchain. Blockchain, in simple terms, is a technology that enables a shared ledger to be maintained by multiple parties and updated simultaneously. The ledger stored on the blockchain is shared amongst a distributed network of computers. New transactions are entered in blocks into the shared ledger once validated in accordance with the consensus protocol, without the need for a central authority and are protected by encryption. These entries generate a time-stamped record of history and audit trail, with the possibility of automatic identity verification.

Why is it important to derivatives transactions?

Cost savings

Applying DLT to derivatives transactions could result in huge benefits, including large scale savings on back office functions, greater certainty, reduction in counterparty risk, faster execution and verification of information, reduction in duplicative record-keeping and compliance benefits.

Given its potential to create significant efficiencies in the derivatives markets, DLT has generated attention around the globe as market participants collaborate or explore their own initiatives.

Smart contracts

A potential further application of this technology in the derivatives market would be the use of "smart contracts", which are computer programmes that allow agreements to be executed when certain conditions are met. For example, a smart contract could be created to execute a straightforward option between two contracting parties and then could deal with the ongoing payments or the margin requirements. However, while a smart contract could conceivably be created on the basis that the industry

1 Discussion Paper on distributed ledger technology – DP17/3 – April 2017

standard documentation is incorporated by reference, the parties would need to agree on what would happen where an event occurred which required a degree of analysis or discretion. It is also not clear how disputes would be resolved or indeed who would be responsible for the coding. It is also not certain whether the technology could facilitate close-out netting. However, given the benefits, the FCA is of the view that there will no doubt be situations where smart contracts may be a useful option.

Central clearing

The European Market Infrastructure Regulation (**EMIR**) requires certain standardised OTC derivative contracts to be cleared through a central counterparty (**CCP**). If market participants were to set up a DLT network to clear these transactions, the DLT network would need to comply with the requirements in EMIR. However, the European Securities and Markets Authority (**ESMA**) is of the view that the clearing of some spot transactions with DLT as the underlying seems the more likely near term scenario. Spot transactions are not within the scope of the clearing obligation under EMIR.

In the longer term, the development of DLT might see the disintermediation of CCPs if it could facilitate the immediate execution and settlement of transactions (although this is currently not viewed as a priority by many market participants). It would then be acting as the definitive record of title to the traded derivatives. However, the removal of CCPs could introduce new systemic risk and is likely to require amendments to EMIR.

Regulatory reporting

EMIR, the Securities Financing Transactions Regulation (**SFTR**) and the Markets in Financial Instruments Directive II (**MiFID II**) impose significant requirements on derivative counterparties to reconcile their trades, keep records and report trades to trade repositories, which require huge back office costs. DLT could significantly ease derivatives counterparties' burdens in reconciling and reporting trades as there would just be one record on the DLT, which the regulator could also be given access to, so there would be no need to report trades to a trade repository, for example. This would clearly require amendments to these regulations.

The use of DLT could obviate the need for trade confirmations, given that all participants to the DLT should see the details of the trade immediately. The requirement to produce trade confirmations under EMIR may then need to be amended.

Overview of the FCA discussion paper

Whilst the FCA is committed to fostering innovation that advances its objectives, it also recognises that as a regulator it needs to strike a balance between supporting innovation and ensuring customers are adequately protected. The FCA sees DLT as an example of rapidly developing technology which offers exciting potential to support the needs of consumers and the market, although it may present new challenges and risks.

The FCA is of the view that the benefits are likely to emerge in sectors where multiple participants need to share data and/or processes safely, especially where firms are still reliant on paper-based records.

Although the FCA generally takes a 'technology neutral' approach to regulating financial services, it is considering whether there is anything distinctive about DLT which would require a different approach as there may be regulatory barriers to the development of DLT which are currently unknown. DLT's potential and processing speed suggest that aspects of existing rules may need to be reviewed.

The FCA Discussion Paper states that there may be specific areas where DLT does not fit within its regulatory requirements but still achieves its desired outcomes, and the FCA will consider whether any rules prevent or restrict sensible development that would benefit consumers. However, at this stage, the FCA does not see a clear need to consider changes to its regulatory framework for DLT solutions to be implemented. Instead, the FCA is keen to explore emerging business models and the FCA Discussion Paper therefore invites responses on the risk and opportunities that DLT presents as well as thoughts as to whether any of DLT's characteristics make it challenging to fit within the existing regulatory framework.

The FCA recognizes that there are certain legal questions that are beyond the remit of the FCA Discussion Paper, such as the conflict of laws issues regarding contracts executed on a DLT platform across multiple jurisdictions simultaneously, which would be a matter for the courts to decide and changes to primary and secondary legislation which would require the involvement of HM Treasury.

Given the cross-border applications of DLT, the FCA views regulatory collaboration as important to ensure that disproportionate barriers to innovation can be identified and is actively working with other regulators including the ESMA and the International Organization of Securities Commissions (**IOSCO**).

The FCA acknowledges that although there have been many successful Proof of Concepts, DLT may face challenges before widespread use, as it will need to interact with non-DLT legacy systems, so the likely breadth and depth of market adoption of DLT is still uncertain.

In order to stimulate this discussion, it has asked market participants to respond to a series of questions which are set out in the FCA Discussion Paper.

Approach from other regulators

Regulators across the globe have been monitoring the development of DLT and many have published reports which strike a similar tone on their current approach of monitoring developments. The shared view is that any changes and related efficiency gains are likely to be incremental rather than revolutionary.

ESMA

In its recent report dated 7 February 2017, ESMA says that it has adopted a "wait and see" approach towards DLT so it can monitor developments rather than regulate activity that could hamper the growth of the technology. ESMA believes that the technology could bring a number of benefits, including more efficient trade processes, enhanced reporting and supervisory functions, greater security and availability, reduced counterparty risk, enhanced collateral management and reduced costs. However, the report accepts that these benefits are conditional upon a number of challenges being met including that if DLT deployment is gradual, DLT-systems will need to co-exist with legacy systems and it will need to facilitate Delivery versus Payment (DvP) and netting if it is to be widely adopted. Users would need to put in place an appropriate governance framework and other risks such as cyber and operational risks would need to be carefully managed. ESMA also believes that, under certain market circumstances, DLT may contribute to increase market volatility, because of the embedded automated triggers, although this would be relatively low in the short term but could increase as the technology develops.

ESMA is of the view that DLT is most likely to be used for post-trading activities such as clearing and settlement and considers that the current EU regulatory framework does not represent an obstacle to the emergence of DLT in the short term, although some requirements may become less relevant over time whilst new rules may be needed.

BIS

In its recent report on DLT (published on 27 February 2017), the Bank of International Settlements (**BIS**) states that DLT has promise but that there is still a long way to go before that promise may be fully realised. BIS warns that DLT may pose new or different risks including potential uncertainty about operational and security issues arising from the technology and the absence of an effective legal and governance framework. It stresses that much work is needed to ensure that the legal underpinnings of DLT arrangements are sound, governance structures are robust, technology solutions meet industry needs and that appropriate data controls are in place and satisfy regulatory requirements.

FINRA

In its report on DLT in the securities industry, issued on 18 January, 2017, the Financial Industry Regulatory Authority (**FINRA**) provided a detailed look at DLT and requested comments on how DLT would interact with the securities industry. The report recognizes that there are some great potential synergies in DLT and the securities industry, especially in clearing and settlement, but that DLT's activities in the highly regulated US financial sector requires more review and research. The report goes into considerable depth on potential applications of DLT to the securities industry, including applications in the equity, debt and derivatives markets, as well as for use cases involving industry utilities such as product reference data and customer identity management.

The report also considers potential impacts of DLT on the securities industry, such as reducing market inefficiencies, improving transparency, clarifying roles of intermediaries, and addressing operational risk. In addition, FINRA also identifies factors in the report that it believes should be considered when implementing DLT-based solutions, including governance, operational structure, and network security. Finally, FINRA concludes with consideration of a variety of regulatory issues in the US relevant to the adoption of DLT solutions in the context of the capital markets, including the handling of customer funds and securities, broker-dealer net capital rules, anti-money laundering requirements, books and records maintenance requirements and customer data privacy.

Next steps

As industry efforts to use DLT continue, the FCA expects that in the second half of 2017 and into 2018 there will be more movement from the "Proof of Concept" stage to "real-world" deployments. No doubt the regulators around the world will continue to monitor these developments. For its part, the FCA is interested in exploring where the balance of risk and opportunities may lie in relation to DLT, and will accept comments on the discussion paper until 17 July 2017. After the comment period concludes, the FCA will issue either a Summary of Responses or a Consultation Paper.

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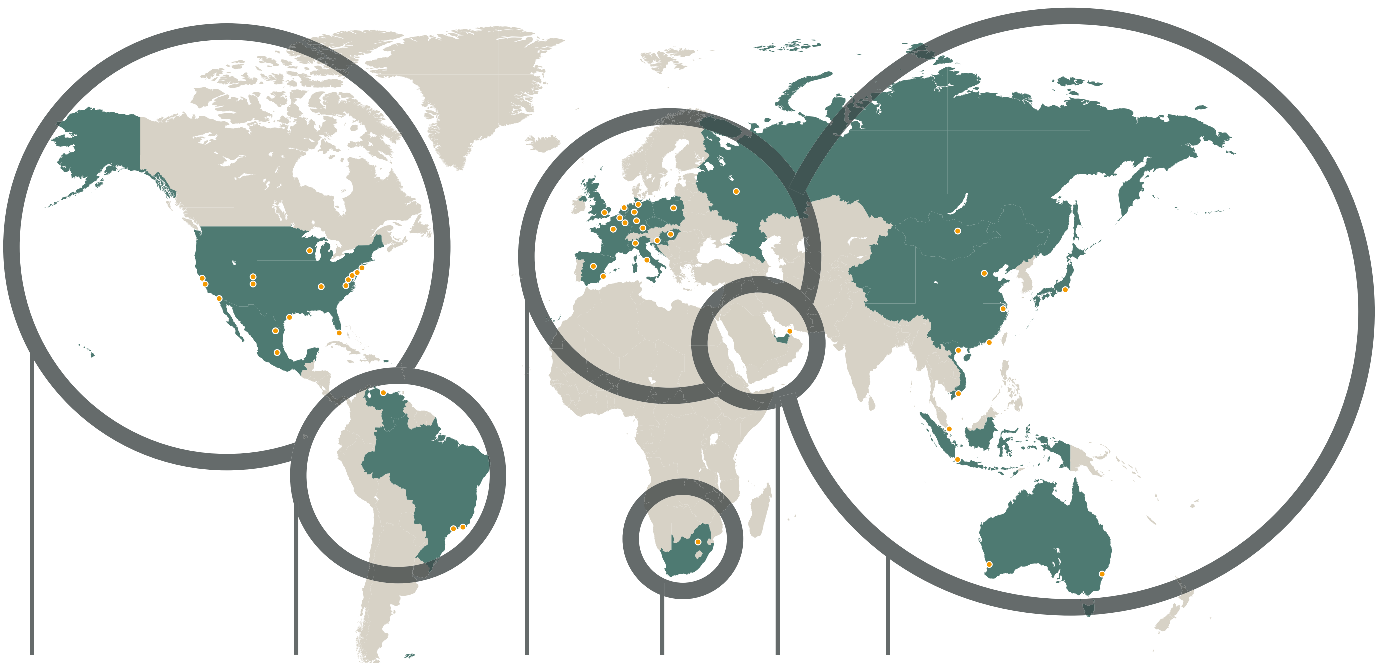

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Our International Debt Capital Markets practice

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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