

Law in transition 2012



European Bank
for Reconstruction and Development

Developing capital markets



The EBRD is changing people's lives and environments from central Europe to central Asia. In 2011 the Bank began laying the foundations for the expansion of its operations to the southern and eastern Mediterranean (SEMED) region. Working together with the private sector, the Bank invests in projects, engages in policy dialogue and provides technical advice that builds sustainable and open-market economies.

About this report

Legal reform is a unique dimension of the EBRD's work. Legal reform activities focus on the development of the legal rules, institutions and culture on which a vibrant market-oriented economy depends. Published twice a year by the Legal Transition Programme, *Law in transition* covers legal developments in the region, and by sharing lessons learned aims to stimulate debate on legal reform in transition economies.



Foreword: Developing capital markets	2
Manfred Schepers	

General section

Credit information reporting systems	4
Frédérique Dahan and Elizabeth Kirk	
Public procurement review and remedies bodies – models for success	22
Alan Colman and Eliza Niewiadomska	

Focus section Developing capital markets

The EBRD's legal and regulatory assessment – what limits development of local capital markets?	32
Lewis Cohen, Frédérique Dahan, Jacek Kubas, Yana Mihaleva, Margaret Welsh	
The EBRD at the forefront of developing the Russian domestic capital market	42
Elena Sulima	
Close-out netting and the world of derivatives in central and eastern Europe and beyond – ISDA's perspective	48
Dr Peter M Werner	
Regulatory framework of Egypt's capital market: room for reform?	56
Amr Abbas and Mohamed Nabil Hazzaa	
The rollercoaster of Romanian capital market development	66
Madalina Rachieru	
Close-out netting in Russia: are we almost there?	74
Vladimir Khrenov	
Keeping up with the Kazakhs – an update on recent regulatory changes and recommendations for further reforms	82
Shaimerden Chikanayev and Marina Kahiani	
The wider context: the future of capital market regulation in developed markets	88
Cally Jordan	
Abbreviations	96

Foreword

Developing capital markets

The global financial crisis has shown that the economies of the EBRD region are exposed to the intertwined systemic risks of financial “dollar/eurorisation” and excessive reliance on foreign lending in the context of low domestic savings. The root causes of these problems are diverse: weak macroeconomic policies, a lack of confidence in domestic currencies and institutions and underdeveloped domestic financial markets.

In May 2010 the EBRD launched the Local Currency and Local Capital Markets Development Initiative at the Bank’s Annual Meeting in Zagreb to support the deepening of local capital markets to actively tackle these root causes. Building a sound legal and regulatory framework is an integral part of the market development process. Effective enforcement of contracts among market participants and prudent regulations over their business conduct to safeguard market integrity and stability are key building blocks of a sound capital market. In carrying out its mandate under the Initiative, the EBRD has often encountered situations where the uncertainty of legal and regulatory treatment hampers capital market development. In this spring issue of *Law in transition*, practitioners and

leading scholars share the insights that they have gained through engagement in a wide range of countries. In addition, the EBRD presents the findings from its legal and regulatory assessment of local capital markets.

Capital market development is not a new topic; and it has always been high on the transition agenda for the majority of the EBRD countries of operations. Policy-makers, both at the national and multilateral levels, have already implemented various measures during the past two decades, including the introduction and amendment of relevant legislation. Despite these efforts, as we witnessed during the global financial crisis, we must admit that a large proportion of the local capital markets in our region have not developed in the way we envisaged.

One potential reason may be that the market reality which we face today is very different from that encountered even a decade ago. As Cally Jordan highlights in her article, the distinction between the developed and developing markets is becoming increasingly blurred. Today, emerging economies of varying sizes and at different stages of market development attract international capital flows and some carry a significant



weight in the global markets. Further, it is increasingly evident that local capital market development cannot be addressed in isolation or treated solely as a domestic issue; instead it must be approached in the context of broader global issues. Management of cross-border capital flows, and the modern business models at large international banks which centrally determine capital and liquidity allocation across the countries and business lines must be taken into account. Indeed, as the local capital markets develop, coordination among the regulators in different countries will be increasingly important.

Another observation gained in the EBRD's ongoing work under the Initiative, as well as its past engagements as a market participant, is that the legal and regulatory framework may need to play a more active role of "stimulating" the market development in the transition economies. In the Western tradition, the predominant approach today, including that of the EBRD, focuses on removing the legal and regulatory obstacles. However, in markets which have only limited expertise in the judiciary system and/or weak institutional capacity to enforce laws in a predictable manner, market participants may not be sufficiently confident or incentivised

to create new markets unless there is a more explicit "positive list". Looking ahead, perhaps more attention should be paid to how the legal and regulatory framework can stimulate market development rather than just facilitate transactions in the transition economies in order to have a real impact.

We believe that the insights in this edition of *Law in transition* will not only provide up-to-date knowledge on specific and concrete issues but also stimulate discussion, provoke further thought and help us sharpen our focus and approach in order to deliver real results. Strong growth potential exists in the EBRD countries of operations – in central and eastern Europe, central Asia, and the southern and eastern Mediterranean region. On this occasion, we would like to express the EBRD's commitment to supporting these countries' local capital market development efforts.

A handwritten signature in black ink, consisting of a stylized 'M' followed by a long, sweeping horizontal line that ends in a small hook.

Manfred Schepers
EBRD Vice President and
Chief Financial Officer

01

Credit information reporting systems

FRÉDÉRIQUE DAHAN AND ELIZABETH KIRK

Extension of credit depends on the ability of lenders to access credit information and overcome inherent information asymmetries about their potential borrowers' ability to pay. This article builds on recent standard-setting developments on credit information reporting systems and proposes an approach to assess the effectiveness of existing systems. It then presents the results of a study carried out by the EBRD on 16 countries where credit reporting information systems are in place, and compares and contrasts such efficiency. It then draws some conclusions and potentially important policy implications for future developments.

General section



An analysis of the continuing fallout from the global economic crisis of 2008-09 has highlighted the importance of an institutional environment in which credit decisions can be made effectively and efficiently. Extensions of credit depend on the ability of lenders to access credit information and overcome inherent information asymmetries about their potential borrowers' ability to pay, despite the availability of other supporting credit documentation, such as collateral security or guarantees.

Access to credit has been a cornerstone of the Bank's Legal Transition Programme since its inception. The scope of the legal reform work in this area has evolved over the years in synchronisation with the products offered by financial institutions (including the Bank itself) in transition countries. The development of micro and SME finance has emphasised the need to develop an information system around the

credit histories of prospective clients: obtaining information on a potential client's past credit performance and taking collateral over the client's property to secure the loan are often conceptually seen as two faces of the same coin.

Since the 1990s, the Legal Transition and Knowledge Management Team (LTT) has maintained a focus on collateral law reform. Far less attention had been paid to credit bureaus. One of the reasons for this is historical: the EBRD in its first decade put more emphasis on large corporate finance, which was vital for engineering economic growth, rather than on SME or microfinance, or indeed consumer finance. This has changed over the years and the Bank has increasingly focused its policy dialogue on serving the development of micro, small and medium enterprises finance. The ability to take collateral has remained very important for reducing and mitigating credit



Effectiveness of credit information reporting institutions can be limited by the lack of an appropriate legal framework

risk; however, the ability of lenders to access credit information on borrowers has also become a key pillar of access to credit.

However, the effectiveness of these credit information reporting institutions can be limited by the lack of an appropriate legal framework and proper institutional structure and processes. To complement its work in financial law, the EBRD launched an assessment in 2010 to review and measure the functionality and legal efficiency of some existing credit information reporting systems in the region.

Assessment and methodology

The assessment drew from a number of existing materials. These materials included the 2006 IFC *Credit Bureau Knowledge Guide*, the World Bank/BIS, *General Principles for Credit Reporting*, Consultative Report (2011),¹ Task Force General Principles for Credit Reporting and the World Bank *Doing Business Reports*.² The EBRD's assessment aims to capture the differences among legal systems, oversight and ownership of credit reporting systems, data protection and consumer protection issues, and practical considerations of the users of credit information in its countries of operations. At present, the most comprehensive database for credit reporting information systems is provided in the World Bank *Doing Business Reports*, updated every year. The Reports provide a very brief snapshot of credit information reporting systems, formalised as a score from 0 to 6. The score is calculated as a sum of six binary checks, differentiated by whether the system in place is public or private (see below for further definition of this distinction):

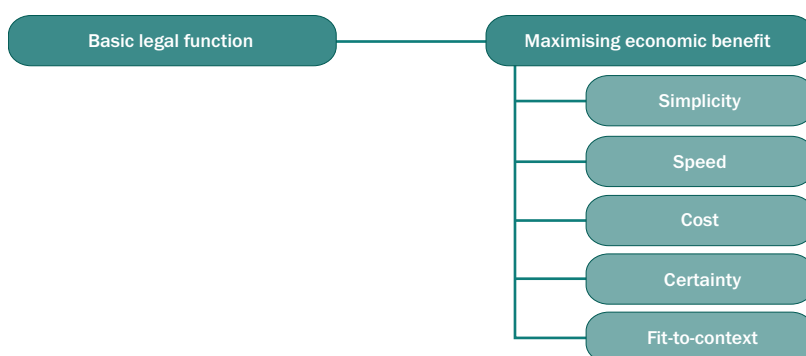
- whether the information provided is both positive and negative
- whether both individuals and firms are covered
- whether the data from retailers, trade creditors and utilities are collected in addition to the data from financial institutions
- whether more than two years of historical data are distributed
- whether small loans are included
- whether borrowers have a legal right to access their data.

Although this information is very useful, it may also be too summary and does not necessarily capture some aspects that are important for the further development of the systems – in particular the ease of obtaining a credit report, the associated costs, or the frequency of corrections made to credit information. The EBRD Survey thus collected *additional* information to the *Doing Business Reports*, and also attempted to take a more *comprehensive* approach to the efficiency of credit information reporting systems.

Methodology

The assessment has two purposes. First, it provides descriptive information on the institutional structure of the credit information reporting systems in the transition region. Second, it presents, mirrored against experience in previous assessment exercises,³ a new

Chart 1
Legal efficiency criteria of credit information reporting system, EBRD





Legal efficiency consists of a set of criteria, grouped under two headings: basic legal function and the maximisation of economic benefit

Table 1
Glossary of relevant legal terms

Credit history	A borrower's past payment history, including credit applications and payment history.
Credit reporting system	Overall term encompassing credit bureaus and credit registries. Refers to the database that contains information on data subjects and the processes for accessing information on subjects to support users in their analysis of creditworthiness.
Credit bureau	Privately owned entity that processes information on data subjects to support users. Can be operated by banks (which are then considered non-neutral, since banks are also users) or neutral data processing companies.
Credit registry	Public entity operated by central banks or other agencies collecting information from data providers about the indebtedness of data subjects.
Credit report	Document produced by credit bureaus or registries for users about the credit history of data subjects. May include a credit score.
Credit information	Core information on data subjects, which may include borrowers' identity details, past and present payment history and updated basic credit risk information. <i>Positive credit information</i> is a record of good repayment behaviour, such as on-time payments. <i>Negative credit information</i> describes missed payments, tax arrears, and so on.
Data provider	An institution which has disclosed information about a data subject and a payment history to the credit reporting system. In most cases, data providers are government agencies and financial institutions with which the data subject has credit relationships.
Data subject	Individual or legal person (a company, for example) whose data are subject to processing.
User	Individual/company who asks the credit reporting system for credit reports and other information about data subjects for permissible purposes.

Source: EBRD, Credit information reporting system survey, 2011.

measure of “legal efficiency” of the credit information reporting systems. Legal efficiency consists of a set of criteria, grouped under two headings: the basic legal function and the maximisation of economic benefit. The basic legal function of a credit reporting system is to allow for the sharing of accurate and sufficient credit information. This supports credit providers in assessing the creditworthiness of a potential borrower/debtor, while respecting the sensitive and confidential nature of such information. Maximising economic benefits of the system consists of allowing for all functions of the system to be fulfilled simply, within an appropriate time and cost, while providing the different users with certainty as to how the system and its safeguards are to operate. There should also be evidence that the system fits in the context (social, economic, and so on) of the particular country, in the present and in the foreseeable future.

The assessment was conducted through surveys and desk research. Surveys were sent to key stakeholders in the region, to seek their views, perceptions and information on a number of key questions. The stakeholders were divided between:

- operators of the credit registry and/or credit bureau(s) in existence in the country; who were asked for information on how their institutions are operated and used
- regulators of the credit information reporting system, who were asked about their role, responsibilities and experience in regulating and sometimes disciplining such a system
- data providers and users of the systems – institutions that provide credit information to the system and also retrieve information on data subjects when permitted.

The EBRD also reviewed the laws and other regulations applicable to the subject matter, including data protection laws, and any materials that were publicly available in order to complete the picture drawn by the responses to the survey.

The research gathered a minimum of information on all of the EBRD's 29 countries of operations, and surveyed in depth a sample of 16 (which were considered to allow for a fairly representative overview of the region), namely: Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Georgia, Hungary, Kazakhstan, Kyrgyz Republic, Latvia, Mongolia,



There is no consensus on whether credit information reporting systems should be run by public agencies, private companies, or some hybrid of these models

Table 2
Credit information reporting systems in transition countries: basic classification

Grading	Availability of credit information reporting system	Countries
No system	There is no system of credit information reporting which allows the assessment of creditworthiness of potential borrowers.	Moldova; Tajikistan; Turkmenistan
Limited system	Credit information reporting system is in place but is too limited in terms of data, data providers and potential users to serve its function.	Belarus; Croatia; Estonia; Montenegro; Slovenia; Uzbekistan
System in place	The credit information reporting system is in place, and although it may in some cases present a number of inefficiencies in terms of processes, data quality and consumer protection, it is deemed generally to fulfil its purpose.	Albania; Armenia; Azerbaijan; Bosnia and Herzegovina; Bulgaria; FYR Macedonia; Georgia; Hungary; Kazakhstan; Kyrgyz Republic; Latvia; Lithuania; Mongolia; Poland; Romania; Russia; Serbia; Slovak Republic; Turkey; Ukraine

Source: EBRD, Credit information reporting system survey, 2011.

Poland, Romania, Russia, Serbia (excluding Kosovo), Slovak Republic and Turkey.

Regional institutional and market structure

Existing data from the World Bank *Doing Business* Report 2011 on credit reporting systems in the EBRD's countries of operations, suggests that the transition region is one of the most advanced regions in the world, especially when compared with other emerging markets regions. Table 2 shows that 26 of the EBRD's 29 countries of operations have an existing credit information reporting system. Only Moldova, Tajikistan and Turkmenistan are without a credit reporting system. However, in six of those jurisdictions (specifically, Belarus, Croatia, Estonia, Montenegro, Slovenia and Uzbekistan), the system in place is unduly restrictive through limiting data or participating institutions. In Croatia, for example, the credit bureau established by the banking association permits only banks and other related financial institutions to receive credit information and excludes other credit providers, such as utilities or leasing companies from using the system.

In all the other countries (20 out of 29), a credit information reporting system is in place, although in some cases it presents a number of inefficiencies in terms of processes, data quality and consumer protection. These are captured by the main survey.

A number of specific features of credit reporting systems can be highlighted.

Institutional structure of the credit reporting service providers

There is no consensus on whether credit information reporting systems should be run by public agencies, private companies, or some hybrid of these models and, to some extent, the optimal structure will be determined by the size of the market. Credit registries and credit bureaus in the transition region have a wide diversity of ownership structures which have evolved over time. The oldest credit information reporting system in the region is in Turkey, where the credit registry operated by the Central Bank of Turkey opened in 1951. Most other systems in the region were developed during the last 10-15 years. Private ownership currently dominates, as illustrated in Table 3 below.

Some of the systems in the region are undergoing further changes and the current institutional environment may not be static. None of the 16 countries surveyed has a structure which solely comprises a public registry. In Mongolia, where the Credit Information Bureau which has operated out of the Bank of Mongolia from the mid-1990s is undergoing privatisation, it seems likely that a joint venture company will be formed with the US-based commercial information company Dun & Bradstreet.

Seven of the surveyed countries – Bosnia and Herzegovina, Bulgaria, FYR Macedonia, Latvia, Romania, the Slovak Republic and Turkey – have a private credit bureau and a public credit registry. Bulgaria and FYR Macedonia both have a private credit bureau and a public credit registry, but the latter dominates the



Among the countries surveyed there is a fairly even split between countries with specific laws related to credit information reporting and those which rely on general legislation

Table 3
Transition countries: main institutional form of credit information reporting systems (early 2011)

	Central bank public registry only	Both public registry and private bureau (but registry dominant)	Public registry and private bureau co-existing	Both public registry and private bureau (but bureau dominant)	Single private bureau only	Multiple private bureaus / registry – competitive environment
Bosnia and Herzegovina			✓			
Bulgaria		✓				
Croatia					✓	
FYR Macedonia		✓				
Georgia					✓	
Hungary					✓	
Kazakhstan					✓	
Kyrgyz Republic					✓	
Latvia			✓			✓
Mongolia*					✓	
Poland						✓
Romania			✓			✓
Russia						✓
Serbia**					✓	
Slovak Republic			✓			
Turkey			✓			

Source: EBRD, Credit information reporting system survey, 2011.

* This is a prospective interpretation of the reformed system currently under development. ** Excluding Kosovo.

market at present in each country, although this may change. The public credit registry in FYR Macedonia was established in 1998 and the private bureau became operational this year. In Latvia the public registry (operated by the Bank of Latvia) is the main credit information reporting system, but some private companies offer reporting services alongside their primary business of debt recovery. In the Slovak Republic the private bureau covers only individuals, while the public registry applies only to firms. In Bosnia and Herzegovina the private bureau was formed in 2000 and the public registry in 2006; the coverage of the latter has since increased greatly, while that of the private bureau has dropped significantly. The public registries in Bulgaria and Romania, which were formed in 2000 and 1999, respectively, were joined by private credit bureaus in each country from 2004. Despite these similar formation timelines, it should be noted that in Romania the private credit bureau has larger coverage, while the financial institutions in Bulgaria that responded to the survey indicated that they only used reports from the public registry. Lastly, Turkey has a significantly longer track

record in providing credit information services; the central bank has owned and operated a credit registry since 1951, and a private credit bureau has been operational since 1997.

The other nine countries rely on private credit bureaus to provide credit information services, but there are significant differences in the number of operating bureaus in a particular country. In Serbia there is one private bureau, which was established by the Association of Serbian Banks. In Russia, as of January 2011, there were 32 registered bureaus throughout the country, many of which were affiliated directly with various financial institutions.

Legal framework

Among the countries surveyed, there is a fairly even split between those with specific laws or regulations relating to credit information reporting and those which rely on other general legislation (typically banking law and data protection law) to control the operations of credit bureaus and registries. Nevertheless, there seems to be a trend towards developing specific laws on credit reporting, as for example



Competition within a credit reporting system can provide market pressure to provide an effective, accurate and cost-effective product for a large number of users

in Croatia, the Kyrgyz Republic and Mongolia. In Croatia HROK credit bureau was founded by 20 Croatian banks under the auspices of the country's banking association. There is no legal framework other than the 2003 Act on Personal Data Protection, and participation in the system is determined by the internal regulations of the bureau. Public registries are all based on laws and/or regulations governing banking or financial services. Some private credit bureaus have been set up by experienced international firms (such as Experian) using existing data protection law to base their operations. The Kyrgyz Republic is a special case in that the credit bureau was developed without any legal framework; a draft law which reflects the current system is being developed.

Level of competition among credit reporting service providers

Competition within a credit reporting system can provide market pressure to provide an effective, accurate and cost-effective product for a large number of users. However, competition may also lead to a fragmented and confusing system in which a data subject's complete credit history can only be pieced together from multiple sources.

A number of jurisdictions in the transition region have competitive markets for credit reporting service providers, whether operating as a private bureau providing services alongside a public registry (for example, in Bosnia and Herzegovina), a public registry coexisting with multiple credit bureaus (as in Latvia and Romania) or in an entirely private bureau environment (as in Poland, and Russia, where the sheer size of these markets can accommodate a number of competing organisations). See Table 3.

Hungary is unique among countries in the region insofar as it permits only one credit bureau at a time to operate.

In Russia the competitive environment is enabled by the Central Catalogue of Credit Histories (CCCH), a database run by the central bank containing information about where a data subject's credit history is stored. The role of the CCCH is to direct a lender (or an individual) to all the credit bureaus that keep records of that individual's (as a potential borrower) credit history. This should reduce the possibility of getting a blank report when

a potential borrower has an existing credit history. The catalogue database receives information identifying data subjects from all of the existing credit bureaus, so data can be sourced from a single reference point.

Stress resistance and system integrity

Defining the rights of credit information operators over data in cases of cessation of trading, transfer of a business to a third party or insolvency of a credit registry is an essential part of ensuring data protection. In Russia the Federal Law on Credit Histories dictates that, in the event of a credit bureau's insolvency, the credit histories owned by the insolvent bureau should be sold in an auction involving only other state-registered credit bureaus. The CCCH would temporarily store databases of liquidated, re-organised or excluded credit bureaus. In Hungary, in the event of the Central Credit Information System becoming insolvent, the data would reportedly be transferred to the replacement institution designated by the Supervisory Authority. Other countries do not seem to have procedures in place to respond to such a situation and surveyed parties were uncertain as to what the outcome of such a scenario would be.

Regulatory oversight and enforcement

The privacy concerns inherent in personal credit information suggest that effective oversight of institutions in the credit reporting system and appropriate enforcement authority are essential for regulators to protect data subjects and to promote data accuracy and good business practices. The central bank typically plays a role in regulating credit reporting systems, but other financial system or banking authorities are often involved and many regulatory and supervisory functions are the responsibility of data protection agencies. In general, central banks regulate public credit registries, while private credit bureaus are subject more generally to laws on personal data protection, with supervision and enforcement powers falling on the data protection authorities. The objective is to have effective regulatory oversight of the credit reporting system, ensuring that the system operates as a public service for all borrowers and lenders (debtors and creditors).

The degree to which the credit reporting system is regulated may vary widely. In the least regulated countries, regulation may be



The main purpose of the study was to evaluate the effectiveness of credit information reporting systems in place in the EBRD region

limited to the licensing of the credit information provider or even simply issuing clarifying statements about the law. In the majority of EBRD jurisdictions, however, regulation is more intensive and may include issuing industry regulations or administrative guidelines, auditing credit bureaus, collecting and investigating complaints, and imposing penalties. A regulatory authority whose activities extend beyond licensing and registration is thought to be a better model because the regulatory activities may mitigate some of the inherent risks to privacy present when dealing with collection of and access to personal information.

In most countries in the EBRD region, regulators – whether they are central banks or other supervisory agencies – have extensive powers. Both private credit bureaus and public registries are subject to data protection laws in most countries. Bosnia and Herzegovina illustrates the approach in the region. The Central Bank has the powers to collect complaints and issue penalties and disciplinary sanctions, while the Data Protection Commission has corresponding powers to consult on legislation, collect complaints, conduct investigations, and issue monetary fines. Although this is consistent with the development of a dual system of credit information reporting, there is a significant risk of implementation gaps if personal data are being treated differently in different institutions. Similar powers exist in other countries in the region, with most supervisory agencies authorised to issue fines of varying amounts.⁴ In the Slovak Republic, Section 19 of the Act on Protection of Personal Data makes the personal data controller responsible for internal supervision of protection of personal data. Data controllers, such as credit bureaus, with more than five employees are required to appoint one or more personal data protection officials to ensure that data are processed properly and legally. The Office for Protection of Personal Data in the Slovak Republic also conducts inspections, issues decisions, and has the power to impose sanctions and substantial fines. A few countries (such as Georgia, Kyrgyz Republic, Romania) indicated that there was no dedicated regulatory or supervisory authority for the credit reporting system and a few more, including Russia, indicated that regulators had no enforcement or penal authority. In the Kyrgyz Republic, the credit bureau is only registered with the Ministry

of Justice and presently not externally regulated by the central bank or any governmental entity. There is a draft law in discussion that will place supervisory and regulatory functions on either the National Bank or the Banking and Financial Supervisory Authority.

The results of the survey relating to regulatory oversight and enforcement were somewhat troubling in that many respondents were unable to identify the regulatory authority for the credit reporting system. Data subjects do have some level of responsibility for ensuring that their right to an accurate credit history is not violated. In many jurisdictions, the primary law governing the operation of credit bureaus is the data protection law, which may or may not be enforced by a data protection authority. In addition to enforcement by regulators, data subjects themselves should play a role in advocating for themselves regarding the accuracy of their credit histories. The legal right for a data subject to challenge the accuracy of his or her credit history is essential to identifying data protection violations and at the macro level in exposing any regulatory gaps.

Depth of credit information

All countries surveyed reported that the credit reporting system collected data on loans. We additionally asked what information about those loans was reported (that is amount, interest rate, maturity). Most of the features of loans and lending transactions are reported, with one exception – interest rates. In Hungary, Kyrgyz Republic, Romania, Slovak Republic and Turkey, respondents indicated that interest rates were not collected, while in other countries (Bosnia and Herzegovina and Bulgaria) far fewer respondents identified interest rates than other loan information. While the limitation on including interest rates in a borrower's credit history may be related to bank secrecy laws or practices, it could be beneficial for users and for data subjects if this information was contained in credit reports.

Legal efficiency of credit information reporting systems

The main purpose of the study was to evaluate how effective the credit information reporting system in place is. For that purpose, the questions in the main survey of 16 countries were grouped into two main categories: those referring to the basic legal function of credit



Croatia is an interesting case, it received a high score on maximising economic benefit, but the lowest with regard to basic legal function

information reporting systems, and those describing how economic benefits have been maximised. These main categories in turn consist of five subcategories, each comprising between two and five questions. For each of these, survey answers were coded from 0 (categorical negative answer) to 6 (unqualified positive answer), yielding a theoretical maximum of 114 points for the basic legal function and 108 for maximising economic benefits. The maxima actually attained in each category were 105 for the basic legal function (in Poland) and 97 for maximising economic benefits (in Serbia). To allow for a better visual presentation, the results were adjusted on a scale of 100, where each main category carries a maximum of 50.

Chart 2 shows the results for the two main categories and the total score by country. The results demonstrating the highest legal efficiency were recorded in Hungary, the Kyrgyz Republic, Poland, Romania, Russia and Serbia, all of which achieved total scores above 80. This reflected good performance in both of the main categories, although the Kyrgyz Republic and Serbia scored a little lower than the other countries on the basic legal function while doing particularly well on maximising economic benefits. The countries with the lowest legal efficiency results were Mongolia and, perhaps surprisingly, the Slovak Republic. Although reform was under way at the time of the survey, Mongolia had not yet enacted a specific legal framework for credit information systems, and access to its existing system was limited to financial institutions. The Slovak Republic did not

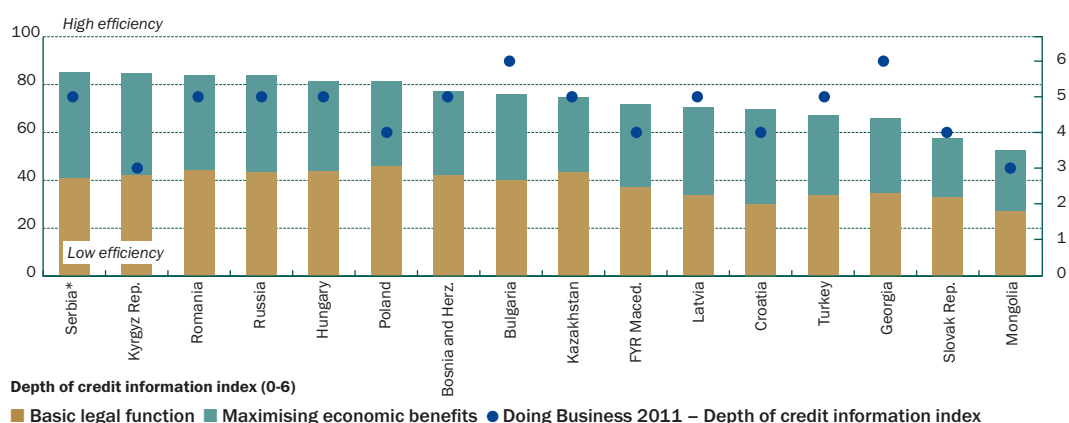
score well due to the very fragmented structure of the system in place, in which different databases serve different users and data subjects (something unique in the transition region).

Croatia is an interesting case insofar as it received a high score on maximising economic benefits, but the lowest score among all 16 countries with regard to the basic legal function. As in the case of Mongolia, this was due to the lack of a specific legal framework and the restriction of access to information under its prevailing system to financial institutions. In Table 2, Croatia is in fact classified as having a “limited system” of credit information reporting in place.

The chart also shows how the legal efficiency scores from the survey compared with the depth of credit information index compiled by the World Bank and IFC as part of its *Doing Business* project (the right axis). This is calculated as the sum of six binary checks, which award a point if: the credit history information gives positive aspects (for example, a track record of regular payment) and also negative ones; individuals and firms are covered; data from retailers, trade creditors and utilities are collected in addition to data from financial institutions; more than two years of data are distributed; small loans are included; and borrowers have a legal right to access their data. The point is granted if either of the private bureau or public registry scores positively on the question.

Chart 2
Legal efficiency of credit information systems in transition countries

Total legal efficient results (0-100)



Source: Source: EBRD, Credit information reporting system survey, 2011 and Doing Business Report (2011).

* Excluding Kosovo.



The main cause of discrepancies between the World Bank index and the legal efficiency results of the EBRD Survey is that the latter takes a broader view of what defines the quality of a credit information system

As one would expect, there is a correlation in the chart between the World Bank index and the legal efficiency index, but it is low, and mostly driven by the basic legal function subcomponent. The dimensions checked by the *Doing Business* index overlap only partly with the 10 subcategories covered by the legal efficiency survey, primarily under the basic legal function. Therefore, the main cause of discrepancies between the World Bank index and the legal efficiency results of the EBRD Survey is that the latter takes a much broader view of what defines the quality of a credit information system – via its “maximising economic benefits” category. Another reason could be that the *Doing Business* index, having to design simple measures that can be applied to 100+ countries, is based on binary (yes/no) information, whereas the present survey uses a six-point scale which tries to capture the quality of implementation, based on the views of not just the systems operators but also the users and regulators.

It is important to distinguish the two parts of a system’s legal efficiency – first, how well the credit reporting system fulfils its basic legal function, and second, how it succeeds in maximising economic benefits that it should bring.

Basic legal function

Chart 3 plots the subcategories that constitute the basic legal function as defined in the survey, that is to say, how widely information

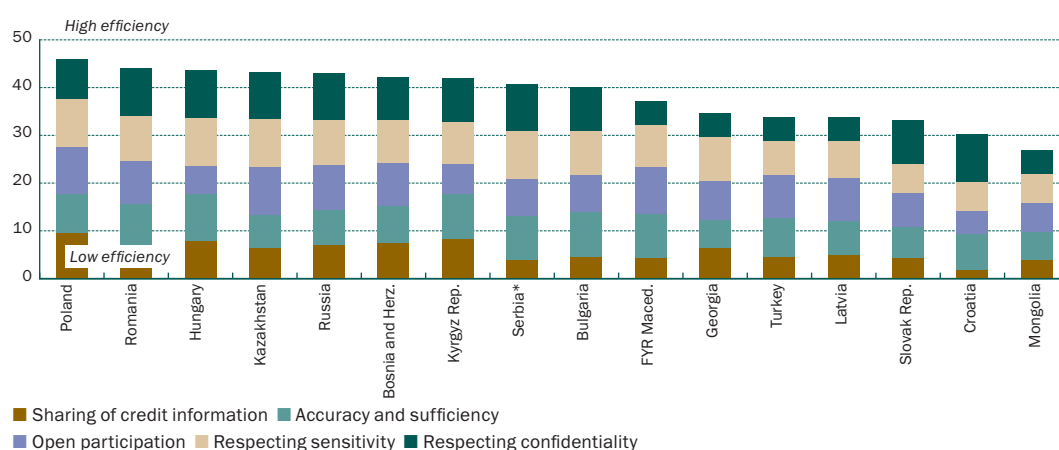
is shared within a system (or whether the system creates “silos” of information that cannot be accessed), whether information is sufficient and accurate, whether the system is open to broad participation, and whether it respects information sensitivity and protects confidentiality. The following analysis describes some of the main factors that determine cross-country differences in these categories.

The two systems that appear to least fulfil the basic legal function of a credit reporting system are Croatia and Mongolia. As mentioned above, neither of these jurisdictions has enacted a sufficient legal framework and importantly, each has limited access to the system to certain market players – namely financial institutions – to the exclusion of other credit providers. A broad understanding of credit and inclusion are essential to a system which relies on credit information as its primary driver. The situation is changing in Mongolia as part of current reform efforts. The Slovak Republic is also fairly weak in fulfilling its basic legal function due to the very fragmented structure of the system in place, according to which different databases serve different users and also data subjects (something unique in the region). Georgia also scores low in fulfilling its basic legal function because of the lack of a basic legal framework for the credit reporting system, including no regulatory/supervisory authority and no guidelines for access to credit information by users.

Chart 3

Basic legal function of credit reporting systems in transition countries (subscores)

Results (0-50)



Source: EBRD, Credit information reporting system survey, 2011.

* Excluding Kosovo.



A critical factor in assessing information gathered by a credit bureau is whether both positive and negative credit data are collected and distributed

Sharing of information

Sharing of information concerns the various credit reporting information systems. If only one credit reporting system (either a public registry or a private bureau) exists in a country, the sharing of information is impossible. Nevertheless, in six countries in the survey where several systems exist, this opportunity for cross-checking has been missed. Only in Bosnia and Herzegovina, Poland and Russia does such sharing take place. Moreover, a diversity of credit information reporting systems should not promote a “silo” mentality where data providers or data subjects are assigned exclusively to one system (such as in the Slovak Republic).

It is perhaps less surprising that cross-border links have not yet been developed between institutions from different countries, given that the process has barely started in the European Union (although Hungary, Poland and Romania – all new EU members – have taken a lead). Since many private bureaus are owned or operated by large international organisations, there would be a great advantage in establishing such links, especially in countries which have close commercial connections with their neighbours. The Kyrgyz Republic seems to have recognised this opportunity.

Accuracy and sufficiency of information

A critical factor in assessing information gathered by a credit bureau is whether both positive and negative credit data are collected and distributed. Most transition countries which have a credit information system in place have chosen to include positive and negative data in either a public registry or private bureau. One notable exception is Poland, where it appears that the main database – Biuro Informacji Gospodarczej InfoMonitor (BIG InfoMonitor) – contains only negative economic entries, although this is supplemented by positive information from the Biuro Informacji Kredytowej (BIK) credit bureau. In Latvia the private credit bureaus that operate beside the Credit Register of the Bank of Latvia also collect only negative information, while the Central Credit Information System (CCIS) in Hungary contains only negative data about debtors, based on legal provisions. Hungary’s Credit Reference service (CR), on the other hand, contains positive information about debtors but is not supported by a legal framework.

While it is important that sufficient data are collected to give an accurate borrower profile, there is a risk that collecting excessive information may actually be detrimental. An important issue is the length of time that data – in particular negative data – are retained and distributed by a credit reporting system. In general, negative data should be retained by credit bureaus and registries for up to five years, while positive data are often retained longer. The Kyrgyz credit bureau, for example, has a policy of retaining positive data for 10 years, and removes negative information after three. The absence of legislation in Mongolia means there is no legal limit on how long data are retained and included on credit reports. In Russia credit bureaus may retain all data for 15 years (far exceeding what is permitted in most other jurisdictions) but there is not yet evidence that credit bureaus will choose to do so. In Georgia, two concerns emerge on this subcategory: first, there seems to be no system or legal requirement for ensuring data accuracy. CreditInfo expects data providers to be responsible for the correctness of the data they collect. Second, the collection of data is not limited to credit reporting purposes.

Open participation

An important characteristic of credit information systems is the extent to which they are open to a range of market participants. A system should not be exclusive, where small market players are denied vital information. This does not seem to be the pattern in the transition region. However, there is still a bias in favour of financial institutions: in the majority of the countries surveyed, only financial institutions can receive data from at least one of the existing reporting systems. Interestingly, this situation prevails when a central bank operates the credit information reporting system but also when the system has been privately developed (for example, by banking associations). In FYR Macedonia, the Credit Registry of the National Bank, which was the only system in operation until 2011, includes only data on financial institutions (domestic banks, savings houses and branches of foreign banks), while the private credit bureau (MKB) similarly includes data from financial institutions but also other credit providers, service providers and government entities (such as the tax authority and pension fund). The MKB was founded in December 2008 and started operations in January 2011.



Data protection requires that information is collected and distributed solely for assessing creditworthiness

In Hungary the private credit bureau BISZ Zrt operates the Central Credit Information System (CCIS), the Credit Reference service (CR) and Credit Bureau services. Initially restricted to banks, savings cooperatives and credit unions, its remit was then widened to include all financial institutions and those investment companies engaged in investment lending. Enterprises engaged in commercial lending have become eligible to subscribe to the CCIS since 2010. Institutions such as tax authorities, ministries, municipalities, public utility and telecommunications providers and non-governmental organisations (NGOs) are not allowed to subscribe to the service.

The Credit Reporting Agency in Serbia is a private credit bureau established in 2004 by the Association of Serbian Banks. Only financial institutions are required to provide data. Government entities and other credit providers are excluded although some, such as telecommunications companies, may access credit histories as users.

Data protection requires that information is collected and distributed solely for assessing the creditworthiness of potential borrowers. In most countries permissible purposes are specified in legislation or regulations. Where a country does not have a credit information reporting law in place, there may be concern that data can be requested for purposes other than assessing a subject's creditworthiness. In Mongolia, for example, there is no law

explicitly restricting data usage to permissible purposes, although the data providers and users who were surveyed maintained that the aim of data requests was solely to assess the credit history of existing or prospective borrowers. Croatia is a similar case. Georgia also provides no specific legal restriction.

Respecting the sensitivity of information

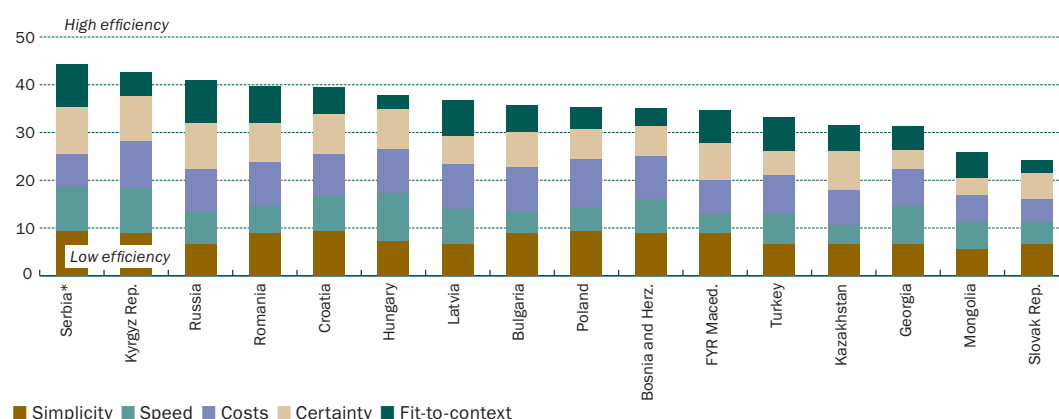
This refers to subjects' right of access to their own data and the right to challenge incorrect information and have it corrected promptly. They should be able to request corrections through an internal mechanism at the credit bureau and to have those requests recorded, investigated and acted upon. Such a right is evident in all the countries surveyed. The usual practice is for credit bureaus and registries to allow data subjects to access their credit report once a year for free and then to charge small fees for additional access. In some countries, such as Bulgaria and the Kyrgyz Republic, there are procedures in place for the correction of erroneous credit data although there is little evidence regarding their effectiveness. In contrast, the Serbian Credit Reporting Agency reported approximately 8,000 corrections taking place in 2009, and the public registry in Turkey indicated that an average of 80 corrections take place each month.

Respecting the confidentiality of information

The consent of data subjects for their personal data to be collected and used in credit reporting systems is a generally accepted data protection

Chart 4
Maximising economic benefits of credit reporting systems (subscores)

Results (0-50)



Legend: Simplicity (dark blue), Speed (light blue), Costs (green), Certainty (orange), Fit-to-context (dark green)

Source: EBRD, Credit information reporting system survey, 2011.

* Excluding Kosovo.



Credit reports are available online to users in all of the 16 surveyed countries

principle. Borrower written consent is required before credit information may be reported in the majority of transition countries. The most common approach is to obtain consent as part of a loan application. In Kazakhstan a loan agreement cannot be signed, and credit cannot be advanced, if there is no written authorisation from the client to report credit information to the credit bureau. There are, however, some countries that do not require consent. In addition to Mongolia, where there is no law or practice requiring consent, survey respondents in FYR Macedonia and Turkey all indicated that consent is not required. In Latvia too, respondents were conflicted as to whether or not consent was required.

In summary, it is encouraging to note that, with exceptions, most of the surveyed countries have achieved a credit information reporting system which, by and large, fulfils its basic legal function.

Maximising economic benefits

Chart 4 shows the scores of the subcategories that together evidence how the system is maximising economic benefits as defined in the survey. They refer to simplicity, speed, costs, certainty and fit-to-context. As the Mongolian system is under development, many scores were marked as unclear, which led to an overall poor grading on these subcategories.

Simplicity

Credit reports are available online to users in all of the 16 surveyed countries. Data subjects, however, find it harder to access their own credit histories. In some countries they have to make a request through their bank, which will pass the query on to the credit information reporting system. In Georgia the data subject must present his or her identification in person at CreditInfo's office, although once verification has been completed the subject may access a service which allows the monitoring of credit information online. Similarly, in Latvia data subjects have to present themselves at the Credit Register in person and prove their identity (or, in the case of a subject's representative, produce a document certifying that person's legal right to represent the subject). Furthermore, a credit history cannot be sent electronically to individuals for security reasons, although the Bank of Latvia is working to amend this. Simplifying a data subject's access to his or her

credit history is very important, since accuracy depends very much on the subject's opportunity to review, and if necessary challenge, the data.

Speed

The speed of processes depends to a large extent on how simple they are to use. Speed is also essential in ensuring the accuracy of data subject credit histories when they are affected by changes. It is important that users are made aware of any such changes as quickly as possible. In six of the surveyed countries (Bosnia and Herzegovina, Georgia, Hungary, the Kyrgyz Republic, Serbia and Turkey) significant changes are reported immediately, or within a week, and this prompts user notification. However, users in all the other countries must update their records on their own initiative (through regular monitoring of the reporting system) or changes will not be recorded before the next reporting cycle (which may undermine the validity of the credit information).

Costs

As evidenced in Chart 4, the costs of obtaining a credit report are low in all of the surveyed countries. In the majority of countries, members of the credit registry or bureau can obtain a report for free or for less than €1, or alternatively through an annual or monthly membership fee. In all cases, data subjects have the right to one free report of their own credit history each year (with additional reports often costing under €10).

Certainty

Certainty about credit reporting is an issue in just under half of the countries surveyed and revolves around two key questions. First, what are the requirements for obtaining consent from data subjects? Respondents in Bosnia and Herzegovina, Bulgaria, FYR Macedonia, Latvia, Mongolia, Poland and Turkey were confused by, or gave contradictory answers to, this question. Clarity regarding consent of the data subject is essential for public confidence in the credit reporting system. Second, is existing credit data in dispute? Most of the surveyed countries do not record ongoing disputes initiated by data subjects over their credit histories in the information supplied to lenders. Notable exceptions include FYR Macedonia, the Kyrgyz Republic, Russia and Serbia. In the Slovak Republic, it seems that data subjects (which are firms exclusively) are not allowed to access their credit history in the public registry.



The survey reveals that most credit information users believe the system in place is effective

Fit-to-context

Fit-to-context refers to market coverage (which shows whether the use of the credit reporting system is sufficiently broad to serve the market) and also the perceived effectiveness of the system from the perspective of users in predicting the repayment behaviour of data subjects. Based on the *Doing Business* coverage data, it is clear that the region still has some way to go in this respect (Croatia, Poland, Serbia and Turkey are notable exceptions).

Most of the users of credit information in the survey felt that the system in place was reasonably effective in determining the creditworthiness of data subjects. Only the private credit bureaus in Bosnia and Herzegovina and Hungary were rated negatively, although in each case only one or two financial institutions had provided a response. In Latvia (the country with the highest number of user responses at 14), none of the financial institutions gave the registry a negative rating, while 9 of the 14 rated it as “effective” or “very effective”.

In summary, the credit reporting systems in place in the 16 surveyed countries score well in terms of the user-friendliness of their processes (and perhaps even higher than some of the more established systems in the world). However, the relative immaturity of systems in the transition region is evident in relation to certainty and fit-to-context. Since most of these systems are not yet 10 years old, what they have already achieved is nevertheless impressive.

Conclusion and policy implications

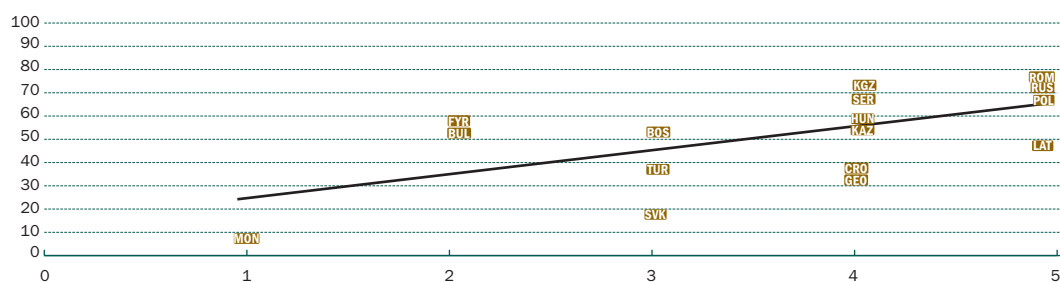
The survey has proven to be a unique tool in assessing credit reporting systems and demonstrates a few important lessons. First, looking at positive features, both legal and institutions, without consideration of the overall picture will tend to produce a distorted picture of how a system operates in practice. A detailed analysis at the ground level of how the system is used by and impacts all key stakeholders is essential for determining whether, and to what extent, a credit reporting system truly fulfils its basic economic function. Second, an analysis of whether the credit information reporting system is maximising the economic benefits which underlie the need for the system is essential for understanding the system. When a system operates simply, fast, at low cost, with certainty and fits in the context of the particular country, the impact of the law and institutions is assessed. Any law, no matter how good on paper, can drastically diminish economic benefits for the stakeholders if the implementation of the law is such that it does not maximise these features.

Credit information systems that fulfil their basic legal function operate in all but a handful of transition economies. Nevertheless, the survey shows that there are large, and sometimes surprising, differences in the quality of these systems across countries. These differences relate not only to basic aspects, such as data coverage, accuracy, protection and access, but also to economic benefits that should

Chart 5

Credit information systems in transition countries: legal efficiency and private-sector involvement are positively correlated

Total legal efficiency results (0-100)



Private sector involvement in the credit information reporting system (0-5)

Source: EBRD, Credit information reporting system survey, 2011.

BOS – Bosnia and Herzegovina, BUL – Bulgaria, CRO – Croatia, GEO – Georgia, FYR – FYR Macedonia, HUN – Hungary, KAZ – Kazakhstan, KGZ – Kyrgyz Republic, MON – Mongolia, LAT – Latvia, POL – Poland, ROM – Romania, RUS – Russia, TUR – Turkey, SER – Serbia (excluding Kosovo), SVK – Slovakia.

Table 4
Credit information reporting systems in transition countries

I Basic legal function																
1 Sharing of credit information																
1.1 Does the system allow data providers to share credit information with all credit reporting organisations?	Bosnia and Herz.	Bulgaria	Croatia	FYR Macedonia	Georgia	Hungary	Kazakhstan	Kyrgyz Republic	Latvia	Mongolia	Poland	Romania	Russia	Serbia	Slovak Republic	Turkey
	✓✓	✓✓	✗✗	✓✓	✓✓✓	✓✓	✓✓✓	✓✓✓	✓✓✓	✗✗	✓✓✓	✓✓	✓✓✓	✓✓	✓✓	✓✓
	✓✓	✓✓	✗✗	✓✓	✓✓✓	✓✓	✓✓✓	✓✓✓	✓✓	✓✓	✓✓✓	✓✓	✓✓✓	✗✗	✓✓	✓✓✓
	✓✓	✗✗✗	?	✗✗✗	N/A	N/A	N/A	N/A	✗✗✗	N/A	✓✓✓	✗✗✗	✓✓	N/A	✗✗✗	✗✗✗
	✗✗✗	✗✗✗	✗✗✗	✗✗✗	✗✗✗	✓✓✓	✗✗✗	✓✓	✗✗	✗✗✗	✓✓	✓✓	✗✗✗	✗✗✗	✗✗✗	✗✗✗
2 Accuracy and sufficiency of credit information																
2.1 Is credit information collected in such a way as to ensure accuracy?	✓✓	✓✓	✓✓	✓✓	✗✗✗	✓✓✓	?	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓	✓✓	✓✓	✗✗	?
2.2 Is the amount of collected data adequate (completeness, including positive data, etc)?	✓✓	✓✓	✓✓	✓✓✓	✓✓✓	✓✓	✓✓✓	✓✓✓	✓✓	✓✓	✗✗	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓
2.3 Are the collected data necessary for credit reporting purposes (for a clearly defined permissible purpose, etc)?	✓✓	✓✓✓	✗✗	✓✓	✗✗✗	✓✓✓	✓✓✓	✓✓	✓✓	✗✗	✓✓✓	✓✓✓	✓✓	✓✓✓	✓✓	✓✓
2.4 Is the credit information kept up to date (data should be regularly updated)?	✗✗	✓✓✓	✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓	✓✓	✓✓	✓✓✓	✓✓	✓✓✓	?	✓✓✓
2.5 Is the credit information not excessive (time-limited data retention, etc)?	✓✓	✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✗✗	✓✓	✗✗✗	✗✗✗	✓✓✓	✓✓	✗✗	✓✓	✓✓✓	✓✓
3 All credit providers and data subjects as potential borrowers																
3.1 Does the legal framework take an open approach to participation in the system?	✓✓	✓✓	✓✓✓	✓✓	✓✓	✗✗✗	✓✓✓	✗✗	✓✓	✗✗	✓✓✓	✓✓✓	✓✓✓	✓✓	✓✓	✓✓
3.2 Are users not excluded from participating in the system because of their type of organisation?	✓✓	✓✓	✗✗	✓✓✓	✓✓✓	✓✓	✓✓✓	✓✓	✓✓	✓✓	✓✓✓	✓✓	✓✓✓	✓✓	✓✓	✓✓
3.3 Does the system promote a broad understanding of credit?	✓✓	✗✗	✗✗	✓✓✓	✓✓✓	✗✗	✓✓✓	✗✗	✓✓	✓✓	✓✓✓	✓✓	✓✓	✗✗	✗✗	✓✓
3.4 Does the legal framework clearly define circumstances under which a user can request a credit report?	✓✓	✓✓✓	✓✓	✓✓✓	✗✗	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✗✗	✓✓✓	✓✓	✓✓	✓✓✓	✓✓	✓✓✓
3.5 Does the system take an open approach to which entities can be a data subject?	✓✓	✓✓✓	✗✗	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓	✓✓✓
4 Respecting sensitive nature of information																
4.1 Can data subjects access their own credit information?	✓✓	✓✓✓	✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓	✓✓✓
4.2 Can data subjects request the rectification of their credit information and credit history, if inaccurate or processed unlawfully?	✓✓	✓✓	✓✓	✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓	✓✓✓	✗✗	✓✓✓	✓✓	✓✓✓	✓✓✓	✓✓	✓✓✓
4.3 Does the legal framework provide for liability resulting from inaccurate information or other unlawful wrongdoing?	✓✓	✓✓✓	✗✗	✓✓	✓✓	✓✓✓	✓✓✓	✓✓	?	✓✓	✓✓✓	✓✓✓	✓✓	✓✓✓	✗✗	✗✗

5 Respecting confidential nature of information		Bosnia and Herz.	Bulgaria	Croatia	FYR Macedonia	Georgia	Hungary	Kazakhstan	Kyrgyz Republic	Latvia	Mongolia	Poland	Romania	Russia	Serbia	Slovak Republic	Turkey
5.1 Does the legal framework require consent of the data subject for credit information to be shared?		✓✓✓	✓✓	✓✓✓	✓✓✓	✓✓	✓✓✓	✓✓✓	✓✓	✓✓	✓✓✓	✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓
5.2 Is access to credit histories limited to permissible purposes?		✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓	✓✓✓	✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓	✓✓✓
II Maximising economic benefits																	
6 Simplicity																	
6.1 Is it simple for users to obtain credit reports?		✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓	✓✓
6.2 Is it simple for data subjects to access their credit histories?		✓✓	✓✓	✓✓	✓✓	✓✓	✓✓	✓✓	✓✓	✓✓	?	✓✓✓	✓✓	✓✓	✓✓	?	✓✓
6.3 Is making a correction in a credit report simple?		✓✓	✓✓	✓✓✓	✓✓	✓✓	✓✓✓	✓✓	✓✓	✓✓	?	✓✓	✓✓	✓✓✓	✓✓✓	✓✓	✓✓✓
7 Speed																	
7.1 Is accessing a credit report fast?		✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓	✓✓
7.2 Is correcting a credit report fast?		✓✓	✓✓	✓✓	✓✓	?	✓✓✓	✓✓	✓✓✓	✓✓✓	?	✓✓	?	✓✓✓	✓✓✓	✓✓	✓✓
7.3 Can users be made aware of sudden changes in the credit history of data subjects quickly?		✓✓✓	✓✓	?	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓	?	?	?	✓✓	✓✓	?	✓✓
8 Costs																	
8.1 Is getting a credit report inexpensive for users?		✓✓	✓✓	✓✓	?	?	✓✓	✓✓	✓✓✓	✓✓	?	✓✓✓	✓✓	✓✓	✓✓	✓✓	✓✓
8.2 Is accessing their credit report inexpensive for data subjects?		✓✓	✓✓	✓✓	✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓	✓✓	?	✓✓
8.3 Is correcting a credit report inexpensive?		✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	?	✓✓✓	✓✓✓	✓✓✓	✓✓✓	?	✓✓
9 Certainty																	
9.1 Is the permissible purpose for issuing a credit report sufficiently certain?		✓✓	✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓	✓✓	✓✓✓	✓✓	✓✓✓	✓✓✓	✓✓	✓✓✓
9.2 Is the access by data subjects to their credit history clear and certain?		✓✓✓	✓✓✓	✓✓✓	✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓	✓✓✓
9.3 Are the requirements for obtaining consent from data subjects clearly defined and understood?		✓✓	✓✓	✓✓✓	✓✓	✓✓✓	✓✓✓	✓✓✓	✓✓	✓✓	✓✓✓	✓✓✓	✓✓	✓✓	✓✓✓	✓✓✓	✓✓✓
9.4 Are there clear data quality standards?		✓✓	✓✓	✓✓	✓✓	✓✓✓	✓✓	✓✓	✓✓	✓✓✓	✓✓	✓✓	✓✓✓	✓✓✓	✓✓	?	✓✓
9.5 Are ongoing disputes on data subjects regarding the data subject's credit history noted?		?	✓✓	?	✓✓✓	✓✓✓	?	?	✓✓✓	✓✓✓	✓✓	?	?	✓✓✓	✓✓✓	?	?
10 Fit to context																	
10.1 Is the system sufficiently broad to serve the market's needs?		✓✓	✓✓	✓✓✓	✓✓	✓✓✓	✓✓✓	✓✓	✓✓✓	✓✓	✓✓✓	✓✓✓	✓✓	✓✓	✓✓✓	✓✓	✓✓
10.2 Is there an effective regulatory system with enforcement powers in place?		✓✓	✓✓	✓✓	✓✓	✓✓	✓✓	✓✓	✓✓	✓✓	✓✓✓	✓✓	✓✓✓	✓✓	✓✓	?	✓✓
10.3 Do users find the system effective in predicting the creditworthiness of data subjects?		✓✓	✓✓✓	✓✓	✓✓	✓✓	✓✓✓	✓✓	✓✓	✓✓✓	✓✓✓	?	✓✓✓	✓✓	✓✓	?	✓✓
10.4 Are data subjects aware of their rights under the system?		?	?	?	✓✓✓	?	✓✓✓	?	?	?	✓✓	?	✓✓✓	✓✓✓	✓✓✓	?	?

Key ✓✓✓ Yes ✓✓ Yes, but with some reservations x x Response is negative, but there are some mitigating factors in law or practice x x x Categorical no ? Uncertain N/A Not applicable
Note: Serbia excludes Kosovo.



There is a clear correlation that private-sector provision of credit information benefits the quality of the system

be derived from the system, including speed and costs. Some countries score highly in some respects but poorly in others.

Accordingly, priorities for reform vary markedly from country to country. Table 5 maps these priorities based on the limitations identified in the survey, using a “traffic light” colour code. A diverse picture emerges not only across countries, but also across the areas where reform should be focused first.

Nevertheless, the mapping also shows that all these areas have been successfully tackled by at least one existing system, which should encourage countries to learn from each other.

Lastly, the survey may be able to shed some light on the question which has perhaps been the thorniest and most controversial in the development of credit information reporting systems in the last decade or so – that of the most efficient model between a public registry and a private bureau. It has shown that, despite a trend towards the “privatisation” of reporting systems, the transition region has developed a diversity of models where the share of private-sector involvement varies.

Is there a correlation between the structural features of these systems, on the one hand, and their performance (as measured by total legal efficiency), on the other?

To answer this question, a value based on the extent of private-sector involvement in credit information systems was given to each country in the survey, as per Table 3 ranging from 1 (only public registry) to 5 (private provision in a competitive environment). Chart 5 plots these values (on the horizontal axis) against the total legal efficiency results (on the vertical axis).

There is a clear positive correlation in the chart (with a coefficient of 0.61), suggesting that private-sector provision of credit information, particularly in a competitive environment, benefits the overall quality of the system. However, there are also some counter-examples, such as in Croatia, Georgia, Latvia and the Slovak Republic, which show that private bureaus do not automatically result in an efficient system. Nevertheless, the positive correlation is noteworthy, especially for those transition countries which do not yet have, and may be planning to establish, a credit information reporting system.

Table 5
Mapping priorities for reform of credit information reporting systems

	Basic legal function	Maximising economic benefits				
		Simplicity	Speed	Cost	Certainty	Fit-to-context
Bosnia and Herzegovina						
Bulgaria						
Croatia						
FYRM						
Georgia						
Hungary						
Kazakhstan						
Kyrgyz Republic						
Latvia						
Mongolia						
Poland						
Romania						
Russia						
Serbia*						
Slovak Republic						
Turkey						

Source: EBRD, Credit information reporting system survey, 2011.

*Excluding Kosovo.

very efficient
efficient
some inefficiency
inefficient
unclear

Notes

¹ [http://siteresources.worldbank.org/FINANCIALSECTOR/Resources/GeneralPrinciplesforCreditReporting\(final\).pdf](http://siteresources.worldbank.org/FINANCIALSECTOR/Resources/GeneralPrinciplesforCreditReporting(final).pdf)

² <http://www.doingbusiness.org/>

³ See for example EBRD work on mortgage law: Mortgages in transition economies, 2008, EBRD.

⁴ For example, in FYR Macedonia the Directorate for Protection of Personal Data can issue fines ranging from MKD 25,000 to 50,000 (approximately €400-800), while the Bulgarian Commission for Personal Data Protection can issue fines up to BGN 100,000 (over €51,000).

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02

Public procurement review and remedies bodies – models for success

ALAN COLMAN AND ELIZA NIEWIADOMSKA

This article reflects upon the findings of the 2010 EBRD public procurement assessment¹ which confirms that accessibility, independence, certainty, and market awareness, can be achieved by remedies bodies without affecting their efficiency.



Introduction

For a number of years the EBRD's commercial law reform unit, the Legal Transition Programme (LTP), has worked towards improving the capacity of judges to deal effectively with commercial law matters in the EBRD's countries of operations. The rationale for this work is that predictable, transparent and efficient resolution of trade disputes is critical to the investment climate; and improving the business climate in the region is the LTP's ultimate objective. However, some disputes of a commercial nature are heard not by courts, but specialised tribunals or review bodies. Such is often the case with review bodies responsible for complaints relating to public procurement. This article therefore looks at the capacity of public procurement remedies bodies in their various guises, and considers whether certain types of bodies work better than others.

Particular reference is made to an analytical assessment of public procurement law and practice in the EBRD region conducted in 2010, which included a study of the efficacy of public procurement review and remedies procedures.

Enforcing compliance: beyond monitoring and audit

In public procurement, government exercises its purchasing power over private sector suppliers and contractors. In transition countries, government is frequently the largest buyer in the local market. Accordingly, the power dynamics within the public procurement process are inherently unequal. To address this imbalance, public procurement laws must be simple and easily enforced. Well-functioning review and remedies procedures are a key factor in ensuring a procurement system that delivers value for money for public contracts;



Today, governments are making greater use of corrective measure before public contracts are signed

legality of government procurement decisions; widespread private participation in government contracting; and an undistorted market.

Enforceability in public procurement, as defined by the EBRD's Core Principles,² has two principal dimensions:

- (i) assessing compliance with public procurement rules – this involves reviewing, monitoring and auditing how the system works in practice
- (ii) applying necessary corrective measures (remedial actions).

Historically, governments addressed the challenge of public procurement enforcement through general fiscal administration, which involved monitoring and auditing procedures. In cases when a serious malfunction of a public entity's procurement officers was *post-factum* identified by the audit, legislation allowed the aggrieved contractor to submit a compensation claim to a civil court. There were no enforcement procedures available to address problems while the procurement process was under way.

Today, governments are making greater use of corrective measures *before* public contracts are signed. Policy-makers recognise the benefits this can bring in terms of fair competition and value for money. LTP supports these efforts, and is convinced that a dedicated enforcement mechanism including remedial actions should be a feature of any public procurement system.

The modern concept of a remedies body

The modern concept of “remedies” refers to legal measures which can rectify the alleged defects or irregularities in a public procurement process while it is still under way. Remedies enable the integrity of the public tender to be maintained. They are to be distinguished from “compensation”. With compensation, the irregularity in the public procurement process is *not remedied*. Rather, compensation is awarded to the aggrieved party once the tender process has finished, in lieu of rectification of the irregularity. Compensation is today viewed more as a remedy of final “last resort”, an acknowledgement that the public procurement system did not operate as it should have done. From a private sector perspective, such remedies are often viewed as suboptimal, particularly in transition countries, as the

quantum of compensation, if ever awarded, tends to be modest, especially compared with the potential value of many public contracts.

Any remedies system, offering the possibility of halting or undoing the procurement process, can come at a cost. National regulators have to take this into account. Review of public procurement and remedial actions can slow down the procurement process and raise the administrative burden. This means that, if the circumstances in which remedies are available are too widely cast, the “cost” may not be worth it. A minor infraction of the rules may not deserve the interruption or cancellation of the process. The system would become inefficient and open to abuse. On the other hand, if access to review and remedies is too narrowly confined, and serious non-compliance leads only to potential compensation, the credibility of the remedies system will be impugned. Thus, the challenge is to strike a balance between effective remedies and the efficiencies derived from allowing the public procurement process to proceed expeditiously to its conclusion.

Minimum standards for remedies bodies

Some fundamental requirements for the public procurement review and remedies procedures are established by the 1994 WTO Agreement on Government Procurement and the UNCITRAL Model Law (updated in 2011). These basic function indicators set a foundation on which governments can build remedies institutions and review procedures that can accommodate the public interest in the efficient use of public expenditure at the same time as the interests of the private stakeholder participating in the public tender. As is evident from the chart below, international standards afford substantial flexibility as to the type of review and remedies procedures that might be established.

In the EU public procurement policy context, the notion of the effectiveness of a review and remedies procedures has been clarified by the European Court of Justice case law.³ The Court has confirmed that under the EU public procurement policy framework, an effective remedies system must comprise:

- (i) an operational review and remedies body
- (ii) adequate review and remedies procedures



As remedies have emerged as standard in public procurement policy, governments have had to address the challenge of providing adequate means of public procurement review and remedies

Fundamental requirements for public procurement review and remedies procedures

Based on the WTO 1994 Government Procurement Agreement and the 2011 UNCITRAL Public Procurement Model Law.

- Right of the tenderer to seek a review
- Right of the tenderer to seek remedial action as opposed to monetary compensation
- A dedicated remedies system
- An independent body, authorised to sanction remedial action
- Access to judicial review
- Where remedies procedures are not available, right of the tenderer to seek compensation
- Access to alternative dispute resolution, in particular when public contract has been signed

(iii) rules on costs, scope and on the effect of filing a request for review

(iv) rules on the remedial actions: possibility to set aside individual decisions including the award decision, damages, and interim measures.

Types of remedies bodies

As remedies have emerged as a standard in public procurement policy, governments have had to address the challenge of providing adequate means of public procurement review and remedies. This has entailed making important policy choices as to what kind of remedies bodies they should put in place. As demonstrated by the EBRD assessment, there are a number of different models for establishing a remedies body. The principal options are to confer remedies function on:

- a commercial or civil court
- an administrative court
- an administrative tribunal

■ a specialised administrative body

■ a general administrative body.

These various models of remedies bodies have their strengths and weaknesses. One might think that ideally, in cases of stakeholder complaints regarding individual public procurement processes, remedies should be provided by a commercial court. Such courts are generally best suited to handling trade disputes, and can be well placed to understand the broader commercial context, and surrounding legal framework, of the public contract in question. However, commercial courts can sometimes lack specialised knowledge of procurement procedures, which can be critical for remedies bodies to correctly identify irregularities in the procurement process, especially in some of their more subtle guises.

Administrative courts can offer the benefit of sharper expertise in the area of public procurement, although the extent to which this is the case can vary widely. Courts, whether commercial or administrative, should in principle be the most independent from the administration of government, and inspire the greatest confidence in private sector parties that an impartial decision will be reached. On the other hand, in many transition countries courts have a reputation of operating slowly and being costly, and of not being independent.

Administrative tribunals have the potential advantage of combining very sharp public procurement expertise with a reasonable degree of independence and procedural safeguards. New tribunals usually require some innovation, start-up resources, and in particular training. Further, one can expect that newly established tribunals will take some time to establish their own protocols and rules of procedure. Depending on the discretion afforded to them by their establishing legislation, they will have to consider a wide range of issues, such as whether and how to hold oral hearings, process filing fees, prepare written decisions, maintain the internal consistency of their own “jurisprudence”, and ensure that their approaches to remedies is proportionate and consistent from case to case. Once they are up and running, an administrative tribunal presents itself as a good option. But this may require an investment of both time and budget resources.

“
Internal administrative review procedures are unlikely to command public confidence, particularly in those transition economies where public authorities do not have a reputation for transparency and impartial decision-making

Another possibility is to vest authority for remedies functions with a specialised (for example, departmental) or general administrative body. An administrative review body is typically a dedicated and nominally independent administrative body. It is integrated into the national executive administration, but independent from the contracting entity. The requests for review are resolved on a discretionary basis; based on a request for review from the tenderer, some investigation may take place, but no judicial review proceedings are conducted. By contrast a general administrative review body is usually part of a complaint mechanism of the general public administration in the country, integrated into the national executive administration. Complaints are resolved essentially at will by the administrative authority officers, frequently only based on a content of the request for review from the tenderer; no formal proceedings are conducted.

These aforementioned options have certain attractions from the perspective of the policy-maker, as either of these options can be done quickly and cheaply. They involve potentially little change to existing law and infrastructure. Expertise can often be found within the public procurement administration. However, frugality and minimalism are likely to bear fruits of a

similar kind. Internal administrative review procedures are unlikely to command public confidence, particularly in those transition economies where public authorities do not have a reputation for transparency and impartial decision-making. The market may query whether such bodies of limited independence offer sufficient protection to the private sector.

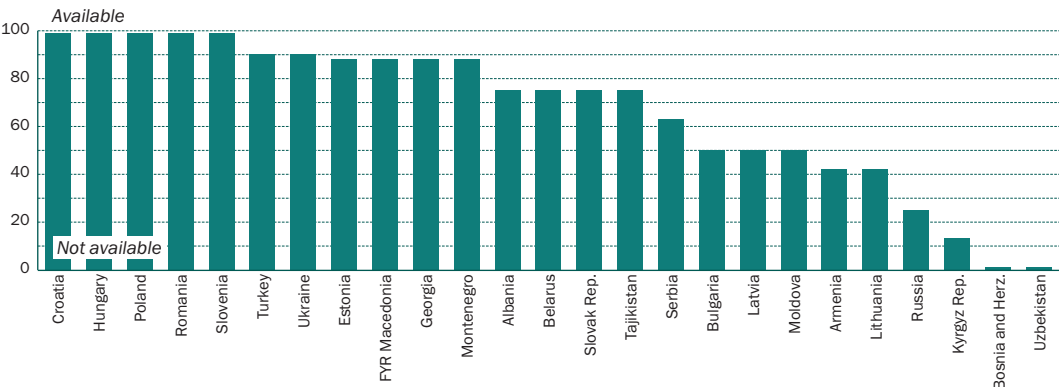
The EBRD assessment

The above in-principle considerations about the likely functioning of various types of remedies bodies were tested in the course of the EBRD 2010 public procurement assessment. In general terms, the analysis supported the hypotheses outlined above.

However, some further important observations were made about the functioning of the various types of remedies bodies that are found in the EBRD region.

The assessment found that the quality of review and remedies systems was a problem in many countries, regardless of the type of remedies body concerned (see Chart 1). Local practitioners reported particular problems with the perceived impartiality of administrative review in many countries of operations.

Chart 1
Availability of an impartial and independent review and remedies system, as reported by local stakeholders in transition countries



Question: In practice, is public procurement review conducted by a court or by an impartial and independent remedies body with no interest in the outcome of the procurement and the members of which are secure from external influence during the term of appointment?

Note: The figure shows scores for availability of independent and impartial public procurement review and remedies procedures in the EBRD region, calculated as a mean average. The scores have been calculated on the basis of the questionnaires and case studies, developed from the EBRD Core Principles benchmark, and answered by local lawyers and contracting entities in 2010. Given this timing, scores presented do reflect that an independent remedies body was established in Georgia in late 2010, but do not reflect that an independent remedies body was established in Armenia in 2011. Total scores are presented as a percentage, with 100 per cent representing the optimal score for the benchmark indicator.
Source: EBRD 2010 Public Procurement Assessment.



The assessment proved that administrative bodies perceive themselves to be “guardians of the public interest”

The contracting entities were widely considered to receive better treatment from remedies bodies than the private sector. One conclusion drawn from the data was that administrative bodies perceive themselves to be “guardians of the public interest”, and do not bring a fully independent and objective mindset to disputes involving private sector entities.

The problem is not just one of self-perception and attitudes to public-private conflict. There was also evidence of direct hierarchy interference in the review process from the government administration. Many contracting entities candidly acknowledged that “interference by higher level officials” occurred at least occasionally. This was the case in 19 of the EBRD countries of operations which have administrative remedies bodies. From the remaining 6 countries with administrative review in place, no data was received.

Given these negative opinions, local legal advisers were requested, as part of the assessment, to assess the extent to which the remedies bodies in the EBRD region had genuine procedural safeguards in place to ensure fair treatment of the parties, including the right to a public hearing; to be heard within a reasonable time; legislative safeguards of the remedies body’s independence; the right to be present at the proceedings,

and to respond to the arguments of the other party; and the right to a reasoned decision.

Most countries with administrative remedies bodies were reported to have public procurements review procedures lacking in the above guarantees (see Chart 2). While in these countries it is possible to appeal a review decision to a court, such courts do not have the power to apply remedial action in order to stop or undo the irregular procurement process. In theory, courts could be given injunctive powers of this nature, however this has not been done in transition countries.⁴

In the countries where local practitioners reported concerns about lack of independence and impartiality (Armenia, Azerbaijan, Belarus, Georgia, Kyrgyz Republic, Moldova, Mongolia, Montenegro, Russia, Tajikistan, Turkey and Ukraine) public procurement review procedures were found to be lacking in most of the above safeguards. However, other countries with administrative type review bodies were reported to have several, still not all, of the above safeguards incorporated in their review procedures. This was the case in Albania, Bulgaria, Bosnia and Herzegovina, Estonia, Hungary, Romania, Slovak Republic and Slovenia.

Chart 2

Procedural fairness safeguards do not affect overall efficiency of national remedies systems



Note: The figure presents a comparison between total average efficiency marks and results of an appraisal of the public procurement review procedures as applied in practice by remedies bodies in respect of procedural fairness safeguards. The efficiency scores have been calculated on the basis of questionnaires and case studies developed from the Legal Efficiency Concept benchmark and answered by local stakeholders in order to assess speed, cost, legal certainty, simplicity and fit to context of remedies systems in the EBRD region. The procedural fairness scores have been calculated on the basis of questionnaires and case studies developed from the EBRD Core Principles benchmark and answered by local stakeholders in order to assess enforceability of public procurement laws. Scores presented do not reflect that independent remedies bodies were established in Georgia in 2010 and in Armenia in 2011. Total scores are presented as a percentage, with 100 per cent representing the optimal score for each benchmark indicator.

Source: EBRD 2010 Public Procurement Assessment.



Features expected from the remedies process by the private sector, namely accessibility, independence, certainty, and market awareness can be achieved, while ensuring efficiency of the remedies system

Interestingly, of the countries which were found to possess *all* of the above safeguards on paper, one was in fact an administrative remedies body (Poland). Two were courts of EU Member States (Lithuania and Latvia);⁵ and two were courts of CIS countries (Uzbekistan and Turkmenistan). Unfortunately, we were not able to obtain any data on local practice in Turkmenistan; in Uzbekistan where we managed to obtain feedback from local lawyers, only limited application of these safeguards in practice was reported. In Lithuania, Latvia, Uzbekistan and Turkmenistan there were no special remedies systems; all public procurement related disputes were dealt with through the commercial courts. Clearly, from these results we can conclude that courts do not necessarily deliver the best outcomes in a review context. While in principle courts should function more independently and with greater objectivity than administrative bodies, this will naturally be subject to the quality and independence of the national judicial system. At the same time, a well structured administrative tribunal can satisfy all procedural safeguards.

The assessment revealed that most remedies bodies in the EBRD region conduct public procurement review procedures which do not accord a high level of procedural fairness. Based on reports by local lawyers, remedies bodies in only nine countries ensure a substantial degree of procedural fairness (Albania, Bulgaria, Croatia, FYR Macedonia, Georgia, Hungary, Latvia, Poland, Romania and Slovenia). Still, in practice the highest level of procedural fairness of the public procurement review and remedies was identified in the EU Member States in the EBRD region (83 per cent) next to 79 per cent compliance level in the Balkan countries and Turkey (see Chart 2).

Conclusion

One might have thought the higher levels of procedural fairness would adversely impact on the speed and cost of the process. However, one interesting conclusion to emerge from the assessment was that the remedies bodies

which accord substantial procedural fairness appear to do so at little expense of the overall efficiency of the remedies process (see Chart 2). Although none of these countries received full marks for the efficiency of their review and remedies procedures, all of the countries populate the top of the “remedies efficiency” ranking. All these countries consistently scored between 75 per cent and 90 per cent compliance rate for efficiency of their remedies systems based on both reports from local legal advisers and local contracting entities.

The above results appear to confirm that features expected from the remedies procedures by the private sector, namely accessibility, independence, certainty, and market awareness can be achieved, while ensuring efficiency of the remedies system. There were some cases where there did exist a reasonable gap between high marks for fairness on the one hand and poorer scores for efficiency on the other. Bulgaria and Poland are cases in point. However, these particular cases were reported to be affected by lack of institutional capacity (Bulgaria) and high review fees (Poland), which were not considered to be related to the procedural fairness issues (such as rights to fair treatment, a public hearing; to be heard within a reasonable time, and so on).

Policy-makers should be willing to consider granting significant public procurement review and remedies function to review bodies. To return to the question posed in the introduction, do certain types of bodies work better than others? Although courts offer the highest standards of fairness, the assessment showed that administrative tribunals can in practice do very well, if they are equipped with the right review procedures. What accounts for the relatively good performance of these “tribunals”? One factor may be the presence on these bodies of professionals with good knowledge of the procurement processes and their practical understanding of relevant market challenges. The assessment showed that administrative tribunals in fact enjoy more trust from the private sector than other types of bodies.

Notes

¹ <http://www.ebrd.com/pages/sector/legal/procurement/assessment.shtml>

² Full text of the EBRD Core Principles can be accessed at:
http://www.ebrd.com/pages/sector/legal/procurement/core_principles.shtml

³ See: case C-92/00, paragraph 67 and Case C-390/98 Banks v Coal Authority and Secretary of State for Trade & Industry [2001] ECR I-6117, paragraph 121; Case C-453/99 Courage and Crehan [2001] ECR I-6297, paragraph 29.

⁴ In several countries a right to appeal review decision is guaranteed, but there is no requirement to suspend procurement process until review is heard. Thus, a court deciding on the appeal is no longer in position to decide on remedial action.

⁵ Due to recent amendment of the laws, in Estonia the commercial courts no longer deal with public procurement review as remedies bodies, as reflected in the assessment result.

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Developing capital markets



The EBRD Legal Transition Programme has always emphasised the importance of robust legal frameworks and institutions for economic environment. Until recently the so-called developed economies and their financial markets were booming. The financial crisis, however, has halted the boom and, moreover, has had a major impact on the development of local capital markets in the economic regions of the EBRD.

This edition of *Law in transition* relates to the legal and regulatory pillars of the EBRD-wide initiative on Local Currency and Local Capital Markets Development, which is aimed at addressing the impediments to the development of local capital markets in the Bank's region. This issue of *Law in transition* not only provides insights into these various legal and regulatory impediments but also illustrates how such impediments could be addressed.

History has shown that at the height of the crisis – and shortly thereafter – regulatory activity seemed to be operating at the highest level. Regulators are now trying to address the identified

weaknesses of legal frameworks by issuing a high number of rules and regulations with the aim of trying to prevent the next crisis. However, are such rules and regulations robust enough? And, at the same time, do such rules not limit market development?

This issue of the journal may not give definite answers to these questions but it provides useful pointers as to what the answers could be. As Cally Jordan specifies in her article, we are in the midst of a great sea change and, therefore, looking to the future direction of capital markets regulation is a particularly risky business. She points out several current phenomena which are likely to shape capital markets regulation in advanced markets. Are these phenomena also relevant to the EBRD region?

This question is addressed by Frédérique Dahan, Lewis Cohen and Jacek Kubas in their article which describes legal and regulatory impediments in some of the economies of the EBRD's region. Looking at specific jurisdictions we can, together

Focus section



with Madalina Rachieru, take a ride on the “rollercoaster of Romanian capital market development” to see how EU membership impacts on market development. In the next article, we keep abreast of recent regulatory changes in the financial markets of Kazakhstan.

Addressing more technical issues, one should not neglect the importance of over-the-counter (OTC) trading for the development of local capital markets, especially at the initial stage of development. How OTC markets are regulated in transition countries and whether the concept of close-out netting is widely accepted – are questions examined by Peter Werner, from the International Swaps and Derivatives Association. Vladimir Khrenov provides an insight into Russian financial regulation over the past few years. The system is marked by fundamental shifts that have finally rewarded the industry’s efforts to overhaul the regulatory framework for OTC derivatives, including the introduction of close-out netting. From Elena Sulima we learn about the Bank’s

role in developing a domestic capital market in Russia. More specifically, she provides an overview of the EBRD’s recent domestic bond issues and the challenges created by the current Russian regulatory framework.

As the Bank prepares for the expansion of its operations into the southern and eastern Mediterranean (SEMED) region, this issue of *Law in transition* provides an introduction to the Egyptian capital market, how it has been reborn over the last two decades and what impact the Arab uprising may have had on it.

Lastly, what does the future hold for the global financial regulatory landscape? Will it resemble a centralised, harmonised and symmetrical French garden? Or will it be more like a disorganised English-style garden, with different rules and regulations in each jurisdiction? Or will it look like a Japanese garden, “*with new details and perspectives emerging at each step*”? – as referred to by Cally Jordan, citing the scholars Stéphane Rottier and Nicolas Véron.

03

The EBRD's legal and regulatory assessment – what limits development of local capital markets?

FRÉDÉRIQUE DAHAN, JACEK KUBAS, LEWIS COHEN, YANA MIHALEVA, MARGARET WELSH

This article describes legal and regulatory impediments in some of the EBRD's countries of operations to the development of vibrant local capital markets, as identified within the EBRD Local Currency and Local Capitals Market Development Initiative. It also describes how such impediments could be addressed.



Background

The development of vibrant local capital markets in the EBRD's countries of operations is crucial to long-term financial stability because it allows for raising capital and providing liquidity in a safe manner, in local currency and without reliance on a frequently constrained financial sector. Underdeveloped local capital markets and the lack of domestic funding in some of the EBRD's countries of operations have proved to be a major vulnerability in the global economic crisis that we are still experiencing. In 2010 the EBRD launched the Local Currency and Local Capital Markets Initiative (the "Initiative"), which aims to encourage local currency lending and also the development of local capital markets where local sources of domestic funding can be mobilised, thereby reducing the reliance on foreign currency lending and the related foreign exchange risks. As part of the Initiative, the EBRD

identifies key impediments and assists countries in developing deeper and more efficient local capital markets. This is achieved by combining policy dialogue and technical support with some of the EBRD's investment projects.

The sophistication of the legal and regulatory framework is fundamental to the development of local capital markets. After 20 years of transition, the development of the legal regimes in many of the EBRD's countries of operations remains a work in progress. Countries that have become members of the European Union, such as Poland, Hungary and Romania, have adopted relatively sophisticated legal and regulatory frameworks, which are in line with EU legislation. However, implementation and institution-building are still problematic in some areas (see article by Madalina Rachieru, "The rollercoaster of Romanian capital markets", at page 66). At the other end of the spectrum,



The assessment consists of reviewing the status and quality of the legal and regulatory framework against the stage of development of jurisdiction in question

the so-called early transition countries (the “ETCs”)¹ still seem to lack fundamentals, such as functioning money markets.

The initial task of the EBRD Legal Transition Programme was to develop a set of tools with which it could conduct an assessment. The assessment consists of reviewing the status and quality of the legal and regulatory framework, which is necessary to support a vibrant local capital market, against the stage of development of the jurisdiction in question (“The Legal Assessment” or “Assessment”). This is not an easy task: indeed, capital markets are not the product of a unique law or set of laws. They are complex systems that depend on a wide range of legal provisions, but also on regulations, institutions and practices in order to deliver the economic benefits mentioned above. Thus, the task consisted more of capturing the key features that in practice make the difference for investors and issuers, rather than cataloguing a single law, perhaps the securities law, against “international best practices”, which may be very important in theory but which does not necessarily translate into practical results. In other words, given the stage of development where such markets operate, it was deemed more important for the assessment to drill deeper into the issues within the local capital market of a jurisdiction and identify the incentives or disincentives that operate with regard to issuers and investors. Indeed, experience in the EBRD’s countries of operations has shown that too often a good deal of work has gone into developing laws which, unfortunately, do not match the market’s demands, or which cannot operate as intended because the local tax, accounting or listing rules, for instance, prevent it from doing so.

These concerns have led to the following guiding principles for the legal assessment:

- i) The assessment would be driven by the overall concern of incentives versus disincentives (or “facilitating” versus “impeding”) for development of local capital markets
- ii) The assessment would focus on money markets, taking into account the actual use of derivatives and repo transactions, as well as debt and equity markets, recognising that the former are as essential as the latter
- iii) The assessment would review not only the procedural rules (for example, local issuance

of debt securities) but also the functioning of the institutions involved (for example, clearing and settlement, credit rating agencies, supervisors and market regulators).

In order to validate its assessment, the EBRD set up an advisory panel. The panel includes individuals with extensive knowledge of capital markets development in various sectors (legal, market infrastructure, regulatory, investment, policy), including representatives from international financial institutions, investment banks, rating agencies, law firms, academia, and more. Using its experience at the interface of developed and developing markets, the panel was instrumental in refining both the breadth and depth of the assessment tools and has made this Initiative special and unique. The results of the assessment for seven jurisdictions, namely Hungary, Kazakhstan, Poland, Romania, Russia, Turkey and Ukraine, are presented in Table 1.

Key results

Recurring themes

The legal assessment revealed a number of significant common areas where legal or regulatory changes could have the most impact. Although each assessment was carried out independently, several common themes appeared across jurisdictions, notably a need for development of investor rights enforcement following debt securities default, disclosure rules and procedures, credit rating requirements and legislative frameworks for covered bonds and other non-speculative structured securities. These themes highlight a widespread need to create more investor-friendly and issuer-friendly jurisdictions, which can be achieved through legal reform to incorporate local debt finance into capital markets development.

Enforcement of investor rights in case of debt securities default

While large banks may generally be able to successfully enforce payment obligations because of their market position and often superior access to information, investors that hold a relatively small percentage of the debt securities of a given entity typically must rely on the legal and regulatory framework to enforce their rights. Thus, we looked at whether local laws and regulations have formal and/or informal impediments that prevent the



Large banks may generally be able to enforce payment obligations because of their market positions but the investors that hold small percentages of debt securities of an entity must rely on the legal and regulatory framework to enforce their rights

Methodology and results format of the legal assessment

A questionnaire was developed to identify the key legal and regulatory impediments to the development of a jurisdiction's local debt capital markets.

- The questionnaire was designed to be comprehensive by covering a wide range of legal and regulatory issues that could potentially impede capital markets development.
- The questionnaire had to be practical, so that the responses could be used to generate concrete recommendations for the countries examined.
- The questionnaire was structured to provide a snapshot of the strengths and weaknesses of each jurisdiction's current legal and regulatory framework, so that those strengths and weaknesses could be compared and assessed.
- The same questionnaire was used in all jurisdictions assessed so far, but may be amended to fit in jurisdictions with less-developed capital markets, as many of the questions would not be relevant and a different focus altogether is needed.

The questionnaire was completed in each assessed jurisdiction by local jurisdiction teams (the "LJTMs")² with significant expertise and involvement with debt capital markets in the respective jurisdictions. The completed questionnaires were subsequently reviewed, in light of international market, legal and regulatory practice, by the Financial Law Unit of the EBRD and the Capital Markets Team in the New York office of Clifford Chance US LLP. Where appropriate, responses were supplemented by information from

local fact-finding meetings (in particular in Kazakhstan and Romania).

From the completed questionnaires and with the assistance of the LJTMs, we developed recommendations for each jurisdiction that aim to provide practical suggestions for improvement of the legal and regulatory debt capital markets framework. These recommendations attempt to give a sense of timing: short-term recommendations encapsulate fairly self-contained measures, which, if adopted, would deliver impact quickly, and are distinguished from other recommendations that focus on the longer-term and call for legal and/or regulatory changes which would likely require a more time-consuming and less straightforward reform process.³ The advisory panel assisted, again, in reviewing both the findings and recommendations. Each report also outlines areas where debt capital markets in the relevant jurisdiction work well, highlighting that any legal or regulatory changes should not affect such areas.

In addition to the recommendations, the assessment's results are presented in a tabular form under 18 specific headings covering the most important areas relevant to local capital markets development (see Table 1). Under each heading, each country's regulatory and legal framework is assigned a grade on a +2 to -2 scale, depending on the level at which the given regulatory framework currently encourages or impedes local capital markets. These grades help to quantify the strengths and weaknesses of legal and regulatory frameworks of local debt capital markets, both on a jurisdiction-by-jurisdiction basis and across jurisdictions.

efficient enforcement of payment obligations with respect to debt securities in case of insolvency of the issuer and otherwise. Our study revealed several jurisdictions with such impediments. In Kazakhstan, for example, the current law requires the consent of all creditors for the successful restructuring of a corporate debt, which is highly impractical (although there are plans to address this issue).

Additional impediments across the jurisdictions include inconsistencies in the application of laws and/or judicial precedents,⁴ a general insufficient use of collective action clauses and

lengthy, expensive and uncertain enforcement proceedings. For example, in Hungary, the average length of judicial enforcement litigation in the first instance is between three months and two years. If the judgment in the first instance does not become final and thus non-appealable, the procedure may take even longer. Where these issues arise, we recommend *inter alia* that laws and regulations be amended or adopted to clarify set-off rights and to ensure that enforcement rights of beneficial owners are not adversely impacted if intermediaries (that is, brokers or clearing houses) hold legal title to debt securities; and



The assessment also reveals that while there are recurring themes among systems in place, there are several areas where the systems showed significant disparities

to eliminate any unnecessary special rules (that is, registration/filing requirements) for enforcing collateral taken to secure debt securities.

Disclosure rules and procedures

The assessment showed that, by and large, the disclosure rules and procedures of the countries studied are cumbersome and tend to impede the development of the local debt capital markets. Hindrances include excessive documentation requirements, lack of adequate training/staffing of reviewing agencies, inconsistent procedures for the review of required documentation, for example, offering documentation or a prospectus and a lack of public access to the required documentation. In some instances, these impediments were inadvertently created during the adoption and implementation of EU directives. For example, in Romania, the inconsistent implementation of EU directives led to three separate laws governing bonds that currently overlap and (to a certain extent) contradict each other. We recommend that changes be made to the current legal and regulatory framework to:

- require a central repository of offering documents to which the general public has access
- set forth a clear and efficient process for approval and filing with a regulatory institution of information materials used to market debt securities
- set forth less rigorous disclosure requirements for large, sophisticated and/or institutional investors
- set forth clear and efficient rules for updating disclosures
- require more extensive training and education of the staff at the regulatory institution responsible for reviewing offering documents.

Credit rating requirements

While credit rating agencies have come under significant scrutiny during the global financial crisis, they can provide useful local market information to investors, particularly in the absence of cost-efficient alternatives to credit ratings for the evaluation of credit risk in traded debt instruments. Both a general absence of credit rating requirements and a lack of

reputable credit rating agencies (whether based locally or abroad) with appropriate experience in the studied jurisdictions impede the local debt capital markets of the assessed countries. The lack of local experience of potential rating agencies and/or the relatively high cost of obtaining a credit rating from a reputable credit rating agency with an appropriate local market experience deters such credit ratings from being obtained by local issuers.⁵

Collateralised debt securities frameworks

As a whole, the countries reviewed lack functioning frameworks for the issuance of covered bonds and other non-speculative collateralised debt securities, such as residential mortgage-backed securities. Legislation and regulations permitting the issuance of covered bonds and other collateralised debt securities are either absent or so limited and impractical that issuance does not take place. It is recommended that legislation and regulations be enacted or modified in the jurisdictions where there is a potential market for covered bonds and other collateralised debt securities. This would ensure that the framework for these securities fits the needs of the market, including the authorisation of a single cover pool to secure several issuances of covered bonds⁶ and the flexible usage of the pool of receivables.

Disparate themes

In addition to the recurring themes, the assessment also revealed that in the reviewed jurisdictions there are several areas where the systems in place showed significant *disparities*. Specifically, the greatest disparities surfaced in the areas of cost of debt securities issuance, insider trading protection and firewall regulations, settlement systems and governing law requirements.

Cost of issuance

We noted wide discrepancies in the cost of issuance of local debt securities, including fees or charges levied by governmental entities in the jurisdiction and underwriting and legal fees in connection with an offering of debt securities. For example, the very moderate cost of issuance in Kazakhstan encourages issuance even by relatively small issuers.⁷ In contrast, the relatively high cost of the approval fee and the requirement that the fee be paid upfront in Romania⁸ discourage issuers



In Kazakhstan, Russia and Ukraine, secondary trades are generally settled bilaterally through physical delivery, which is both costly and lengthy

from issuing bonds in Romania (preferring to issue bonds in other EU countries and then “passport” the securities into Romania).⁹

Firewalls/insider trading protection

Insider trading protection laws and regulations and firewall requirements¹⁰ are important to a well-functioning debt securities market, as they aim to achieve market integrity (and hence, encourage market participation) by ensuring that all market participants have access to the same information when making their investment decisions. Some of the assessed jurisdictions have explicit firewall requirements and insider trading protection laws/regulations for both banks and other regulated investors, such as brokerage firms and portfolio managers, and the legislation is considered effective and is applied in practice. For example, this is the case in Turkey. Other jurisdictions have banking secrecy laws and other insider dealing laws that essentially function as firewall requirements (such as Romania, Hungary and Poland). However, some legal regimes (for example, the one in Kazakhstan) have neither explicit firewall requirements for banks or other regulated investors, nor general laws on insider trading or banking secrecy. In other cases, the laws and regulations in place are too recent or underdeveloped for the provisions to be deemed effective (this is the case in Russia and Ukraine).

Settlement system

Both Hungary and Turkey have no restrictions on, or impediments to, transfer of locally issued debt securities (such as requirements for bilateral settlement of secondary trades by physical delivery) which could discourage local debt capital markets activity. They have central settlement systems which are used and function well. At the other end of the spectrum, in Kazakhstan, Russia and Ukraine, secondary trades are generally settled bilaterally through physical delivery, which is both costly and lengthy. Between these two extremes lies Poland, where issuers can use a central depository system, but in practice typically use investment firms or banks – a practice which is perceived as limiting the liquidity of the securities.

Governing law requirements

In our assessment, we considered it an advantage where local law permitted the flexibility for locally issued debt securities to be governed by non-local law and to use foreign

languages for documentation. The use of foreign law where local law is less developed may increase investors’ confidence in the debt instruments (particularly that of non-local investors). Likewise, the use of foreign languages in addition to the jurisdiction’s local language for offering documents would allow wider investor participation, including from abroad. Several of the countries reviewed (Hungary, Romania, Kazakhstan, Poland) allow for foreign law and/or language usage in connection with local debt securities issuance, but three others (Russia, Ukraine and Turkey) prohibit the use of both foreign law and foreign language in connection with local debt securities issuances.

Next steps

While very important, these assessments, and the recommendations derived from them, are only a very preliminary step of the overall ambition of the Initiative. As mentioned above, the intention is to trigger an understanding and consensus around the highlighted problems as well as create a momentum where reform efforts can be initiated and successfully completed. It is still early days, but there are already a few encouraging developments:

- In Ukraine, the EBRD, together with the IMF, is discussing the development of a legal framework that would provide for validity and enforceability of derivatives transactions. The proposed reform would help developing capital markets by allowing financial institutions and corporates to hedge their risks
- In Romania, the banking association is actively engaged in reviewing the legal regime for covered bonds and the EBRD is assisting in the dialogue, between the banking association and the Romanian authorities
- In Kazakhstan, the EBRD is looking at the regulation of private pension funds and how prudential requirements can be properly balanced with the overall concern of developing an investment policy that encourages a broadening of investment into local capital markets by funds managers.

Furthermore, with the EBRD’s expansion to the southern and eastern Mediterranean region (SEMED), legal assessments in Egypt, Morocco,



The recent financial crisis has highlighted new risks but also new routes for the development of capital markets

Tunisia and Jordan are also envisaged to take place in 2012, with the aim of identifying priority reforms in order to encourage the development of local capital markets in the SEMED region.

Lastly, the EBRD and the London School of Economics have launched a training seminar programme for practising lawyers, judges and regulators on “Financial Markets Law and Regulation for Transition Economies”.¹¹

Conclusion

Although the regions in which the EBRD operates are very diverse, the legal assessment

carried out so far offers an interesting window into the functioning of local capital markets in a number of countries. It has showed that, despite a clear diversity, one can nevertheless observe common themes where reforms would be beneficial for encouraging the development of local capital markets.

Moreover, the recent financial crisis has highlighted new risks but also new routes for the development of capital markets, not only in the EBRD’s countries of operations, but also globally, which must be considered in the context of transition economies.

Table 1
Quality of legal and regulatory framework for capital markets in selected transition countries

Issues	Hungary	Kazakhstan	Poland	Romania	Russia	Turkey	Ukraine
Debt securities investors (banks and non-banks)							
1. Capital requirements	+1	+1	+1	+1	-1	0	-2
2. Policies on buying locally issued debt securities	0	0	+1	0	0	0	+2
3. Firewalls/insider trading protection	+1	-2	+1	+1	+1	+2	+1
4. Tax policies	0	+1	+1	+1	0	+2	+1
5. Use of derivatives	+1	-1	+1	-1	+1	+2	-2
6. Use of repos and financial collateral transactions	-1	-1	+2	-2	+1	-1	-2
7. Enforcement of investor rights in case of debt securities default	-1	-1	+2	-1	-2	+1	-1
8. Investor remedies against market participants for market abuse	0	-1	+2	0	0	+1	-1
Debt securities issuers							
9. Disclosure rules and procedures	+1	-1	+1	-1	-1	-1	-2
10. Availability of shelf registration	+1	-2	+1	+1	+1	-2	-2
11. Costs of issuance	0	+2	+2	-2	+1	+1	0
12. Rules on issuance in the local markets	-1	-1	+2	-1	+1	+1	-1
13. Governing law requirements	+2	+1	0	+1	-2	-2	-2
14. Credit ratings requirements	+1	0	0	-1	-1	-1	0
Debt securities trading and settlement							
15. Settlement system	+2	-1	+2	-1	-1	+2	-1
Equity securities							
16. Disclosure rules for equity securities	+1	-1	+2	+1	-1	-1	-2
17. Market integrity – insider trading for equity securities	+1	-2	-1	+1	-1	+1	-2
18. Corporate governance of listed entities	+1	-2	+1	+1	-2	+1	-1

Source: EBRD.

Assessment scale

+2	Strongly facilitates capital markets activity
+1	Facilitates capital markets activity
0	Neutral
-1	Impedes capital markets activity
-2	Strongly impedes capital markets activity

Table 2

Assessment table – explanatory notes

The assessed issues deem to cover the most important areas relevant for local capital markets development. The following notes provide background information on how the scope of the questions has been defined and the methodology used for deciding the grading.

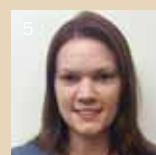
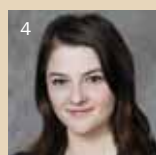
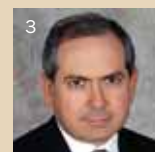
1. Capital requirements	The gradings are provided only in connection with the stimulus which certain capital requirements provide for holding local debt securities, and the gradings do not purport to assess the capital requirements <i>per se</i> and particularly, with respect to their primary goal of risk management. Any grades should be evaluated separately against the effects of the given capital requirements on risk management. The grade given covers the risk weighting applied to locally issued debt securities for the purpose of calculating required capital (and liquidity ratios) for banks, other financial institutions or regulated investors. An upgrade is given when in the Jurisdiction the risk weighting rules are clear and appropriate and applied on an on-discretionary basis. There are incentives for the holding of locally issued debt securities.
2. Policies on buying locally issued debt securities	There are no limitations/prohibitions applicable to banks, other financial institutions and regulated investors on buying debt securities issued by issuers based in the jurisdiction; and there are informal/unwritten policies, applied by regulators, creating incentives for banks, other financial institutions or regulated investors to invest in locally issued debt securities.
3. Firewalls/insider trading protection	There are regulations requiring banks and other regulated investors in the jurisdiction to maintain “firewalls” or the like between non-public information received separately from borrowers of the bank and/or from their capital markets investment activity and the information used to invest in debt securities issued by the same borrower and/or client entities, and that such regulations are effectively implemented and enforced.
4. Tax policies	The highest grade is given if the jurisdiction has tax or other fiscal rules creating strong incentives for local investors to buy, hold or dispose of debt securities issued by local issuers.
5. Use of derivatives	Banks and other investors may freely purchase and sell derivative instruments in the jurisdiction and are permitted to hedge risk taken on through the purchase of debt securities. There is no uncertainty in relation to enforcement and validity of derivatives transactions and underlying legal documentation.
6. Use of repos and financial collateral	Repo transactions with respect to locally issued debt securities are permitted in the jurisdiction, and there are no legal or documentation issues relating to repo transactions that would impede local capital markets activity.
7. Enforcement of investor rights in case of debt securities default	Upgrade is given when there are no formal or informal impediments to enforce payment obligations with respect to debt securities in insolvency proceedings or otherwise; laws, regulations and practices show that investor enforcement rights and options are optimal.
8. Investor remedies against market participants for market abuse	The highest grade is given when there are laws providing for specific remedies for investors against market participants that issue or trade in debt securities based on false or misleading information they have provided to prospective purchasers (or have otherwise engaged in “market abuse”) and such laws are implemented; there is a regulatory institution which can bring enforcement claims where they are not brought by private investors; such claims are actually brought; the jurisdiction has an “ombudsman”-type entity (advocate) for investors with securities law claims; governmental issuers are not treated differently from other issuers with respect to such remedies/enforcement.
9. Disclosure rules and procedures	The disclosure requirements do not impede local debt securities' issuance; the offering process is speedy and efficient; there is a central repository of offering documents to which the general public has access; there is a process of approval/filing, with a regulatory institution, information materials used to market debt securities and such process is efficient and prompt; large, sophisticated and/or institutional investors are subject to less rigorous disclosure requirements; the underwriting and legal costs for local issuance of debt securities are reasonable; any listing requirements, if applicable, do not create an impediment to issuance of debt securities; any updating disclosure requirements do not create an impediment to issuance of debt securities; no documentation issues impede local capital markets activity.

10. Availability of shelf registration	If a “shelf” programme (one in which, following an initial approval process with the relevant regulatory institution, subsequent public offerings can be made without further approval) is available and is used, functions well and is efficient, the highest grade is given.
11. Costs of issuance	The cost of issuance of debt securities is such that it encourages local issuance of debt securities.
12. Rules on issuance in the local markets	The rules on issuance of debt securities in the local markets encourage local issuance of debt securities (for example, minimum or maximum tenors, as well as minimum denominations are reasonable; no/or reasonable limitations on requirements on currency of denominations; no prohibition on “put” or “call” options or “equity kickers” (such as warrants); early redemption rights permitted; no/or reasonable maximum interest rate.
13. Governing law requirements	Highest grade is given if local law allows that locally issued debt securities be governed by foreign law and foreign language be used for documentation).
14. Credit ratings requirements	Locally issued debt securities are required to have a rating from a reputable credit rating agency with appropriate experience in the local market; overall, the credit rating requirements encourage local debt capital markets activity. There could be no legal requirement but there is a market practice to use a rating from a credit agency with appropriate experience in the local market. If there is no such requirement or market practice, then downgrade is given.
15. Settlement system	There are no restrictions on transfer of locally issued debt securities by law which would impede local debt capital markets activity; there is a local settlement system with central counterparties that clear secondary trades in debt securities; such a settlement system is used and functions well and has a number of links with other settlement systems; any requirements regarding the settlement of debt securities do not impede the effectiveness of the settlement process.
16. Disclosure rules for equity securities	No improvements are needed to the disclosure regime for initial public offerings or secondary placements of equity (that is, the process is fast and efficient, generally in line with international standards, the fees are reasonable and so on.
17. Market integrity-insider trading for equity securities	The highest grade is given for high overall integrity of the market (for example, current and accurate information about listed companies is available; insider trading generally not present; effective curbs on manipulative share trading).
18. Corporate governance of listed entities	Effective corporate governance and protection of minority interests is implemented and applied in practice (for example, independent directors are required; transactions with insiders have to be disclosed).

Notes

- ¹ The EBRD Early Transition Countries Initiative covers the following countries: Armenia, Azerbaijan, Belarus, Georgia, Kyrgyz Republic, Moldova, Mongolia, Tajikistan, Turkmenistan and Uzbekistan.
- ² We have used the same local jurisdiction questionnaire for all jurisdictions studied so far: Kazakhstan, Hungary, Romania, Russia, Ukraine, Turkey and Poland. We are using the same questionnaire for Serbia's assessment as well, which is still ongoing. We will be amending the questionnaire for the purposes of studying jurisdictions with less-developed debt capital markets, such as Mongolia, as many of the questions in the current questionnaire would not be applicable to such jurisdictions, and a different focus altogether is likely to be needed.
- ³ All reports contained long-term and short-term recommendations, except for the report on Poland, where our recommendations were split instead into high-priority and lower-priority, as the timing needed for the implementation of the recommendations was not a distinguishing feature of the recommended actions.
- ⁴ For example, in Russia, it seems that investors seeking to enforce payment obligations are unsure about the legal provisions which would be applied to their claims.
- ⁵ Furthermore, additional requirements in some studied jurisdictions further discourage issuers from obtaining credit ratings. For example, Turkish rules provide that if a credit rating is obtained, it must be updated annually.
- ⁶ In Romania, for example, a proposed new law on covered bonds would allow a given pool of mortgage loans to support several issues of covered bonds; the current mortgage law requires that a given pool of mortgages supports only a single issue of covered bonds, which is relatively inefficient.
- ⁷ In Kazakhstan, the approximate cost for offering debt securities is US\$ 31,000, while state registration of bonds is free of charge.
- ⁸ In Romania, the applicable approval fee may be up to 0.5 per cent of the offering proceeds (not applicable to sovereign or municipal bonds).
- ⁹ "Passporting" of securities is possible due to the implementation in Romania of EU Directive 2003/71.
- ¹⁰ Regulations requiring banks and other regulated investors to maintain "firewalls" or the like between non-public information received separately from borrowers of the bank and/or from their capital markets investment activity and the information used to invest in debt securities issued by the same borrower and/or client entities.
- ¹¹ See the programme of the seminar at the EBRD's web site: www.ebrd.com/downloads/legal/developments/LSEfin.pdf

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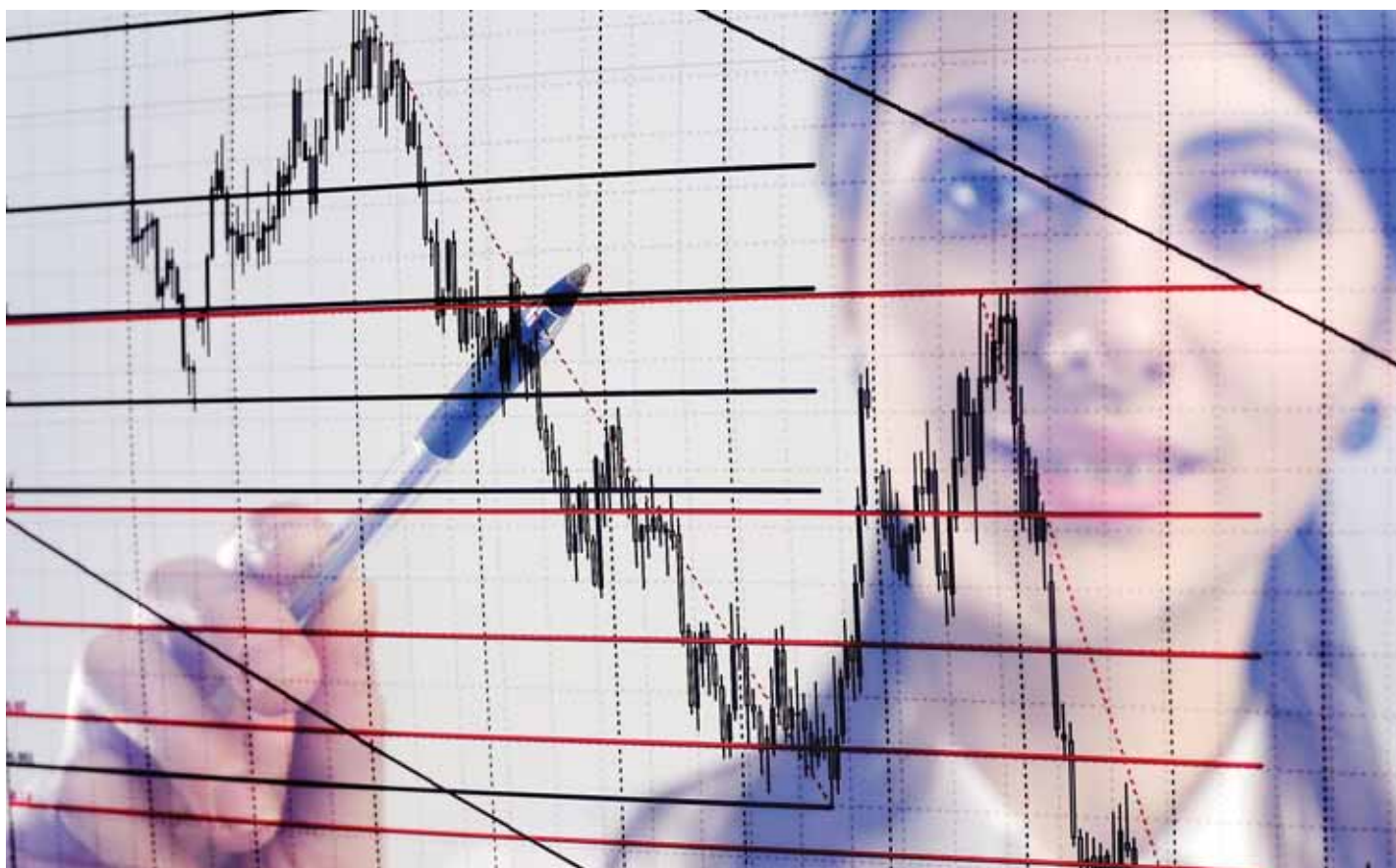
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04

The EBRD at the forefront of developing the Russian domestic capital market

ELENA SULIMA

This article discusses the role of the Bank in the process of developing the domestic capital market in Russia. It describes recent domestic bond issues and provides an insight into the challenges posed by the current Russian regulatory framework.



Introduction

The rapid growth of debt capital markets in emerging economies, including in the Bank's countries of operations, in the years preceding the recent financial crisis had shown the great potential of these markets. More importantly, this growth was reflected by the improvement of private sector credit quality, transparency and growing domestic liquidity. The financial crisis and the resulting increase in currency risks in many countries in particular, and a heightened awareness of risks in the financial sector in general, underlined the need for further development of liquid and self-sustaining local currency capital markets in these economies.

Rationale for local currency financing

The EBRD has been committed to the development of domestic capital markets

in the countries of its operations since its establishment. One of the functions of the Bank, under the Agreement Establishing the Bank, is *"to stimulate and encourage the development of capital markets"*.¹ As early as 1994 the Bank issued its first local currency domestic bond in Hungary. Since then the Bank has issued domestic bonds in Romania and Russia and eurobonds in the currencies of nine countries of operations.

Why is local currency financing such an important part of the Bank's mandate? Foreign currency loans in the Bank's countries of operations are best suited to borrowers that are able to manage their currency risks, such as exporters and companies with foreign currency receivables, or companies that are generally able to mitigate such risks due to well-established risk management techniques. Foreign currency loans are, however, not an appropriate option



EBRD's lending in the local currency helps to improve the creditworthiness of projects and reduce foreign exchange risk

for many borrowers in the Bank's countries of operations. Therefore, the Bank's lending in local currency becomes an important tool in mitigating the currency exposures of such borrowers.

By lending in local currency the Bank helps to improve the creditworthiness of projects which solely generate local currency income, as it reduces foreign exchange risk. The Bank is also able to direct short-term domestic liquidity into longer-term lending in local currency to investments in the real economy and to extend the maturity of local currency financing in the market. In addition, depending on applicable local legislation, projects may be legally required to be funded in local currency, for example, projects in the municipal sector of some countries. The Bank is also reinforcing existing market indices or it helps create new, transparent ones, such as MosPrime, KievPrime, KazPrime, ROBOR and so on.

On the other hand, by borrowing in local currency, the Bank helps to stimulate the development of local capital markets. Bonds of a triple-A issuer like the Bank serve as an alternative pricing benchmark to the government bond market. For domestic investors, the EBRD bonds serve as an additional highest credit quality investment asset, the choice of which is usually quite limited in the local market. The bonds also attract new investors that want to gain exposure to local currency without being exposed to local credit risk. In addition, the Bank is able to introduce innovative techniques in local currency financing activities that help to foster the overall development of the market.

The Bank's recent Russian rouble domestic bond issues

The Bank's four most recent domestic rouble bond issues are good examples of innovative issuance structures introduced in the Russian capital market. The index-linked rouble bonds issued by the Bank in 2010–11 were among the first such offerings on the Russian domestic market.

In international markets, index-linked bonds not only allow investors to diversify their investment portfolio, but also to find assets which better match their liabilities. They offer the security of principal protection as well as a return on investment based on the performance of the

underlying stock market or commodity index. At maturity, investors receive the original principal invested, plus interest (if any), plus some or all of the return based on the percentage change in the equity or commodity underlying component. The investors can, therefore, benefit from any positive performance of the underlying index, but with additional protection of the principal amount invested. That is one of the reasons why this instrument is very popular among institutional investors (like pension funds) that tend to hold them until maturity.

The debut of such instruments in the Russian capital market represents an important landmark. The successful placement of the EBRD's index-linked bonds in the Russian domestic market also has an important demonstration effect, as such issues promote the local capital market and attract new long-term investors.

The two long-term domestic bond issues placed in the Russian market in September 2010 with a principal amount of RUB 3.5 billion each were indexed to an identical basket of commodities comprising gold, silver and platinum. The bonds' structure provides for 100 per cent protection of the capital and a minimum fixed coupon payable annually (it is expected by market participants in Russia that a bond should be interest-bearing). The notes also pay an additional final coupon linked to the performance of a basket of commodities, although the potential gain on the price of these commodities in eight years' time is capped at a maximum of 200 per cent.

In October 2010 the EBRD placed another long-term RUB 7 billion bond whose final return is linked to the performance of the Russian Depository Index® ("RDX®"). This is a capitalisation-weighted index tracking the price movements of the most liquid American depository receipts (ADRs) and Global depository receipts (GDRs) on Russian shares – blue chips traded at the London Stock Exchange. The Index itself is calculated in US dollars and is sponsored by the Vienna stock exchange (Wiener Börse).

The RUB 7 billion issue is another capital protected bond which pays a minimum fixed coupon. At the maturity of this bond investors would potentially receive an additional coupon based on the performance of the RDX® to which this bond is linked. In the case of the RDX® index-linked EBRD bond, there is no



The successful placement of the EBRD's index-linked bonds in the Russian domestic market promotes the local capital market and attracts new long-term investors

cap on the maximum profit investors can expect from the potential rise in Russian equity values over the term of the bond.

The fourth structured bond, launched in the Russian domestic market in June 2011, was a RUB 1 billion bond whose final return is linked to the performance of the Dow Jones-UBS Commodity Index (DJ-UBSCISM) over the bond's five-year life. The bond is also capital protected and pays an annual fixed coupon. As with the previous instrument, the potential gains on the bond will be the gains on the commodities index at maturity of the bond. The DJ-UBSCISM index provides broad-based exposure to commodities as an asset class as it covers a basket of 19 commodities from different sectors of the economy and no single commodity or commodity sector dominates the index. This provides investors with a hedge against inflation and allows them to better match their liabilities. The bond structure does not provide for any cap on the maximum performance of the DJ-UBSCISM index.

These complex structured bonds may seem relatively usual in the developed capital markets, but they represent a very significant milestone event for the Russian market where the choice of financial instruments available to investors is not that broad and the regulatory environment is constantly evolving.

Regulatory environment

With a view to establishing Moscow as one of the world's leading financial centres, the Russian parliament introduced substantial changes to the Russian Securities Market Law² in May 2009, including a new legal framework for the admission of foreign securities to private and public placement (primary offering) and public circulation (public secondary trading) in Russia.

The amendment permits primary offering of foreign securities in Russia, subject to certain requirements:

- (i) such securities must have assigned both an ISIN code and a CFI code (the "qualified securities")
- (ii) such qualified securities must be issued by a sovereign issuer or a central bank of a country, or by an issuer incorporated in a

country which is a qualifying country (country which is a member of OECD,³ a member or observer of FATF⁴ and/or a member of MONEYVAL,⁵ or a country whose securities market regulator signed a cooperation treaty with the FSFM),⁶ or by an international financial institution (IFI) included in the list approved by the Russian government

- (iii) a prospectus in relation to the issuer and securities has to be registered with the FSFM. Only qualified securities are allowed for public secondary trading, whereas a secondary offering of other foreign securities is permitted only to qualified investors.

In order to make a new regime operational, the FSFM has introduced a number of implementing regulations since that time, including Regulation No 10-20.⁷ In addition, as of the date this article is being written, the Ministry of Justice of the Russian Federation registered a new Disclosure Regulation.⁸ In respect of foreign issuers, the new Disclosure Regulation aims at making disclosure requirements consistent with rules that apply to such issuers in jurisdictions where they have issued securities before. In particular, the Disclosure Regulation provides that if foreign issuer's securities are listed on a foreign stock exchange recognised by the FSFM, such issuers have to disclose the same information as required by such foreign stock exchange.

The new Disclosure Regulation aims at making the disclosure requirements more transparent and clear, providing foreign issuers with an opportunity to use translated prospectuses, prepared according to foreign standards, in Russia. However, it remains to be seen how these requirements would work with bond programme documentation of foreign issuers, as under Russian regulations a separate prospectus is required for each bond issue. The Russian securities market regulator may have to consider introducing a concept of programme issuance in order to address this issue.

In respect of bond issuance by the Bank and other IFIs, the new Russian regime for a placement of foreign securities still involves a number of uncertainties. The FSFM has abolished the section of the Issuance Standards⁹ which regulated special procedures and exemptions for domestic bonds by IFIs. Such exemptions are required since a prospectus



The EBRD's involvement in the Russian financial market is widely recognised as contributing significantly to its development

registration involves the production of a number of documents that IFIs are, by their very nature, unable to provide (and for which they used to have specific exemptions). We are confident that previously established exemptions governing IFI issuance will be reinstated.

Furthermore, an important prerequisite for an efficient capital market is the development of financial derivatives and access by locals and foreigners to domestic hedging instruments. This requires an adequate legal and regulatory treatment of over-the-counter derivatives transactions. In this respect, the EBRD is fully supportive of the recent promulgation of amendments to Russia's securities and bankruptcy legislation¹⁰ that have introduced the concept of close-out netting in Russia. These amendments came into effect on 11 August 2011 and should become fully operational on the enactment of certain implementing regulations by the FSFM.

Once the amendments are implemented, close-out netting provisions will be recognised and enforced in relation to derivative instruments, repo transactions, foreign exchange and certain securities transactions entered into between eligible counterparties and documented under eligible master agreements. Despite certain issues raised by various market participants in connection with these amendments (including eligibility

criteria, reporting and registration requirements, lack of clarity in respect of collateral transfers and so on) they are widely considered to be a very positive development for the Russian financial system. They should remove major barriers that have limited derivatives and financial markets business within Russia and allow wider access of foreign entities to the Russian securities, currency and derivatives markets (for further reading see Vladimir Khrenov's article "Close-out netting in Russia: Are we almost there?" on page 74).

Conclusion

The above developments in the securities and insolvency legislation, together with a new legal framework for clearing activities provided by the new Clearing Law,¹¹ should facilitate securities, derivatives and other financial transactions under Russian law. The EBRD's involvement in the Russian financial market, both on the regulatory level (through ongoing dialogue on technical and policy matters) and by issuing bonds and entering into other financial transactions in the local market, is widely recognised as contributing significantly to its development. Provided it is further supported by a broader effort in regulatory and infrastructure building, there is a good prospect for developing a more liquid, sound and resilient local financial market in Russia and the country's greater integration in the global capital markets.

Notes

Author

¹ Article 2.1(v) of the Agreement Establishing the European Bank for Reconstruction and Development.

² Federal Law "On the Securities Market" No. 39-FZ dated 22/4/1996 (the "Securities Market Law").

³ Organisation for Economic Co-operation and Development.

⁴ The Financial Action Task Force on Money Laundering.

⁵ The Council of Europe Select Committee of Experts on the Evaluation of Anti-Money Laundering Measures.

⁶ Federal Service for Financial Markets.

⁷ Regulation of the FSFM No 10-20/pz-n "On the approval of the Procedure for registration of prospectuses of foreign issuers' securities and for admission of foreign issuers' securities to placement and/or public circulation in Russia based on the decision of the federal state body for the securities market" (the "Regulation 10-20").

⁸ Order of the FSFM No 11-46/pz-n "On the approval of the Regulation on the disclosure of information by issuers of securities" (the "Disclosure Regulation").

⁹ Order of the FSFM No 07-4/pz-n "On the approval of Standards of issuance of securities and registration of securities prospectuses" (the "Issuance Standards").

¹⁰ Federal Law "On Amending certain legal acts of the Russian Federation following the enactment of the Federal law "On Clearing and Clearing Activities"" No. 8-FZ dated 07/02/2011.

¹¹ Federal Law "On Clearing and Clearing Activities" No. 7-FZ dated 07/02/2011 (the "Clearing Law").



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05

Close-out netting and the world of derivatives in central and eastern Europe and beyond – ISDA's perspective

DR PETER M WERNER

Legal certainty as to the enforceability of close-out netting and financial collateral arrangements is crucial for any cross-border derivatives transaction in over-the-counter (OTC) derivatives. A number of related issues (for example, conflict of law rules) have become more relevant in recent years as well. The International Swaps and Derivatives Association (ISDA) currently focuses its law reform work on around 30 emerging market jurisdictions across Europe, the Middle East and Africa in order to improve the local legal and regulatory framework. Particular emphasis is given to jurisdictions in central and eastern Europe, the south-eastern Europe/Commonwealth of Independent States region, that is, the EBRD's countries of operations. This article summarises the ISDA's views on recent developments in this region.



Introduction: the importance of close-out netting

ISDA is the global trade association representing leading participants in the privately negotiated derivatives industry, a business that includes interest rate, currency, commodity, credit and equity swaps, options and forwards, as well as related products such as caps, collars, floors and swaptions.

ISDA has over 830 member institutions from 60 countries worldwide. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end-users that rely on (OTC) over-the-counter derivatives to efficiently manage the financial market risks inherent in their core economic activities.

Promoting legal certainty for cross-border financial transactions through law reform has

been one of ISDA's core missions since it was chartered in 1985. ISDA publishes the ISDA Master Agreement, which is the standard documentation template used for cross-border transactions in OTC derivatives across the globe. Along with standard documentation ISDA publishes industry legal opinions on the enforceability of close-out netting as well as financial collateral arrangements.

The main starting point for every law reform effort aimed at improving legal certainty for OTC derivatives transactions entered into with counterparties from emerging market jurisdictions is the enforceability of close-out netting and financial collateral arrangements (in a very limited number of jurisdictions the issue of anti-wagering provisions needs to be addressed also).

Close-out netting is the primary means of mitigating credit risks associated with OTC derivatives transactions. The risk mitigation



By the middle of 2011 over 40 countries had enacted legislation that provides explicitly for the enforcement of close-out netting

benefits of netting are substantial: according to the Bank for International Settlements's regular surveys, netting benefit, measured as the difference between gross mark-to-market value and credit exposure after netting, has been over 85 per cent for many years now.¹

Support for netting is practically universal in the financial industry as well as among policy-makers; by the middle of 2011 over 40 countries had enacted legislation that provides explicitly for the enforceability of close-out netting (several more jurisdictions allow for the enforceability of close-out netting without the need for specific statutes). The longstanding consensus among industry and policy-makers suggests that addressing close-out netting is one of the more successful examples of international legal and regulatory harmonisation. Most recently, in July 2011 and November 2011, respectively, the Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board (FSB) reaffirmed their support for close-out netting.²

In reaffirming its support, however, both BCBS and FSB called for short delays to termination and close-out of insolvent financial institutions in order to allow time to transfer the insolvent firm's financial contracts to a solvent firm. The general suggestion is to have such delays limited to two business days at most. While highlighting the importance of netting and financial collateral as part of systemic risk reduction, there is the perceived need for a temporary stay in connection with the exercise of transfer powers. A delay is said to be for the purpose of giving resolution authorities time to decide which assets or liabilities of a failing firm should be transferred, and also to effect the transfer. This perception arises from the belief that the ability to close-out early will lead financial creditors to make a "disorderly rush for the exits". The effect is a temporary stay of the initiation of the close-out netting process, namely, the early termination of transactions following an event of default.

The need for cross-border coordination in matters around bank resolution provides more reasons to ensure that a sound legal framework underlies netting of financial contracts in every jurisdiction.

The objective of this article is to show the necessary conditions for netting to mitigate

risk effectively. The first section describes the mechanics of close-out netting. The second section reflects the situation in central and eastern Europe, south-eastern Europe and the Commonwealth of Independent States (CEE/SEE/CIS) region in particular.

What is netting?

Master agreements are regularly used as contracts under which over-the-counter derivative transactions between two counterparties take place. Each transaction is not a separate contract, but is incorporated by reference into a *single agreement*. Most cross-border transactions in OTC derivatives transactions worldwide are documented under the ISDA Master Agreements. Netting takes two forms in the ISDA Master Agreement (as well as several of national equivalents for domestic transactions). *Payment netting* takes place during the normal business of a solvent firm, and involves combining offsetting cash flow obligations between two parties on a given day in a given currency into a single net payable or receivable; payment netting is essentially the same as *set-off*.

The other form of netting is *close-out netting*, which applies to transactions between a defaulting firm and a non-defaulting firm. Close-out netting refers to a process involving termination of obligations under a contract with a defaulting party and subsequent combining of positive and negative replacement values into a single net payable or receivable. Chart 1 shows how netting works. The defaulting and non-defaulting party are engaged in two swap transactions: for the non-defaulting party, Transaction 1 has a negative replacement cost of USD 1 million while Transaction 2 has a positive replacement cost of USD 800,000. If close-out netting is enforceable, the non-defaulting party is obliged to pay the net difference of USD 200,000 to the defaulting party. Had the net amount favoured the non-defaulting party, the non-defaulting party would become a general creditor to the defaulting party for the net obligation. But if close-out netting were not enforceable, the non-defaulting party would be obliged immediately to pay USD 1 million to the defaulting party but then wait, possibly months or years, for whatever fraction of the USD 800,000 gross amount it recovers in bankruptcy. The result of close-out netting is to reduce credit exposure from gross to net exposure.



The close-out netting process involves three steps: termination, valuation and determination of net balance

The close-out netting process involves three steps: termination, valuation and determination of net balance. Termination means that the non-defaulting party puts an end to the obligations under the Master Agreement. The second step, valuation, is the process of determining the replacement cost of each transaction under the contract. Lastly, determination of net balance means that positive values – those owed to the non-defaulting party – and negative values – those owed by the non-defaulting party – are netted against each other under the single agreement in order to determine a final *close-out amount*.

What happens next depends on which party owes the netted close-out amount to the other. If the defaulting party owes the close-out amount to the non-defaulting party, the non-defaulting party can apply the value of collateral posted by the defaulting party to the net obligation. Collateral in excess of the net obligation must be returned to the insolvency administrator; alternatively, the non-defaulting party's residual claim after netting and application of collateral will be treated the same as other unsecured claims, and will be paid at the same time as other unsecured claims as determined by a bankruptcy court. But if the non-defaulting party owes the close-out amount to the defaulting party, it may set off the amount that it owes against the amount owed to it by the defaulting party under other, non-derivative contracts. The non-defaulting party will pay to the insolvency administrator any net close-out amount remaining after set-off.

Why close-out netting is necessary

Close-out netting is an essential component of the hedging activities of financial institutions and other users of derivatives. For swap dealers, who specialise in bringing counterparties together for transferring risk, the need for netting stems from the dealer's central role in risk intermediation. Each time a dealer enters into a transaction with a counterparty, the dealer takes on exposure to the transferred risk. The dealer does not normally wish to retain the exposure however, so it enters into offsetting hedge transactions. By maintaining a *matched book* – or more accurately, a *balanced book* – of offsetting transactions, the dealer avoids unwanted exposure to movements in interest rates, currencies and other sources of market risk. The result of this hedging activity is that, over time, the aggregate of derivatives activity includes a large number of inter-dealer and other hedge transactions that function largely to adjust risk positions and limit exposure to market movements. Indeed, the trillions of dollars of derivative notional amounts outstanding are largely the result of this ongoing hedging and rebalancing process.

Dealer hedge transactions involve many counterparties, all of which pose some risk of default. If the counterparty were to default, the dealer can no longer assume its exposures are hedged. The dealer will consequently find himself exposed to unanticipated market movements. In order to neutralise the exposures, the dealer needs to adjust the portfolio to bring it back into balance by either replacing the defaulted transactions or by unwinding the

Chart 1
Payment obligations with and without close-out netting

Close-out netting under Sec. 6 of 2002 ISDA Master Agreement



If close-out netting is not enforceable





**Across the CEE/
SEE/CIS region there
have been major
developments in the
legal frameworks
for OTC derivatives
transactions**

offsetting hedge transactions, or both. Netting and collateral facilitate this rebalancing process; netting, by reducing the exposure that needs to be rebalanced and collateral, by providing resources that can be offset against replacement costs. Even when derivatives are cleared through a central counterparty, it is necessary to balance market risks; if a default occurs under clearing, close-out netting is essential to the ability of the clearing house to manage its risks through rebalancing.

Similar considerations apply to users of derivatives. In contrast to dealers, derivatives users such as corporations or hedge funds do not maintain a matched book, yet they do seek to attain a desired risk profile. A corporation, for example, might use derivatives to control its exposure to currency fluctuations, while a hedge fund might use derivatives in arbitrage or relative value trades. If a dealer were to default, these counterparties would need to replace the defaulted transactions in order to return to their desired risk positions. As with dealers, netting would facilitate returning to the desired exposures.

Necessary conditions for netting

In some jurisdictions, most notably England and other jurisdictions that follow English legal traditions, established insolvency law supports the right of creditors to pursue the close-out netting process following the insolvency of a counterparty. But in many jurisdictions, insolvency laws and other statutes place restrictions on a creditor's ability to implement the process. In the United States, for example, the Bankruptcy Code does not normally recognise *ipso facto clauses* that allow termination of a contract as a consequence of bankruptcy. Further, the United States and many other jurisdictions place "stays" on the ability of most creditors to pursue their claims against a debtor that files for bankruptcy and to apply collateral posted by the debtor. Lastly, insolvency administrators might engage in *cherry picking*, which involves an insolvency administrator demanding performance of contracts favourable to the bankrupt firm but rejecting contracts burdensome to the bankrupt firm.

In most countries, it has been necessary to enact specific netting legislation in order to achieve statutory recognition of the elements of the netting process described above. More

than 40 jurisdictions have enacted – and several more are considering – legislation that explicitly provides for the enforceability of close-out netting. ISDA also collects legal opinions regarding enforceability of the close-out netting provisions of the ISDA Master Agreement with counterparties located in a particular jurisdiction. ISDA currently has netting opinions for almost 60 jurisdictions. And similarly, ISDA has obtained opinions regarding the enforceability of ISDA Credit Support Documents in around 50 jurisdictions.

**Country-specific developments
in the CEE/SEE/CIS region**

In 2011 a large number of jurisdictions across the CEE/SEE/CIS region have experienced significant developments regarding the legal and regulatory framework that affects transactions in OTC derivatives. The paragraphs below summarise and assess developments as of December 2011.

Those jurisdictions in the region that are also EU Member States had to implement the EU directive amending the settlement finality directive and the financial collateral arrangements directive (2009/44/EC; Amending Directive) in 2011. The main feature of the Amending Directive from the derivatives point of view is the addition of credit claims as an eligible type of collateral to financial collateral arrangements. A number of EU Member States have used the opportunity of implementing the Amending Directive to also improve the existing legislation on netting and collateral arrangements.

In Slovenia, the legislator broadened the scope of counterparties eligible for financial collateral arrangements to include corporates. This brings the local collateral regime in line with the new Slovenian netting legislation that was adopted in 2010. As a result of this, positive industry legal opinions can now be obtained.

Thus far, the relevant EU legal framework does not provide for any substantive provisions on close-out netting. Neither the EU directives on Settlement Finality (98/26/EC), Winding-up of Credit Institutions (2004/EC), Financial Collateral Arrangements (2002/47/EC) nor the EU Banking Directive (2006/48/EC) or Insolvency Regulation (1346/2000) contain any such provisions. They merely make reference to netting agreements.



Amendment to the Bankruptcy Act in Poland has done away with uncertainty regarding enforcement of financial collateral arrangements

Lithuania, for the first time, adopted substantive netting legislation while implementing the Amending Directive. Thus far, the relevant EU legal framework does not provide for any substantive provisions on close-out netting. Previously, the country had been one of the four remaining EU Member States without any substantive law on netting. Previously and similar to Bulgaria, Estonia and Latvia, only the initial EU Directive on Financial Collateral Arrangements had been implemented. However, this directive does not provide for substantive provisions on close-out netting. It only assumes that netting agreements are enforceable in each EU Member State based on previously existing local law.

In Bulgaria, besides no netting legislation being in place, the existing framework for collateral transactions continues to be sub-optimal. The implementation of the Amending Directive led to increased uncertainties as to the inclusion of non-EU based entities that enter into financial collateral transactions. These issues need to be addressed in the future.

Significant progress has been made in Poland in 2011. Amendments to the Bankruptcy Act have done away with uncertainty, which had so far prevented market participants from obtaining positive industry opinions on the enforceability of financial collateral arrangements. The latest amendments expressly state that collateral transactions (and securities lending transactions) fall within the scope of eligible transactions under the existing netting regime.

In early 2011 a new Law on Collateral entered into force in the Czech Republic. It consolidates the various pieces of collateral-related provisions scattered across a number of laws into a single Act. However, some ancillary provisions outside of the new law regarding the conflict of law rules relating to securities held as collateral are out of sync with international standards. Industry has approached the local authorities about this. Such international standards include the conflict of law provisions in, *inter alia*, the Hague Securities Convention.

While in the Slovak Republic the existing insolvency regime has been clarified to expressly state that measures applied under the so-called involuntary administration do not negatively impact the validity and enforceability

of netting agreements, other concerns raised by market participants remain unresolved for the time being. The main concerns are about the scope of eligible counterparties for both netting and collateral agreements as corporates remain outside the scope. This limited scope is contrary to the trend across all Member State jurisdictions. An additional concern stems from new requirements to disclose financial contracts entered into with Slovakian public entities. The new provisions stipulate that non-disclosed transactions may become unenforceable (as of January 2012).

In Hungary, several pieces of legislation have been adopted which are not necessarily in sync with the existing wider local regime for netting and collateral agreements. A new law on the insolvency of certain enterprises that are deemed “of national importance” has been introduced. Thus far, the legislator has not adopted any list of entities that are considered to fall within this group. Neither has it been expressly clarified if the new provisions are meant to be outside of the existing (positive) legal framework for netting and collateral arrangements in Hungary. Another law adopted with effects on derivatives transactions deals with loans and mortgages denominated in foreign currency. The new provisions allow repayment of foreign currency-denominated loans and mortgages at exchange rates that are way below market rates. The aforementioned new laws raise several issues as to the compatibility with EU law. As the new laws override existing contractual arrangements agreed upon by the counterparties, a degree of legal uncertainty is being introduced. The economic terms of these contracts were used as a guideline for the economic conditions of the hedging transactions related to the relevant mortgage and loan agreements.

In Romania, the local legal regime for netting and collateral transactions has been subject to some reservations expressed by market participants. Existing inconsistencies were not removed at the time of implementing the Amending Directive. However, certain developments that stem from draft provisions prepared for more general purposes of the Civil Code (for example, proposals to introduce the concept of “economic hardship”) and the Insolvency Act (for example, acceleration upon insolvency of the debtor) may cause additional problems.



Attempts to draft comprehensive legislation to cover all issues related to derivatives in a single law have failed

These issues have to be clarified before legal certainty for transactions with Romanian counterparties increase and market participants will be able to obtain positive legal opinions.

CEE/SEE jurisdictions outside of the EU area where significant developments relating to derivatives have occurred include Serbia and Croatia.

In Serbia, new provisions have been added to the Bankruptcy Act that allow for “insolvency set-off”. From the current wording in the law it is not entirely clear if this terminology is meant to include forms of netting other than by way of set-off as well. The latter is just one among several ways of achieving netting. Furthermore, the new Foreign Exchange Act has not clarified a number of existing uncertainties around currency trading. Market participants will continue to work with local authorities.

Croatia has undertaken efforts to implement various pieces of EU legislation before its accession to the European Union in 2013. However, inconsistencies across various pieces of Croatian legislation with regard to the definition of close-out netting remain. Industry has made several submissions to the authorities to highlight the issues.

In the CIS region the three jurisdictions most relevant to the derivatives markets in terms of volumes are Russia, Kazakhstan and Ukraine. Jurisdictions with nascent market activities include Armenia, Azerbaijan and Georgia.

After several years of debate, Russia has enacted substantive netting legislation that entered into force in the summer of 2011. For the first time, netting with certain Russian counterparties will be enforceable. However, netting will become operational and enforceable only once two pieces of secondary legislation have entered into force. The lead regulator needs to enact a regulation on eligible documentation used for transactions with Russian counterparties as well as a regulation on trade repositories and reporting of these transactions. At this stage the scope of the latter regulation remains unclear. It will be crucial to define the reporting requirements in a way that is manageable from an operational perspective and in line with emanating global standards (for example, CPSS-IOSCO). Once these two

regulations are in force, market participants and industry will be able to obtain netting opinions on Russia. This is significant progress. One major issue that needs to be addressed is an upgrade of the Russian legal framework for collateral transactions (in particular, the recognition of title transfer arrangement).

In Kazakhstan, the current legal regime does not provide for the enforceability of netting and collateral arrangements. Amendments to the Bankruptcy Code, adopted in 2009 to address restructuring of financial institutions, did not address this issue. A draft law currently under consideration to achieve what is referred to as “risk minimisation in the banking sector” does not include any such provisions either, despite legislating for capital market transactions that include OTC derivatives. This draft law certainly requires heightened attention from market participants.

Over the last couple of years, several attempts have been made in Ukraine to draft comprehensive legislation to cover all issues related to derivatives in a single law. However, these attempts have failed and not surprisingly no such attempt has succeeded in any other jurisdiction. It usually is more efficient and practical to address derivatives-related issues in a number of different laws. Previous drafts have shown insufficient reflection of market realities and structures and were therefore abandoned. In June 2011, another attempt has been undertaken to revive this draft bill. It remains to be seen if comments from the markets will be reflected in any re-draft or may lead to an approach that addresses the issues in a more appropriate way.

It appears worthwhile to mention several law reform projects at regional and global levels, which are likely to have an impact on jurisdictions across all regions. With regard to the legal framework for netting and collateral transactions in all EU jurisdictions, one would look with great attention to the EU initiatives on cross-border crisis management and bank resolution, the proposed netting directive/regulation (both due in early 2012), as well as the forthcoming review of the EU Insolvency Regulation (in mid-2012). Global projects initiated in 2011 by the FSB (Financial Stability Board) and UNIDROIT (International Institute for the Unification of Private Law) on cross-border banking resolution

Notes

and global principles for close-out netting, respectively, will provide useful guidance for further law reform affecting the derivatives markets in the CEE/SEE/CIS region.

Conclusion

Significant progress has been made in emerging market jurisdictions across the CEE/SEE/CIS region in 2011. Against a backdrop of ongoing multi-layered activities at the global, regional and national levels, market participants sometimes observe the lack of a great degree of coordination. Looking ahead, market participants will have to keep an eye on any inconsistencies between the various projects.

¹ The Bank for International Settlements (BIS) publishes statistics on volumes in OTC derivatives on a regular basis, for example, BIS, Semiannual OTC derivatives statistics end-June 2011, published in November 2011, www.bis.org/statistics/derstats.htm (last accessed 6 January 2012)

² Basel Committee on Banking Supervision, Report and Recommendations of the Cross-Border Bank Resolution Group, March 2010, pp.36 et seq, Recommendation 9; Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions; October 2011, pp. 10, 41 et seq; European Commission, DG Market Working Document, Technical details of a possible EU framework for bank recovery and resolution, January 2011; chapter G11/part 4.

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06

Regulatory framework of Egypt's capital market: room for reform?

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The Egyptian capital market was reborn during the last two decades and has been developing since then. This article discusses the regulatory framework of the Egyptian capital market and highlights some of the recent and potential reforms.



Introduction

Considered to be among the oldest markets in the region, the securities market in Egypt dates back to the 19th century, to 1888 to be exact, when Alexandria Exchange was established, followed by the Cairo Exchange in 1903. These two securities exchanges were very active in the 1940s and, at one point, were ranked in the top five exchanges in the world. Due to various government policies adopted in the mid 1950s, they were largely dormant until the early 1990s when new reforms were implemented.

In 2007 the two exchanges were merged into one exchange, government owned and controlled, and called the Egyptian Exchange (EGX) which became the only registered securities exchange in Egypt. By 2010 the number of activities and mechanisms which fell under the supervision of the capital market regulator rose to incorporate more than 16 different activities

including, *inter alia*, promoting and underwriting in securities, securities brokerage, portfolio management, mutual funds, fund management, venture capital, advisory services in relation to securities, management services in relation to mutual funds, settlement and set-off services in relation to securities transactions, margin trading services and intraday trading services.

This article highlights the current regulatory framework of Egypt's capital market and touches on recent and potential reforms.

General legal framework

Main legislative and regulatory framework

The capital markets in Egypt are regulated by the Egyptian Financial Supervisory Authority (EFSA). It was established as a public authority with independent legal status and is managed by a board of directors. It was established to supervise all non-banking financial activities



There was anticipation in the market that legislation would be updated to widen the categories of securities that can be listed

in Egypt, including capital market operations. It also acts as the supervisory authority for the board of directors of EGX. On 1 July 2009 EFSA began operations and officially replaced the Capital Market Authority, the former capital markets regulator.

The EFSA has a wide range of discretionary powers to issue binding directives for issuers and financial service providers in Egypt. EFSA oversees key market participants such as member firms, mutual funds, investment banks and rating companies. In addition, EGX has its own internal regulatory remit and has established a number of committees including the “Listing Committee” whose mandate is to regulate compliance with the Board of Directors Decree no. 30 for 2002 the former Capital Market Authority, now the EFSA (*Listing Rules*) and the Capital Markets Law No. No. 95 for 1992 (*CM Law*).

Several laws, regulations and decrees govern admission to listing and ongoing disclosure requirements.³ There was anticipation in the market that the current legislation will be updated in due course, so as to widen the categories of securities which can be listed (for example, futures, options and swaps) and to reform the corporate governance regulations for issuing companies. However, there have been no subsequent statements in relation to these anticipated developments, which might imply that they have been put on hold due to the “Arab Spring”.

Securities offering

Public offering

Conducting an initial public offering (IPO) in Egypt requires, *inter alia*, a shareholders’ resolution with special majority, fair value report by an independent financial adviser and a subscription prospectus subject to EFSA’s approval. Approaching the regulator at an early stage of any proposed IPO is advisable in Egypt to ensure that the process is conducted as smoothly as possible.

As with most jurisdictions, the issuer will need to appoint appropriate advisers at an early stage in the process in order to assist with the complexities of the IPO process. Typically such advisers would include lawyers, investment banks/underwriters, brokers and financial

advisers. Underwriters need to be licensed by EFSA. According to the CM Law, the minimum capital for companies offering shares in an IPO is EGP 1,000,000 (around USD 90,000) and provided that founders subscribe in at least 50 per cent of the company’s share capital.

It must be noted here that there is a distinction between the offering of securities to the public and admission to listing on EGX. It is not possible to carry out these two processes in parallel as the listing on EGX is a subsequent step to the IPO procedure. The IPO process (which includes the preparation and submission of the prospectus) is supervised by, and requires the approval of, EFSA.

On the other hand, listing is done through EGX. The Listing Committee of EGX is responsible for reviewing and verifying all applications and for providing the approval for listing.

It is not clear from the black letter of the law whether unlisted shares in the secondary market can be offered in a public offering. The regulations and procedures set out in the CM Law related to public offering assume that the public offering of shares is made in the primary market only (that is, shares issued by the company either in the incorporation process or for capital increase). In practice, however, there has been a precedent in the Egyptian market in 2010 for public offering of shares of a company in the secondary market, under which some of the existing shareholders of the company sold a portion of their shares in a public offering.

Public offering of shares in the secondary market may introduce additional flexibility for unlisted companies as it may offer an easy exit for a strategic investor in an unlisted company without the need to search for qualified investors as required in the private offering. Companies may also benefit from this if a company which satisfies the minimum capital for listing on EGX wishes to go public as a first step to being listed on EGX without having to increase its capital. Accordingly, we believe that this can be subject for consideration for development through future regulators aiming at creating a balance between the increasing market needs for flexibility and the protection of retail investors in the Egyptian capital market.



A company must have a fully paid up capital of at least EGP 20,000,000 to list its shares on the Egyptian Exchange

Private offering

A private placement, unlike an IPO, is targeted at certain types of persons who are deemed to be “qualified investors” for the purposes of the regulations. A private placement does not require the submission of a subscription prospectus, unlike an IPO, but requires the submission of an information memorandum which contains less detailed information compared with an IPO prospectus.

Qualified investors must either satisfy certain financial criteria⁴ or have adequate experience of the securities market.⁵

Marketing securities

An issuer must ensure that its marketing materials are true, accurate, up-to-date and not misleading so as to mitigate any potential action by investors. In addition, any entity wishing to market securities in Egypt must be licensed by EFSA to market and underwrite securities in Egypt. It is a criminal offence for any other person to do so.

While the prospectus must be approved by EFSA before publishing, the CM Law allows for certain marketing materials to be distributed before obtaining EFSA's approval, but only after the filing of the application to approve the prospectus (with respect to an IPO). Any such materials may only contain basic information about the issuing company and must also include a very clear and prominent warning that the prospectus has not yet been approved by EFSA.

Once approved by EFSA, a summary of the prospectus should be published before the offer is due to commence, or, as the case may be, within 10 days of the approval of any amendments to the prospectus. Thereafter, the subscription period must remain open for a period of not less than 10 days and not more than two months (although this may be extended by EFSA if the offer is not fully subscribed during this period).

Listing on EGX

Regulatory requirements

The listing of shares on EGX is predominantly governed by the Listing Rules which include the eligibility criteria which must be satisfied before securities can be listed. The CM Law includes the underlying regulatory regime of EGX as well as

some additional general disclosure obligations relating to the contents of the offer document.

For a company to list its shares on EGX it must have a fully paid up capital of at least EGP 20,000,000 (about USD 3,308,600) comprising of at least 2,000,000 shares.

In addition, the company applying for listing must satisfy certain criteria set out in the Listing Rules, such as a minimum of 100 shareholders and a minimum free float of 5 per cent of its share capital.

It is worth noting that some of the listing requirements set out in the Listing Rules require ongoing compliance. The Listing Committee monitors these requirements on an ongoing basis and a listed company may be mandatorily delisted⁶ from EGX if non-compliance is not remedied within certain grace periods decided by EGX.

Dual/secondary listings

It is also possible for foreign issuers to have a dual primary listing in Egypt provided their securities are already listed on a recognised exchange (that is, a foreign exchange which is subject to the supervision of authority which exercises authorities similar to the authorities of EFSA). Such foreign securities will also have to meet the eligibility criteria as set out above.

In addition, it is possible to register Egyptian issued depository receipts for offshore issuers and this latter possibility is common in practice. In 2010, a Swiss company having depository receipts on EGX, Orascom Development Holding (AG), launched a rights issue on the Swiss Stock Exchange involving Egyptian depository certificates, which was the first rights issue offered for holders of Egyptian depository certificates in the Egyptian market.

Compliance

Corporate governance

Corporate governance is a growing subject in Egypt. There is currently no single all-encompassing code for corporate governance in Egypt. The fiduciary duty and corporate governance related regulations can be found in several different laws and regulations including the Listing Rules, the CM Law and the Companies Law.



Any trade of listed shares must be concluded through the Egyptian Exchange and must be purchased from the open market

In 2007 EFSA issued governance rules (the “EFSA Rules”) which must be followed by all companies incorporated under the CM Law (that is, companies that perform one or more of the capital market activities as set out in the CM Law). EFSA Rules include further governance requirements in relation to, *inter alia*, the composition of the board of directors, structure of the mandatory board sub-committees, disclosure requirements, conflict of interest and internal trading, dividend distribution and internal supervision.

In addition, every listed company must have an audit and compliance committee comprising at least three non executive directors. Companies which fail to comply with any corporate governance requirements are typically fined. EGX has recently indicated that it intends to adopt a more robust approach to compliance.

Furthermore, as a general protection, any shareholder may, before the Egyptian courts, challenge the decision of the general assembly which has been issued in prejudice to or in favour of a specific group of shareholders.

With respect to trading, there are no black out periods (that is, periods during which shareholders or certain persons related to the issuing company are prohibited from concluding any trades on the company's shares) that must be complied with apart from:

- (i) any persons connected to the issuing company may not deal in the company's shares within the period of 15 days before and three days after the company has released to the market any material price sensitive information
- (ii) no transfers of ownership of shares shall be effected within the period starting from the date on which the invitations for the company's shareholders' general assembly is sent until the conclusion of the shareholders' general assembly.

Ongoing compliance for listed companies

The disclosure section of the Listing Rules (the Disclosure Rules) sets out the ongoing compliance obligations for any company listed on EGX.

In addition to the list below, listed companies must provide EGX and EFSA with their quarterly financial statements (which must

be reviewed by auditors) and must publish their annual and semi-annual financial statements in two daily Egyptian newspapers.

The reporting requirements under the Listing Rules are split into two main areas:

- (i) any listed company must immediately report to EGX any change to the information set out in the issuer's listing application or in its board of directors' annual reports
- (ii) all listed companies must appoint an investor relations officer who is responsible for reporting to EGX and for publishing press releases (which includes information that is required to be published by EGX).

Securities trading

Any trade of listed shares must be concluded through EGX and must be purchased from the open market. Orders are placed on EGX only by licensed member firms (that is, licensed securities brokers) and executed through the system. Trades may also be carried out through protected transactions under the rules and procedures set out by EGX and as approved by EFSA. EGX has indicated some illustrative examples of when its Trading Committee may grant a protection such as connected party deals and a bank exercising a pledge. While these are only examples and there is a clear power for the chairman of EGX to refer other cases to the Trading Committee to consider giving a protection, in practice, EGX and EFSA are reluctant to use their discretion and grant any protection in cases other than those explicitly mentioned in the Trading Committees rules.

As for non-listed shares, trading must also be concluded through a broker licensed by EFSA who will effect and complete the transaction. Unless the unlisted company has offered any of its shares to the public, there are no notice requirements and no mandatory offer obligations or pre-emption rights, except in cases where otherwise provided for in the statutes of the company.

Clearing and settlement

Listed shares

All listed shares are held in dematerialised form and are managed by Misr for Clearing Depository and Registry (the MCDR), which is the sole central depository company in Egypt and



There are no material nationality requirements or restrictions in relation to ownership of securities in any Egyptian company, whether listed or not

the sole entity authorised to perform clearing and settlement for all shares traded on EGX. Clearing and settlement is done on a delivery versus payment basis, whereby MCDR acts as the clearing house between the buying and selling member firms. The MCDR is responsible for the settlement of member firms' accounts at the request of and notification by EGX.

The broker will receive the buy or sell order and will then confirm with the custodian or settlement bank that the subject shares or funds required to complete the transaction are available. The broker will execute the deal at the exchange which in turn will notify the MCDR of the transaction. The MCDR will thereafter notify the broker and the custodian of the transaction and settlement will occur on T+2. The MCDR is also responsible for the recording of pledges of dematerialised shares, whether listed or unlisted.

Unlisted shares

Unlisted shares may be materialised (that is, issued in the form of physical share certificates backed up by the shareholders' ledgers held by the issuing company) or dematerialised (that is, centrally deposited with MCDR). Any trades over unlisted shares, whether materialised or dematerialised, must be executed by a licensed securities broker and registered at EGX. The title to the shares is legally transferred to the purchaser on the date EGX issues a certificate of the transfer of ownership. Afterwards, the purchaser of the shares is recorded as the owner of the shares either in the shareholders' ledger (with respect to materialised shares) or in MCDR registers (with respect to dematerialised shares).

Securities ownership restrictions

In general, there are no material nationality requirements or restrictions in relation to the ownership of securities in any Egyptian company, whether listed or not.

Also there are no absolute ownership restrictions with regard to specific sectors; however, the approval of the relevant sector's regulator is required for ownership of shares in Egyptian companies working in certain sectors. For example in the banking sector, any investor who wishes to acquire, directly or indirectly, five per cent or more of the issued share capital of an Egyptian bank must notify the Central Bank of Egypt (CBE). The prior approval of the

CBE is required if any such investor wishes to acquire 10 per cent or more of the issued share capital of the bank in question.

Similarly, any entity which wishes to acquire five per cent or more of the issued share capital of an insurance company must notify EFSA, and must obtain the prior approval of EFSA if the acquisition is for 10 per cent or more of the issued share capital of the insurance company in question.

In addition, the prior approval of the Chairman of the General Authority for Investment and Free-zones must be obtained for the transfer of title in the shares of companies running business in the Sinai area.⁷

There are various notification thresholds that apply to any persons acquiring the share of listed companies or unlisted companies which offered shares to the public, including prior-acquisition notification thresholds⁸ and post-acquisition notification thresholds.⁹ The consequences for violation of the said thresholds vary from discretionary measures applied by EGX and/or EFSA, including warnings or fines, to invalidation of the acquisition of the shares and mandatorily reversing the transaction.

Takeovers

Chapter 12 of the Executive Regulations to the CM Law was introduced in 2007 (the Takeover Rules). Takeovers fall under the ambit of EFSA's jurisdiction.

The Takeover Rules apply to all listed Egyptian companies and to any unlisted Egyptian company that has offered any shares to the public in Egypt. Foreign companies which have chosen to list their securities on EGX on a secondary or dual basis are also subject to the Takeover Rules, unless explicitly exempted by virtue of a decision by EFSA.

In general, the Takeover Rules set out a number of objective cases which justify the exemption from the said rules (for example: inheritance or mergers) and reserve for EFSA a discretion to grant exemptions in other cases as EFSA may deem appropriate. However in practice, EFSA is reluctant to use its discretion to grant an exemption from the Takeover Rule unless the applicant secures the acceptance of 100 per cent of the shareholders of the target company to sell their shares.



There are no specific regulations in Egypt governing derivatives transactions

Any person wishing to acquire by himself, or together with persons acting in concert, one-third of the share capital or one-third of the voting rights of a company which is subject to the Takeover Rules, or increases its shareholding or controlling stake in such company above certain thresholds,¹⁰ must submit a tender offer in respect of all of the shares or the voting rights of the company, as the case may be (Mandatory Purchase Offer).

It is worth noting that there is nothing in the Takeover Rules that forces a minority shareholder to sell their shares to the offeror, hence squeezing out a minority shareholder without their consent is not possible under Egyptian law. As further protection to minority shareholders, any minority shareholder holding at least three per cent of the shares of a company subject to the Takeover Rules may force a shareholder (either alone or together with concert parties) which acquired 90 per cent or more of the issued share capital of the company to buy out the shares of the minority shareholder within one year following the acquisition of the majority interest in the company. The price at which the minority shares shall be purchased must not be less than the highest price paid by the majority shareholder in any purchase offer made during the previous 12 months.

Recent updates and potential reforms

Derivatives

There are no specific regulations in Egypt governing derivatives transactions. So far, EGX has not issued rules for trading in futures or options. Nevertheless, the concept of options is generally recognised under the Egyptian Civil Code as long as a promise to execute a contract in the future is valid and that its duration and all the essential elements of that contract are provided. Also the Egyptian Commercial Code specifically validates future contracts even if there is no intention by the parties to do anything other than pay price differences thereunder, if the trade is carried out through the stock exchange.

Yet speculation on upward or downward movements in interest rates or currency exchange could be considered as prohibited gambling. The Egyptian Civil Code renders void any gambling contract.¹¹ Consequently,

any person who loses in a game of chance may, notwithstanding any agreement to the contrary, recover what he has paid within three years of the time of payment. Accordingly, derivative transactions must be entered into for non-speculative purposes and only for a genuine commercial purpose (for example, hedging purposes).

There have been a number of statements that EGX is considering establishing a market for derivatives which was delayed following the global financial crisis and the Egyptian revolution earlier in 2011.

With respect to repurchase transactions and buy/sell back transactions, according to Article 465 of the Civil Code, if a seller, at the time of sale, retains for himself the right to purchase back the sold property within a specified period, the sale will be deemed void. Based on this Article, repurchase transactions are problematic under Egyptian law.

As an exception to the above rule, the Executive Regulations of the CM Law allow Egyptian companies which are licensed to trade in bonds by EFSA to enter into repo agreements with its customers in relation to bonds.

Also during the 2003-04 financial year, a further exception was introduced by CBE by regulating Outright Sale and Reverse Repos in relation to the Egyptian Treasury Bills for the purpose of boosting open market transactions. On 21 March 2011 a new regulation was issued in relation to repo transactions over Egyptian Treasury Bills. Under the new repo regulation, the CBE started to conclude repo agreements on a weekly basis as part of the operational framework of the CBE's monetary policy.

Margin trading

Margin trading was introduced in 2007 in Chapter (9) of the Executive Regulations of the CM Law, allowing traders to execute leveraged trades on EGX subject to opening special accounts with member firms in accordance with the margin trading rules in the Executive Regulations and the trading rules issued by the CMA and EGX. Margin trading applies only to particular shares which satisfy the criteria set out by EGX. EGX periodically publishes lists of the shares eligible for margin trading.



Uncollateralised short-selling is banned

Following the Egyptian revolution in early 2011 and as a result of the deterioration in the market value of shares a number of amendments have been introduced to the margin trading rules with the purpose of mitigating the losses of existing traders through this system, but at the same time imposing further limitations on new margin trades.

First, the Executive Regulations of the CM Law were amended to raise the statutory thresholds of client indebtedness relative to the value of the shares purchased with margin as follows:

- (i) the threshold upon which the client is required to submit additional collateral became 70 per cent (instead of 60 per cent)
- (ii) the threshold upon which the broker is entitled to mandatorily sell the client's shares purchased with margin and liquidate the submitted collateral became 80 per cent (instead of 70 per cent).

Second, EFSA issued a decree raising the advance cash payment for any shares purchased with margin to 75 per cent instead of 50 per cent.

Intraday trading

In 2005 the CMA (EFSA's predecessor) introduced the Same Day Trading mechanism, which allowed for the purchase of shares on EGX and re-selling the purchased shares during the same trading session. In 2008 the Same Day Trading system was upgraded to Intraday Trading which allowed for trading during the same session on both sides (that is, purchasing

shares and then selling them or selling shares and then purchasing them before the end of the trading session). In 2010 the Intraday Trading rules were amended to leverage the maximum limit for daily transactions for each client under the system to 1/5000 of the total number of the company's securities (instead of 1/10000).

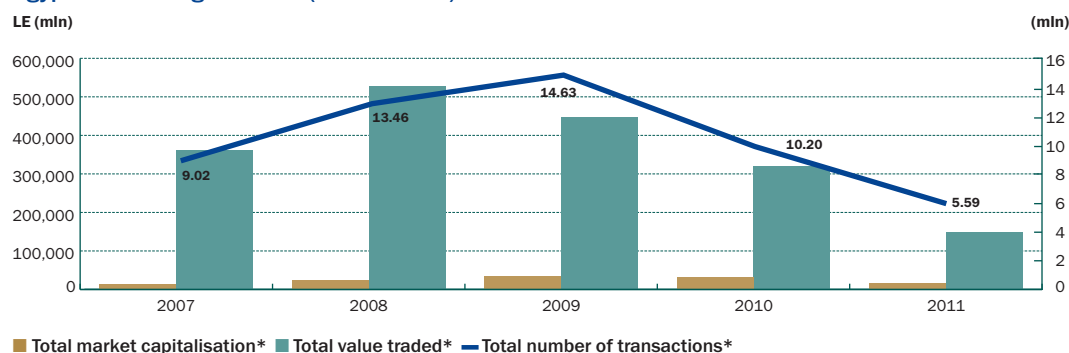
However, on 18 December 2011 EFSA imposed further limitations on Intraday transactions to suppress the maximum limit for daily transactions for each client under the system to 1/20000, which is 25 per cent of the previously applicable maximum limit. One interpretation for such further limitations is that EFSA is trying to limit leveraged speculative transactions over securities given the market fragility after the Egyptian revolution.

Short-selling

For short-selling there is a distinction between uncollateralised and collateralised short-selling. Uncollateralised short-selling is banned. According to the Executive Regulations to the CM Law, the short-seller must, before its sale, have borrowed the securities or have entered into an arrangement whereby the securities will be lent to the short-seller.

On the other hand, collateralised short-selling is in principle permitted under Egyptian law and broadly regulated under Chapter 9 of the Executive Regulations to the CM Law. Yet any such short-selling would need to be done in accordance with standards and rules to be issued by EGX in relation to securities lending. So far, EGX has not issued these

Chart 1
Egyptian Exchange volume (2007–2011)



Note. *Including listed/unlisted/ NILEX securities.
Source: Egyptian Exchange, www.egx.com.eg.



Although the “Arab Spring” may limit the development of Egyptian capital markets, regulatory framework reforms are being implemented

standards and rules, which have been frozen since the global financial crisis. Accordingly, short-selling is effectively not permitted and there have been no indications by EGX as to when securities lending will be permitted.

New Index – EGX 20

EGX has introduced a new index as of 2 October 2011. The main addition introduced in the new EGX 20 Index is balancing the Index relative weight by focusing on the mechanism of the relative weight and including the most active 20 companies in terms of liquidity and activity.

By limiting the portion of each share in the index to a maximum of 10 per cent, the new Index tries to offer a more balanced allocation of relative weights in the index to overcome the problem witnessed in the market’s principal index, EGX 30, which is the domination of a limited number of shares of significant portions of the index. This index is expected to be more appealing to Egyptian investment funds as it coincides with the statutory investment parameters for such funds limiting investment in any single share by a maximum of 10 per cent of fund assets.

Reform of the mutual funds’ regulations

A draft new chapter of the Executive Regulations to the CM Law was introduced by EFSA on 16 July 2010 with the intention of replacing the current regulations in the Executive Regulations in connection with mutual funds. Since the date of introducing the said draft, EFSA opened the door for receiving opinions and comments on the draft in preparation for the final draft to be ratified and issued by the relevant minister. However, this matter is still under consultation and there have not been any statements published confirming when the final draft is expected to be finalised.

The salient reforms proposed in the new draft intend to address previous weaknesses in the regulation in particular in relation to the corporate structure and legal personality of the fund and the lengthy procedures in relation

to fund incorporation and offering of fund certificates. In addition, the draft regulations intend to address, in more detail, the activities of specific purpose funds and fill in some of the gaps encountered in the current regulation.

Small and medium cap stock exchange – NILEX

On 13 November 2011 EGX started activating its new trading system for NILEX, as well as applying the listing rules amendments, which were announced during the press conference that was held on the same day.

NILEX is the EGX market for growing medium and small capital companies whose issued capital does not exceed EGP 50,000,000 (about USD 8,290,000) at the time of incorporation, or EGP 100,000,000 (about USD 16,577,000) after incorporation. NILEX is intended to offer medium and small capital companies a chance to raise capital with relaxed listing and disclosure requirements as well as lower listing and trading fees compared with the principal EGX market.

The trading of listed shares session is one hour per trading day under the same mechanisms used in EGX. The closing price for each share shall be calculated according to the volume-weighted average prices at the end of the trading day, subject to minimum traded quantities of at least 100 shares and minimum value of at least EGP 20,000 or its equivalent in other foreign currencies. The price limits per session should not be more than five per cent upwards or downwards and settlement of listed shares takes place on T+2.

Conclusion

The Egyptian capital market was reborn during the last two decades and has been developing since then. Although the “Arab Spring” may limit such development for a while there are still regulatory framework reforms of the Egyptian capital market being implemented and, moreover, there is a perspective for further potential reforms.

Notes

¹ Partner, Sharkawy & Sarhan Law Firm.

² Associate, Sharkawy & Sarhan Law Firm.

³ These include: (i) the Capital Markets Law No. 95 for 1992 and its Executive Regulations (the "CM Law"), which regulates EGX and capital markets issues affecting all Egyptian companies (whether listed or not); (ii) the Companies' Law No. 159 FOR 1981 and its Executive Regulations (the "Companies' Law"), which regulate incorporation and management of all Egyptian companies; and Decree of the CMA's Board of Directors no. 30, dated 18 June 2002 concerning the securities listing and de-listing rules of EGX (the "Listing Rules"), as amended in 2008, 2009, 2010 and 2011, regulating all matters relating to the listing of securities on EGX (including the eligibility criteria) and ongoing compliance obligations once listed.

⁴ Different criteria are proscribed depending on whether the investor is a natural or a legal person. Natural persons will be treated as "qualified investors" if they satisfy at least one of the criteria set out by EFSA, which include, *inter alia*, ownership of assets of no less than EGP 2,000,000 (about USD 330,900) or annual income of no less than EGP 500,000 (about USD 82,700). As for a company or a legal person, it will be treated as a "qualified investor" if at least one of the criteria set out by EFSA is satisfied; which include, for example, ownership of equity with a book value of no less than EGP 10,000,000 (about USD 1,654,300) or ownership of assets with a total book value of no less than EGP 20,000,000 (about USD 3,308,600).

⁵ An investor will also be treated as a qualified investor if he has at least five years' experience in the field of securities and capital markets (whether national or international). Such a minimum experience period shall be reduced to four years only in relation to investors who successfully passed the relevant training courses accredited by EFSA.

⁶ Under the Listing Rules, securities listed on EGX may be de-listed in a number of circumstances such as if the listing was based on incorrect information, the company's failure to comply with the disclosure requirements of the Listing Rules or the passage of six successive months without any trading on the listed securities.

⁷ Sinai is a peninsula located on the north-eastern side of Egypt and due to its strategic importance and historic political disputes restrictions have been imposed on the ownership of real estate and on companies operating in Sinai for national security considerations.

⁸ Any person who intends to acquire more than 10 per cent of the issuing company's issued share capital must first give the issuing company at least two weeks' prior written notice of the intended acquisition. Failure to give the requisite notice to the issuing company will render the transaction void. These requirements are also applicable to transactions which would result in a board member or employee of the issuing company holding more than 5 per cent of the shares of the company.

⁹ Any person who acquires five per cent or any multiple of five per cent of an issuing company's issued share capital, either through one transaction or a series of transactions (but who holds less than one-third of the issued share capital) must disclose such a holding to EGX and EFSA. This disclosure must be made within two days from the completion of the relevant trade which takes the shareholder through this threshold. The abovementioned threshold drops from five per cent to three per cent in the case of acquirers who are employees or board members of the issuing company.

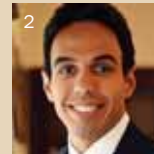
¹⁰ In addition, a Mandatory Purchase Offer will be triggered, if a shareholder who holds (either alone or together with its concert parties) more than one-third but less than 50 per cent of the issued share capital of the issuer: (i) increases their shareholding by two per cent or more during any 12 month period; or (ii) increases their shareholding to more than 50 per cent. There is also a similar requirement for shareholders holding more than 50 per cent but less than 75 per cent of the issued share capital.

¹¹ Gambling is defined as contracts or transactions with flagrant speculation.

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07

The rollercoaster of Romanian capital market development

MADALINA RACHIERU

This article presents recent developments in the Romanian capital market and its continuous upgrading process. It also describes the Romanian securities legislation and how the legislation works in practice, highlighting certain areas that need further improvement.



The Romanian capital market, while still young, has progressed over recent years from being an incipient market to a fairly regulated and complex one. The Romanian legal framework for securities trading was first initiated in 1994 and led to the establishment of the Romanian capital markets regulator, the National Securities Commission (CNVM) and to the establishment of the Bucharest Stock Exchange. Presently, the infrastructure of the Romanian capital market is similar to other European Union (EU) markets. There are two regulated markets in Romania: (i) the Bucharest Stock Exchange which is the main regulated market and (ii) Sibex – the Sibiu Stock Exchange, which is mainly a derivatives market. Clearing and settlement are performed by the Romanian Central Securities Depository for transactions concluded on the Bucharest Stock Exchange and by the Romanian Clearing House for transactions performed on Sibex.

The implementation of the necessary institutional and regulatory framework and the liberalisation process made access by foreign investors to the Romanian market easier and led to a prolonged bull market between 2000 and 2007. The trading volume increased by almost 20 times between April 2000 and April 2008 and the trading value increased by almost 300 times.¹ Since 2008 Romania has experienced, like many other markets in the European Union, a prolonged financial crisis and, currently valuations of Romanian stocks continue to be low compared with peers in the region. However, a number of interesting new listings and government-planned initial and secondary public offerings, expected in a wide range of sectors and industries, paint a brighter picture for the future.

These envisaged listings include, among others: Hidroelectrica (the largest Romanian energy producer); Nuclearelectrica (the



Thanks to the EU accession, Romanian securities legislation has had many positive changes, consolidated in the new Capital Market Law

nuclear power producer); Transelectrica (the operator of the national electricity transmission system); Romgaz (the largest Romanian natural gas producer); Transgaz (the operator of the national system of natural gas transmission); Romtelecom (the largest Romanian telecommunications company); CFR Marfa (the state-owned freight railway carrier); and Tarom (the Romanian airline company).

The EU accession process and the boosting effect on Romanian capital markets

Thanks to the EU accession process, Romanian securities legislation experienced numerous changes which culminated in a new, consolidated Capital Market Law that was enacted in 2004. The Capital Market Law (Law No. 297/2004) is aimed at bringing the Romanian capital market in line with the EU *acquis communautaire* by implementing several EU directives.² This law covers the following:

- (i) regulated markets and their operation
- (ii) financial investment services companies and other intermediaries and their activities on the market
- (iii) issuers and operations concerning securities including public offers
- (iv) undertakings for collective investments and investments management companies
- (v) the central depository and clearing house together with the registration, clearing and settlement operations performed through their systems.

While the Capital Market Law outlines only the general principles, additional secondary legislation was incorporated by the National Securities Commission. In addition, when Romania became a member of the European Union on 1 January 2007, the EU regulations and other enactments directly applicable to Member States also became applicable to the Romanian market.

Romania adopted the following strong investor protection rules, and transparency and corporate governance principles that are generally in line with OECD and EU principles:

- The corporate governance framework ensures equal treatment of all shareholders of the same class, including minority and foreign shareholders.
- Board members of listed companies are required to disclose material interests in transactions or matters affecting the company.
- Listed companies are required to promptly and accurately disclose all new material matters that may affect their patrimony, financial condition or business and are also required to prepare and release quarterly, half-yearly and annual reports.
- Transactions with securities tradeable on the capital markets on the basis of privileged information are prohibited and such transacting parties may be also penalised regarding insider dealings and market abuse. Issuers must promptly disclose any privileged information of which they become aware. Also, they must prepare and regularly update records of persons who have access to inside information and submit such records to the National Securities Commission on request.³
- All individuals and entities who directly or indirectly acquire shares in Romanian listed companies which entail their voting rights to reach, exceed or fall under certain thresholds must notify the relevant company, the National Securities Commission and the regulated capital market where the shares are traded. Individuals and entities who directly or indirectly acquire more than 33 per cent of the voting rights in a Romanian listed company, must launch a takeover public offer addressed to all the other shareholders for the balance of the remaining shares in that company.
- The issuer, the offeror and other parties involved in a public offering of securities (including the investment banks that intermediate the offering) are liable for the truthfulness and accuracy of the information they included in the offering document and the offering announcement.
- In addition, the Capital Market Law provides for an Investors Compensation Fund which is established to compensate investors



There are still many elements of the Romanian capital market that are not functioning as they are in more developed markets

in case of failure by the Fund's members (including intermediaries, who are compelled to become members) to reimburse the investors for the money/securities held in such investor's name.

Remaining issues that may limit the further deepening of the market

While many elements of the Romanian capital market are functioning well, there are still areas which are not functioning the way they do in the more developed capital markets. Some of these areas that need further improvement are briefly detailed below.

Preliminary prospectus

In line with the Prospectus Directive, only marketing materials to be used during the offering must be approved by the National Securities Commission, while roadshow materials and any other materials used before the commencement of the public offering do not need to be approved. However, the preliminary prospectus itself must be approved by the National Securities Commission before starting the roadshow. Following the completion of the roadshow, the final prospectus must be approved by the National Securities Commission before the offering can be launched and subscriptions can be collected.

In practice, as the final prospectus is identical to the preliminary prospectus (the only addition being the information regarding the price and the number of offered securities) this requirement leads in effect to the double approval of the offering prospectus (this being the initial approval of the preliminary prospectus before commencing the roadshow and the second approval of the final prospectus before the start of the subscription period). This also leads to the payment of two approval fees (a flat fee for the approval of the preliminary prospectus and a percentage of the estimated offering proceeds for the approval of the final prospectus).

Simplified prospectus

In line with the Prospectus Directive, the Romanian securities legislation provides that the obligation to publish a prospectus does not apply, among others, to offers addressed solely to qualified investors or to fewer than 100 individuals or legal persons, other than qualified investors. However, the regulations of the National

Securities Commission require that even in these cases a "simplified prospectus" (describing mainly the offering and the offered securities) be prepared and submitted for approval; such a prospectus is not made available to the public but only to the targeted investors. The fee charged by the National Securities Commission for the approval of such a simplified prospectus is the same as the fee applicable to the approval of public offering prospectuses, consisting of a percentage of the estimated proceeds.

Waiting period

Until recently the subscription period for a public offering sale of securities could not start earlier than six business days after the offering announcement had been made public (the so-called "waiting period"). This requirement has acted as a deterrent to dual offerings, as the book-building process outside Romania could be commenced immediately after the offering prospectus was approved, while subscriptions within the domestic offering could be collected only after the "waiting period" expired. In June 2011 the National Securities Commission shortened the "waiting period" from six business days to two business days, which allows domestic offers to be launched sooner after the approval of the offering prospectus.

While the initiative of the National Securities Commission to shorten the "waiting period" is beneficial, the complete elimination of the "waiting period" would be very welcome for the purpose of allowing dual offerings to be launched simultaneously on the domestic and international markets, immediately after the approval of the offering prospectus.

Global depositary receipts

The essence of global depositary receipts (GDRs) is that shares issued by a company are transferred to a depositary which then issues receipts (the GDRs) that give their holders many of the economic and other benefits of holding the underlying shares. GDRs are designed to enable issuers of shares in emerging markets to attract investors from other countries without requiring those foreign investors to go through any of the requirements or risks involved in dealing in shares in the country and currency of the issuer of the shares. As far as the foreign investors are concerned, they acquire GDRs in a manner, market and currency, with which they are familiar but which give them economic



Although legislation on mortgage bonds was enacted in 2006, no mortgage bonds have been issued on the local market so far

exposure to the underlying shares. A holder of a GDR has the right to surrender the GDR to the depositary and to receive in exchange the corresponding underlying shares at any time.

Although GDRs provide a significant component of international investments and would enable Romanian companies to attract investors which might otherwise invest elsewhere, (due to actual restrictions in their investment policies to invest in the Romanian market, lack of familiarity with the local market, the need to arrange for local custody accounts and so on), to date no GDRs have been issued on the basis of Romanian listed shares, mainly due to certain restrictions regarding their conversion.

As a rule, transactions with shares admitted to trading in a Romanian regulated market must be performed in the market where they are traded, on a “delivery versus payment” basis. As an exception to this rule, Romanian securities regulations allow GDRs issued on the basis of listed shares to be converted, by means of a direct free-of-payment transfer, from the securities account of the GDRs depositary into the securities account of the relevant GDRs holder, without having to cross the shares on the market. However, in practice, in order to be able to convert GDRs into listed shares, the Romanian Central Securities Depositary must supplement its code with certain technical rules applicable to such conversions. As a consequence, although Romanian securities regulations allow the conversion of GDRs into publicly traded shares, due to delays in the implementation of the necessary technical details by the Central Securities Depositary, in practice as yet GDRs cannot be actually converted into listed shares.

In addition, as Romanian legislation has no concept of nominal versus beneficial holder, the GDRs depositary would be viewed as the single owner of the entire block of Romanian shares in its deposit. The regulations issued by the National Securities Commission⁴ provide that a shareholder in a Romanian listed company can vote all the shares it owns in a single uniform way only. As such, when attending shareholders’ meetings on behalf of the GDRs holders, the GDRs depositary cannot split votes in order to accurately reflect the instructions received from the GDRs holders.

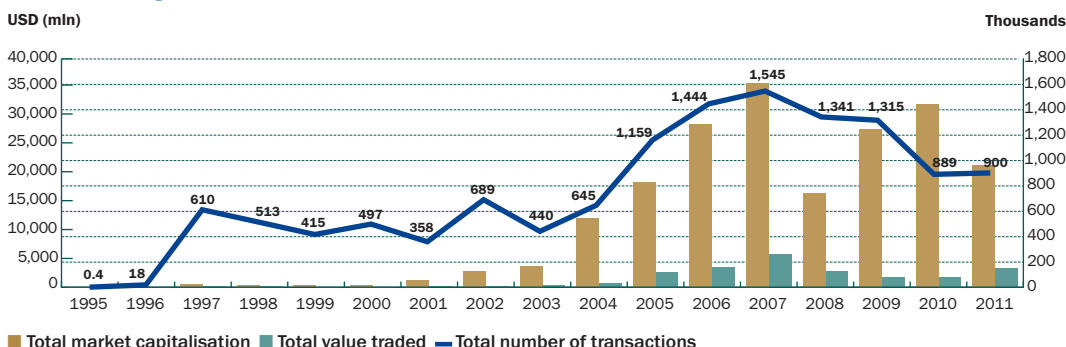
As GDRs would provide significant benefits to Romanian issuers, the implementation of the technical aspects allowing the Central Securities Depositary to convert GDRs into publicly traded shares should be accelerated. Also, Romanian securities legislation should be amended so as to allow the GDRs depositary to split votes within the shareholders’ general meetings in accordance with the instructions of the GDRs holders.

Covered bonds

Covered bonds are typically an important tool for banking and capital markets as they enable credit institutions to access a less expensive funding source and to decrease their dependence on financing from their parent-banks. The legislation governing mortgage bonds in Romania was enacted in 2006. However, due to several deficiencies, no mortgage bonds have been issued on the local market so far.⁵ Some of the deficiencies are as follows:

- Under the current mortgage bonds legislation, only mortgage loans (both residential and

Chart 1
Stock exchange volume in Romania (1995–2011)



Source: Bucharest Stock Exchange, www.bvb.ro.



Improvement is needed to further stimulate investments on the Romanian market

commercial mortgage loans)⁶ can be included in the pool that secures the bonds. As there are other assets on the balance sheet of Romanian credit institutions that may be eligible to cover the issuance of bonds (senior secured loans, loans granted to the public sector, and so on) the extension of the type of assets that can be included in the cover pool could be considered by the regulator.

- The pools of receivables that secure bonds issues are not dynamic but rather static. Mortgage loans included in a cover pool can be taken out and replaced by other loans only if they no longer meet the eligibility criteria, have become non-performing or trigger the decrease of the value, the weighted average of the maturities or the interest amount of the mortgage loans included in the cover pool. Such mortgage loans can be replaced only with other mortgage loans, while other eligible assets can be used for supplementing the cover pool only if the issuer has no other eligible mortgage loans. This requirement limits the flexibility of mortgage bonds issuers to relocate receivables from one pool of receivables to another.
- The current mortgage bonds legislation applies solely to mortgage bonds issued on the Romanian market, on the basis of a prospectus approved by the National Securities Commission. Any mortgage bonds issued on a foreign market and/or on the basis of a prospectus approved by the competent authority in another state would not benefit from the protection created through the mortgage bonds legislation (for example, the pool securing such bonds would not be bankruptcy remote). This is problematic, especially given the listing problems highlighted above.
- As regards the disclosure requirements, presently offering documents for mortgage bonds must contain a description of the mortgage loans included in the pool securing the bonds, including the general characteristics of each borrower and of the insurance policies concluded in connection with the mortgage loans collateral. In practice, not only is that description cumbersome but it also limits the flexibility of mortgage bonds issuers to relocate receivables from one pool of receivables to another, as mentioned above.

- The mortgage bonds legislation provides for the mandatory appointment of an agent to monitor the pool of receivables on behalf of the bondholders and to observe the issuer's compliance with the law and the prospectus requirements. Due to the fact that such agents have to be authorised jointly by the National Securities Commission and by the National Bank of Romania and due to the bureaucracy related to such authorisation, to date no entity has applied to be authorised to operate as an agent for mortgage bondholders.

It is hoped that the current mortgage bonds legislation will be revised in order to eliminate the present deficiencies, thus enabling local banks to access less expensive funding resources.

Credit ratings

Many current rules and regulations encourage certain entities to invest in securities with credit ratings issued by an approved credit rating agency; yet this is perceived by many issuers as costly and difficult to obtain. Presently, there are no local Romanian credit rating agencies. When issuing securities on the international market, Romanian issuers contract for the services of international rating agencies, which can be quite expensive for local issuers. As quality ratings are important, it is desirable that discussions take place, including with international credit rating agencies, to encourage the development of credit ratings which would be reliable and affordable.

Conclusion

While Romania's efforts to improve its local capital market framework has yielded notable success, areas in need of improvement remain and the development of these areas should be expedited in order to stimulate investments on the Romanian market. The reaction of the Romanian authorities in relation to these areas has been encouraging and amendment initiatives have been recently launched in relation to the legal frameworks dealing with GDRs and mortgage bonds, respectively. These measures are expected to have a positive impact on the development of the securities market in Romania, leading to an increase in the number of domestic and foreign investors, issuers and professional market participants.

Notes

¹ A. Stoian, D.T. Pele, E. Mitrica, M. Bensafta, V. Dragota (2009), "The development of the Romanian capital market: evidences on information efficiency" – *Romanian Journal of Economic Forecasting*, No. 2/2009.

² The Capital Market Law implements the following EU directives: Council Directive 93/22/EEC on investment services in the securities field, as subsequently amended; Directive 97/9/EC of the European Parliament and of the Council on investor-compensation schemes; Council Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS); Directive 98/26/CEE of the European Parliament and of the Council on settlement finality in payment and securities settlement systems; Directive 2003/71/CEE of the European Parliament and of the Council on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC; Directive 2001/34/EC of the European Parliament and of the Council on the admission of securities to official stock exchange listing and on information to be published on those securities; Directive 2003/6/CEE of the European Parliament and of the Council on insider dealing and market manipulation (market abuse); Directive 2002/65/EC of the European Parliament and of the Council concerning the distance marketing of consumer financial services and amending Council Directive 90/619/EEC and Directives 97/7/EC and 98/27/EC; Council Directive 1993/6/EEC on the capital adequacy of investments firms and credit institutions.

³ Privileged information is defined as the information of precise nature, which (i) regards one or several issuers or one or several financial instruments; (ii) has not been publicly disclosed; and (iii) if made public, might have a significant effect on the prices of such financial instruments or of the related derivative financial instruments.

⁴ National Securities Commission Regulation No. 6/2009 regarding the exercise of certain rights of shareholders within companies' general meetings.

⁵ Romanian mortgage bonds legislation currently in force consists of: the Mortgage Bonds Law no. 32/2006; the National Securities Commission Regulation No. 13/2006 regarding mortgage bonds; the Joint Regulation No. 12/3/2006 regarding the authorisation of agents, issued jointly by the National Securities Commission and the National Bank of Romania.

⁶ Mortgage loans are loans granted with the observance of Law No. 190/1999 regarding mortgage loans for immovable investments, as further amended.

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08

Close-out netting in Russia: are we almost there?

VLADIMIR KHRENOV¹

Russian financial regulation over the past few years has been marked by some fundamental shifts that have finally rewarded the industry's efforts to overhaul the regulatory framework for OTC derivatives, including the introduction of close-out netting. This article describes legal and regulatory reforms providing for Russia's OTC derivatives markets.



For over a decade, Russia's over-the-counter (OTC) derivatives markets were rather subdued. A slew of court decisions in the wake of the 1998 financial meltdown denied enforcement to non-deliverable foreign exchange forward transactions on the basis of the anti-gaming provisions of Article 1062 of the Russian Civil Code.

But as the country gradually overcame the consequences of the 1998 crisis the financial sector began to emerge from the doldrums to cater for the ever-increasing needs of the economy. The financial industry's lobbying efforts solidified around the need to lay down the statutory foundation for new types of financial products and services, including OTC derivatives.

Russian financial regulation over the past few years is marked by some fundamental

shifts that have finally rewarded the industry's efforts to overhaul the regulatory framework for OTC derivatives. While several aspects of the new regulation attract some well-deserved criticism, significant progress has certainly been made and once the final pieces of the new regime are put in place, opportunities previously unavailable to participants of the OTC derivatives market will appear.

The principal milestones of the regulatory change over the last few years include:

- amending Civil Code Article 1062 to provide a safe harbour from the anti-gaming statute to eligible derivative transactions
- amending Federal Law No. 39-FZ (the Securities Market Act) to introduce a definition of financial derivatives



After the 1998 financial crisis, court decisions denied enforcement to non-deliverable foreign exchange forward transactions on the basis of the anti-gaming provisions of the Russian Civil Code

- amending the Securities Market Act to allow for multiple repurchase, OTC derivative and certain other transactions to be governed by a single master agreement
- amending the insolvency legislation to allow close-out netting of eligible repurchase, derivative and certain other transactions governed by a single master agreement
- amending the Tax Code to improve the tax treatment of OTC derivative transactions, both by the dealers and the end-users
- developing, through industry efforts, a standard form of a master agreements to govern: (i) domestic OTC derivative transactions and (ii) repo transactions
- amending the currency control legislation to allow onshore settlement in foreign currency of derivative transactions.

While all of the above measures will influence the shape and pace of growth of the domestic and cross-border financial markets, this article focuses on close-out netting of OTC derivative transactions.

Exempting eligible transactions from the Insolvency Act

The Insolvency Act (Federal Law No. 127-FZ) was amended on 7 February 2011 (by Federal Law No. 8) in order to create a special insolvency regime that applies to financial transactions. The regime exempts eligible transactions from some of the restrictive provisions of the Insolvency Act.

The Insolvency Act (as amended) provides that

“...obligations arising out of contracts governed by a master agreement (single agreement) which corresponds to the model terms envisaged by [the Securities Market Act] (hereinafter financial contracts) shall terminate in accordance with the procedure envisaged by said master agreement (single agreement) (...) Such termination shall give rise to a monetary obligation the amount of which is to be determined in accordance with the procedure envisaged by the master agreement (...)”

Eligibility requirements

*Model terms of a contract.*² The Insolvency Act requires the master agreement to correspond to the model terms envisaged by the Securities Market Act, which implies that an eligible master agreement that governs local market transactions must incorporate the model terms of a contract developed by a self-regulatory organisation of professional market participants (an SRO).

One set of such model terms has already been developed by the National Stock Market Association (NFA) for domestic repurchase agreements and approved by the Federal Financial Market Service (FFMS). The other was jointly developed by the National Association of Professional Market Participants (NAUFOR), the Association of Russian Banks (ARB) and the National Foreign Exchange Association (NFEA) to govern domestic OTC derivative and, optionally, certain spot transactions.

The NAUFOR/ARB/NFEA model terms were published in 2009 and have already gained a substantial market share in terms of the volume of OTC derivative transactions entered into in the local market. A revised version has been prepared to accommodate the new requirements of the Insolvency Act and ensure netting eligibility of the model terms under the new regime.

The model terms must contain grounds for an early termination of outstanding transactions, which includes the occurrence of a specified event of default and the procedure for determining the amount of monies or other assets payable or deliverable in connection with such early termination.

Special requirements apply to an early termination triggered by a bankruptcy event in relation to a party. If triggered by a bankruptcy event, the close-out mechanics and the determination of an early termination amount must envisage that:

- all outstanding transactions be terminated as of the date to be determined in accordance with the master agreement but no later than the date immediately preceding the date on which (i) the insolvent party is recognised by a court to be bankrupt and ordered to be



The Securities Market Act expressly accommodates the needs of the cross-border market

liquidated, or (ii) in relation to banks, the defaulting party's banking licence is revoked

- the early termination amount may not include fines and penalties or any "lost benefit".³

The above features (as well as any others that the relevant SRO may indicate as compulsory) must not be altered by the parties when executing the master agreement in order for the master agreement to be recognised as "compliant" with the applicable model terms. Failure to abide by this restriction may disqualify the master agreement from close-out netting if a party becomes insolvent. By contrast, any other part of the model terms may be altered by the parties, for example, when entering into the master agreement or a trade confirmation.

The model terms developed by an SRO that meet the above requirements, as well as any amendment to such model terms, must be approved by the FFMS before publication by the SRO.

The Securities Market Act expressly accommodates the needs of the cross-border market by allowing forms of master agreements developed by international associations to be used to document derivative and repo transactions, provided that such forms have been approved by the FFMS. The FFMS is expected to approve the 1992 ISDA Master Agreement (Multicurrency – Cross-Border) and the 2002 ISDA Master Agreement, provided that the Second Method applies – that is, that the non-defaulting party is not excused from paying the early termination amount upon termination of the transactions if such amount were due to the defaulting party. It is also expected that the 1995, 2000 and 2011 versions of the Global Master Repurchase Agreement (GMRA) will be approved for the cross-border repo market.⁴

Eligible transaction types. Under the Insolvency Act, contracts entered into under a master agreement (single contract) that comply with approved model terms of a contract are treated as "financial contracts" eligible for close-out netting. Under the Securities Market Act, an approved master agreement (single contract) may govern financial derivatives, repo transactions and other contracts regarding foreign exchange or securities. A financial

derivative is defined as a contract that provides for one or more of the following:

- (i) an obligation of a party or the parties to make a single or periodic payments of monies dependent on a change in the price of commodities or securities, the exchange rate of a foreign currency, an interest rate, a rate of inflation, indicators calculated by reference to the prices of financial derivative instruments, official statistical data, physical, chemical and/or biological characteristics of the environment, the occurrence of an event evidencing a failure to perform or properly to perform an obligation by a legal entity (or a group of legal entities), a sovereign state or a municipal entity (except suretyship or insurance contracts) or any other circumstance which is uncertain to occur as may be specified by federal statute or [the FFMS] regulation...;
- (ii) an obligation of a party or the parties, upon demand by the other party and on the terms specified in the contract, to buy or sell securities, foreign currency or a commodity or to enter into a financial derivative instrument; or
- (iii) an obligation of a party to transfer securities, foreign currency or a commodity to the ownership of the other party and an obligation of the other party to accept and to pay for such assets not earlier than on the third day following the date of the contract, provided that such contract expressly states that it constitutes a financial derivative instrument.

The specific types of financial derivative instruments are set out in the Regulation on the Types of Financial Derivative Instruments enacted by the FFMS Order No. 10-13/pz-n and include various forward, option and swap transactions.

Financial derivatives therefore include (i) cash-settled or deliverable transactions with payouts linked to an eligible underlying asset,⁵ (ii) put and call options on foreign exchange, securities and commodities, as well as swaptions, and (iii) deliverable forward-settling transactions that the parties have expressly chosen to have treated as financial derivative instruments.



One of the parties to the master agreement must be an eligible counterparty

Although the intention of the draftsmen was to apply the netting regime primarily to repos and derivatives, as well as similar transactions with a shorter settlement cycle (such as spot foreign exchange or cash equity transactions), the broad reference to “other types of transactions, the object of which is foreign exchange or securities” introduces some uncertainty as to how far the scope of the Master Agreement can be stretched to absorb non-derivative transactions without compromising its eligibility for close-out netting under the Insolvency Act. Time will tell.

Additional eligibility requirements

As well as a Master Agreement needing to comply with approved model terms of a contract, the netting regime imposes certain additional eligibility requirements.

Timing of the transactions. The netting regime applies to transactions which pre-date the appointment by a regulator of a temporary administration (external management) to a financial organisation, an introduction of any of the insolvency procedures set out in the Insolvency Act or the revocation of a banking licence, whichever is applicable and occurs earlier.

Parties to the master agreement. One of the parties to the master agreement must be an eligible counterparty. Eligible counterparties for these purposes include:

- the Bank of Russia
- a regulated Russian bank or investment firm
- a foreign-regulated bank or investment firm incorporated and authorised in a member state of the Organisation for Economic Co-operation and Development, Financial Action Task Force or Micro, Small and Medium Size Enterprise
- a central bank of a member state of the OECD, FATF or MONEYVAL
- an international financial organisation.

The other party to the master agreement may be any legal entity (including a foreign entity incorporated in a member state of

the OECD, FATF or MONEYVAL), beneficial holders of units in mutual funds, the Russian Federation, its constituent entities or municipalities, any member state of the OECD, FATF or MONEYVAL or their subdivisions. The Insolvency Act thus ostensibly disallows close-out netting of transactions where one of the parties is a natural person which reflects a long-standing policy of discouraging derivatives trading with individuals.

Registration with a trade data repository. Under the Securities Market Act, netting-eligible transactions must be recorded in a specialised trade data repository operated by an SRO or a stock exchange. The Moscow Interbank Stock Exchange (MICEX) is expected to operate the repository. The procedure for recording the trade data will be set out in a regulation to be put out by the FFMS.⁶

The Insolvency Act makes registration with a repository a pre-requisite for a transaction to be eligible for close-out netting. The set-up of the repository has turned out to be a more challenging task than originally expected. Much like the debate over the details of the registration requirements unfolding in other jurisdictions, the Russian regulator and MICEX (currently the sole candidate for the operator of a nationwide repository) are doing their best to work out the format for trade reports for various types of reportable transactions as well as the model for the optimal allocation of data aggregation and processing functions among the repository, the FFMS and the Bank of Russia. As a result, it is not yet known when the new registration system will be implemented but it will probably be several more months before it becomes operational. The effective date of the close-out netting regime is accordingly put on hold.

Net obligation amount. The early termination amount (referred to as a “net obligation”) must be a monetary obligation determined in accordance with the model terms of a contract as described above. It is worth noting that, when entering into a cross-border master agreement such as an ISDA Master Agreement or a GMRA, one needs to consider carefully whether any of its provisions need to be amended to ensure compliance with the specific requirements of the Insolvency Act applicable to the eligible model terms of a contract.



Close-out netting legislation incorporated into the Insolvency Act came into effect on 11 August 2011

Credit Support Annex

The close-out netting legislation is designed to serve a two-fold objective. First, it reduces the net exposure of the parties to one another under a master agreement. Second, it allows the parties to enter into a title-transfer credit support annex to cover the residual net exposure. The structure of the Russian derivatives market, which is characterised by relatively low liquidity in the inter-dealer market and a largely unidirectional exposure in the client-facing sector, makes the second aspect of netting particularly important. The lack of explicit statutory protection for title-transfer security arrangements has caused a fair amount of debate among commentators as to the enforceability of title-transfer credit support annexes to the master agreements.

Since its publication by NAUFOR, ARB and NFEA in 2009, the Russian variation margin agreement (modelled on the English law ISDA Credit Support Annex) has found only a limited use in the market. The main reason is the uncertainty around its enforceability in its own right (the recharacterisation risk), as well as the lack of the statutory protection of close-out netting. Without such protection any attempt to terminate outstanding transactions and factor the margin amount into the determination of the early termination amount remains at risk of being avoided by the bankruptcy administrator.

The Russian law agreement for the transfer of variation margin according to its terms constitutes a transaction. The margin amount is periodically calculated by reference to the transferee's exposure (credit risk) to the transferor. The transferee's credit risk is calculated on the basis of the close-out values of the rest of the transactions under the master agreement. The close-out value of a transaction is the cost of a replacement transaction in the market as of the relevant valuation date. If the close-out value of the transactions governed by the master agreement (excluding the margin agreement) changes, the transferee or the transferor has an obligation to transfer a margin amount to the other party.

As part of revising the Russian law master agreement for OTC derivative transactions, the experts of NAUFOR, ARB and NFEA have also revisited the basic tenet of the

margin agreement. Under the new proposal, rather than linking the margin amount to the amount of the transferee's counterparty credit risk, the new form will define the margin amount as an amount payable by the parties dependent on the change in the aggregate value of the other transactions governed by the master agreement. Because the parties' obligation to make payments under the margin agreement depends on a change in the price of financial derivatives (that is, the aggregate cost of replacement transactions), the margin agreement should itself fall within the statutory definition of a financial derivative (as long as certain simple rules are observed) and as such become eligible for close-out netting. The FFMS is also considering expanding its regulation setting out the types of financial derivative instruments to explicitly include credit support annexes.

Effective date

On the face of it, the close-out netting legislation incorporated into the Insolvency Act came into effect on 11 August 2011. In practice, however, the benefits of close-out netting at the time of writing are not yet available to the market because some of the pre-requisites for the relevant legislation to become operational are still missing.

Most notably, while the implementing regulations that failed to be published in time for the 11 August 2011 effective date have since been enacted, the trade data repository will take a while to be set up and tested.

Migration of heritage transactions

NAUFOR, ARB and NFEA have developed a form of amendment to the current version of the master agreement that is designed to qualify existing transactions for the benefits of the close-out netting regime once such a regime gains traction.

Conclusion

Financial derivatives have been known in the Russian market for quite some time. Their enforcement history, however, is controversial. The new close-out netting regime will no doubt leave a number of questions unanswered until clarified by further regulation



The new close-out netting regime will leave a number of questions unanswered until clarified by further implementing regulations or court practice

or court practice. Important questions remain unaddressed in relation to the claw-back and other risks upon insolvency.

That said, however, the importance of seeing the current netting legislation come into effect is difficult to overstate as it provides the necessary, even if not exhaustive, guidance as to the basic parameters of the new netting regime, and encourages market

growth and liquidity while significantly reducing systemic risks in the Russian financial sector. All the benefits, as well as occasional mishaps, of the modern derivatives markets are yet to be learned by the Russian market, but with the enactment of the netting legislation the country is making a qualitative leap in the right direction.

Notes

Author

¹ Vladimir was the lead draftsman of the Russian standard documentation for local OTC derivative transactions, the components of which include: the model terms of a contract, a form of the master agreement, product annexes for derivative transactions with foreign exchange, interest rate, equities and fixed income securities as an underlying asset as well as the standard variation margin agreement form. He is adviser to the Chairman of the Executive Board of NAUFOR and a member of the joint expert panel of NAUFOR, ARB and NFEA, which was charged with revising the current version of the documentation to accommodate the requirements of the new close-out netting regime.

² “Model terms of a contract” is a term of art under Russian law which refers to a set of published standardised contractual provisions incorporated by reference into an agreement between the contracting parties. The Russian forms of a master agreement for repurchase transactions and the OTC derivative transactions developed respectively by the National Stock Market Association and jointly by the National Association of Professional Market Participants, the Association of Russian Banks and the National Foreign Exchange Association both rely on the model terms structure. In reference to the ISDA architecture, the Russian model terms would be analogous to the form Master Agreement while the Russian master agreement would be analogous to the Schedule, except that, unlike the ISDA Master Agreement, the model terms under the Russian structure are incorporated by reference rather than executed.

³ “Lost benefit” is a term of art that refers to damages which, along with “direct damages”, are allowed to be claimed by the aggrieved party for a breach of covenant. At a risk of oversimplification, direct damages are damages the aggrieved party has suffered directly from the loss of bargain under the breached contract. Lost benefit refers to the loss of bargain the aggrieved party has suffered under other contracts which, as a result of the defaulting party’s breach, can no longer be realised.

⁴ Unlike the repo market, the securities lending market in Russia, both domestic and cross-border, is underdeveloped primarily over enforceability concerns. It is, therefore, unclear whether the International Securities Lending Association form will be on the approved list of foreign master agreements.

⁵ The definition of this type of financial derivative is somewhat confusing in that it provides that such contracts may also provide for the delivery of securities, foreign exchange or a commodity or for entering into another financial derivative transaction. This appears to overlap with the reference in (iii) to deliverable instruments which, however, imposes two additional pre-requisites for the relevant transactions to be treated as derivatives, that is, a T+3 settlement cycle and an indication that it is a financial derivative. This confusion is a result of an unfortunate drafting of clause (i) which was originally intended to cover only cash-settlement instruments while allowing for transfers of margin in the form of securities, foreign exchange and commodities. It now appears to include deliverable derivative transactions with a payout linked to a variable indicator and as such are different from vanilla forward purchase and sale transactions captured by clause (iii).

⁶ A draft regulation was posted for comments on the FFMS web site on 14 November 2011.



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09

Keeping up with the Kazakhs – an update on recent regulatory changes and recommendations for further reforms

SHAIMERDEN CHIKANAYEV AND MARINA KAHIANI

This article examines recently adopted and proposed regulatory and legislative changes related to the development of local equity and debt capital markets in Kazakhstan and makes recommendations for future reforms.



Introduction

The difficulties the banking sector in Kazakhstan is experiencing, and the fact that international financial markets have been closed for most Kazakh companies for some time, can in fact be seen as a blessing in disguise for the development of Kazakhstan's local capital markets. With cheap bank credit cut off and opportunities to list abroad out of reach, Kazakh companies have started to consider using the local capital market to raise money instead. The development of a local capital market has become one of the priorities of the government of the Republic of Kazakhstan, who fully appreciated the risks related to the over-dependence on foreign markets, borrowing in foreign currency and the importance of stable, local sources of funding. One of the latest ambitions of the Kazakh government is a massive

privatisation programme of Kazakh blue-chip companies, the so-called "People's IPO".

This article will first examine the changes that have been recently adopted and second, critically review the reforms which are now being proposed.

Effective regulatory and legislative changes

Financial mega regulator

To begin with it is worth mentioning that in 2011 Kazakhstan consolidated its financial and securities regulators under the auspices of the National Bank. According to the President of Kazakhstan's decree of 12 April 2011, the Agency on Regulation and Supervision of the Financial Market and Financial Organisations (the FMSA) and the Agency on Regulation of Activities of the Regional Financial Centre of



There have been a number of laws and regulations adopted in Kazakhstan as a direct reaction to the financial crisis of 2008

Almaty were abolished and their functions transferred to the National Bank.

Defaulted bonds restructuring

There have been a number of laws and regulations adopted as a direct reaction to the financial crisis of 2008, in particular to address the issue of the increased number of defaulted bonds listed on the Kazakhstan Stock Exchange (KASE). In 2009 the FMSA reduced the capitalisation requirements of KASE-listed issuers of debt securities without rating. This measure gave an opportunity to the issuers to use funds for the repayment of debt rather than keep them for meeting the tough capital requirements of the regulator. Another measure was the introduction by the FMSA of the so-called “buffer category” to the official list of KASE. Securities whose issuer has:

- (i) ceased to comply with KASE requirements
- (ii) defaulted on its obligation to pay interest (except interest payment on the last coupon) or
- (iii) started restructuring of its obligations, may, if approved by KASE, be included in this buffer category for a maximum period of 12 months.

Should the financial position of the defaulted issuer improve during this 12-month period, the securities of the issuer may be transferred back to the relevant listing category of the KASE official list where they were listed before. Moving securities into the buffer category has two main goals:

- (i) it gives the defaulted issuer 12 months to improve its financial position without its securities being delisted
- (ii) it allows bondholders to keep abreast of the ongoing performance of the defaulted issuer.

In addition the 2011 Law on Investors Protection¹ introduced the possibility to restructure corporate bond debt on securing a minimum of 85 per cent of bondholders' votes at the general meeting. However, it seems that even on approval of the proposed restructuring by more than 85 per cent of the bondholders, a dissenting creditor may still have a legal right to file for bankruptcy. Such a

regime is different from the judicial restructuring framework available for financial institutions where, on approval of the restructuring by more than two or three creditors, the bank would benefit from a judicial shield against any claim of dissenting creditors. It is not clear why commercial entities cannot benefit from a similar legal framework which market participants have been demanding for some time now.

Corporate governance

Corporate governance is another important issue for the development of the securities market in Kazakhstan and the Law on Investors Protection contains a number of provisions in this respect. First, the personal liability of the management of a joint stock company (JSC) for actions and/or inactions which have caused losses to the JSC as a result of those actions and/or inactions, has been introduced. Second, shareholders are now entitled to file an action for compensation from the management of the JSC in relation to so-called major transactions and (or) interested party transactions. Interestingly, although this measure has been aimed to encourage management to perform their duties and take corporate decisions thoroughly, it seems that in practice the result has been to discourage good candidates to act as independent directors of Kazakh companies and, reportedly, members of management bodies of JSCs are now reluctant to take any significant risk or take important decisions for the company.

Lastly, the Law on Investors Protection has also introduced a mandatory requirement for the JSC to make prior evaluation of the market value of any property the JSC intends to acquire or sell, if the property value is estimated to be 10 per cent or more of the JSC's total assets.

Pension regulation

From 1 January 2012 a Kazakh pension fund will have to offer its participants two types of investment portfolio. A “conservative” portfolio and a “moderate” portfolio and, at some point in the future, it is envisaged that the fund would be able (but not obliged) to offer a so-called “aggressive” investment portfolio. The main idea behind such change is that assets in the conservative portfolio would only be invested in the most reliable financial instruments (for example, cannot be invested into equity securities). Such a portfolio would be particularly suited to people who are close to retirement age. Assets of the moderate portfolio would



Significant changes in the Kazakh capital markets legal framework are expected in the near future

be invested in a broader range of financial instruments (including up to 30 per cent in equity securities), which are more risky but also potentially carry a higher-yield. As for the aggressive portfolio, this would be a good option primarily for young citizens who are able to take higher risk (limitation on equity investment of up to 80 per cent will be applicable). Importantly, the state guarantee which is currently provided for all pensions would only cover conservative and moderate investment portfolios and not aggressive portfolios.

Overall, we believe that the proposed changes in pension regulation will have a positive effect on the development of a capital market in Kazakhstan, as pension funds are the largest group of investors in Kazakhstan and the reform will enable them to invest part of their assets in more risky securities to increase their profitability. Currently the investment activity of pension funds is limited to high-quality but low return financial instruments (such as state bonds) that barely cover inflation.

Islamic bonds

To diversify sources of financing and alleviate the dependence of Kazakhstan from external funding from Western capital markets, the Kazakh government has pursued the development of Islamic finance and certain legislative amendments² were adopted in 2011 that now allow a much broader range of Kazakh companies to issue sukuk (Islamic bonds).³ Although no issuance of sukuk has yet happened, putting relevant legislation in place creates the possibility for corporate issuers to use this new tool for raising capital.

Expected regulatory and legislative changes

Significant changes in the Kazakh capital markets legal framework⁴ are expected in the near future with the very recent adoption of the Law on Minimisation of Risks, which was signed by the President of Kazakhstan on 28 December 2011 and should take legal effect in the first half of 2012.⁵ The most important changes are presented here.

Ownership structure of pension funds

Specific conditions would become applicable to the ownership structure of Kazakh pension funds⁶ as of 1 January 2013:

- (i) all shares shall be listed on KASE and can also be listed offshore, subject to the approval of the National Bank
- (ii) A pension fund shall have at least three so-called “large shareholders” (that is, who have 10 per cent and more shares each) and who are not affiliated with each other. A single shareholder or group of affiliated shareholders shall have not more than 75 per cent voting shares of a pension fund. Alternatively, the total stake of minority shareholders in a pension fund shall exceed 25 per cent of voting shares.

It seems that the government of Kazakhstan considers an IPO to be an effective means of diversification of shareholding of pension funds and that it can positively affect development of equity capital markets in Kazakhstan.

Approval for listing of securities abroad and placement abroad

A new provision of the Law on Minimisation of Risks requires that a “resident”⁷ of Kazakhstan receives prior approval from the National Bank for the “listing” of securities on a foreign stock exchange.

The current Kazakhstan law already required that any placement abroad of securities by an issuer who is a “resident” of Kazakhstan shall be subject to, *inter alia*, prior listing of the issued securities on KASE. The Law on Minimisation of Risks has now clarified that if

- (i) the issuer is a foreign legal entity
- (ii) whose *de facto* place of effective management is in Kazakhstan
- (iii) 50 per cent or more of its shares/participatory interests belong to a Kazakh (parent) company, the abovementioned statutory requirement of prior listing of securities on KASE shall be applicable not to the foreign issuer itself, but to its Kazakh parent company. In other words, if a Kazakh company establishes an offshore special purpose vehicle (SPV) for an initial public offering (IPO) on a foreign stock market, the securities of such Kazakh company (and not that of the SPV) must now be listed on KASE as a condition precedent to IPO of the SPV.



The Law on
Minimisation of Risks
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“insiders” for the
purpose of the
Securities Law

The underlying intention of the financial regulator for making the process of listing and placing abroad more regulated appears to make raising capital domestically more attractive.

Local offer requirement

The Law on Minimisation of Risk goes even further in that it compels Kazakh resident issuers not only to just *offer* bonds on the local stock exchange simultaneously with a placement on the foreign stock exchange, but to actually *sell* at least 20 per cent of the total issuance *if there is demand*. Perhaps it is also part of the overall trend of protecting the Kazakh domestic capital market by limiting competition with international capital markets.⁸ In the past, Kazakh issuers had circumvented the rules by simply offering securities on KASE without having any actual intention to sell them in Kazakhstan.

Thus we expect that fewer Kazakh companies will be eager to run an IPO or issue eurobonds in foreign markets such as London and may now prefer to raise finance (at least partially) in Kazakhstan.

Insider trading

The Law on Minimisation of Risks has also substantially expanded the list of persons that shall be considered “insiders” for the purposes of the Securities Law. Auditors, brokers, independent appraisers, stock exchange staff, state officials of the National Bank and any other persons who have access to insider information could now be considered as “insiders”. The legislator has also clarified which transactions would entail administrative liability for insider trading:

- (i) an “insider” would now be administratively liable not only for *transfer* of insider information to a third party or for *providing recommendations* to third parties based on insider information as under current Kazakhstan law, but also for *usage* of insider information while making transactions with securities and/or derivatives by the insider himself
- (ii) officials of the Kazakh company (that is the issuer of securities) may be held administratively liable for failing to meet statutory requirements of due control over usage and transfer of insider information about the company or its securities.

Insider trading is a real problem in Kazakhstan that undermines the trust of investors and professional participants of the securities market. While there is no court practice in Kazakhstan on insider trading at the moment, improvement of the insider trading framework is to be welcomed.

Representative of bondholders

The Law on Minimisation of Risks provides that interests of any bondholders before the issuer shall be represented by a special organisation (that is, representative of bondholders) which has previously been available only for the bondholders of infrastructure bonds and secured bonds. In addition, statutory powers of the representative have been broadened. These would better protect interests of the bondholders.

Mandatory covenants of bonds issuer

From now on, all Kazakh companies⁹ will have to undertake and comply with (until the bonds' expiration date) certain mandatory negative covenants to be able to issue local bonds:

- (i) the issuer cannot sell more than 25 per cent of its assets
- (ii) the issuer shall not be in default under any of its obligations other than bonds for the amount of more than 10 per cent of its total assets as of the date of state registration of the bonds issuance
- (iii) the issuer cannot make changes in its constituting documents which would provide for a change in the core business of the company
- (iv) the issuer cannot change its form of incorporation.

These prohibitions are evidently aimed at protecting the interests of the bondholders. Should the issuer breach any of the above covenants, bondholders are entitled to require the issuer to buy back the bonds at par value with accrued interest.

Central counterparty

The Law on Minimisation of Risks has also introduced a central counterparty (the “CCP”) concept. It is assumed that CCP will lower the market-side risks and the

Notes and authors

costs of post-trade processing, for example, as part of the introduction of the T+3 settlement by KASE. We note, however, that, whereas CCP implementation normally requires the establishment of a special reserve and guarantee funds, the proposed legislative changes are silent on this matter.

“People's IPO”

Apart from the Law on Minimisation of Risks discussed above, a Law “On People's IPO” has been prepared for the purpose of the privatisation of a number of blue chip companies and is now under consideration by the senate of Kazakhstan.¹⁰ Once adopted, the Law would allow an IPO's first three candidates¹¹ to be done on KASE. The main provisions of the draft IPO Law concern:

- (i) the removal of the obstacles for proposed IPOs (for example, KEGOC cannot be privatised because of statutory restriction)
- (ii) the improvement of the legal framework related to disclosure of information to investors
- (iii) the strengthening of the protection of investors' rights and interests
- (iv) the improvement of infrastructure of the securities market.

The main target investors of the proposed offerings under the People's IPO programme are the citizens of Kazakhstan and pension funds.

Conclusion and recommendations

There is fierce competition between different capital markets in the world for issuers and liquidity. The only chance for Kazakhstan to develop its own capital market and become the financial centre of central Asia is, as a minimum, to put in place a friendly legal framework for investors and issuers and to create the appropriate infrastructure.

This has indeed been the concern of the financial regulator and the government of Kazakhstan and more reforms are expected under the framework of a state programme called “Road Map of Development of Pension Saving System and Securities Market of the Republic of Kazakhstan”, as approved by the government of Kazakhstan.

We would generally recommend an approach that concentrates on motivating market participants to raise finance locally (for example, providing a tax exemption for a company whose shares are listed and traded on KASE), rather than on making this process abroad more bureaucratic and complicated. Experience shows that a balance between the “carrot and the stick” approach is always preferable.

¹ Law of the Republic of Kazakhstan 406-IV 3PK dated 10 February 2011 “On Amendments and Additions to Certain Legislative Acts of the Republic of Kazakhstan on Questions of Mortgage Crediting and Protection of Rights of Financial Services Consumers and Investors” (the “Law on Investors Protection”).

² Law of the Republic of Kazakhstan N475-IV 3PK dated 22 July 2011 “On Amendments and Additions to Certain Legislative Acts of the Republic of Kazakhstan on Questions of Arranging Islamic Finance”.

³ Prior to the reform, only very limited legal entities were allowed to issue sukuk (e.g. NWF Samruk-Kazyna JSC's Group entity).

⁴ We must note, however, that the primary purpose of the proposed legislative changes is the introduction of stringent rules governing relations between a Kazakh bank and its affiliates and cutting off banks from expressly or impliedly affiliated structures. This seems to be a reaction of the financial regulator to BTA Bank case (BTA, before it was bailed out by the Government of Kazakhstan in 2009, made many loans to its affiliates and now it is practically impossible for BTA to get its money back).

⁵ Draft Law of the Republic of Kazakhstan “On Amendments and Additions to Certain Legislative Acts of the Republic of Kazakhstan on Questions of Regulation of Banking Activity and Financial Organisation in the Part of Minimisation of Risks” (the “Law on Minimisation of Risks”). For the purposes of this article, we only analysed the draft as submitted to the Senate of Kazakhstan.

⁶ These legal requirements would not be applicable to pension funds if one of its shareholders is the Republic of Kazakhstan.

⁷ For the purposes of the Law of the Republic of Kazakhstan “On Securities Market” № 461-II dated 2 July 2003 (the “Securities Law”), residents of Kazakhstan shall be considered companies incorporated outside of Kazakhstan if their place of management is *de facto* in Kazakhstan or if two-thirds of their assets are located in the territory of Kazakhstan.

⁸ Due to some inconsistency between the Securities Law as amended by the Law on Minimisation of Risks and the KASE Listing Rules as amended on 21 September 2011 there is some uncertainty as to whether the new rules will apply to both debt and equity securities, on placement in foreign securities markets.

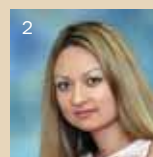
⁹ These statutory restrictions are not applicable to banks and organisations under restructuring as provided in relevant laws.

¹⁰ Draft Law of the Republic of Kazakhstan “On Amendments and Additions to Certain Legislative Acts of the Republic of Kazakhstan with regards to Development of the Capital Market in the Republic of Kazakhstan” (the “Draft IPO Law”). These companies are members of the NWF “Samruk-Kazyna” JSC's group.

¹¹ KazTransOil JSC, KEGOC JSC and AirAstana JSC.



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The wider context: the future of capital market regulation in the developed markets

CALLY JORDAN

Developing capital markets in eastern Europe and Central Asia is of course not happening in isolation from the formidable changes taking place in the rest of the world. Especially at a time of such great turbulence, looking to the future directions of capital markets regulation in developed economies is a particularly risky business. We are in the midst of a great sea change. Nevertheless, there are several current phenomena which are likely to shape capital markets regulation in the near future. None operates independently, of course; all interact, contributing to the potential uncertainty and complexity of outcomes.



“All in all, the future global financial regulatory landscape is more likely to resemble a Japanese garden, with new details and perspectives emerging at each step, than a centralised and symmetrical jardin à la française. Consistency will not be uniformly achieved, the boundary between global and local decision-making will remain in flux and controversial, and a spirit of experimentation and institutional entrepreneurship will be required.”
(Stéphane Rottier, Nicolas Véron, 2010)

Introduction

Developing capital markets in eastern Europe and Central Asia is of course not happening in isolation from the formidable changes taking place in the rest of the world. Especially at a time of such great turbulence, looking to the future directions of capital markets regulation in developed economies is a particularly risky business. We are in the midst of a great sea change.

Nevertheless, there are several current, and readily observable, phenomena which are

likely to shape capital markets regulation in developed economies in the near future:

- the blurring of distinctions between developed and developing, domestic and international, markets
- the rise of “multipolarity” and dispersion of capital market centres
- the transformation of market institutions such as stock exchanges
- the changing “perimeter” of regulation and potential indiscriminate over-regulation
- the re-thinking of regulatory goals
- the questioning of established regulatory models
- the future role of the Financial Stability Board (FSB) and the International Organization of Securities Commissions (IOSCO).



The distinctions between “developed” and “developing” markets are less and less compelling

None of these factors operates independently, of course; all interact, contributing to the potential uncertainty and complexity of outcomes.

Blurring of distinctions

For decades now, we have become accustomed to segregating capital markets, considering separately “developed” and “developing” markets.¹ These distinctions, popular in the financial press, are reinforced by the formal distinctions along similar lines institutionalised by international organisations, such as the International Monetary Fund (IMF) and The World Bank.

Even now, these distinctions are less and less compelling, at least among large economies. In response to the global financial crisis, the G-8 quickly transmogrified into the G-20.² No one doubts the significance of China among the world’s leading capital markets; the HKEx, that gateway to China, is now the largest exchange in the world by some measures.³ Brazil’s BM&FBOVESPA, the consolidated futures, commodities and securities exchange, has zoomed from near oblivion to the fourth largest in the world in less than 10 years.⁴

Contemporaneously, another longstanding distinction between domestic and international capital markets is blurring, a fact also brought home by the global financial crisis. Financial contagion, a regional phenomenon associated with the Asian financial crisis of 1997–98, went global. Contagion demonstrated graphically (and disastrously) that capital markets were not watertight compartments, constrained by geographical boundaries and regulated by the exercise of national authority.⁵

The blurring of these distinctions has put into question the adequacy of existing regulatory frameworks as well as proposed regulatory responses. New powerhouses such as China and Brazil, for better or for worse, may be going their own regulatory way. Experiences with the development, implementation and assessment of international financial standards are fraught with difficulty.⁶ The recently created FSB, successor to that failed initiative, the Financial Stability Forum, is still in its infancy.

Despite widely publicised pressures to “internationalise” capital markets regulation, there remains a joker in the pack: the national interest. In the United States, the intensely domestic focus of the US Congress is offset, to a certain degree, by an experienced and internationally aware regulator, the Securities and Exchange Commission (SEC).

But the SEC is not insulated from the isolationist winds blowing through Congress. And, elsewhere, there are vivid examples of the “national” interest prevailing even over obvious self interest, for example, in the rejection by the Australian parliament of the proposed merger of the Singapore Exchange with the Australian Exchange.⁷

Rise of multipolarity

There was a time when world capital markets revolved around the twin poles of London and New York. The hegemony of their market practices and regulatory models was somewhat shaken by the Lamfalussy Report in 2001, a wake-up call for European capital markets and their regulators,⁸ and then, a few years later, with the creation of NYSE-Euronext in 2007. Both Paris and Brussels were brought squarely into the picture. But the transatlantic dialogue, by industry and regulators alike, continued to drown out other discussions.

Not any longer. As Rottier and Véron of the Breugel Institute (a Brussels think-tank) persuasively argue,⁹ the once dominant capital markets of the transatlantic corridor are being challenged by the emergence of other centres of gravity in Asia, Latin America and the Middle East. Hong Kong’s brand new “dim sum” bond market¹⁰ is an example, attracting issuers such as the World Bank and McDonald’s, issuers which would ordinarily be found raising capital in the exempt eurobond market.

Another story, that of Brazil’s BM&FBOVESPA, is an especially dramatic one, even by “emerging” markets standards. At the end of the 1990s the BOVESPA, as it then was, considered shutting down. Trading in Brazilian equities had migrated to the NYSE and the American depository receipt or ADR market;¹¹ there had been virtually no initial public offerings made in Brazil for several years. Concerted action by regulators, legislators and the BOVESPA itself (such as the creation of the Nova Mercado or Corporate Governance Listing Board) revitalised Brazilian capital markets. The BM&FBOVESPA, now the fourth largest exchange in the world,¹² recently announced a cross-listing arrangement with a Chinese counterpart, the HKEx.¹³ And, ironically, given that ADRs nearly undermined the very existence of the BOVESPA, it is now possible for non-Brazilian companies to create BDRs, Brazilian depository receipts, for trading in Brazil.

There are any number of reasons why rival financial centres would be siphoning capital market flows



International capital markets have always thrived on regulatory arbitrage: “grease to the wheels of finance”

away from London and New York. The disarray of markets and regulation in both the United States and the United Kingdom immediately springs to mind, as does technology which permits the instantaneous transmission of information, capital and, as we all discovered recently, risk.

Transformation of market institutions

The traditional stock exchange is a powerful and very visible symbol of capitalism, with its imposing architecture and seemingly timeless solidity. This centuries old market institution, however, is undergoing a radical transformation. The flurry of international mergers and consolidations completed, proposed and failed are an outward manifestation of the transformative effect of technological change. The formal institutional realignments are belatedly catching up with the technological reality.

Much has been written about the fading importance of the traditional stock exchange and the rise of competing, virtual exchanges. The Goliaths are changing business models,¹⁴ scrambling for strategic geographic advantage and embracing new products.¹⁵ As the merger route has proved a bumpy one, alliances or alignments are appearing.¹⁶ Markets, of any kind, have cultures though and roots extending back millennia. Despite the flash of international mergers, local markets in one form or another will persist; the niche markets of Luxembourg and Switzerland, for example. And as recent experience with NYSE-Euronext demonstrates, even the biggest of international mergers has not erased the “local” markets involved.

All of this frenetic activity, however, produces the equivalent of regulatory jetlag. Regulators are still trying to adjust to that groundbreaking transatlantic merger of NYSE-Euronext. Occurring barely four years ago, it now seems to have taken place in a different lifetime. The great market upheaval and change taking place has put enormous stress on even the most basic principles of regulation and market practice – the segregation of clients’ accounts for example.¹⁷

Traditional self-regulation of market institutions has been marginalised in many places,¹⁸ especially by the rising tide of formal regulation. However, given the rapidly changing nature of market institutions themselves and the impossibility of adequate or comprehensive regulatory responses, at least in the short term, new varieties of self-regulation are likely to appear.

The changing “perimeter” of regulation

Capital markets, especially international capital markets, have always thrived on regulatory arbitrage, much of which has been relatively benign: grease to the wheels of finance. The eurobond market, for example, attracted stellar issuers such as The World Bank and McDonald’s and has been remarkably resistant to formal regulation, seemingly without untoward consequences.

However the existence of “unregulated” markets, obvious to anyone close to the industry, apparently came as a great surprise to much of the world. In the United States, the volume of privately placed securities (that escape most of the regulatory apparatus) exceeded that of publicly offered securities for the first time several years ago. Now, the dominant capital market in the United States is the private placement market. As the name implies, it is a private market and one not subject to the glare of public scrutiny.

So now, establishing the “perimeter” of regulation is the new mantra of the FSB, the IMF, the World Bank and IOSCO. Among other things, and crudely put, this implies sweeping the varied and multi-faceted world of derivatives into the regulatory net. Although indiscriminate regulation of derivative products has been plaintively decried recently by the head of the International Swaps and Derivatives Association (ISDA),¹⁹ the forces of torrential regulation are not abating.

At the heart of this particular issue is the artificial, and historically determined, definition of a “security” in the United States, a product of the fragmented and fiercely territorial regulatory landscape there. The most well-known financial regulator, the SEC, has never had jurisdiction over most derivatives. That authority lies, for the most part, with a competing regulator, the Commodities and Futures Trading Commission (CFTC). Although this artificial distinction among financial products (which results in competing regulatory oversight) has been eliminated (or never adopted) in many other places in the world, it appears destined to persist in the United States.²⁰ Some exchanges in the United States, tied as they are now to specified financial products that are aligned with the jurisdiction of their primary regulator, would welcome the elimination of these distinctions and an expanded range of tradeable products. In emerging markets, some early adopters of the US regulatory model may demonstrate the same product/market/regulator fragmentation (Korea,



Addressing systemic risk has popped up everywhere as a new goal of capital markets regulation

for example), but elimination of the distinctions has been occurring, and without any undue reticence.

Certainly, the avalanche of regulation precipitated by the global financial crisis is worrisome. Irrespective of the wisdom, (or not,) of its substantive provisions, very little of the Dodd Frank Act²¹ has actually been implemented.²² Costs of compliance mount, regulatory uncertainty sets in. By the time implementing agencies such as the SEC plough through their assigned reports and other mandates, the world's capital markets will inevitably have moved on.

Rethinking regulatory goals

Addressing systemic risk has popped up everywhere as a new goal of capital markets regulation.²³ That capital markets, especially international capital markets, could be purveyors of systemic risk appears ridiculously obvious in hindsight. Systemic risk concerns, though, had been the bailiwick of prudential regulators, proceeding on an institution-by-institution basis, not capital markets regulators.

Simply adding systemic risk to what is now quite a lengthy list of capital markets regulatory goals, however, does not necessarily produce results. It may, in fact, be adding one more goal to an already long list of conflicting and potentially unrealisable, goals. The effectiveness of capital markets regulation, especially in the United States, is already undermined by the accretion, over time, of numerous, ideologically determined objectives.

Take, for example, section 2(b) of the Securities Act of 1933:²⁴

"...Whenever pursuant to this title the Commission [SEC] is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition and capital formation."

So here we have stated goals enshrined in legislation, the oldest and original being investor protection.²⁵ However, the later legislated goals such as efficient markets, promotion of competition and capital raising, counterbalance, not to say undermine, the original goal of (retail) investor protection. The efficient market hypothesis has long served as a justification for a non-interventionist approach to market regulation, decidedly at odds with retail investor protection.

Much the same can be said of promotion of competitiveness and capital formation, an example of political ideology disguised as capital markets regulation. US capital markets legislation is laced with these competing regulatory goals, intensifying its already dysfunctional nature.

This may explain the creation of the new US Bureau of Consumer Financial Regulation and its oversight by the Federal Reserve.²⁶ Taking retail investor protection out of the purview of the SEC, to a certain extent at least, is quite a radical step and an implicit acknowledgement of the regulatory difficulties engendered by the burden of competing goals. However, the creation of new, separate "consumer" or retail investor protection agencies (and there may be emulators elsewhere)²⁷ entails different kinds of risk, in particular that of low level expertise and lack of regulatory "clout".

In addition, given the beating which the efficient market hypothesis has taken lately, it will be interesting to see whether "efficiency" goals drop out of the regulatory mix. Certainly there is already re-regulation of professional investors occurring and a tacit admission that disclosure is not enough, particularly with respect to retail products.²⁸

Shifting demographics and investment patterns too may force reconsideration of regulatory goals and their relative priority. The popularity of more conservative investment products or ones which may have a greater or lesser degree of government backing (for example, *Pfandbriefe*, covered bonds, Canada Mortgage Bonds) may in fact be indicative of the market substituting for ineffective regulation (which may be as it should be).

One area of the market in developed economies which has been subject to chronic regulatory neglect constitutes a disaster in waiting: pension funds and insurance products. The potential political ramifications of regulatory and institutional failure in this area are explosive. For example, the investment models and regulatory guidelines of many large pension schemes in the United States, such as TIAA-CREF²⁹ or CalPERS³⁰, may now be wildly out of touch with the new realities of the marketplace (for example, blithe assumptions of a 6 per cent "safe" return on investment). In addition, the benefits which they provide to retirees are based on the operation of complex, insurance-like products which few retirees understand. If these scenarios ring a familiar bell, they should be sounding an alarm given recent events. As the demographic profile of the United States shifts inexorably towards an



Let us leave the speculation on the future of capital market regulation for now to the hedge funds and look back again in five years' time

older population, the stresses on these plans can only increase. A failure would bring misery to millions, many of them educated, vocal voters.³¹

Questioning regulatory models

For decades the United States and the United Kingdom have provided capital markets regulatory models for the world. Although quite different in structure and regulatory philosophy, mini SECs and FSAs are scattered all over the globe. However, the original models themselves are in disarray and under attack on the home front. In the United States the fragmentation and complexity of regulatory oversight of capital markets will continue, flying in the face of logic and common sense. If anything, it will be more of the same but even more of it. At least one positive sign, though, is the SEC-CFTC-FINRA³² alliance which now presents a more coordinated face to the world.

In London, the much emulated consolidated financial regulator, the FSA, is currently being dismembered, again flying in the face of logic and common sense: “[T]here was not a clear-cut case for outright abolition of the Financial Services Authority. Fixing it was a solid option in principle and it was politics that dictated a different result”.³³

There is much to lament in each of these instances. The United States has missed the crisis-driven opportunity to rationalise and consolidate its capital markets regulatory framework. The United Kingdom has trashed a sound regulatory model that had not demonstrably fallen into disrepair. The reorganisation of regulatory functions, an effort-sapping endeavour, comes at a time when regulatory energies could be put to better use elsewhere.

However, especially in the case of the FSA, many other places in the world which had adopted its consolidated financial regulator model are now left high and dry. Countries such as France or Germany will make their own decisions to carry on, but small jurisdictions and emerging markets face a dilemma, whether to persist with a now defunct model or, yet again, follow the latest UK path, irrespective of its merits.

Role of the Financial Stability Board (FSB) and the International Organization of Securities Commissions (IOSCO)

The crisis has brought to the surface a number of ideas that rise and fall with various currents. One idea, and a misguided one, is the creation of a World Financial Authority, a supra-national financial regulator structured perhaps along the lines of the World Trade Organisation (WTO). Given

the virtually insurmountable difficulties of actually creating such a regulator (to say nothing of its desirability), two organisations – one created in direct response to the global financial crisis and the other, decades-old – are filling the void.

In the aftermath of the Asian financial crisis, the Financial Stability Forum (FSF) was created in 1999 with a mandate to serve as both a prophylactic against and as an “early warning” beacon for impending cross-border financial crisis. That it failed miserably at either task is indisputable.³⁴ Its successor, the FSB, has an even more challenging mandate in much choppier financial waters.³⁵ Will the FSB escape the fate of its predecessor (that is, irrelevance)? Its early focus on G-SIFI (Globally Systemically Important Financial Institutions) is fraught with difficulty. Housed at the Bank for International Settlements in Basel, it would be hard for the FSB to escape a central bank mentality (lacking in capital market sensibilities) and, arguably, it is working on the margins (credit rating agencies and executive compensation).

IOSCO, on the other hand, has been in existence since 1983. Originally a somewhat informal talk shop for developed economy securities regulators and institutions, the composition of its membership and its role has changed dramatically in the last decade. IOSCO is now an important forum for the exchange of information among capital markets regulators all over the world, in both developed and developing economies. The Technical Committee of IOSCO was instrumental in the development of International Financial Reporting Standards. IOSCO has assumed the role of a standard setter, and given the considerable technical expertise of its members, an informed and knowledgeable one. In addition, it has now taken on some aspects of a think-tank, such as the OECD, in undertaking research and publishing technical reports. IOSCO may be transforming itself into a body somewhat akin to the now superseded Committee of European Securities Regulators, better known by its acronym, CESR.³⁶

Conclusion

It will be interesting to see how the current phenomena, which are likely to shape capital markets regulation in developed economies, will impact the EBRD region. Moreover, we could indulge in much more speculation as to the future of capital market regulation in developed markets. But for now, let us leave the speculating to the punters and the hedge funds, and take a look back in five years' time.

Notes

- ¹ Even finer distinctions have developed such as “emerging”, “transitional” and “frontier” markets.
- ² The G-7 expanded to 19 countries and the European Union in 1999 due to the financial crises of the late 1990s and a recognition that emerging economies had been excluded from global financial discussion and governance. The countries added in 1999 were Argentina, Australia, Brazil, China, the European Union, India, Indonesia, Mexico, Russia, Saudi Arabia, South Africa, the Republic of Korea and Turkey. In September 2009, the G-20 formally replaced the then G-8 as the major forum for discussions among finance ministers and central bankers.
- ³ “LSE and Canada’s TMX agree merger”, *Financial Times*, London, 8 February 2011.
- ⁴ *ibid.*
- ⁵ “Securities regulatory regimes around the world, largely developed on the conceptual basis of segregated national markets, are fast being outpaced by market developments and are finding themselves unable to address effectively the realities of the accelerating integration of global capital markets”. Aaron Unterman (2008), “Exporting risk: global implications of the securitization of U.S. housing debt” *Hastings Business Law Journal*, Vol. 4(1), pp. 77-135.
- ⁶ See Cally Jordan (2009), “Does ‘F’ stand for failure: the legacy of the Financial Stability Forum”, *Legal Studies Research Papers*, Melbourne Law School Research Paper No. 429, pp. 1-28.
- ⁷ The Australian parliament rejected the merger on 5 April 2011 after the Foreign Investment Review Board determined a merger was not in Australia’s best interests.
- ⁸ “There is no serious alternative available. The status quo would entrench the continuation of European financial market fragmentation. This means lost benefits. Lost opportunities ... with European savings diverted to foreign market places.” Alexandre Lamfalussy (2001), “Final report of the committee of wise men on the regulation of European securities markets”, Brussels, 15 February 2001, pp. 1-115, 8 (‘Lamfalussy Report’).
- ⁹ Stéphane Rottier and Nicolas Véron (2010), “The new disintegration of finance”, Bruegel Institute, 10 September 2010, pp. 1-2.
- ¹⁰ Lingling Wei and Carol Chan (2011), “Turmoil stings Yuan bonds”, *Wall Street Journal*, 28 September 2011, p. 1. The term describes the RMB dominated, Hong Kong based bond market and is “driven by the amount of RMB deposits available for investment in Hong Kong and by the supply of debt from issuers in mainland China”: Luis Sanchez (2010), “What is the dim sum bond market and why it could be the next bubble”, *Business Today*, Princeton University, 13 August 2010, p. 1.
- ¹¹ See John C. Coffee (2002), “Competition among securities markets: a path dependant perspective”, Columbia University Law School, Center for Law and Economic Studies Research Paper No. 192, 25 March 2002, pp. 1-32.
- ¹² James Wilson (2011), “BaFin approves Deutsche Börse-NYSE merger”, *Financial Times*, London, 12 September 2011.
- ¹³ There is a cross listing alliance consisting of the Hong Kong Exchanges and Clearing, BM&FBOVESPA of Brazil, the National Stock Exchange of India, the Bombay Stock Exchange, Johannesburg Stock Exchange and the two Russian exchanges that are in the process of merging – Micex and RTS – will cross-list each others’ stock index futures and index options contracts.
- ¹⁴ Selling information flows and creating or reinforcing vertical “silos” of complementary businesses such as clearing and settlement.
- ¹⁵ “The challenge of great exchanges”, *Financial Times*, London, 13 February 2011. It is estimated that 37 per cent of revenues of the proposed NYSE-Euronext-DeutscheBörse will be from derivatives and not traditional equity products.
- ¹⁶ Jeremy Grant (2011), “Six emerging market exchanges combine in cross-listing alliance”, *Financial Times*, London, 13 October 2011.
- ¹⁷ The recent bankruptcy of MF Global, with assets of \$US 41 billion is the eighth largest bankruptcy in US history. At the time of writing \$US 163 million of client funds could not be accounted for. Tom Braithwaite, John Gapper, Dan McCrum, Gregory Meyer, Kara Scannell and Hal Weitzman (2011), “It shouldn’t have taken positions so big – let alone the one it did’ – downfall of MF Global”, *Financial Times*, London, 5 November 2011.
- ¹⁸ Although fiercely defended in the United States. See Cally Jordan and Pamela Hughes (2007), “Which way for market institutions: the fundamental question of self regulation”, *Berkeley Business Law Journal*, Vol. 4, pp. 205-227.
- ¹⁹ Stephen O’Connor, ISDA Chairman, Managing Director and Global Head of OTC Client Clearing, recently gave an address on derivatives regulation at which he stated: “Should the regulations in each country or region be introduced without consistency, such institutions could be prevented from engaging in cross-border transactions and executing their global risk management strategies efficiently. This could potentially lead to regulatory arbitrage, segmented markets, reduction in liquidity, resulting in reduced market efficiency and increased systemic risk.” Stephen O’Connor (2011), “Chairman’s address”, Morgan Stanley 2011 ISDA Annual Japan Conference: *Shaping the Future of Derivatives*, 27 October 2011.
- ²⁰ In the aftermath of the global financial crisis, an attempt was made to formally consolidate the two major financial regulators in the United States, the SEC and the CFTC; although the attempt failed, there is now more formal cooperative measures undertaken. However, the number of financial regulators in the United States has multiplied, with the creation of new agencies such as the Bureau of Consumer Financial Protection, now under the aegis of the Federal Reserve.
- ²¹ *Dodd-Frank Wall Street Reform and Consumer Protection Act* 12 USC § 5301.
- ²² Professor Donald Langevoort speaking recently at the University of Sydney estimated only about 20 per cent of Dodd-Frank reforms had been implemented. Donald Langvoort (2011), “Current U.S. and international trends in market and share trading regulation”, speech given at the Supreme Court of New South Wales Annual Corporate Law Conference: *New Trends in Sharemarket Regulation*, 23 August 2011.
- ²³ Three new principles of securities regulation dealing with systemic risk were added to the IOSCO Objectives and Principles of Securities Regulation in June 2010:
1. Principle A (6) “The Regulator should have or contribute to a process to monitor, mitigate and manage systemic risk, appropriate to its mandate.”
 2. Principle H (32) “There should be procedures for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.”
 3. Principle I (38) “Securities settlement systems and central counterparties should be subject to regulatory and supervisory requirements that are designed to ensure that they are fair, effective and efficient and that they reduce systemic risk.”
- ²⁴ *Securities Act of 1933* 15 U.S.C. 77a-77mm.
- ²⁵ Dating back to the 1930s in the United States.
- ²⁶ The FSA is due to be replaced by two agencies in 2013. These are the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). The mandate of the PRA is promotion of stable and prudent operation of the financial system, regulation of all deposit taking institutions, insurers and investment banks. The mandate of the FCA is the regulation of conduct in retail, wholesale financial markets and firms outside the scope of the PRA, a mandate which may be wider than the new US Bureau of Consumer and Financial Regulation.

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- ²⁷ In the UK, for example this will now be the mandate of the Financial Conduct Authority to commence in 2013.
- ²⁸ Sharlene Goff and Elaine Moore (2011), "Banks prepare for deluge of PPI complaints", *Financial Times*, London, 21 April 2011, p. 18.
- ²⁹ TIAA-CREF stands for "Teachers Insurance and Annuity Association-College Retirement Equities Fund". It is a leading provider of retirement benefits to the academic, research, medical and cultural community and has some 3.7 million active and retired employees among its members.
- ³⁰ CalPERS stands for "California Public Employees' Retirement System" and is a leading "activist" institutional investor.
- ³¹ See "Is TIAA-CREF safe?", *The Chronicle of Higher Education*, 13 April 2009: "Since many professors have TIAA-CREF as the core of their retirement plan," writes a reader in response to Pennywise's depiction of the financial crisis (The Chronicle, December 19, 2008), 'please do an in-depth report on its financial health and how solid its accounts are.' In analogous spirit, Laurie Fendrich, professor of fine arts at Hofstra University, posted a brilliant mock-populist rant on The Chronicle's Brainstorm blog under the title 'Someone's Gotta Pay.' Fendrich recounts an evening when, sipping a glass of merlot, she fantasized over who to sue for 'the decline in value in my TIAA-CREF retirement portfolio.' Eventually she settles on her campus TIAA-CREF rep for defrauding her 'by giving me several pamphlets written in Aquitanian, and insisting on speaking only Aquitanian whenever we would meet — even though he knew full well I could barely speak a word of it.' Available at <http://chronicle.com/article/Is-TIAA-CREF-Safe-/44807> (last consulted 29 November 2011).
- ³² FINRA is the acronym for the Financial Industry Regulatory Authority, a self-regulatory organisation and "the largest independent regulator for all securities firms doing business in the United States [overseeing] nearly 4,495 brokerage firms, 163,450 branch offices and 635,515 registered securities representatives. [The] chief role is to protect investors by maintaining the fairness of the U.S. capital markets." See <http://www.finra.org/> [accessed 15 November 2011].
- ³³ Eilis Ferran (2010), "The break-up of the financial services authority", University of Cambridge Faculty of Law Research Paper Series, Research Paper 10/04, pp. 1-127, 1.
- ³⁴ For more on the FSF, see Cally Jordan (2009), "Does 'F' stand for failure: the legacy of the Financial Stability Forum", *Legal Studies Research Papers*, Melbourne Law School Research Paper No. 429, pp. 1-28.
- ³⁵ "The FSB has been established to coordinate at the international level the work of national financial authorities and international standard setting bodies and to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies in the interest of financial stability. It brings together national authorities responsible for financial stability in 24 countries and jurisdictions, international financial institutions, sector-specific international groupings of regulators and supervisors, and committees of central bank experts." Financial Stability Board, available at <http://www.financialstabilityboard.org/about/overview.htm> [accessed 10 November 2011].
- ³⁶ CESR was replaced as of 1 January 2011 by a full-fledged pan-European capital markets regulator, the European Securities and Markets Authority, or ESMA. ESMA is one of three newly created pan-European regulators (the other two being the European Banking Authority (EBA) and the European Insurance and Occupational Pensions Authority (EIOPA)) which have replaced the so-called 3L3 committees of the European Union.

Abbreviations

ADR	American Depositary Receipts
BIS	Bank for International Settlements
CCP	Central Counterparty
CEE	Central and Eastern Europe
CESR	Committee of European Securities Regulators
CFI	Classification of Financial Instruments
CFTC	Commodities and Futures Trading Commission
CIS	Commonwealth of Independent States
CM Law	Capital Market Law
CPSS	Committee on Payment and Settlement Systems
EBRD	European Bank for Reconstruction and Development
ETC	Early Transition Countries
EU	European Union
FATF	Financial Action Task Force
FINRA	Financial Industry Regulation Authority
FSA	Financial Securities Authority
FSB	Financial Stability Board
FSFM	Federal Service for Financial Markets
GDR	Global Depositary Receipts
IFC	International Finance Corporation
IMF	International Monetary Fund
IOSCO	International Organisation of Securities Commissions
IPO	Initial Public Offering
ISDA	International Swap and Derivatives Association
ISIN code	International Securities Identification Number
JSC	Joint Stock Company
LTP	Legal Transition Programme
LTT	Legal Transition and Knowledge Management Team
MONEYVAL	The Council of Europe Select Committee of Experts on the Evaluation of Anti-Money Laundering Measures
MSME	Micro, Small and Medium Size Enterprise
NGO	Non-Governmental Organisation
OECD	Organisation for Economic Co-operation and Development
OTC	Over-the-counter
SEC	Securities and Exchange Commission
SEE	South Eastern Europe
SEMED	Southern and Eastern Mediterranean
SME	Small and Medium Size Enterprise
SPV	Special Purpose Vehicle
UNIDROIT	International Institute for the Unification of Private Law

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