CASES & LACAMBRA

| NEWSLETTER | FINANCIAL SERVICES |
| DECEMBER 2022 | ANDORRA |

REFORM OF LAW 8/2013 ON THE ORGANISATIONAL REQUIREMENTS AND THE OPERATIONAL CONDITIONS OF ENTITIES OPERATING WITHIN THE FINANCIAL SYSTEM, INVESTOR PROTECTION, MARKET ABUSE AND CONTRACTUAL NETTING ARRANGEMENTS, DATED 9 MAY.

Act 8/2013, of 9 May, on the organisational requirements and operational conditions of entities operating within the financial system, investor protection, market abuse, and contractual collateral arrangements (hereinafter, the "Act 8/2013") is the corner stone of the Andorran financial system regulation on investment services. Likewise, Act 8/2013 has been one of the most important ways for Andorran law to approach the European banking and securities market regulations, in accordance with the obligations assumed by the Principality of Andorra in the Monetary Agreement entered into in 2011 with the European Union. Its annex has been yearly amended in order to incorporate an essential part of the acquis communautaire in financial matters into the Andorran legal system.

The recent publication of the legally compulsory report of the Legislative Budget and Finance Committee (Bulletin of the General Council, no. 133/2022, of 31 October 2022) has led to the publication of the final text on the next reform of Act 8/2013. This formal step concludes the process started on 11 May, when the Andorran General Council published a draft law to harmonize Act 8/2013 with Regulation (EU) No. 648/2012, of 4 July (EMIR), Regulation (EU) No. 2015/2365, of 25 November (SFTR), and Regulation (EU) No. 2016/1011, of 8 June (BMR). Considering the great scope of the innovations to be adopted, the project also modifies Act 10/2008, of 12 June, regulating Andorran collective investment undertakings and, in particular, provides that both the full and simplified prospectuses of these organizations and their periodic reports, shall inform on securities financing transactions and total return swaps, as well as on the use of benchmarks. Lastly, Act of 27 November regulating the disciplinary regime of the financial system is amended in order to complement the rules on infringements and penalties in relation to the use of benchmarks.

These intended changes are particularly relevant in view of the involvement of the Andorran financial system in international finance and shall encourage Andorran entities to gradually adopt the usual business practices among European financial groups. Indeed, the subjects described above have merited special attention in the main financial centres over the last years to the point of becoming characteristic elements of this branch of activity. However, the promulgation of an own regulation on areas such as securities markets or private international law, already aligned with the principles of European law, is urgent and necessary.

Our purpose in this newsletter is to set out the relevance of these amendments which are, too often, easily overlooked. Furthermore, we will also pay attention to the problems that may arise from the adoption of the Anglo-Saxon legal and economic terminology, which is of interest so as to maintain the coherence of the draft bill, not only with the rest of the Andorran legal system, but also to ensure that it is aligned with the legal practice in Civil Law countries.

1. Terminological matters

The European Union legislation on financial matters, although published in all the official languages of the European Union, constantly incorporates Anglo-Saxon legal and financial terminology, as these are the standards established in international practice. This tendency is inevitable, and even useful. However, it requires a primary effort to ensure that Andorran law does not incorporate usages or legal concepts of the Common Law that are completely out of context. A clear example of this can be found in cases such as the following: "subscribing contracts" instead of "entering into contracts" ("celebrar contractes"), "rescission of contracts" instead of "early termination pursuant to an event of default or a termination event" ("resolució anticipada" or "venciment anticipat"), "termination of contracts" instead of "completion", "derivative contracts" instead of simply "derivatives." These are matters that need to be considered, as well as some other more subtle issues. For example, the term "novation" with regards to the derivatives is used without considering that it indeed refers to assigned or transferred derivatives. Since in English law it is not possible to assign contracts because of the personal nature of the contractual obligations, in practice they are transferred via novation: the original transaction is extinguished and a new transaction, identical to the previous one, is concluded in which one of the parties has been replaced by another person. In other legal systems, this legal limitation does not exist, which would mean that, under the current draft, transfers instrumented via assignments shall fall outside the rule. Lastly, the proposed wording for the new Art. 15bis.5 of Act 8/2013 refers to the frustration of contracts, i.e., to an English jurisprudential doctrine without a clear reflection in continental Europe.

In addition to the above, the project includes financial terminology that is certainly rare in practice, although it is used in several jurisdictions. A clear example is the use of the term "extrabursátil" in Spanish, which is a precise translation from the expression "over-the-counter." However, in international practice, as is done in the English version of the EMIR regulation, it is used the term "OTC" and the contracts in question are defined as "OTC derivatives." No further details are needed, even when these contracts are closed on trading venues or cleared on a CCP (for instance, via LCH or Eurex). With regards to benchmarks, the terms "borrowing rate" and "interval," despite having been used in other jurisdictions, are also confusing, when in fact we are talking about "interest rate" and "differential," terms that are well known and understood in practice. All this without taking into account the term "overdraft facility" ("possibilitat de descobert") referred to in the new Art. 2.53. In our opinion, it would be sufficient for such article to simply refer to consumer and real estate financing, as the BMR refers to both types of financial contracts in this area.

At first, these are certainly minor terminological matters. However, it is worth recalling the restrictions to which the term "close-out netting" has been subjected in the case law of the Spanish Supreme Court based on the translation of this term as "contractual set-off agreement" ("acord de compensació contractual"). This meant that its novation nature was dismissed, so that it was denied that it could be applied in respect of a single transaction. The commotion was not only remarkable, but even international in scope. Suffice is to say that the recent Malaysian legislation on the subject was obliged to emphasise that close-out netting was also applicable even in the case of a single transaction.

2. Adaptation to BMR

The BMR regulation was the European Union's reaction to the scandals concerning the attempts to manipulate EURIBOR and LIBOR, a reaction clearly interventionist (as European benchmark administrators became subject to stringent regulation and the use of benchmarks requires prior registration in the ESMA's Register of Administrators and Benchmarks) led by the European Union and whose follow-up in other jurisdictions remains to be seen. For this reason, Art. 51.5 of the current version of the BMR allows the continued use of third countries benchmarks until 31 December 2023, date to be also considered in Andorra. Furthermore, it should be appropriate to accept all the exceptions provided for in the BMR to its own material scope of application, and not only the one related to the benchmarks published by central banks and other public institutions. Thereupon, reference single prices for financial instruments (such as stock prices) and certain commodity benchmarks should be excluded. However, it should not be forgotten that the European Union must still take a decision on exchange rate fixings and is about to undertake a reform of the BMR that will result in relevant modifications of the existing exceptions and the use of third states benchmarks. As a consequence, Act 8/2013 should be subject to a major reform in the near future.

Alternatively, to avoid the continuous updating of Act 8/2013, the Andorran standard could be referred to the European one or the General Council could be empowered to adopt the appropriate regulations, as it is done in other parts of the project.

Moreover, there is some confusion concerning financial instruments and contracts to which the Act is to be applied. As for the former, the concept of financial instrument includes OTC derivatives, whose legal nature is clearly contractual. However, in any case, these instruments must be liquid, i.e., admitted (or at least requested to be admitted) to a trading venue or offered by a systematic internaliser, in accordance with Art. 3.1.16 of the BMR. The absence of this precision is important as illiquid financial instruments are generally non suitable for BMR due to their inherent characteristics. As for financial contracts, we have already observed that it would be more appropriate to refer to consumers and real estate financing contracts (defined in Art. 4.3 of Regulation (EU) 2014/17).

For its part, the new Art. 15ter establishes a legal regime on the legal designation of substitute benchmarks in line with the provisions of Arts. 23.a, 23.b and 23.c of the BMR. Nevertheless, unlike Art. 15ter.1.(b), Art. 23.a.(b) is not only limited to financial contracts, but it also covers any contract subject to a law that does not provide for any substitute and whose parties are resident in the European Union. The current proposal would prevent the application of Art. 15ter.1.(b) to financial instruments of a contractual nature, such as OTC derivatives. Moreover, the proposed wording is strange because it strictly refers to internal contracts (both parties shall exclusively reside in Andorra) subject to a foreign law (which shall be unusual in such cases).

Regarding new Art. 15ter.6, it is completely logic in terms of legal security and is in line with the BMR: the substitutes agreed by the parties should prevail over the legal ones. However, it may be clearer to simply state the following: "The designation of a substitute benchmark, in the case of negotiable financial instruments, shall not prevent the parties of a financial contract or an OTC derivative or the majority of the affected persons from designating a different benchmark or from applying different conditions, either before or after the entry into force of the technical regulation of benchmark substitution provided for in paragraph 3." Nor has anything been said about the content of such regulations, of which the technical content is not straightforward.

Lastly, it is important to point out that the new Art. 15bis.2 allows Andorran entities to use substitute benchmarks. Certainly, such wording is perfectly correct, but it does not take into account that Art. 21 of the BMR also provides for the compulsory administration of critical benchmarks (a term not used in the project), which has in fact already happened in practice, with the corresponding contracts construction problems. Indeed, the United Kingdom, in order to avoid the problems related to the disappearance of LIBOR regarding the British pound and the Japanese yen, obliged the administrator of such benchmark to calculate and publish a synthetic benchmark for a year, subject to possible extensions. Consequently, it may be appropriate to authorise the Andorran institutions to also use such synthetic benchmarks, even temporarily. These difficulties, to some extent, have been aggravated by the amendment approved to the project in connection with this subject matter, since no minimum period is now set forth to adapt the contracts made prior to the reform.

3. Adaptation to SFTR

Regarding the adaptation to SFTR, two aspects are indeed relevant: (i) the establishment of a transaction notification regime, and (ii) the imposition of a duty to warn of the risks linked to the re-use of financial collaterals. The first issue is not fundamentally different from the European model, except for the fact that, instead of using the services of transactions repositories, notifications must be addressed to the AFA. The impact of this choice on the dissemination of information to be obtained on the basis of these new transparency obligations remains to be seen, but it is certainly of interest in order to control shadow financial activity.

Although perfectly correct, the technique followed in the second of these matters is a bit rare. The term "re-use," as stated in the same draft, refers to the use of assets received as collateral by means of a pledge with the right to use (a figure already provided for in Art. 60 of Act 8/2013), or by means of the transfer of ownership. A separate article is focused on each of these types of financial collaterals with practically identical content. Moreover, it would have been very useful to legislate on the effects of non-compliance with these information duties. This loophole is already present in the SFTR, but it is acceptable in such framework, as the regulation of financial collateral is a matter for the State Member laws that implemented the financial collateral directive. In case of Act 8/2013, the requirements for the perfection of these collaterals are contained in Arts. 55 and 57 which, whether the reform is approved in the current terms or not, will not improve the regulation of these information duties introduced in the new Arts. 81 and 81bis. In this vein, it is worth to mention the absence of limitations on collateral ownership transfers made by retail investors other than individuals.

4. Adaptation to EMIR

This adaptation, even not complete, extends the fundamental parts of EMIR regulation to the Principality of Andorra. We refer to the following matters: (i) the clearing of OTC derivatives, (ii) credit risk mitigation of OTC derivatives by posting collateral, (iii) derivatives repositories, (iv) formal duties to timely confirm OTC transactions, and (v) portfolio reconciliation (the bill does not regulate portfolio compression of OTC derivatives). It is worth to point out that, after importing the definition of "Financial Counterparty" ("FC") and that of "Non-Financial Counterparty" ("NFCs"), as well as the figure of FC- (i.e., the FCs whose reduced volume of activity exempts them from the obligation to clear OTC derivatives, since such obligation is triggered after notifying the AFA that the thresholds provided for in EU law in this respect have been exceeded), all Andorran NFCs are exempted from this obligation, even though NFCs would fall within the scope of application of Art. 4.1 of EMIR when closing OTC derivatives with European Union FCs. On the other hand, it should be noted that the overstepping of clearing thresholds by a FC, as well as by a NFC, must be reported to ESMA, which is based on common criteria across the European Union. However, in the case of third countries, the flow of information is more complex, and it may arise the problem of the liabilities in which the parties may incur in the event of an error in qualifying the regulatory status of the counterparty. In practice, as ESMA states, it is usual to require the counterparties to issue a declaration of such status and, if this disclosure is not satisfactory nor obtained, it should be presumed that the counterparty is obliged to clear the OTC derivative transactions. In the event that such disclosure is considered a “representation“ under English law, it may have adverse legal consequences if uncertain, so it would be appropriate that there was also a duty to notify the AFA that the thresholds are not exceeded by a FC-.

As regards the obligations to report derivative transactions, this obligation extends to all derivatives, not being limited only to OTC derivatives, as EMIR does. The notification must be addressed to one of the officially recognised repositories under EMIR, and this obligation is only applicable to FCs, since transaction notifications by NFCs are not mandatory nowadays. That is the reason why the exceptions provided for NFCs with regards to notification duties are of little substance. Moreover, curiously, this obligation in the bill is only enforceable in respect of transactions concluded by an Andorran FC when contracting with EU FCs, but not in purely internal transactions. On the other hand, given that FCs other than credit entities have limited internal administration systems, the Andorran rule continues to authorise the delegation of this duty.

After laying these foundations, as the adaptation to EMIR is limited to the essential principles on which this regulation is based, the project refers to further regulatory development by the ministry of finance in charge or the AFA, depending on the subject matter, in very broad terms. As a consequence, EMIR provisions on collateral posting (both variation margin and initial margin, although initial margin obligations are only triggered when EMIR relevant thresholds are exceeded, what will be unusual for most NFC-s in practice) are to be already applied in transactions entered by Andorran banks vis-à-vis EU FCs, as it currently happens. In fact, these future regulations will be of utility to introduce exemptions in connection with collateral obligations, provided that the related transactions are entered into among Andorran entities. In this vein, it is important to stress that collateral obligations can be hard to meet and manage by FCs other than banks, and haircuts applicable to negotiable securities posted as collateral can be of paramount importance, since only banks use cash for such purposes.

Portfolio reconciliation is also to be covered by such future regulations. In fact, the standard contractual forms used in practice are well suited to provide a solid contractual framework for this specific obligation. Only two issues can be of relevance in practice: the first one, the convenience to coordinate this EMIR obligation with the information duties already involved in practice, because the point is not the knowledge on the product, but risk managing considerations; the second one, the regulation of potential controversies regarding the portfolio valuation. Such controversies, strictly speaking, cannot be deemed either potential pieces of litigation or even disputes, because they will be generally caused by the use of different valuation approaches and should not affect the calculation of the amounts or deliveries to be exchanged between the parties. Consequently, these discrepancies, if any, may not be solved in practice, at least not always, and the subsequent legal consequences must be limited, to say the very least. In other words, this obligation is not aimed to attain a specific result such as the use of common valuation techniques by both parties, but to encourage the surveillance over market valuations.

Finally, the compression obligations, although being a part of EMIR obligations, are driven mostly by financial considerations (i.e., substantial cuts of the number of transactions, but keeping volatility levels unchanged). Provided that only large OTC transaction portfolios are to actually benefit from these risk reduction procedures, and further provided that such compressions are managed by highly specialized service providers, the current lack of regulation on this subject matter will be neglectable when it comes to practice.

****

CASES & LACAMBRA

Our Financial Services team will be pleased to provide you more information. Please, do not hesitate to contact us:

Miguel Cases

Partner

miguel.cases@caseslacambra.com

Laura Nieto

Partner

laura.nieto@caseslacambra.com

Claudi Rossell

Of Counsel

claudi.rossell@caseslacambra.com

© 2022 CASES & LACAMBRA.

All rights reserved.

This document is a compilation of legal news prepared by Cases & Lacambra.
The information and content in this document do not constitute, in any case, legal advice.