LEXOLOGY
Getting The Deal Through

EQUITY DERIVATIVES 2023

Contributing editor
Rafal Gawlowski

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Latham & Watkins LLP

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The past several years emphasised the growing importance of strategic equity solutions as part of corporate finance advisory services for both listed issuers and their controlling shareholders. Strategic equity solutions are a range of equity derivatives products, including capital-raising, equity-linked products, structured share buy-back and share accumulation and disposal products, and hedging and monetisation products. Interestingly, the period of the global pandemic highlighted the continued demand for sophisticated methods of capital raising, balance sheet management and hedging solutions, all of which utilise strategic equity solutions. That trend continued until the 2022 downturn in global equity markets. This eighth edition of the Equity Derivatives volume in the Lexology Getting the Deal Through series aims to survey the equity derivatives landscape in key jurisdictions around the world and highlight the critical issues that practitioners and market participants should be aware of. This introduction gives a brief overview of the state of the global market and the primary product classes discussed in this volume.

When considering which jurisdictions are relevant to the legal analysis of a particular equity derivatives product, practitioners must look beyond the jurisdiction of the counterparty to the product's contract. In addition to considering the laws of the counterparty's jurisdiction, practitioners must consider the laws of the jurisdictions in which the underlying equities are listed and traded (likely to be the jurisdiction in which the equity derivatives product is going to be hedged), the laws of the jurisdiction in which the underlying issuer is organised and in which it conducts business, the laws of the jurisdiction in which the collateral is held, the laws of the jurisdiction in which the dealer is organised and regulated, and the laws governing the equity derivatives product itself. Not infrequently, an equity derivatives transaction will span a number of jurisdictions and will require collaboration among practitioners around the globe.

Efficient equity derivatives markets depend on liquid equity markets, making the United States, Japan, greater China, continental Europe and the United Kingdom natural centres for equity derivatives trading. According to data obtained from Statista, as at April 2023, the New York Stock Exchange (NYSE) remained the largest exchange operator worldwide, with market capitalisation of approximately US$22.77 trillion, followed by the Nasdaq Stock Market (US$16.24 trillion), the Shanghai Stock Exchange (US$6.74 trillion), Euronext (US$6.06 trillion), Japan Exchange Group Inc (US$5.38 trillion), Shenzhen Stock Exchange (US$4.7 trillion), Hong Kong Stock Exchanges and Clearing Limited (US$4.56 trillion), National Stock Exchange of India (US$3.34 trillion) and the London Stock Exchange Group (US$3.10 trillion).

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The equity derivatives most commonly used by listed issuers are capital-raising, equity-linked derivative securities (such as convertible notes); products for hedging those derivative securities; and synthetic share repurchase transactions. Issuances of equity-linked derivative securities exploded in 2020 and 2021, tailed off significantly since in public markets, but have been more and more active in private capital markets. In addition to raising capital through traditional offerings of equity-linked convertible and exchangeable notes, issuers have also marketed alternative structures to investors, including convertible preferred shares, mandatory convertible preferred shares and tangible equity units (a combination of a prepaid stock purchase contract and an amortising note). As these convertible securities approach maturity, structured exchange transactions with existing convertible noteholders have provided issuers with an efficient method of refinancing their convertible debt.

Derivative overlays that synthetically raise the conversion price of convertible securities – namely, call spreads and capped calls – have been very popular for US issuers, who enjoy favourable tax and accounting treatment. While that treatment may not be available to non-US issuers, many still use capped calls to hedge against potential dilution or cash expenditure on conversion of the underlying securities, and such issuers can take advantage of alternative structures with potentially more favourable features for which tax integration and accounting concerns are not constraining factors. Call spreads and capped calls have been adapted to hedge a range of other equity-linked securities in addition to convertible notes.

Additionally, US, European and Asian issuers continued robust equity repurchase activity at record levels, driven in large part by initially lower stock market valuations, availability of cash on their balance sheets and investor's demand for capital returns. Many of these repurchase programmes have taken the form of structured repurchase strategies, such as accelerated share repurchase transactions and guaranteed price repurchases. In addition, overall concerns and the restrictions on repurchases by certain US companies receiving financial assistance from the federal government under the Coronavirus Aid, Relief and Economic Security Act of 2020, which might have had implications not just for stock buy-backs but also other issuer hedging products have largely subsided, and new rules in the US focusing on insider trading and repurchase reporting should have minimal impact on these transactions going forward. While buy-back activity picked up in Europe and Asia, US issuers still repurchase significantly more equity than Asian or European issuers. Chinese authorities have sought to encourage share buy-backs to provide support for share prices, including allowing companies to fund such buy-backs through the issuance of bonds and other securities. China has also provided greater flexibility for getting corporate approvals for share buy-backs.

Also, controlling shareholders most commonly use margin loans as a pure monetisation strategy for their ownership position. This product class provides preferred means for controlling shareholders to obtain liquidity from their holdings without losing upside (or, depending on the structure, hedging downside) risk in the stock price or their controlling position. The collateral underlying these margin loans may itself be equity derivative products, including convertible notes, convertible preferred shares or other derivative securities. Increasingly, margin loans are being used as a form of acquisition finance in public takeovers. Finally, the continued presence of 'unicorns', highly valuable pre-initial public offering companies without public markets for their securities, has created a lot of pressure to find 'private market' solutions that would provide liquidity to founders and employees.

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Outside the margin loan market, funded collars, prepaid forwards, enhanced-yield sale strategies, mandatory exchangeable trust securities and other derivative structures allow controlling shareholders to monetise their positions while hedging against future price fluctuations of the equities they own. In addition, investors have used accelerated accumulation and disposal transactions to acquire or make outright dispositions of their stakes. In the UK and Europe, accelerated 'stake-building' transactions have been popular in recent years among investors looking to quickly and quietly establish a significant toehold in listed companies, either as an end in itself or as a first step in a public to private transaction or other public offer.

The market for strategic equity solutions is likely to continue to expand in 2023 and beyond, as hedging products grow in popularity amid the market turmoil, market volatility, rising interest rates and geopolitical factors and issuers in need of immediate liquidity tap the convertible notes market. But the growth of particular product classes will also be shaped by traditional macroeconomic influences, such as global growth; equity prices and liquidity; interest rate changes; and tax, regulatory and accounting policies. In addition, new market entrants and disruptive technologies are challenging the way that many equity derivative products have historically been structured and marketed. Corporate finance advisory services and their clients will need to be prepared to adapt to rapidly evolving market practices and an increasingly globalised landscape.

LATHAM & WATKINS

Rafal Gawlowski	rafal.gawlowski@lw.com

1271 Avenue of the Americas, New York, NY 10020, United States
Tel: +1 212 906 1200
www.lw.com

Australia

Jamie Ng, Andrew Kim, Jonathan Chapman, Corey McHattan and Emma Malone
Ashurst

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Summary

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OVERVIEW

Typical types of transactions

1 Other than transactions between dealers, what are the most typical types of over-the-counter (OTC) equity derivatives transactions and what are the common uses of these transactions?

While the Australian market for OTC equity derivatives (ie, the market for OTC equity derivatives over Australian underliers, such as shares of Australian listed companies) is not as established as the OTC equity derivatives markets in some other global financial centres, the Australian OTC equity derivatives market is active and growing. Some of the more common types of OTC equity derivatives transactions in the Australian market are:

- equity swaps and other equity derivatives used in a mergers-and-acquisitions context as part of the strategy to acquire a substantial equity stake;
- collars and prepaid forwards used to hedge or monetise shareholdings;
- margin loans used to finance or leverage shareholdings;
- equity swaps and other equity derivatives used by investors to gain synthetic exposures; and
- certain structured retail products that reference equities or equities indices.

Borrowing and selling shares

2 May market participants borrow shares and sell them short in the local market? If so, what rules govern short selling?

'Naked' short selling is prohibited in Australia, subject to certain limited exceptions. 'Covered' short selling (ie, where the seller has acquired a 'presently exercisable and unconditional right to vest' the relevant shares prior to selling the shares) is permitted. The regulation is generally contained in the Corporations Act 2001 (Cth) (Corporations Act) and associated guidance from the Australian Securities and Investments Commission (ASIC).

There are reporting obligations in respect of short selling, both at a transactional level and at a positional level.

Applicable laws and regulations for dealers

3 Describe the primary laws and regulations surrounding OTC equity derivatives transactions between dealers. What regulatory authorities are primarily responsible for administering those rules?

The following are the primary laws and regulations applicable to inter-dealer activities in the Australian OTC equity derivatives market:

- The Corporations Act and the Australian Securities and Investments Commission Act 2001 (Cth) (ASIC Act) are relevant statutes that cover financial services licensing regime and market conduct matters. The relevant regulator is the ASIC.

- Australia has also implemented a legislative framework and rules in the areas of OTC derivatives reporting, clearing of certain OTC derivatives through central counterparties, and margin and risk mitigation requirements for non-centrally cleared derivatives. The primary regulators in these areas are the Minister and the Council of Financial Regulators (comprised of the ASIC, the Reserve Bank of Australia and the Australian Prudential Regulation Authority).

Entities

4 In addition to dealers, what types of entities may enter into OTC equity derivatives transactions?

Apart from a particular entity's capacity or authority restrictions and (to the extent the transaction confers on the entity a relevant interest (within the meaning prescribed under the Corporations Act) in the underlying securities) restrictions that may apply to acquisitions of interests by a foreign person or in a sensitive business such as the media sector, broadly speaking there is no general prohibition under Australian law on the types of entities that may enter into OTC equity derivatives transactions. However, transactions should be analysed case by case to assess whether entry by a particular type of entity may be prohibited or restricted under any applicable law or regulation.

Apart from dealers, other types of entities that also enter into OTC equity derivatives in the Australian market include:

- corporates;
- shareholders;
- asset managers;
- investment funds;
- family office and high net worth individuals; and
- insurance companies.

Applicable laws and regulations for eligible counterparties

5 Describe the primary laws and regulations surrounding OTC equity derivatives transactions between a dealer and an eligible counterparty that is not the issuer of the underlying shares or an affiliate of the issuer? What regulatory authorities are primarily responsible for administering those rules?

OTC equity derivatives transactions are regulated under the Corporations Act. ASIC has responsibility for administering the Corporations Act and accordingly has oversight of OTC equity derivative transactions. ASIC has established certain rules in relation to derivative transaction reporting (the ASIC Derivative Transaction Rules (Reporting) 2013, remade into the ASIC Derivative Transaction Rules (Reporting) 2022) and published a number of regulatory guides that set out guidance applicable to OTC equity derivative transactions.

The Takeovers Panel, a body that is given statutory power to resolve disputes in takeovers and other change of control transactions, has also issued guidance with respect to disclosure of OTC equity derivatives that are relevant in the context of control transactions.

Securities registration issues

6 Do securities registration issues arise if the issuer of the underlying shares or an affiliate of the issuer sells the issuer's shares via an OTC equity derivative?

The Corporations Act does not permit an issuer to hold shares in itself (including as treasury stock). Accordingly, under Australian law an issuer cannot sell shares in itself (whether via an OTC equity derivative or otherwise).

An 'affiliate' is not defined under the Australian Corporations Act. It is possible for a controlling shareholder to enter into an OTC equity derivative transaction to sell shares in the issuer. However, such a controlling shareholder would need to ensure that it does not contravene, among other things, the prohibitions against insider trading under the Corporations Act if it is in possession of inside information regarding the issuer.

Repurchasing shares

7 May issuers repurchase their shares directly or via a derivative?

Under Australian law, an issuer may repurchase its own shares provided that doing so does not materially prejudice its ability to pay its creditors and that the procedures set out in the Corporations Act are followed. Any shares repurchased are automatically cancelled. The Corporations Act procedures relating to a share repurchase (or 'share buy-backs' as referred to in the Corporations Act) include a requirement to give 14 days' notice to ASIC of the proposed share buy-back and disclosure of all information relevant to the buy-back. In relation to shares other than ordinary shares, or offers made to specific shareholders only, the shareholders must approve the buy-back by special resolution with voting restrictions imposed on the persons whose shares are proposed to be bought back (or, alternatively, a resolution being passed at a general meeting by all shareholders of the issuer). These procedures do not easily accommodate repurchasing shares by way of a derivative. If the issuer is listed, the Listing Rules of the Australian Securities Exchange (ASX) also require the issuer to make certain announcements to ASX concerning the share repurchase.

An issuer must not be in possession of inside information if it wishes to repurchase shares and, provided that the buy-back is a genuine transaction and not implemented for a purpose outside the interplay of genuine market prices, ought not to fall foul of the market misconduct prohibited under Part 7.10 of the Corporations Act, including market manipulation, creating a false or misleading appearance of active trading and artificially creating or maintaining a trading price of financial products (which includes shares and derivatives over shares).

Risk

8 What types of risks do dealers face in the event of a bankruptcy or insolvency of the counterparty? Do any special bankruptcy or insolvency rules apply if the counterparty is the issuer or an affiliate of the issuer?

Generally speaking, the risks faced by a dealer in a counterparty insolvency scenario involving equity derivatives are similar to the risks faced by a dealer in the same scenario involving derivatives generally.

There are three main types of insolvency proceedings applicable to an Australian company (other than certain regulated bodies such as authorised deposit-taking institutions (ADIs) and insurance companies that in addition are subject to specific regulation) that may become relevant – liquidation (or winding up), voluntary administration (a procedure to appoint an independent person to take control of and investigate the affairs of the company whose future is decided by its creditors resolving to accept an arrangement, end the administration or place the company in liquidation) and receivership (where a secured creditor appoints a receiver to realise the secured assets).

In a liquidation, a liquidator will also have certain rights to make claims in respect of voidable transactions, including unfair preferences and uncommercial transactions. An unfair preference will generally involve a transaction between the company and an unsecured creditor within six months prior to the commencement of the liquidation (but while the company is insolvent), which results in the creditor receiving more from the company than if it had claimed in a liquidation for the debt. An uncommercial transaction will generally involve a transaction of the company (usually while it is insolvent), which a reasonable person in the company's circumstances would not have entered into.

In the case of an insolvent liquidation, if the derivatives transactions are subject to a close-out netting arrangement (such as an International Swaps and Derivatives Association, Inc (ISDA) Master Agreement), then a dealer may have protection under the Payment Systems and Netting Act 1998 (Cth) (the Netting Act) to close out its derivatives transactions to manage its credit risk exposure. If protection is not available under the Netting Act and the dealer seeks to rely on any contractual set-off provisions, such contractual set-off will be subject to the application of mandatory set-off provisions under the Corporations Act, which require mutuality to exist between the parties.

In the case of a voluntary administration, a dealer as a creditor may be subject to the imposition of a moratorium (automatic stay) upon certain enforcement actions. However, if the derivatives transactions are subject to close-out netting protection under the Netting Act, then generally speaking the dealer can still close out its derivatives transactions to manage its credit risk exposure.

In the case of a receivership, priority of a dealer's security interest becomes more important. Where the Personal Property Securities Act 2009 (Cth) (PPSA) applies, the dealer will need to have perfected its security interest under the PPSA to have priority over other competing security interests.

There are special legislative regimes applying to ADIs and insurance companies in financial difficulty that need to be considered, including, in the case of ADI, stays on certain close-out rights against such entities.

In September 2017, Australia enacted legislation relating to ipso facto rights that provides for the stay on enforcement of certain rights as a result of the occurrence of certain insolvency events. The legislation commenced on 1 July 2018. A right contained in a contract, agreement or arrangement that is, or is directly connected with, a derivative, or in a close-out netting contract under the Netting Act, is exempted by regulations from the stay on enforcement.

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Reporting obligations

9 What types of reporting obligations does an issuer or a shareholder face when entering into an OTC equity derivatives transaction on the issuer's shares?

A key reporting obligation that potentially arises under the Corporations Act when entering into an OTC equity derivatives transaction is the obligation to file a substantial holding notice.

A shareholder of the issuer will have an obligation to file a substantial holding notice with the issuer and the ASX if, as a result of entry into the OTC equity derivative, the shareholder:

- begins to have, or ceases to have, a substantial holding; or
- has a substantial holding and the OTC derivative transaction results in a movement of at least 1 per cent in their holding.

A shareholder will have a substantial holding if they (together with their associates) have a relevant interest in voting shares carrying 5 per cent or more of the total votes of the issuer. Certain OTC derivatives that confer on a party a right to acquire the underlying shares will result in that party acquiring a relevant interest in those shares.

Under the Corporations Act, it is possible for an issuer to acquire a relevant interest over its own shares (this being a concept different from having a legal interest in the shares) and therefore in certain circumstances the above filing obligation can apply to the issuer itself.

If an OTC derivative over the shares of an ASX-listed company is cash-settled only and does not give the taker the right to physical settlement, entry into the OTC derivative would not ordinarily require the taker to file a substantial holding notice (even if it relates to 5 per cent or more of the company's shares). This is because a cash-settled equity derivative would not ordinarily give the taker any relevant interest in the underlying shares unless it gives the taker any right to control the voting or disposal of the underlying securities.

However, for listed companies, the expectation of the Takeovers Panel is that all long positions that already exist, or that are created, over that company's shares are disclosed unless they are under a notional 5 per cent (Takeovers Panel Guidance Note 20). This applies regardless of whether or not there is an announced control transaction or a potential control transaction.

In respect of derivatives transaction reporting, the Australian Securities and Investments Commission (ASIC) Derivative Transaction Rules (Reporting) 2013 (now remade into the ASIC Derivative Transaction Rules (Reporting) 2022) apply to reporting entities, which may in practice be domestic or foreign. However, in practice, the obligations would apply only to a foreign entity to the extent it had brought itself within the scope of the Australian regulation by obtaining an Australian licence, authorisation or exemption (or that it had registered or provisionally registered as a swap dealer with the US Commodity Futures Trading Commission in accordance with the Commodity Exchange Act 1936 (US)).

Restricted periods

10 Are counterparties restricted from entering into OTC equity derivatives transactions during certain periods? What other rules apply to OTC equity derivatives transactions that address insider trading?

The insider trading prohibitions in the Corporations Act (which apply generally to transactions involving financial products and not just OTC derivatives) will prevent a counterparty, if they are in possession of inside information in relation to an issuer, from entering into an OTC equity derivative in respect of an issuer's securities or procuring another person to enter into an OTC equity derivative in respect of an issuer's securities.

'Inside information' is information that is not generally available, and if it were, a reasonable person would expect it to have a material effect on the price or value of securities.

Legal issues

11 What additional legal issues arise if a counterparty to an OTC equity derivatives transaction is the issuer of the underlying shares or an affiliate of the issuer?

An important issue that arises if a counterparty to an OTC equity derivatives transaction is the issuer of the underlying shares is that the Corporations Act does not permit an issuer to hold shares in itself (including as treasury stock). Accordingly, under Australian law an issuer cannot sell shares in itself (whether via an OTC equity derivative or otherwise). Similarly, the Corporations Act regulates an issuer's ability to repurchase its own shares (which, if repurchased, are automatically cancelled). Accordingly, the circumstances in which an issuer could be a counterparty to an OTC equity derivatives transaction are limited.

An 'affiliate' is not defined under the Australian Corporations Act. It is possible for a controlling shareholder to enter into an OTC equity derivative transaction in respect of the shares in the issuer. However, such a controlling shareholder would need to ensure that it does not contravene, among other things, the prohibitions against insider trading under the Corporations Act if it is in possession of inside information regarding the issuer.

Tax issues

12 What types of taxation issues arise in issuer OTC equity derivatives transactions and third-party OTC equity derivatives transactions?

Australian tax law does not contain specific rules dealing with the tax treatment of equity derivatives, although there are a number of specific provisions that deal with the tax consequences of transactions that commonly affect equity derivatives (eg, exercise of options, conversion or exchange of convertible or exchangeable instruments).

As such, the tax treatment of equity derivatives is determined under the general provisions of the Australian tax law, including, where relevant, the specific rules mentioned below and, where applicable, the 'taxation of financial arrangements' rules in the tax law (which is a comprehensive 'code' governing the tax treatment of certain types of financial instruments for certain classes of taxpayers).

The specific types of taxation issues that arise for issuers and holders of equity derivatives depend on the particular type of equity derivative involved. Some of the taxation issues that commonly arise include (but are not limited to):

- classification of the instrument under the debt/equity rules;
- assessability or deductibility of payments made or received under the instrument;
- capital gains tax consequences of acquiring, holding and disposing of the instrument; and
- taxation consequences of exercise, conversion and exchange of instruments.

For the purposes of Australian goods and services tax (GST, the Australian equivalent of VAT), dealings in interests in equity derivatives and securities will usually be classified as 'financial supplies'. Financial supplies are one of the main categories of input taxed (exempt) supplies in Australia. This means that no GST is payable on the supply but both the supplier and the acquirer may not be entitled to claim full input tax credits for the GST incurred on any costs associated with the supply (eg, legal fees, accounting fees). Certain acquisitions (eg, brokerage) that relate to making input-taxed financial supplies or acquisitions may qualify for a reduced input tax credit (broadly equal to 75 per cent of the GST amount or 55 per cent for certain expenses of funds and trusts in certain cases).

As the rules applicable to equity derivatives are complex and varied, specific advice should be obtained regarding the relevant rules and their application in the circumstances of the particular transaction.

Liability regime

13 | Describe the liability regime related to OTC equity derivatives transactions. What transaction participants are subject to liability?

In addition to liabilities that can arise for derivatives transactions generally (eg, liabilities arising under contract, tort, equity or statutes), OTC equity derivatives transactions can also give rise to liability if there is a breach of the prohibitions against insider trading or other types of market misconduct or, if the derivative transaction gives the taker a relevant interest in the underlying securities (of a listed company) in excess of 20 per cent of the company's voting securities, in breach of the takeover provisions of the Corporations Act.

Stock exchange filings

14 | What stock exchange filings must be made in connection with OTC equity derivatives transactions?

A shareholder of the issuer will have an obligation to file a substantial holding notice with the issuer and the ASX if, as a result of entry into the OTC equity derivative, the shareholder:

- begins to have, or ceases to have, a substantial holding; or
- has a substantial holding and the OTC derivative transaction results in a movement of at least 1 per cent in their holding.

A shareholder will have a substantial holding if they (together with their associates) have a relevant interest in voting shares carrying 5 per cent or more of the total votes of the issuer. Certain OTC derivatives that confer on a party a right to acquire the underlying shares will result in that party acquiring a relevant interest in those shares.

Under the Corporations Act, it is possible for an issuer to acquire a relevant interest over its own shares (this being a concept different from having a legal interest in the shares) and therefore in certain circumstances the above filing obligation can apply to the issuer itself.

If an OTC derivative over the shares of an ASX-listed company is cash-settled only and does not give the taker the right to physical settlement, entry into the OTC derivative would not ordinarily require the taker to file a substantial holding notice (even if it relates to 5 per cent or more of the company's shares). This is because a cash-settled equity derivative would not ordinarily give the taker any relevant interest in the underlying shares unless it gives the taker any right to control the voting or disposal of the underlying securities.

However, the expectation of the Takeovers Panel is that all long positions that already exist, or that are created, over that company's shares are disclosed unless they are under a notional 5 per cent (Takeovers Panel Guidance Note 20). This applies regardless of whether or not there is an announced control transaction or a potential control transaction.

Typical document types

15 | What types of documents are typical in an OTC equity derivatives transaction?

In the Australian market for OTC equity derivatives, parties typically enter into a confirmation under an ISDA Master Agreement to document an equity derivatives transaction. The confirmation will typically incorporate the relevant equity derivatives definitions, such as the 2002 ISDA Equity Derivatives Definitions. Depending on the nature of the security arrangement, parties may document their security arrangements using the ISDA Credit Support Annex or other tailored security documentation such as a specific security deed. In the case of margin loans, it is not uncommon for parties to use the Asia Pacific Loan Market Association documentation or other bespoke forms of documentation.

Legal opinions

16 | For what types of OTC equity derivatives transactions are legal opinions typically given?

As with derivatives transactions generally, a dealer typically obtains legal opinion comfort on close-out netting and collateral enforceability from industry published opinions. A dealer may also request capacity and authority opinion from the counterparty. For OTC equity derivatives transactions that are more structured in nature, additional legal opinions (such as opinions on contractual enforceability and security interest) may also be sought.

A dealer may sometimes require detailed legal advice on corporate law issues, such as for OTC equity derivatives transactions used in a mergers and acquisition context as part of the strategy to acquire a substantial equity stake, to ensure that the specific requirements that may arise in this context are identified, including in relation to the prohibition against insider trading, acquisition of relevant interests in the underlying securities and disclosure of substantial holdings. If the taker is a foreign person, requirements under the Foreign Acquisitions and Takeovers Act 1975 (Cth) will also need to be considered.

Hedging activities

17 May an issuer lend its shares or enter into a repurchase transaction with respect to its shares to support hedging activities by third parties in the issuer's shares?

As an issuer is not entitled to hold its own shares under Australian law, it will not be able to lend its own shares in any circumstance.

While an issuer may enter into a repurchase transaction with respect to its shares, there are procedures that must be followed under the Corporations Act. Under these procedures, the shares are automatically cancelled on repurchase. In addition, the issuer would need to consider insider trading and market manipulation provisions.

Securities registration

18 What securities registration or other issues arise if a borrower pledges restricted or controlling shareholdings to secure a margin loan or a collar loan?

Generally, where a security interest granted over shares is subject to the PPSA, the lender will want to ensure that appropriate steps under the PPSA are taken to protect that security interest. This might include registration of a financing statement on the Personal Property Securities Register.

If a borrower pledges shares in a listed company for the benefit of a lender, the lender will need to consider whether the creation of the security interest causes the lender to acquire a 'relevant interest' in those shares. The Corporations Act prohibits, subject to certain exceptions, the acquisition of a relevant interest in shares where doing so will cause a person to have an interest in 20 per cent or more of a listed company. Furthermore, if the relevant interest relates to 5 per cent or more of the listed company's shares, a substantial holding notice obligation will arise.

An exception to the creation of a relevant interest exists for commercial lenders if the lender has acquired a security interest over shares in the ordinary course of the business of lending, and the acquisition is on ordinary commercial terms. This exception operates so that no relevant interest arises at all if the exception applies, and therefore the lender would not be required to file a substantial holding notice even if the security interest is over more than 5 per cent of the shares. For this exception to apply, however, the lender and the borrower must not be associates – for instance, they must not be parties to (or propose to enter into) an agreement for the purpose of controlling or influencing the composition of the listed company's board or its affairs.

If the lender taking security interest over shares is a foreign person or entity, the lender should also consider the application of the Foreign Acquisitions and Takeovers Act 1975, which requires that certain forms of acquisitions of interests over shares (that can include the circumstance where shares are pledged in favour of a lender) be notified to the Treasurer before being undertaken.

Borrower bankruptcy

19 If a borrower in a margin loan files for bankruptcy protection, can the lender seize and sell the pledged shares without interference from the bankruptcy court or any other creditors of the borrower? If not, what techniques are used to reduce the lender's risk that the borrower will file for bankruptcy or to prevent the bankruptcy court from staying enforcement of the lender's remedies?

A margin loan lender to an Australian company borrower that becomes subject to certain types of Australian insolvency proceedings may in some circumstances be prevented from enforcing the security against the secured assets without consent or court leave. To address this, a lender may look to structuring techniques that engage the protection under the Netting Act, which will apply despite other laws imposing restrictions on security enforcement. A lender may structure the security as a title transfer arrangement (which relies on close-out netting for enforceability) that is protected as a close-out netting contract under the Netting Act. Alternatively, as a result of amendments to the Netting Act in 2016, a lender may also structure a grant of a security interest over financial property in respect of obligations of a party to a close-out netting contract that satisfies certain Netting Act requirements such that protection would be afforded to the enforcement of the security interest.

Particular issues can arise in relation to shares in a listed company that are acquired by a lender pursuant to an enforced security interest and are proposed to be sold, such as insider trading (in respect of which an exception may apply on the basis that the transaction involves a sale of shares under mortgage) and disclosure (eg, cleansing notices that may be required in certain circumstances to enable on-sale of the securities sold in this process).

Market structure

20 What is the structure of the market for listed equity options?

Listed options (over unissued shares) are issued by the ASX-listed entity, entitling the option holder to subscribe to additional shares in the entity upon exercise of the option. Such options may be quoted or unquoted on the ASX and, if they are quoted, are traded on the ASX in the same manner as shares in the issuer.

Exchange-traded options are equity options over ASX-approved companies that are traded via the ASX. The ASX permits the trading of both call and put options.

Warrants are issued by banks and other financial institutions over a range of various underlying instruments, including shares, exchange-traded funds or a basket of different securities. While the terms of the warrant differ depending on their series, warrants typically give holders the right to buy or sell the underlying instrument to the warrant issuer for a particular price according to the terms of issue, or entitle holders to receive a cash payment relating to the value of the underlying instrument at a particular warrant.

Governing rules

21 | Describe the rules governing the trading of listed equity options.

Listed options are governed by the ASX Listing Rules and the ASX Settlement Operating Rules. Exchange-traded options are governed by the ASX Operating Rules. Warrants are also governed by the ASX Operating Rules, in particular Schedule 10 (Warrant Rules). These rules provide ASX with broad powers to take action in the interests of maintaining fair and orderly markets, including the ability to suspend trading, impose position limits or exercise limits and terminate open contracts. Similarly, regulatory authorities such as ASIC may give directions to ASX or ASX Clear (which operates the clearing facility for exchange-traded options), for example, to suspend dealings in products.

Trading of listed equity options on ASX must also comply with the Corporations Act, including its insider trading and other market misconduct prohibitions.

TYPES OF TRANSACTION

Clearing transactions

22 | What categories of equity derivatives transactions must be centrally cleared and what rules govern clearing?

Interest rate derivatives denominated in AU$, US$, euro and yen entered into by a 'clearing entity' are subject to mandatory clearing in Australia, and equity derivatives are not subject to the Australian mandatory central clearing regime.

Exchange-trading

23 | What categories of equity derivatives must be exchange-traded and what rules govern trading?

There are no categories of equity derivatives that are required to be exchange-traded. However, in practice, the main equity derivatives that are exchange-traded are options, warrants, futures contracts and contracts for difference, which are subject to the quotation and trading requirements of the relevant exchange. The relevant rules are the ASX Operating Rules, the ASX 24 Operating Rules (and associated clearing and settlement rules) and the various Australian Securities and Investments Commission Market Integrity Rules.

Collateral arrangements

24 | Describe common collateral arrangements for listed, cleared and uncleared equity derivatives transactions.

In the case of OTC equity derivatives in the Australian market, collateral arrangements are more relevant for uncleared transactions (equity derivatives are currently not subject to mandatory clearing in Australia). For uncleared equity derivatives transactions entered into under an ISDA Master Agreement, parties commonly document their collateral arrangement using an ISDA Credit Support Annex under a title transfer approach. Parties may also structure the collateral arrangement using a security interest approach although that has not been as common as the title transfer approach.

In the case of exchange-traded equity derivatives where there is a potential exposure for the clearing house, the relevant clearing house will generally call for margin from the relevant clearing participant, who will in turn call for margin from the relevant client. This may be cash or acceptable securities (subject to a haircut).

Exchanging collateral

25 Must counterparties exchange collateral for some categories of equity derivatives transactions?

Prudential Standard CPS 226 (CPS 226) sets out the margining requirements for non-centrally cleared derivatives, including OTC equity derivatives transactions. CPS 226 imposes both variation margin requirements and initial margin requirements. These margining requirements can apply directly to an 'Australian Prudential Regulation Authority (APRA) covered entity', which includes entities such as an authorised deposit-taking institution (ADI) (including a foreign ADI), a general insurer, a life company and a registrable superannuation entity. These margining requirements can also apply indirectly to a 'covered counterparty' if the covered counterparty is trading with an APRA covered entity directly subject to CPS 226. An entity will be a 'covered counterparty' if it is a 'financial institution', subject to certain exclusions. CPS 226, in turn, defines 'financial institution' fairly broadly, which may include entities such as hedge funds, trading firms and foreign deposit-taking institutions.

In the case of exchange-traded equity derivatives where there is a potential exposure for the clearing house, the relevant clearing house will generally call for margin from the relevant clearing participant, who will in turn call for margin from the relevant client. This may be cash or acceptable securities (subject to a haircut).

LIABILITY AND ENFORCEMENT

Territorial scope of regulations

26 What is the territorial scope of the laws and regulations governing listed, cleared and uncleared equity derivatives transactions?

In respect of derivatives transaction reporting, the ASIC Derivative Transaction Rules (Reporting) 2013 (remade into the ASIC Derivative Transaction Rules (Reporting) 2022) apply to reporting entities, which may be an Australian incorporated entity or a foreign entity. However, in practice, the obligations would apply only to a foreign entity to the extent it is a subsidiary of an Australian entity and/or had brought itself within the scope of the Australian regulation by obtaining an Australian registration, licence, authorisation or exemption.

In respect of the financial services licensing regime, the requirement to obtain an Australian Financial Services Licence is triggered in respect of a person 'carrying on a financial services business in Australia'. Section 911D of the Corporations Act provides an expanded definition of when a financial services business is taken to be carried on 'in Australia'. It provides that a person carries on a financial services business in Australia if the person engages in conduct that is intended to induce people in Australia to use the financial services the person provides or is likely to have that effect, whether or not the conduct is also aimed at persons in other jurisdictions. Such conduct that is directed at customers in Australia, even if occurring offshore, will involve the person being deemed to be carrying on a financial services business in Australia.

Registration and authorisation requirements

27 What registration or authorisation requirements apply to market participants that deal or invest in equity derivatives, and what are the implications of registration?

An equity derivative is a financial product, and to the extent that an entity is a counterparty to the arrangement, it would be considered as 'issuing a derivative' to the other party to the arrangement. Issuing a derivative is a regulated financial service. f an entity is not a counterparty, but is involved in or plays a key step bringing into effect the derivative, it could also be considered as 'arranging a derivative', which is similarly a regulated financial service.

The requirement to obtain an AFSL is triggered in respect of a person 'carrying on a financial services business in Australia'. The concept of carrying on a business is considered by the courts as engaging in activities as part of a business with sufficient system, repetition and continuity. Therefore, to the extent that the entity is entering into or arranging a derivative on a one-off basis, this should not amount to it carrying on a financial services business in Australia. In that case, it would not require an AFSL or an exemption. However, if the entity has entered into or has arranged multiple derivative arrangements (with one or more counterparties) and could be considered as carrying on a financial services business in Australia, there are exemptions that could apply.

If an AFSL is obtained, there are a number of significant and numerous obligations that would apply to a licensee.

In respect of exchange-traded derivatives, becoming a participant of the ASX or ASX 24 markets will result in an entity becoming subject to extensive regulation by the relevant market operators and ASIC.

Reporting requirements

28 What reporting requirements apply to market participants that deal or invest in equity derivatives?

Australia has also implemented a legislative framework and rules in the areas of OTC derivatives reporting. A 'reporting entity' must report 'reportable transactions' in accordance with the ASIC Derivative Transaction Rules (Reporting) 2013 (remade into the ASIC Derivative Transaction Rules (Reporting) 2022).

ASX and ASX 24 participants are also subject to various reporting obligations.

Legal issues

29 What legal issues arise in the design and issuance of structured products linked to an unaffiliated third party's shares or to a basket or index of third-party shares? What additional disclosure and other legal issues arise if the structured product is linked to a proprietary index?

The characterisation of the structured product and whether or not it is being offered to retail investors will determine whether, and if so, what type of disclosure document is required (eg, a prospectus or product disclosure statement). If a disclosure document is required, the content requirements are prescribed by the Corporations Act, but if, for instance, the product is also a warrant there will be additional disclosure requirements under the warrant rules. If the product is offered only to wholesale, there are no disclosure requirements prescribed by the Corporations Act and disclosure tends to be more limited. In this context, the disclosure must not be misleading or deceptive.

Structured products that are linked to other indices (proprietary or otherwise) may give rise to certain intellectual property considerations in relation to the use of those indices.

Liability regime

30 Describe the liability regime related to the issuance of structured products.

The issuance of structured products in Australia to certain categories of persons (eg, retail clients) must be made under a disclosure document in compliance with the Corporations Act. Depending on the terms of the specific issuance of the relevant structured product, the product may be characterised as 'securities' or 'derivatives'. The different characterisations do have implications (at a technical level) as to the categories of investors to whom the products may be marketed and the disclosure regime which applies. Issuing products without appropriate disclosure documents where they are required could constitute an offence under the Corporations Act punishable by imprisonment or a large fine.

The Corporations Act also contains a liability regime for the issue of structured products under a disclosure document where the issue of the disclosure document or the disclosure document itself is misleading or deceptive or the disclosure document is defective. An investor who invests in a structured product under a disclosure document and suffers loss because of a defective disclosure document, or misleading or deceptive conduct, may recover the amount of the loss or damage from any person involved in the contravention. In certain circumstances, such conduct may constitute an offence under the Corporations Act punishable by imprisonment or a large fine.

Other issues

31 What registration, disclosure, tax and other legal issues arise when an issuer sells a security that is convertible for shares of the same issuer?

Unless the issue is being made to sophisticated or professional investors, the issue of securities that are convertible into shares of the issuer will ordinarily require a prospectus or other disclosure document to be prepared under Chapter 6D of the Corporations Act, lodged with ASIC and the ASX and provided to the offerees.

Such a disclosure document may also be required for secondary sales of such securities, if a prospectus was not prepared at the time of their initial issue, the securities were not quoted and the secondary sale takes place within 12 months of their issue.

There is no requirement for the convertible security to be registered; however, if the security is intended to be tradeable on the ASX, it will need to comply with the ASX listing rules and the terms of the security will be reviewed by the ASX.

The main tax issue with a convertible instrument is typically whether the instrument is characterised as a debt interest or an equity interest for Australian tax purposes. This will depend on the terms of the instrument, although notes that are mandatorily convertible or are convertible at the option of the issuer would normally be equity interests. Specific advice should be obtained to confirm the correct characterisation from an Australian tax perspective.

From the holder's perspective, the conversion of a convertible interest into shares of the issuer may give rise to an immediately taxable gain or may be disregarded (that is, any gain or loss on the conversion is not immediately recognised but is deferred until realisation of the shares into which the instrument is converted). Whether the gain is immediately taxable or is disregarded depends on the terms of the instrument. Where the gain is taxable, it is generally taxable as income (and not capital gain).

From an Australian goods and services tax (GST) perspective, the sale and conversion of the security will usually be an input-taxed (exempt) financial supply. This means that no GST will be payable on the supply, but the issuer and the holder may not be entitled to claim full input tax credits for any GST incurred on costs associated with the supply (eg, legal fees, accounting fees). Certain acquisitions may qualify for a reduced input tax credit of 75 per cent or 55 per cent of the GST amount.

The issue of convertible notes or conversion of a convertible interest into shares of the issuer can potentially give rise to Australian landholder stamp duty. This will depend on a number of factors, including whether the issuer is a listed entity or an unlisted entity, whether the issuer holds, directly or indirectly, any interests in land in any state or territory of Australia with a market value exceeding certain thresholds, and the proportionate interest in the issuer that the holder (together with that of any associates, or as part of an associated transaction) acquires upon conversion. For example, if the issuer is an entity listed on the ASX or other recognised exchange, a liability to landholder duty generally does not arise unless the holder's convertible interest (together with that of any associates, or as part of an associated transaction) in the issuer amounts to an entitlement on a notional winding up of the issuer to property of the issuer representing an interest of 90 per cent or more.

32 What registration, disclosure, tax and other legal issues arise when an issuer sells a security that is exchangeable for shares of a third party? Does it matter whether the third party is an affiliate of the issuer?

Broadly similar legal considerations apply to exchangeable securities and to convertible securities.

The main tax, GST and stamp duty issues with an exchangeable instrument are broadly the same as those that arise for a convertible instrument.

UPDATE AND TRENDS

Recent developments

33 Are there any current developments or emerging trends that should be noted?

ASIC has made the ASIC Derivative Transaction Rules (Reporting) 2024 (the 2024 Rules), which will come into effect on 21 October 2024. The 2024 Rules substantially amend the reporting regime in Australia with a number of key changes including to:

- reflect internally adopted technical standards for reporting under ISO 20022, standards for other identifiers and other data elements;
- remove outdated transitional provisions and consolidate exemptions within the 2024 Rules;
- remove the safe-harbour for delegated reporting;
- extending the reporting deadline to generally T+2 (previously T+1);
- to require "lifecycle" reporting for all product types (previously only applied to equities derivatives, CFDs and margin FX); and
- introduce new small-scale buy-side exemption to provide relief from certain reporting requirements.

ashurst

Jamie Ng jamie.ng@ashurst.com
Andrew Kim andrew.kim@ashurst.com
Jonathan Chapman jonathan.chapman@ashurst.com
Corey McHattan corey.mchattan@ashurst.com
Emma Malone emma.malone@ashurst.com

Level 11, 5 Martin Place, Sydney NSW 2000, Australia
Tel: +61 3 9679 3772
www.ashurst.com

France

Thomas Vogel and Suzana Sava-Montanari
Latham & Watkins LLP

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Summary

OVERVIEW

Typical types of transactions

1 Other than transactions between dealers, what are the most typical types of over-the-counter (OTC) equity derivatives transactions and what are the common uses of these transactions?

The market for OTC derivatives transactions in France is well established and equity derivative products are routinely used in the implementation of stake-building transactions, equity price risk hedging strategies and share repurchase schemes.

Typical equity derivatives products used by issuers on the French market include (but are not limited to):

- call options, put options and total return swaps to hedge equity price risks on a bespoke basis;
- funded collar in the context of the leveraged acquisition of a stake in a publicly listed company involving an embedded hedge to the market price of the equity purchase (often on a tranched basis);
- unfunded collar in the context of the disposal of a stake in a publicly listed company involving an embedded hedge to the market price of the equity disposal (often on a tranched basis);
- prepaid equity forward in the context of share buy-backs involving a forward transaction that is settled on the basis of the discounted volume-weighted average price of the shares over a certain period (often to hedge a share employee participation scheme);
- variable prepaid forward in the context of the monetisation of an equity stake combined with a deferral of the taxes owed on the capital gains (this structure is often combined with a call spread for hedging purposes);
- accelerated share buy-backs with guaranteed discount in the context of share buy-backs involving the immediate delivery of shares at a discount with a future adjustment based on the volume-weighted average price of the shares over a certain period;
- contingent prepaid forward allowing for the prepayment and purchase of shares being delivered only subject to certain contingencies occurring (ie, regulatory approvals); and
- call spread to hedge certain features of exchangeable bonds.

Margin loans are not widely used in the French market to finance or leverage large share-holdings. This is essentially due to the idiosyncrasies of the transposition of Directive (EU) No. 2002/47/EC of 6 June 2002 on financial collateral arrangements under French law, which has created, in respect of margin loans, uncertainty in the enforcement of the security interest against an insolvent French borrower (as the enforcement process may be potentially affected or limited by the opening of insolvency proceedings in France).

Borrowing and selling shares

2 May market participants borrow shares and sell them short in the local market? If so, what rules govern short selling?

Yes. The French rules on short selling are derived from Regulation (EU) 236/2012 of the European Parliament and of the Council of 14 March 2012 on short selling and certain aspects of credit default swaps (these rules are therefore applicable across all EU member states for all EU-listed shares unless they are primarily traded on a third-country venue). Naked short selling is prohibited in France, and market participants can only create short positions in shares on the French market if they own or have borrowed the relevant shares or have entered into an agreement with a third party, providing reasonable assurances that the shares will be delivered.

Any natural or legal person that holds a short position equal to or higher than 0.1 per cent of the share capital of a company whose shares are admitted to trading on a French trading venue must notify the French regulator (*l'Autorité des marchés financiers* (the Financial Markets Authority (AMF)) of this position within one trading day (and of each movement through a 0.1 per cent threshold above 0.1 per cent). When the net short position reaches or falls below 0.5 per cent of the share capital, the AMF will publicly disclose the information.

In exceptional circumstances (such as during the opening Lehman bankruptcy proceedings or the covid-19 crisis), the AMF has exercised its power to temporarily restrict or ban short selling in case of a significant fall in the price of financial instruments on a given day (a 10 per cent drop for liquid shares, a 20 per cent drop for illiquid shares when the share price is higher than €0.50 and a 40 per cent drop when the share price is below €0.50).

Transactions entered into in connection with market-making activities or as an authorised primary dealer do not fall within the scope of applicable rules, provided that the AMF is notified beforehand. The AMF may prohibit the use of this exemption if it considers that the relevant conditions for its use are not satisfied.

The AMF provides market participants on its website with a file containing the history of net short positions published since 1 November 2012.

Applicable laws and regulations for dealers

3 Describe the primary laws and regulations surrounding OTC equity derivatives transactions between dealers. What regulatory authorities are primarily responsible for administering those rules?

There is no single body of rules regulating equity derivatives in France. Dealers, as financial counterparties subject to licensing requirements, are generally subject to all the rules and regulations affecting the treatment of derivatives (including equity derivatives). These rules affect various aspects of the life cycle of equity derivative transactions.

We note, in particular, the applicability of the following rules (this list is not exhaustive) pertaining to:

- financial netting: France has implemented Directive (EU) 2002/47/EC of 6 June 2002 on financial collateral arrangements in its Financial and Monetary Code, which introduced derogatory rules to French insolvency and security laws (known as the Financial Netting Regime) that are applicable to derivatives transactions entered into between dealers if certain conditions are met. In particular, the Financial Netting Regime allows counterparties to implement the close-out netting provisions of derivatives framework agreements concluded by a French counterparty, including where it is subject to insolvency proceedings;

- threshold crossing: market participants (when they are unable to benefit from the bank trading exemption) need to comply with the relevant provisions of the French Commercial Code and the General Regulations of the French Financial Market Authority relating to the filing of disclosure threshold notifications by the close of trading on the fourth trading day following the acquisition or disposal of a significant holding, including when long exposures are created through forward financial instruments (either cash or physically settled);
- market abuse: market participants are subject to Regulation (EU) 596/2014 (MAR) on market abuse containing provisions on insider dealing, unlawful disclosure of inside information and market manipulation, which all need to be considered in the context of equity derivative transactions (especially where persons discharging managerial responsibilities within issuers, and persons closely associated with them, are involved);
- market infrastructure: market participants are subject to Regulation (EU) 648/2012 on OTC derivatives, central counterparties and trade repositories (EMIR), which imposes risk-reducing or transparency obligations on all EU undertakings (including, but not limited to, dealers and corporates) that enter into derivative transactions (clearing through central counterparties, reporting of transactions to trade repositories, risk mitigation techniques);
- short selling: market participants are subject to Regulation (EU) 236/2012 of 14 March 2012 on short selling and certain aspects of credit default swaps; and
- benchmark: market participants are subject to Regulation (EU) 2016/1011 on indices used as benchmarks in financial instruments and financial contracts, or to measure the performance of investment funds.

The AMF is the authority primarily responsible for policing these rules in France.

Entities

4 In addition to dealers, what types of entities may enter into OTC equity derivatives transactions?

There are no general regulatory exclusions on the types of entities that may enter into OTC equity derivatives transactions in France. France has implemented the provisions relating to customer classification under the MiFID II/MiFIR regulatory framework. OTC derivatives counterparties benefit from a different level of protection depending on their regulatory classification (professional versus non-professional clients). Entities that enter into OTC equity derivatives transactions in France are mainly banks, credit institutions, financial services institutions, funds and large corporates.

Applicable laws and regulations for eligible counterparties

5 Describe the primary laws and regulations surrounding OTC equity derivatives transactions between a dealer and an eligible counterparty that is not the issuer of the underlying shares or an affiliate of the issuer? What regulatory authorities are primarily responsible for administering those rules?

The primary laws and regulations surrounding OTC equity derivatives transactions between a dealer and an eligible counterparty that is not the issuer of the underlying shares or an affiliate of the issuer are as follows:

- financial netting: France has implemented Directive (EU) 2002/47/EC of 6 June 2002 on financial collateral arrangements in its Financial and Monetary Code, which introduced derogatory rules to French insolvency and security laws (known as the Financial Netting Regime) that are applicable to derivatives transactions entered into between a dealer and an eligible counterparty if certain conditions are met. In particular, the Financial Netting Regime allows a counterparty to trigger the termination of outstanding derivative transactions and implement the close-out netting provisions of derivatives framework agreements concluded by a French counterparty, including where it is subject to insolvency proceedings;
- threshold crossing: market participants (when they are unable to benefit from the bank trading exemption) need to comply with the relevant provisions of the French Commercial Code and the General Regulations of the French Financial Market Authority relating to the filing of disclosure threshold notifications by the close of trading on the fourth trading day following the acquisition or disposal of a significant holding, including when these exposures are created through financial instruments (either cash or physically settled);
- markets in financial instruments: dealers that are trading OTC equity derivative transactions with eligible counterparties (that are not dealers) are subject to the rules relating to the provision of regulated investment services under MiFID to counterparties located in France;
- market abuse: market participants are subject to MAR, containing provisions on insider dealing, unlawful disclosure of inside information and market manipulation, which all need to be considered in the context of equity derivative transactions (especially where persons discharging managerial responsibilities within issuers, and persons closely associated with them, are involved);
- market infrastructure: market participants are subject to EMIR, which imposes risk-reducing or transparency obligations on all EU undertakings (including, but not limited to, dealers and corporates) that enter into derivative transactions (clearing through central counterparties, reporting of transactions to trade repositories, risk mitigation techniques, etc);
- short selling: market participants are subject to Regulation (EU) 236/2012 of 14 March 2012 on short selling and certain aspects of credit default swaps;
- benchmark: market participants are subject to Regulation (EU) 2016/1011 on indices used as benchmarks in financial instruments and financial contracts, or to measure the performance of investment funds; and
- securities financing: market participants are subject to Regulation (EU) 2015/2365 (SFTR) on securities financing transactions and collateral reuse, which provides for a legal framework of transparency requirements to facilitate monitoring and risk identification. SFTR sets out, inter alia, reporting rules in respect of details of securities financing transactions (such as securities lending and repo transactions or certain margin lending transactions) to trade repositories and minimum transparency rules and consent requirements for parties involved in collateral use.

However, for certain types of counterparties that are regulated in France, French law imposes additional restrictions that will impact the entry into, or the treatment of, derivative positions (including equity derivatives). For example, with respect to insurance or reinsurance companies licensed in France, the French Insurance Code allows for entry into derivative instruments if these instruments contribute to reducing risks or improving the efficiency of the management of the portfolio of assets. Similarly, for certain collective investment schemes organised in France, derivative positions can only be entered into if their use is consistent with the strategy of the fund in question, and the derivative position can be terminated at any time (at market value or at a predetermined value) by the fund. The AMF is generally primarily responsible for administering these rules, together with, in certain cases, the Prudential Supervision and Resolution Authority.

Securities registration issues

6 | Do securities registration issues arise if the issuer of the underlying shares or an affiliate of the issuer sells the issuer's shares via an OTC equity derivative?

No specific securities registration issues would arise in France as a result of the issuer of the underlying shares or an affiliate of the issuer selling the issuer's shares via an OTC equity derivative. In all instances, these transactions would, however, be subject to compliance with the applicable disclosure provisions under MAR relating to persons discharging managerial responsibilities, as well as persons closely associated with them.

Repurchasing shares

7 | May issuers repurchase their shares directly or via a derivative?

Yes. French issuers may repurchase their own shares directly or indirectly via a physically settled OTC derivative within prescribed regulatory limits (French issuers are legally prohibited from holding more than 10 per cent of their own shares). If shares are repurchased via a derivative, it will typically be via an equity forward transaction contemplating the delivery by the dealer counterparty of a certain number of shares to the issuer at maturity, and calculated based on the volume-weighted average price (often discounted) of the shares over a certain period.

The following issues are typical of share repurchases via a derivative:

- the shareholders' authorisation taken in the context of the repurchase programme of the issuer must set out explicitly that share repurchases can be conducted via derivative instruments;
- the delivery of the shares being repurchased must not result in the issuer holding more than 10 per cent of its own shares, and the shares must be repurchased for one of the objectives stated in the share repurchase programme (ie, cancellation, hedging stock options or other share allocations granted to some or all eligible employees or executive officers);
- share repurchases conducted via derivatives are not covered by the safe harbour provisions contemplated under MAR and, therefore, do not benefit from the presumption relating to the absence of insider trading or market manipulation;
- share repurchases conducted via derivatives will generally need to be calibrated to follow the parameters of transactions eligible to fall within the safe harbour under MAR (notwithstanding that these derivative transactions do not benefit from the safe harbour, counterparties will need to take precautions to ensure that they can demonstrate to the French regulator that relevant anti-abuse precautions have been taken); and
- issuers purchasing their own shares via a derivative instrument will need to immediately inform the market (often via a press release) once they have concluded the derivative. They must also disclose, in that context, various items of information, including the number of

shares to be repurchased, the maximum price and the period during which the investment service provider will intervene on the market to repurchase the shares.

Risk

8 What types of risks do dealers face in the event of a bankruptcy or insolvency of the counterparty? Do any special bankruptcy or insolvency rules apply if the counterparty is the issuer or an affiliate of the issuer?

Dealers with outstanding equity derivative positions with a bankrupt or insolvent French counterparty are, in much the same way as with other derivative positions, subject to the uncollateralised mark-to-market exposure resulting from the termination and close-out of these transactions. On the assumption that these outstanding equity derivative positions are documented under a market derivative framework agreement (a French Banking Federation (FBF) Master Agreement or an ISDA Master Agreement governed by French or English law) (a version of the ISDA Master Agreement governed by French law was also published by ISDA in 2018 in the context of contingency planning for Brexit), dealers facing an insolvent French counterparty will be able to terminate their outstanding derivative positions and calculate a net close-out balance owed by one party to the other under that contract and taking into account any amount of collateral previously posted (a net close-out debit or a net close-out credit).

In this context, dealers will be able to rely on the derogatory rules to French insolvency and security laws (known as the Financial Netting Regime) introduced in the French Financial and Monetary Code following the implementation under French law of Directive (EU) 2002/47/EC of 6 June 2002 on financial collateral arrangements. The Financial Netting Regime allows counterparties to implement the close-out netting provisions of derivatives framework agreements concluded by a French counterparty, including where it is subject to insolvency proceedings. The provisions of the Financial Netting Regime operate by exception to the general French insolvency regime. There are no specific applicable insolvency rules that would apply if the counterparty is the issuer or an affiliate of the issuer.

Reporting obligations

9 What types of reporting obligations does an issuer or a shareholder face when entering into an OTC equity derivatives transaction on the issuer's shares?

Issuers are generally subject to the transaction reporting rules to trade repositories under EMIR.

In addition, shareholders entering into equity derivatives transactions on a French issuer's shares are required to file with the AMF a disclosure threshold notification by the fourth trading day after reaching, exceeding or falling below (1) 5 per cent, 10 per cent, 15 per cent, 20 per cent, 25 per cent, 30 per cent, one-third, 50 per cent, two-thirds, 90 per cent and 95 per cent of the share capital of an issuer whose shares are listed on Euronext Paris and (2) 50 per cent and 95 per cent of the share capital of an issuer whose shares are listed on Euronext Growth (in either case, under French law, this requirement is triggered at such percentage levels of either voting rights or of non-voting capital). Disclosure is needed where these thresholds are met from holding either shares with voting rights or financial instruments referencing shares with voting rights (entitlements to acquire and financial instruments with similar economic effect) or a combination of both. The notification by the shareholders shall include, inter alia, the total number of shares or voting rights they hold, the number of securities they hold that give deferred access to future shares and the voting rights attached thereto, and the shares already issued that they may acquire by virtue of the derivative instrument. When the underlying securities are effectively acquired, another notification will also need to be filed with the issuer and the AMF.

At the 10 per cent, 15 per cent, 20 per cent and 25 per cent levels, the shareholder's notification must include a statement of intent whereby the shareholder sets forth its intent with respect to the issuer during the coming six-month period. Any change in plans during such six-month period requires an amended filing (this disclosure must be made by the fifth trading day). Securities representing 5 per cent or less of an issuer's voting rights held within the trading book of a credit institution are exempt from these filing requirements, provided that the institution ensures that the voting rights in respect of those shares are not exercised or otherwise used to intervene in the management of the issuer (this is commonly referred to as the 'trading exemption').

Issuers can also set separate disclosure thresholds in their articles of association, requiring shareholders to notify them when they cross individual thresholds upwards or downwards (which can be as low as 0.5 per cent).

Restricted periods

10 | Are counterparties restricted from entering into OTC equity derivatives transactions during certain periods? What other rules apply to OTC equity derivatives transactions that address insider trading?

There are no periods during which counterparties are specifically restricted from entering into OTC derivative transactions. However, the applicable rules relating to insider dealing and market abuse will apply to any counterparty to an OTC equity derivative transaction referencing shares admitted to trading on a regulated market. In fact, MAR includes a prohibition on the ability of a counterparty to enter into a transaction (including an OTC equity derivative transaction) on the basis of inside information (information of a precise nature that is not publicly available and that would be likely to significantly impact the price of the shares if it were to be made publicly available) or engage in the unlawful disclosure of inside information or market manipulation. If the counterparty to an OTC derivative transaction involving shares in an issuer is a 'person discharging managerial responsibility' in respect of that issuer, that person and any person closely associated with them must not deal in that issuer's securities during certain closed periods (30 calendar days before the announcement of an interim financial report or year-end report). In addition, equity derivative instruments (like other types of derivatives) do not qualify for the safe harbour exemption under article 5 of MAR, which means that transactions in own shares conducted by an issuer via a derivative do not benefit from the presumption that they do not constitute market abuse.

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Legal issues

11 What additional legal issues arise if a counterparty to an OTC equity derivatives transaction is the issuer of the underlying shares or an affiliate of the issuer?

If a counterparty to an OTC equity derivatives transaction is also the issuer of the underlying shares, it will be constrained by the requirement imposed by French law that an issuer cannot hold more than 10 per cent of its own shares. Issuers entering into an OTC equity derivatives transaction on their own shares will typically have to represent that the physical delivery of own shares under the OTC equity derivative transaction will not entail the crossing of this 10 per cent threshold and, if it did, the transaction would have to be terminated. This is in addition to legal issues relating to market abuse under MAR. In particular, if a counterparty to an OTC equity derivatives transaction is also an affiliate of the issuer, it is often the case that issues relating to 'persons discharging managerial responsibilities' within issuers, and persons closely associated with them, have to be examined in the context of the applicability of market abuse regulations.

Tax issues

12 What types of taxation issues arise in issuer OTC equity derivatives transactions and third-party OTC equity derivatives transactions?

French tax law provides for a specific corporate income tax regime applicable to equity derivatives traded on organised markets (or markets assimilated to organised markets) that revolves around the recognition of latent capital gains or losses on such instruments (ie, mark-to-market taxation) and the possibility to benefit from a tax rollover regime on certain specific transactions. For all other aspects of French direct and indirect taxation, French tax law does not provide for specific rules but more general tax provisions may apply depending upon the means pursuant to which equity derivatives transactions are structured (eg, exercise of options, conversion or exchange of equity or debt instruments). Issues related to the characterisation of income and gains may also be triggered regarding the application of French withholding tax in the case of cross-border transactions. Consequently, a tax analysis generally needs to be conducted on a case-by-case basis.

In practice, counterparties to equity derivatives transactions will consider the timing of the physical delivery of the shares and the nature of the securities being transferred as collateral in the context of their potential tax implications (including the crystallisation of a gain or a loss at a particular point in time, the tax characterisation of this gain or loss and the possibility to benefit from a tax rollover regime under certain circumstances). In addition, counterparties will generally explicitly address in the documentation the allocation of the payment of French transfer taxes or the French financial transaction tax (when the shares are those of a French company that is listed on a stock market with a market capitalisation greater than €1 billion), irrespective of fall back indemnity provisions that may already be contained in the related derivative framework agreement.

Liability regime

13 | Describe the liability regime related to OTC equity derivatives transactions. What transaction participants are subject to liability?

There is no specific liability regime applicable to OTC equity derivatives transactions in France. Counterparties to OTC equity derivatives transactions are subject to the general principles and mandatory rules of civil law liability arising under contracts (consent, certainty and legality of the contract's purpose, absence of fraud) and to defined statutory offences governing, in particular, the provision of regulated investment services, market abuse and market manipulation, short selling, and compliance with applicable disclosure thresholds. These offences may, in some instances, give rise to criminal liability (in particular, in relation to insider dealing, unlawful disclosure, market manipulation, attempted market manipulation or the provision of regulated investment services in France without a proper licence).

Stock exchange filings

14 | What stock exchange filings must be made in connection with OTC equity derivatives transactions?

There are no specific stock exchange filings that must be made in connection with OTC derivatives transactions under French law. However, some stock exchange markets have set out specific rules governing reporting obligations when trading on their derivative markets.

In addition, various filing requirements with the AMF and, potentially, the issuer, will arise in the event of crossing an ownership or voting rights threshold (under the French Commercial Code or the by-laws of the issuer), the build-up of a short selling position (under the Short Selling Regulation) or the involvement of persons discharging managerial responsibilities and persons closely associated with them (under MAR). Also, in connection with a share buy-back, some issuers using equity derivative instruments have chosen, in addition to reporting share buy-back transactions to the AMF, to report to the competent authority of the trading venue on which the shares have been admitted to trading or are traded each transaction relating to the share buy-back programme (irrespective of the fact that these transactions do not fall within the safe harbour under MAR).

Typical document types

15 | What types of documents are typical in an OTC equity derivatives transaction?

OTC equity derivatives transactions are typically documented under a transaction confirmation forming part of either the FBF Master Agreement governed by French law or the ISDA Master Agreement governed by English or French law (a version of the ISDA Master Agreement governed by French law was published by ISDA in 2018 in connection with contingency planning for Brexit). Counterparties using the FBF Master Agreement and the ISDA Master Agreement governed by French law do, in much the same way as counterparties using the ISDA Master Agreement governed by English law, have the benefit of market legal opinions relating to the enforceability of close-out netting. The type of master agreement and the governing law used to document equity derivatives transactions in France will mainly depend on the jurisdiction of incorporation of the relevant bank.

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When using the FBF Master Agreement, parties will often incorporate the Share Option Technical Schedule published by the FBF, as well as additional relevant technical schedules for the transaction. The Share Option Technical Schedule contains a set of definitions used by counterparties in their equity derivative transactions (it is very high-level and counterparties often amend these definitions in the transaction confirmation to bring them closer in line with the 2002 ISDA Equity Derivative Definitions). When using the ISDA Master Agreement, parties will incorporate the 2002 ISDA Equity Derivatives Definitions. Although the 2002 ISDA Equity Derivatives Definitions were updated in 2011, French market participants rarely use the 2011 version. Parties to OTC equity derivatives transactions may also be required to adhere to ISDA protocols or equivalent bilateral documentation for the purpose of complying with various regulatory requirements under EMIR.

When the equity derivatives transaction is a structured transaction, counterparties will most often (but not always) document the transaction on the basis of a long-form confirmation (a standalone confirmation incorporating the terms of the relevant derivatives framework FBF or ISDA agreement) so as to ensure that the close-out netting set related to that transaction with a particular dealer does not overlap with the close-out netting set under the derivatives framework agreement used for the day-to-day treasury activities of the counterparty with such dealer.

Legal opinions

16 For what types of OTC equity derivatives transactions are legal opinions typically given?

If transactions are entered into under an ISDA Master Agreement or an FBF Master Agreement, the parties will usually rely on the industry market opinions. However, these industry opinions cover only the enforceability of close-out netting in specific scenarios and, therefore, the parties may agree on the need to provide legal opinions if there are specific enforceability issues in a given transaction. Similarly, legal opinions of capacity may be required when there are concerns on the ability of a non-dealer counterparty to enter into derivative transactions. It is also not unusual for an enforceability opinion to be given in relation to collateral arrangements.

Hedging activities

17 May an issuer lend its shares or enter into a repurchase transaction with respect to its shares to support hedging activities by third parties in the issuer's shares?

An issuer may lend its shares (via a traditional stock borrow facility to help the bank with establishing its delta position) or enter into a repurchase transaction with respect to its shares to support hedging activities by third parties in the issuer's shares subject to applicable share buy-back rules.

If the stock-lending or repurchase transaction involves a transfer of title to the counterparty, the issuer may repurchase its own shares at the maturity of the transaction. In that case, the issuer will need to ensure that it complies with the 10 per cent restriction on the holding of its own shares. A shareholder resolution will also be needed for the share buy-back at maturity unless the shareholder resolution authorising the issuer's buy-back programme is already in place and such transactions fall under the programme. The title transfer of shares under a stock-lending or repurchase transaction may potentially trigger disclosure threshold notifications for the dealer counterparty unless an exemption is available.

As in other jurisdictions, stock-lending and repurchase transactions can raise market manipulation and market abuse issues. The return of shares upon the maturity of such transactions should comply with MAR and the guidance from the AMF on share buy-backs (including, but not limited to, restrictions on transfers during closed periods). Repurchase transactions, securities lending and sell-buy back transactions qualify as securities financing transactions, and these transactions will likely be subject to reporting obligations under Regulation (EU) 2015/2365 of 25 November 2015 on transparency of security financing transactions and of reuse and amending Regulation (EU) 648/2012.

Securities registration

18 | What securities registration or other issues arise if a borrower pledges restricted or controlling shareholdings to secure a margin loan or a collar loan?

If the shares are freely transferable, there are no specific securities registration requirements in the event a borrower pledges restricted or controlling shareholdings except for (if security is established via title transfer) the requirement to comply with applicable disclosure threshold obligations and, as the case may be, filing requirements set out under MAR in the case of the involvement of persons discharging managerial responsibilities and persons closely associated with them.

Borrower bankruptcy

19 | If a borrower in a margin loan files for bankruptcy protection, can the lender seize and sell the pledged shares without interference from the bankruptcy court or any other creditors of the borrower? If not, what techniques are used to reduce the lender's risk that the borrower will file for bankruptcy or to prevent the bankruptcy court from staying enforcement of the lender's remedies?

If a French corporate borrower in a margin loan files for bankruptcy protection, the lender will not be able to seize and sell shares provided as collateral and subject to a French pledge without potential interference from the French bankruptcy court or other creditors from the borrower.

This is because a margin loan does not qualify as an instrument eligible to the benefit of the Financial Netting Regime within the meaning of the French financial collateral arrangement rules resulting from the transposition into French law of Directive (EU) 2002/47/EC of 6 June 2002 on financial collateral arrangements (at least not if only one of the parties is an eligible financial counterparty). As a result, as from the opening of an insolvency proceeding against a French corporate borrower, the pledge would be potentially subject to a stay of enforcement and, therefore, the lender may not be able to appropriate the collateral and apply it against any debt owed to it under the margin loan without being potentially subject to a risk of stay.

As a consequence, a margin loan with a French borrower will typically be structured as a form of derivative under an ISDA or FBF framework agreement, such that it would qualify as a category of financial instrument benefiting from the provisions of the financial collateral arrangement regime (which does not completely rule out the risk that a court may recharacterise the derivative as a loan so that the financial collateral arrangement would not benefit from the financial collateral arrangement regime).

Alternatively, French corporate borrowers tend to use English-law documentation and custody the shares in the UK for the purpose of ensuring that the security structure under English law benefits from the financial collateral arrangement regime as implemented in the UK. However, this structure remains largely untested and, in the absence of case law, some commentators have argued that French shares credited to an account in the UK may still be deemed located in France for the purposes of French insolvency proceedings. Following the UK's departure from the European Union, the enforceability of this regime has come under further scrutiny.

Market structure

20 | What is the structure of the market for listed equity options?

The equity option market allows trading of both stock options and index futures and options (such as on the CAC 40 index).

The main market for options on French shares are MONEP in Paris (part of the Euronext Group) and EUREX (Deutsche Boerse Group). A much smaller portion of options on French shares is traded on Euronext Amsterdam, the Italian derivatives market or ICE. According to a document published by the AMF in July 2021, more than half of the trades are placed outside the order book in the form of blocks of option trades.

There is a great variety of instruments for the same underlying share proposed for trading (mainly due to the combination of different maturities and exercise price) but a small number of these is actually traded.

Governing rules

21 | Describe the rules governing the trading of listed equity options.

Trading of listed equity options on Euronext France is governed by the Euronext Rulebook (the Harmonised Rules in Book I and specific rules applicable to the French regulated markets in Book II). Part II contains the rules applicable to MONEP (*Marché des Options Négociables de Paris*).

Trades carried out on the MONEP are cleared and guaranteed by Banque Centrale de Compensation (LCH.CLEARNET), according to the conditions and limits specified by the operating rules of the clearing house LCH.CLEARNET.

The clearinghouse fixes the required amount of collateral deposit and calculates margin calls (if the position is out-of-the-money) and the relevant settlement price per option. Options expire several times a year. The standard expiry date is the third Friday of the expiry month unless the third Friday is a public holiday and the exchange is closed, in which case it is the third Thursday. For the CAC 40 Index derivatives, Euronext France offers weekly futures, mini-index derivatives and total return futures. The participants are clearing members, broker dealers and dealers for own account authorised to carry out execution.

The main rules governing the trading of listed equity options on Eurex include the Exchange Act (BörsG) as the overall statutory framework, the Exchange Rules, and the Trading Conditions of Eurex as well as the Eurex Contract Specification Rules.

TYPES OF TRANSACTION

Clearing transactions

22 What categories of equity derivatives transactions must be centrally cleared and what rules govern clearing?

The clearing obligation under Regulation (EU) 648/2012 on OTC derivatives, central counterparties and trade repositories (EMIR) requires (assuming a clearing threshold is reached) that all OTC derivative contracts within scope are subject to mandatory clearing and must be cleared with a central counterparty (CCP) that is authorised under EMIR (or that is recognised under EMIR for non-EU CCPs). Currently, EMIR does not mandate the clearing of equity derivatives. The specific classes of products that are within the scope of the mandatory clearing obligation under EMIR are set out in the Annex to the EMIR Delegated Regulation and cover standardised and liquid products (including certain interest rate swaps and credit default swaps). While it is contemplated that single stock equity derivative products will become clearable in the future, the equity derivatives market is already predominantly exchange-based. As a result, equity derivatives that remain traded OTC are generally bespoke products and, therefore, are unlikely to easily meet the standardisation and liquidity requirements for clearable products under EMIR.

Exchange-trading

23 What categories of equity derivatives must be exchange-traded and what rules govern trading?

There is no legal requirement for any category of equity derivatives to be exchange-traded, even if the types of OTC derivatives that are exchange-traded are typically equity options and futures. Regulation (EU) No 600/2014 of 15 May 2014 on markets in financial instruments (MiFIR) introduced a mandatory trading obligation for certain types of derivatives (article 28 of MiFIR). It requires financial counterparties (FCs) and non-financial counterparties above the clearing threshold (NFC+) to conclude in-scope derivatives on a trading venue (a regulated market, a multilateral trading facility or an organised trading facility) or an equivalent third-country trading venue when they trade with other FCs or NFCs+. This trading obligation applies to any class (or sub-class) of derivatives that has been declared subject to the EMIR clearing obligation, is admitted to trading or traded on at least one trading venue (the venue test), is considered sufficiently liquid to be traded only on venue, taking into account the average frequency of trades, the average size of trades, the number and type of active market participants and the average size of spreads (the liquidity test), and has been declared by ESMA as subject to the trading obligation. However, currently, this trading obligation only applies to certain categories of interest rate swaps and credit default swaps and does not apply to equity derivatives.

Collateral arrangements

24 | Describe common collateral arrangements for listed, cleared and uncleared equity derivatives transactions.

For uncleared equity derivatives transactions, counterparties will usually document their collateral arrangements contemplating for the exchange of periodic variation margin as title transfer under an ISDA Collateral Support Annex (under English or French law) to the ISDA Master Agreement or the equivalent local collateral annex under the French Banking Federation (FBF) derivative framework documentation. In that context, EMIR imposes risk-reducing and transparency obligations on all EU undertakings (including, but not limited to, dealers and corporates) that enter into derivative transactions (including equity derivatives transactions). In particular, EMIR contemplates risk mitigation techniques for OTC derivatives transactions not cleared by a CCP that include timely exchange of collateral and periodic compression requirements.

For cleared equity derivatives transactions, counterparties will generally document their clearing relationship under a principal-to-principal clearing model with a clearing broker acting as riskless principal (as between the counterparty and the CCP) under the ISDA/FAO Client Cleared OTC Derivatives Addendum (English law), which works as an addendum to the ISDA Master Agreement (with corresponding French law adjustments for the FBF Master Agreement). In addition, counterparties subject to clearing requirements under EMIR may also have to put in place specific initial margin arrangements to guard against the margin period of risk – that is, the risk that there is not enough posted collateral as variation margin.

For listed equity derivatives transactions, the relevant collateralisation requirements will be determined by the relevant clearinghouse.

Exchanging collateral

25 | Must counterparties exchange collateral for some categories of equity derivatives transactions?

The rules for collateralisation of derivatives transactions under EMIR are not specific to equity derivatives transactions. EMIR requires the exchange of variation margin between financial counterparties (credit institutions, insurance undertakings, undertakings for the collective investment in transferable securities, alternative investment fund managers, etc.) and between financial counterparties and non-financial counterparties, depending on whether they are above the clearing threshold although single stock equity options and index options remain out of scope for a transitional period (while this transitional period formally ended on 4 January 2020, it was subsequently extended to 4 January 2024). Currently, equity derivatives transactions are also not subject to clearing.

LIABILITY AND ENFORCEMENT

Territorial scope of regulations

26 What is the territorial scope of the laws and regulations governing listed, cleared and uncleared equity derivatives transactions?

French law applies to counterparties transacting in France, or in respect of French shares or shares which are admitted to trading on a French exchange. The scope of directly applicable European legislation is, in general, also limited to the EU and transactions with an EU nexus (although there is a tendency in new proposed regulations to extend beyond EU borders to maintain a level playing field between EU and non-EU market participants). Third-country counterparties may be indirectly impacted by French or EU laws in connection with cross-border business. For example, a counterparty located outside of the EU may have to comply with requirements under Regulation (EU) 648/2012 on OTC derivatives, central counterparties and trade repositories (EMIR) to allow its French counterparty to comply with its own obligations under EU rules. Notably, EMIR would capture transactions with a 'direct, substantial and foreseeable effect' in the EU or aimed at evading the obligations under EMIR. As a result, to that extent only, some regulations (such as EMIR) may have extra-territorial effect.

Registration and authorisation requirements

27 What registration or authorisation requirements apply to market participants that deal or invest in equity derivatives, and what are the implications of registration?

At least one of the market participants to an equity derivatives transaction will need to be registered as an eligible institution (a credit institution, an investment services provider, a financing company, etc) for the provisions of the Financial Netting Regime to apply to financial instruments (including equity derivatives transactions) under French law. Importantly, if one of the market participants needs to be registered as an eligible institution, it does not need to be registered in France as long as it is a foreign entity with comparable legal status (ie, a licensed foreign institution carrying banking and financial services).

The Financial Netting Regime is the cornerstone of derivatives trading (including equity derivatives) in France as it allows counterparties trading financial instruments to implement the closeout netting provisions of derivatives framework agreements entered into by a French counterparty, including where it is subject to insolvency proceedings. This is because the provisions of the Financial Netting Regime operate by exception to the general French insolvency regime.

If both counterparties qualify as eligible counterparties for that purpose, the Financial Netting Regime is expanded to cover not only financial instruments but also any financial transaction granting the right to cash settlement or the delivery of financial instruments.

Reporting requirements

28 What reporting requirements apply to market participants that deal or invest in equity derivatives?

Issuers are generally subject to the transaction reporting rules to trade repositories under EMIR.

In addition, shareholders entering into equity derivatives transactions on a French issuer's shares are required to file with the AMF a disclosure threshold notification by the fourth trading day after reaching, exceeding or falling below 5 per cent, 10 per cent, 15 per cent, 20 per cent, 25 per cent, 30 per cent, one-third, 50 per cent, two-thirds, 90 per cent and 95 per cent of the share capital of an issuer for which France is the home member state (under French law, this requirement is triggered at such percentage levels of both voting rights and of non-voting capital). Disclosure is needed where these thresholds are met from holding either shares with voting rights or financial instruments referencing shares with voting rights (entitlements to acquire and financial instruments with similar economic effect) or a combination of both. The notification by the shareholders shall include, inter alia, the total number of shares or voting rights they hold, the number of securities they hold that give deferred access to future shares and the voting rights attached thereto, and the shares already issued that they may acquire by virtue of the derivative instrument. When the underlying securities are effectively acquired, another notification will also need to be filed with the issuer and the AMF.

At the 10 per cent, 15 per cent, 20 per cent and 25 per cent levels, the shareholder's notification must include a statement of intent whereby the shareholder sets forth its intent with respect to the issuer during the coming six-month period. Any change in plans during such six-month period requires an amended filing (this disclosure must be made by the fifth trading day). Securities representing 5 per cent or less of an issuer's voting rights held within the trading book of a credit institution are exempt from these filing requirements, provided that the institution ensures that the voting rights in respect of those shares are not exercised or otherwise used to intervene in the management of the issuer (this is commonly referred to as the 'trading exemption').

Issuers can also set separate contractual disclosure thresholds in their articles of association, requiring shareholders to notify them when they cross individual thresholds (which can be as low as 0.5 per cent).

Legal issues

29 What legal issues arise in the design and issuance of structured products linked to an unaffiliated third party's shares or to a basket or index of third-party shares? What additional disclosure and other legal issues arise if the structured product is linked to a proprietary index?

No specific legal issue would arise in the design and issuance of structured products linked to an unaffiliated third party's shares or to a basket or index of third-party shares.

However, where the structured product is to be listed, Regulation (EU) 2017/1129 of 14 June 2017 on the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market (the Prospectus Regulation) will apply with specific disclosure requirements in relation to the issuer and the underlying (third party shares, basket or index of shares) as well as the applicable tax regime (as detailed in Delegated Regulation (EU) 2019/980 of 14 March 2019 supplementing the Prospectus Regulation).

The following applies:

- where the product is linked to a basket of underlyings, the prospectus must include disclosure of various information in respect of each underlying and its relevant weighting in the basket; and
- where the product is linked to an index, the prospectus must include the name of the index and, where the index is not composed by the issuer, an indication of where information about the index can be obtained and also whether the index constitutes a benchmark under Regulation (EU) 2016/1011 of 8 June 2016 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds and amending Directives 2008/48/EC and 2014/17/EU and Regulation (EU) 596/2014 (the Benchmark Regulation). The administrator of an index that qualifies as a benchmark for the purposes of the Benchmark Regulation is required to apply for authorisation and is subject to supervision by the competent authority of the country in which it is located. Also, as the Benchmark Regulation applies to all indices used in the EU regardless of origin, third country administrators located outside the EU are required to seek approval to continue to serve their EU customers.

In that context, if the product references an index that constitutes a benchmark provided by external and independent providers, the issuer will be considered a 'user' under the Benchmark Regulation and, as such, the issuer must put in place written plans to designate an alternative if the benchmark used materially changes or ceases to be published (ie, fallbacks) and must ensure the prospectus or investment memorandum includes clear and prominent information stating whether the benchmark is provided by an authorised administrator. Conversely, if the product references a proprietary index that constitutes a benchmark (ie, an index built in-house to reduce costs that would otherwise have to be paid to external index providers), the issuer would be considered both a 'user' and an 'administrator' under the Benchmark Regulation (and, therefore, both the requirements for 'user' and the onerous requirements for 'administrator' would apply, in particular in relation to governance arrangements and the management of conflicts of interests).

As far as French tax is concerned, structured products might entail, among others, capital gains taxation, loss of the benefit of favourable tax regime on certain securities income, and withholding tax. In addition, French transfer taxes or French financial transaction tax (when the shares are those of a French company that is listed on a stock market with a market capitalisation greater than €1 billion). The tax analysis will need to be conducted on a case-by-case basis.

Liability regime

30 | Describe the liability regime related to the issuance of structured products.

The liability regime related to the issuance of structured products essentially revolves around various overarching general principles, including:

- the sufficiency of the information provided to investors via the disclosure document allowing investors to make an informed investment decision (i.e., appropriate content of the prospectus without misstatement or omission);
- the accuracy of the information provided by financial intermediaries to their clients; and
- the suitability of the proposed product to the target market.

Other issues

31 | What registration, disclosure, tax and other legal issues arise when an issuer sells a security that is convertible for shares of the same issuer?

The offer and sale of a security convertible for shares of the same issuer are generally not subject to the requirements for the drafting, approval and distribution of a prospectus under Regulation (EU) 2017/1129 (the Prospectus Regulation) if the purchasers are qualified investors or the placement is made to fewer than 150 persons per member state of the European Economic Area. Under those circumstances, the convertible instrument would be exempt from registration with the French Financial Markets Authority unless the convertible instrument is admitted to trading on a regulated market– convertible instruments are generally admitted to trading on Euronext Access, a multilateral trading facility (MTF) operated by Euronext Paris.

The main legal issues that arise in the offer and sale of a convertible instrument are as follows.

Corporate law

Assuming that the shares underlying the convertible instrument represent a new issuance, shareholders' approval with a two-thirds majority of the shareholders present or represented with a quorum of one-quarter of the existing voting rights on first convocation and one-fifth of the existing voting rights on second convocation is required. New shares underlying the convertible instrument are generally issued via a capital increase, without the preferential subscription rights that normally apply for existing shareholders. There are three ways to accomplish this:

- the private placement exemption under article L.225-136 of the French Commercial Code, permitting up to 20 per cent of the share capital (or equivalent through exercise of conversion rights) per year to be sold to institutional investors and other related categories;
- the crowd sourcing exemption under article L.441-2 of the Monetary and Financial Code, permitting an offer of up to €5 million; and
- the reserved capital increase under article L.225-138 of the French Commercial Code, permitting the sale of shares to certain designated persons or determined categories of person fixed by the shareholders, with no limit in terms of share capital amount or price (as long as the price or appropriate pricing parameters are approved by the shareholders). Listed issuers often obtain delegations from their shareholders, permitting the board of directors to implement the capital increase that can be sub-delegated to management within prescribed time limits following the shareholders' meeting (26 months for the private placement exemption and 18 months for the reserved capital increase).

Disclosure

Articles 7 and 17 of Regulation (EU) No. 596/2014 on market abuse regarding the need to provide prompt disclosure of inside information regarding the underlying listed shares (assuming Regulation (EU) No. 596/2014 on market abuse containing provisions on insider dealing, unlawful disclosure of inside information and market manipulation (MAR) applies due to admission to trading on a regulated market or an MTF in the EEA) would apply if the issuance of convertible instruments is listed on a regulated market or an MTF in the EEA. Depending on the circumstances, the issuance of a convertible instrument may be price-sensitive for the listed shares, mandating disclosure of its terms, which, according to the recommendations of the AMF, should include, among other things, disclosure of the instrument type, nature of the offering or placement, nominal amount, interest rate, maturity, conversion rights, conversion ratio, number of shares that would be issued or granted to satisfy conversion rights, the dilutive effect, issue price, use of proceeds, undertakings assumed by the issuer, share capital of the listed company following the issuance and governance rights of the holders (if any).

Transparency

Articles 223-10-1 of the General Regulations of the AMF require that issuers provide all investors with the same level of information even in offers and sales that are not subject to the prospectus drafting, approval and distribution requirements of the same. Additionally, the General Regulations of the AMF provide, among other things, the approved and recommended modalities of effective dissemination of regulated information.

Tax

The issuance of convertible securities generally does not trigger any direct or indirect tax issues from a French tax standpoint at the level of the issuer. However, deductibility of interest accrued under such securities may be restricted under several provisions of French tax legislation, in particular in the event that the holders are shareholders or related parties to the French issuer. In addition and subject to certain exceptions, specific rules restrict the deductibility for tax purposes of payments made by a French debtor to persons domiciled in a so-called 'non-cooperative State of territory' or paid on an account opened in a financial institution located in such a state or territory. Conversion of convertible securities into equity may entail immediate capital gains taxation at the level of the holders (directly or through a withholding taxes mechanism), subject to specific tax rollover regimes that may apply subject to certain conditions. Finally, conversion or transfer of such securities may be subject to French transfer taxes (or to the French financial transaction tax, as the case may be), depending upon the characteristics of the securities and the means pursuant to which the conversion or transfer is realised. A tax analysis generally needs to be conducted on a case-by-case basis.

32 What registration, disclosure, tax and other legal issues arise when an issuer sells a security that is exchangeable for shares of a third party? Does it matter whether the third party is an affiliate of the issuer?

The offer and sale of a security exchangeable for shares of a third party is generally subject to the same legal issues that are discussed for convertible instruments in 'Other issues', with the exception of the corporate matters as the approval for the issuance of an exchangeable instrument would be subject to local applicable law and the by-laws of the issuer.

Though the MAR generally does not impose a disclosure obligation on a third party issuer with respect to the underlying shares, third-party issuers are still nonetheless subject to article 223-6 of the General Regulations of the AMF, which imposes an obligation of disclosure on 'any person [preparing] a financial transaction liable to have a significant impact in the market price of a financial instrument, or on the financial position and rights of holders of that financial instrument.' Third-party issuers should take care to comply with the foregoing disclosure obligations, which can be discharged in the manner indicated above. An affiliate issuer may have MAR obligations with respect to the underlying shares if such issuer is an insider with respect to the listed company, and in any case, should likewise comply with article 223-6 of the AMF General Regulations.

As far French tax aspects are concerned, the sale by the issuer of a security that is exchangeable for shares of a third party (or an affiliate) should not per se trigger any direct or indirect tax consequences, other than, as the case may be, transfer taxes. Tax consequences that need to be reviewed on a case-by-case basis may arise at the time of the exchange or in the event of a fluctuation in the value of the underlying shares.

UPDATE AND TRENDS

Recent developments

33 | Are there any current developments or emerging trends that should be noted?

As a result of Brexit, French counterparties have shown an increasing preference to document their structured equity derivatives transactions under framework documentation (FBF or ISDA) governed by French law (as opposed to English law). This is a concerted effort by French counterparties to hedge the unintended effect of having equity derivatives transactions documented under English law (now a third-party non-EU law) to address substantive concerns including (but not limited to) the recognition of the choice of law for contractual and non-contractual obligations, the recognition of jurisdiction clauses or the enforcement of foreign judgments. This is in addition to French counterparties now generally requiring that the equity derivatives transactions be booked by the dealer counterparty out of a regulated entity located in the EU (often in France, Germany or Ireland, depending on the dealer counterparty) to alleviate any concern relating to the provision of a regulated MiFID investment service by the dealer counterparty in France out of an entity regulated outside of the EU. Additionally, France is one of the few EU jurisdictions where corporates routinely use equity derivatives for the repurchase of their own shares irrespective of the fact that derivatives do not benefit from the safe harbour provisions of Regulation (EU) No. 596/2014 on market abuse. Finally, the ability of French issuers to issue securities on the blockchain is starting to raise novel legal issues in the context of equity financings (especially in the context of collateralisation procedures).

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LATHAM & WATKINS

Thomas Vogel	thomas.vogel@lw.com
Suzana Sava-Montanari	suzana.sava-montanari@lw.com

45 Rue Saint Dominique, Paris 75007, France
Tel: +33 1 40 62 2000
www.lw.com

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Frank Bierwirth, Dirk Kocher and Axel Schiemann
Latham & Watkins LLP

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Summary

OVERVIEW

Typical types of transactions

1 Other than transactions between dealers, what are the most typical types of over-the-counter (OTC) equity derivatives transactions and what are the common uses of these transactions?

Typical issuer equity derivatives products include the following:

- equity swaps to hedge an issuer's obligations in respect of the relevant issuer's employee benefit plan, which entails shares or share price-related benefits;
- call options entered into by an issuer to hedge its payment obligations in respect of cash-settled convertibles, known as 'equity neutral' or non-dilutive convertible bond transactions';
- share loans and share repurchase transactions in the context of convertibles to facilitate hedging by investors in convertible bonds; and
- derivative-based share buy-back transactions.

Typical equity derivatives products that allow a shareholder to acquire a substantial position in a publicly traded equity or to monetise or hedge an existing equity position include the following:

- call options, put options, collars, forwards and total return swaps to hedge any equity price risk; and
- margin loans and margin bonds where shares are used as collateral for a leveraged loan bond, usually in the context of an acquisition.

Furthermore, equity derivatives transactions are entered into for general investment purposes or for hedging exposure from investment products issued by banks or funds, such as:

- share basket and index-linked transactions entered into by insurance companies, pension funds, etc;
- equity funds and exchange-traded funds (ETFs) entering into equity derivatives to get a synthetic exposure to a basket of shares or equity index; and
- retail certificates through which investors acquire an equity derivative exposure (eg, share-linked certificates, bonus certificates, express certificates, knock-in and knock-out certificates, index and performance certificates and discount certificates) – the retail equity derivatives market in Germany is one of the biggest retail markets for structured products in the world.

Borrowing and selling shares

2 May market participants borrow shares and sell them short in the local market? If so, what rules govern short selling?

The rules on short selling are set out in Regulation (EU) No. 236/2012 of the European Parliament and of the Council of 14 March 2012 on short selling and certain aspects of credit default swaps, and is supplemented by various delegated and implementing regulations. The short selling rules apply, among others, to shares admitted to trading on a trading venue in the EU irrespective of whether the instruments are traded on such trading venue (except where the principal trading venue of that instrument is in a third country). The Regulation requires that short sales of shares must be covered either by having borrowed the relevant stock or by arranging for such borrowing, or having a locate arrangement with a third party. Uncovered ('naked') short selling of shares is prohibited. In addition, significant net short positions in shares must be notified to the relevant competent authorities if they are equal to at least 0.2 per cent of the issued share capital of the relevant company (and every 0.1 per cent above that) and publicly disclosed if they are equal to at least 0.5 per cent of the issued share capital of the relevant company (and each 0.1 per cent above that). The competent authority is the authority of a relevant member state where the market that is most relevant in terms of liquidity for such shares is located. In Germany, the relevant competent authority is the Federal Financial Supervisory Authority (BaFin).

Market-making activities and authorised primary dealers are exempted from these restrictions. While these European provisions are directly applied in all EU member states based on a generally harmonised approach, the regulatory practice of the national competent authorities may differ in detail. To mitigate such discrepancies and to provide more transparency, the European Securities and Markets Authority (ESMA) has published guidelines on the exemption for market-making activities and primary market operations. In this regard, BaFin announced compliance with ESMA's guidelines, with two exceptions. In BaFin's view, the short selling regulation does not limit the application of the exemption for market-making activities to financial instruments traded on the same trading venue as the market-making activity is conducted in, and, with regard to the product scope, to only shares and sovereign debts. Market participants should also assess whether any further restrictions (including short-selling bans with respect to shares of a particular issuer) imposed by supervisory authorities apply (which is possible in particular for measures protecting the markets).

Applicable laws and regulations for dealers

3 Describe the primary laws and regulations surrounding OTC equity derivatives transactions between dealers. What regulatory authorities are primarily responsible for administering those rules?

The regulation of OTC derivatives, including equity derivatives transactions, in Germany primarily includes:

- Regulatory requirements at the level of the institution that undertakes licensable trading activities; namely, for establishing and maintaining the relevant business such as licensing requirements and related ongoing prudential requirements (including, for example, capital adequacy requirements and risk management requirements). These requirements are primarily set out in the Banking Act (KWG) and relevant European legislation such as the Capital Requirements Regulation (CRR). From June 2021, certain types of investment firms have become subject to a new regulatory framework comprising primarily the Investment Firms Regulation (Regulation (EU) No. 2019/2033, IFR) and the new Investment Firms Act (WpIG) implementing the Investment Firms Directive (Directive (EU) No. 2019/2034, IFD) into German law.
- Supervision of the services and trading activities of an institution such as the rules on conduct and product governance, as well as the general market and market infrastructure

supervision and transparency requirements to be complied with by all relevant market participants, such as disclosure of shareholdings and voting rights, insider trading and market abuse, which are primarily set out in the Securities Trading Act (WpHG) and, with respect to certain matters, in directly applicable EU legislation such as the European Market Infrastructure Regulation (Regulation (EU) No. 648/2012 on OTC derivatives, central counterparties and trade repositories, EMIR), the Securities Financing Transactions Regulation (Regulation (EU) 2015/2365, SFTR), the Market Abuse Regulation (Regulation No. 596/2014, MAR) and the Short Selling Regulation, as well as MiFIR (Regulation (EU) No. 600/2014) and other delegated regulations that, in addition to the relevant provisions of the Securities Trading Act, further implement Directive 2014/65/EU (MiFID II).

Licensable activities under the Banking Act and the Investment Firms Act include financial services such as investment brokerage, investment advisory services, placement business, acquisition brokerage, portfolio management, dealing on own account and certain proprietary trading activities (in all cases if provided on a commercial scale). As regards own account trading, the Banking Act and the Investment Firms Act distinguish between dealing on own account and conducting proprietary business. In particular, market-making activities, dealing on own account as service for third parties and high-frequency trading as a direct or indirect participant of a trading venue qualify as licensable dealing on own account and therefore as financial and investment services requiring a licence. Within the scope of the Banking Act, however, proprietary business is only deemed to be a financial service requiring a licence if it is conducted on a commercial scale and the respective company belongs to the same group or financial conglomerate to which a CRR institution also belongs. Further, CRR institutions and companies belonging to the same group as a CRR rendering proprietary trading and proprietary business activities are only allowed to do so up to a certain limit of business volume. Otherwise, such activities can only be conducted by a financially and legally independent favoured financial trading institution. Furthermore, proprietary trading in shares or equity derivatives undertaken at a commercial scale requires a licence (subject to certain exemptions) if undertaken by a participant of a regulated market or a multilateral trading facility or via direct electronic access to a trading venue. Finally, credit or financial institutions and investment firms require an additional licence for proprietary trading if they intend to conduct proprietary business alongside their main (licensable) business.

The main legal framework for trading in securities and other financial instruments such as derivatives in Germany is set by MiFID II/MiFIR as transposed into German law by the Securities Trading Act and as supplemented by various German and European regulations (eg, with regard to, among other things, definitions, transparency requirements and exemptions). The Securities Trading Act governs disclosure requirements, product governance rules, including organisational and transparency requirements, and the reporting regime, as well as the respective supervision of BaFin as competent authority and sanctions for breaches of law. Since its entry into force in 2016, MAR provides a pan-European legal framework for prevention and detection of insider dealing, unlawful disclosure of inside information and market manipulation. In this regard, the Securities Trading Act only complements the rules set out in MAR, including the application of the MAR rules to commodities and foreign currencies traded on a German stock exchange or on an equivalent EEA market.

In the EU, the G20 commitment on the regulation of OTC derivatives was introduced as part of EMIR, which states obligations on all EU undertakings (including banks, corporates and special purpose vehicles) that enter into derivative contracts, such as interest rate, foreign currency as well as inflation swaps and equity derivatives. These obligations include mandatory clearing of certain OTC derivatives through central counterparties, the implementation of risk mitigation techniques for non-cleared OTC derivatives, such as the exchange of collateral between parties (margin obligations), and the reporting of derivatives to trade repositories. The overall objective of EMIR is to improve transparency and reduce some of the risks associated with the derivatives market, in particular, the risk that the insolvency of one derivatives counterparty may spread through the derivatives market, triggering further insolvencies. EMIR has been amended by EMIR REFIT (Regulation (EU) 2019/834 of 20 May 2019), which, inter alia, simplifies some EMIR requirements, especially for small financial and non-financial counterparties, and aims to make supervision more efficient.

As regards the use of securities financing transactions and collateral reuse, the SFTR – supplemented by several implementing and delegated acts – provides for a legal framework of transparency requirements to facilitate monitoring and risk identification. The SFTR sets out, inter alia, reporting rules in respect of details of securities financing transactions (such as securities lending and repo transactions or certain margin lending transactions) to trade repositories and minimum transparency rules and consent requirements for parties involved in collateral use.

The Benchmarks Regulation (Regulation No. 2016/1011) stipulates a regime for benchmark administrators that ensures the accuracy and integrity of benchmarks and also applies to equity indices across Europe. In addition, a code of conduct for contributors of input data requires the use of robust methodologies and sufficient and reliable data. Users of benchmarks need to establish robust fallbacks and regulated entities may only use registered benchmarks for certain financial products.

The German regulatory authority that supervises compliance with the rules and regulations set out above (and that is the competent authority for purposes of the EU regulations) is primarily BaFin. With respect to the prudential supervision of credit institutions, competent supervisory authorities are BaFin, the German Central Bank and the European Central Bank. Furthermore, ESMA and the European Banking Authority have a guidance and coordination function at EU level.

In respect of share buy-backs and transactions with share issuers, certain restrictions on such share buy-backs (including a buy-back via derivative transactions) apply under the Stock Corporation Act (AktG).

The Civil Code (BGB) and the Commercial Code (HGB) set out certain general principles of contract law, which also affect documentation and interpretation of equity derivatives transactions to the extent that the governing law of the transaction is German law.

In light of standard market documentation for OTC equity derivatives (the German Master Agreement and ISDA Master Agreement) and the reliance on netting provisions, requirements under the Insolvency Act (InsO) and the Act on the Stabilisation and Restructuring Framework for Businesses (StaRUG) must be considered when transactions are entered into with German counterparties.

Entities

4 In addition to dealers, what types of entities may enter into OTC equity derivatives transactions?

OTC equity derivatives are mainly entered into by banks and financial services institutions. In addition, regulated and unregulated funds, including ETFs and alternative investment funds, securitisation and repackaging vehicles, insurance companies, pension funds, professional pension schemes and corporates frequently enter into OTC equity derivatives. In addition, retail investors are heavily investing in equity-linked structured products (typically in the form of structured securities), and more experienced retail investors are also trading equity-linked contracts for differences.

Applicable laws and regulations for eligible counterparties

5 Describe the primary laws and regulations surrounding OTC equity derivatives transactions between a dealer and an eligible counterparty that is not the issuer of the underlying shares or an affiliate of the issuer? What regulatory authorities are primarily responsible for administering those rules?

In addition to the primary rules and regulations, specific rules apply to counterparties that are themselves regulated in respect of their investments and transactions activities, such as insurance companies and regulated funds.

The Insurance Supervisory Act (VAG) is the equivalent of the Banking Act for insurance companies and was fundamentally revised in 2016 to implement the Solvency II Directive (Directive 2009/138/EC). When entering into OTC equity derivatives transactions, insurance companies must ensure compliance with the VAG rules in respect of their investments (including investments in equity derivatives), such as the newly introduced capital requirement rules. There are particular rules for investments made in respect of the guarantee assets of an insurance company, which serve as cover for the claims of insured persons under the relevant insurance contracts. For smaller insurance companies, such restrictions are included in the Investment Regulation.

The Investment Code (KAGB) implements several European directives into German law. Whereas the rules for funds investing in transferable securities derive from Directive No. 2014/91/EU for undertakings for the collective investment in transferable securities (UCITS), alternative investment funds are governed by the Directive on Alternative Investment Fund Managers (AIFMD, Directive No. 2011/61/EU). The AIFMD provides for a regulatory framework for alternative funds and investments by such funds, including investments in assets in which other funds are not allowed to invest. The KAGB implements this European legal framework into German law, the scope of which also includes entering into OTC equity derivatives transactions by funds. The relevant requirements differ depending on the type of fund and the investors to which the fund shall be distributed.

The competent German supervisory authority is BaFin and, as regards the guidance and coordination undertaken at EU level, the relevant authorities are the European Insurance and Occupational Pensions Authority (with respect to insurance companies) and ESMA (with respect to funds).

Securities registration issues

6 Do securities registration issues arise if the issuer of the underlying shares or an affiliate of the issuer sells the issuer's shares via an OTC equity derivative?

The issuer may sell either newly created shares or treasury shares. In the case of registered shares (in contrast to bearer shares) being sold, the share register will be updated following notice by the relevant custodian bank of the issuer and the purchaser. As German shares are predominantly cleared through Clearstream Banking AG, share registers are often updated electronically. In light of equity derivatives transactions, the obligation (or the right) to request a change to the share register only arises with the transfer of the legal ownership of the shares (see section 67 AktG); in other words, the derivative as such is not registered. The registration is decisive for determining voting and dividend rights.

Repurchasing shares

7 May issuers repurchase their shares directly or via a derivative?

The AktG (section 71) allows share buy-backs in the following limited cases:

- if the acquisition is necessary to avoid severe and imminent damage to the company;
- if the shares are to be offered for purchase to the employees or former employees of the company or an affiliated enterprise;
- if the acquisition is made to compensate shareholders in the context of structural measures;
- if the acquisition is made without consideration or made by a credit institution in execution of a purchase order;
- by universal succession;
- on the basis of a resolution of the shareholders' meeting to redeem shares by reducing the share capital;
- if it is a credit institution or financial institution on the basis of a resolution of the shareholders' meeting for the purposes of trading in securities; or
- on the basis of an authorisation of the shareholders' meeting granted for a maximum of five years and defining the price range. Such authorisation may not exceed 10 per cent of the share capital.

The last possibility is most relevant from a practical perspective. To enable a share buy-back via derivatives (eg, options or forwards), the shareholders' resolution should be drafted carefully and include corresponding authorisations. The price range defined in the shareholders' resolution may also be determined as a percentage of the then current stock price. A deviation of the purchase price from the fair market value may also have tax consequences. The company can use funds that would also be available for a dividend to finance a share buy-back even though there are some differences in detail.

A company may hold up to 10 per cent of its nominal share capital shares as treasury shares. Treasury shares do not carry any rights, such as dividend or voting rights.

A third party acting in its own name but on behalf of the company may acquire or hold shares in the company only if and to the extent that the company would permitted to purchase or hold the shares as treasury shares. Share buy-backs are disclosed in the financial statements and reported to the following shareholders' meeting.

The decision to buy back shares will often constitute inside information that triggers restrictions on insider dealing and the publication duties of the company. There are no specific rules on share buy-backs via equity derivatives transactions. However, all parties need to comply with the insider dealing and market abuse provisions set out in the Securities Trading Act and MAR. MAR and further European rules will also require an issuer to disclose individual transactions under a share buy-back if it wants to make use of the safe harbour rules.

Risk

8 What types of risks do dealers face in the event of a bankruptcy or insolvency of the counterparty? Do any special bankruptcy or insolvency rules apply if the counterparty is the issuer or an affiliate of the issuer?

The risk that dealers face in the event of the bankruptcy or insolvency of the counterparty is the credit risk of the counterparty, namely, that the counterparty will not fulfil its payment or delivery obligations under the relevant equity derivative transaction. The time period between an event of default and the termination of the transaction and the related calculation of the close-out amount may also entail market risk. An equity derivative transaction (together with any other OTC derivative transactions of the counterparty under any master agreement that it would typically have entered into with a dealer) usually terminates or may be terminated following the occurrence of an insolvency of the counterparty. Under German insolvency law, the general rule is that the insolvency administrator may elect whether to continue the contract or to terminate it. However, equity derivative transactions would typically be subject to a statutory close-out regime that applies upon the opening of German insolvency proceedings to the extent that the equity derivative transaction has not already been terminated and closed-out before in accordance with its contractual terms. Equity derivatives transactions are typically documented under a master agreement (eg, an ISDA Master Agreement or the German Master Agreement for Financial Derivative Transactions, often also referred to as the DRV). In these circumstances, all transactions under the DRV will be automatically terminated upon the occurrence of an insolvency event as defined in the DRV and the contractual close-out netting will apply. The same will apply to transactions under the ISDA Master Agreement if automatic early termination was selected in respect of the insolvency of a German counterparty. Whether automatic early termination should be selected with respect to a German counterparty in the case of an English or New York law-governed ISDA Master Agreement depends on the type of counterparty and the commercial considerations of the dealer. In general terms, it is recommended by the relevant German industry close-out netting opinion that automatic early termination should be selected if the counterparty is a German corporate. As regards the enforceability of the close-out netting provisions of the DRV and the ISDA Master Agreement in the insolvency of a German counterparty, industry close-out netting opinions have been issued in which any enforceability risks are discussed and any recommendations made.

Where the German counterparty is a regulated entity that is in financial difficulties, supervisory measures, such as a prohibition on making payments, may be taken by BaFin pre-insolvency, and German credit institutions, certain financial services institutions and parent companies of groups that comprise such regulated entities may be subject to restructuring measures such as bail-in measures outside insolvency proceedings based on the German and European law implementing Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms (BRRD). Furthermore, the Act on the Stabilisation and Restructuring Framework for Businesses (StaRUG), most of the provisions of which entered into force on 1 January 2021, has introduced a new framework for the restructuring of companies which, among others, allows a reorganisation of companies outside of insolvency proceedings based on majority decisions of creditors.

There are no special insolvency regimes where the counterparty is the issuer of the underlying shares. However, depending on the economics and the overall nature and purpose of the transactions, additional considerations may need to be made in respect of a potential insolvency of the counterparty (which is also the issuer of the underlying shares). Finally, it should be noted that special regimes as regards reorganisation, moratorium, restructuring and resolution apply in respect of an insolvency of credit institutions.

To deal with the credit risk, parties may agree on collateral be provided. As for the ISDA Master Agreement, the DRV provides for standard forms of collateral annexes, including a collateral annex for margin to be provided for EMIR purposes. Under EMIR, counterparties are now obliged to provide variation margin and initial margin to cover the credit risk as well as any operational or settlement risk, and to reflect the risk involved in the fluctuation of the value of an equity derivative transaction and thus to mitigate the risk of any collateral shortfall.

Reporting obligations

9 What types of reporting obligations does an issuer or a shareholder face when entering into an OTC equity derivatives transaction on the issuer's shares?

The issuer is subject to the reporting obligations applying to share buy-backs if derivatives are used for a share buy-back. In addition, the parties to the derivatives transaction may be subject to reporting obligations concerning voting rights notifications and related instruments. This depends very much on the precise structure of the transaction. Any party that holds 3 per cent, 5 per cent, 10 per cent, 15 per cent, 20 per cent, 25 per cent, 30 per cent, 50 per cent or 75 per cent of voting rights of an issuer whose shares are traded on a regulated market must notify this fact. The same thresholds, with the exception of 3 per cent, apply to any party that holds financial instruments in relation to such shares. Even financial instruments without physical settlement will often be covered by this regime. Further, reporting requirements may be triggered under the rules of an exchange where the shares are listed as well as under MiFIR if the underlying shares are traded on a trading venue, and the issuer or shareholder is a MiFIR investment firm. Moreover, MAR rules on the disclosure of inside information or safe harbour requirements may require adequate publication or reporting by the issuer. Finally, the usual trade reporting obligations of the counterparties under EMIR and MiFID/MiFIR apply.

Restricted periods

10 Are counterparties restricted from entering into OTC equity derivatives transactions during certain periods? What other rules apply to OTC equity derivatives transactions that address insider trading?

There are no specific periods during which counterparties are restricted from entering into equity derivative transactions in general. Only the usual closed periods defined by MAR apply to managers as parties to such transactions. However, the usual insider trading provisions also apply to equity derivatives transactions.

Legal issues

11 What additional legal issues arise if a counterparty to an OTC equity derivatives transaction is the issuer of the underlying shares or an affiliate of the issuer?

The rules governing share buy-backs apply to such transactions. A violation of these rules may result in the equity derivative transaction being void. Consequently, it is crucial for any party dealing with the issuer itself in any derivatives transaction that the issuer is in compliance with the applicable corporate requirements. Such compliance should not only be ensured via appropriate representations and warranties but also by due diligence.

Tax issues

12 What types of taxation issues arise in issuer OTC equity derivatives transactions and third-party OTC equity derivatives transactions?

There is no specific taxation regime applicable with respect to equity derivatives transactions as such, and the general rules should apply. For example, in the case of a share buy-back in issuer OTC equity derivatives transactions, such share buy-back is generally treated as a (tax neutral) capital reduction and a subsequent sale of such shares as a capital increase at the level of the Issuer. At the level of the shareholder, the buy-back should generally be treated as a sale of the shares. The overall tax consequences, however, depend on the precise structure of the transaction.

Liability regime

13 Describe the liability regime related to OTC equity derivatives transactions. What transaction participants are subject to liability?

The general civil liability regime applies, which in particular includes liability for a breach of contract including ancillary contractual duties and pre-contractual duties. The civil law liability regime may already be applicable at an early stage of a proposed transaction. Even where the relevant engagement terms do not expressly contemplate that any advice be given by a party, a party may in fact provide financial advice, for example, where the circumstances suggest some financial advice (eg, structuring, assisting in modelling the transaction, tailored marketing). In such a case, the relevant party must provide appropriate advice and must not omit any facts or information that are material for the parties to which such duties are owed. Extensive case law exists in that area and the relevant party is obliged to explore the needs, the knowledge and the experience of the counterparty and suggest the appropriate derivative. Furthermore, the relevant party needs to disclose the risk and rewards associated with the relevant derivative.

In a series of judgments by the Federal Court of Justice and various regional courts in relation to interest rate swaps entered into between a credit institution and a corporate, the courts have further highlighted the conflict of interest for a party to a swap. If a credit institution is a party to a derivative transaction and at the same time a financial adviser (which is almost always the case in non-standard transactions that are outside the 'execution only' business), the credit institution is inevitably in a conflict. Any gain under the derivative is the counterparties' loss, and if the credit institution is structuring the derivative it may structure it in its favour. Consequently, in these scenarios, credit institutions (which are also financial advisers) need to disclose to the counterparty any initial negative market value of a derivative transaction for the counterparty to fully evaluate the implicit costs of the transaction. This requirement does not need to be fulfilled if the derivative is a hedging transaction for a connected transaction (eg, a convertible or loan). Although these judgments have mainly been applied in respect of interest rate swaps, it is very likely that the same will apply to any other asset classes, including equity derivatives transactions.

If a party provides information about the underlying share issuer, it may be liable under the prospectus liability regime. Even if the information is drawn from publicly available sources, the party that makes available such disclosure about the issuer of the shares needs to ensure that the information is comprehensive and no material information is missing that would render the information provided as misleading or false.

Once the parties have entered into the transaction, the contractual arrangements apply and the liability is usually limited to breach of contract or violation of applicable rules and obligations.

This liability regime applies to all transaction participants. As a rule of thumb, the less experienced a counterparty is (particularly if it is a retail investor), the higher the requirement for disclosure and information.

Stock exchange filings

14 | What stock exchange filings must be made in connection with OTC equity derivatives transactions?

There are no stock exchange filings in respect of OTC equity derivatives transactions, unless as a result of such transaction a counterparty becomes the shareholder. Subject to the general European and German regulatory requirements under MAR and other European or German regulatory law, and depending on the rules of the exchange in relation to shares, notification may be required if the transaction affects the price, the liquidity or the company as such. In addition, the rules governing the notification of voting rights and financial instruments apply even though, under such rules, the filing is not to the stock exchange.

Typical document types

15 | What types of documents are typical in an OTC equity derivatives transaction?

The German OTC market predominantly uses the ISDA Master Agreement or the DRV. The equity derivatives transactions will then be documented by confirmations that set out the economic terms of the transactions. In addition, the confirmation refers to a standard set of definitions used with equity derivatives. Under the ISDA Master Agreement these are the 2002 ISDA Equity Derivatives Definitions or, though rarely used, the 2011 ISDA Equity Derivatives Definitions. Under the DRV, a similar set of definitions is available, which is the (equity) securities derivatives addendum. These definitions deal with the mechanics of exercising an option, valuations, market disruptions, extraordinary events, and share and index adjustment events (eg, merger events and tender offers). Furthermore, the EMIR-compliant collateral arrangements are documented under the collateral addendum for variation margin. There will also be a collateral addendum for initial margin that has, however, not yet been published. In addition, an EMIR addendum is available in which EMIR requirements (other than the margin requirements) are addressed.

In the case of cleared OTC derivatives, the terms and conditions of the relevant derivatives (once accepted for clearing) are set out in the standardised terms and conditions (as applicable to the relevant type of derivative) published by the relevant central counterparty (ie, Eurex Clearing AG, which is the German central clearing counterparty for derivatives). The retail equity derivatives market, which enables retail investors to invest in structured securities, utilises a retail prospectus, which is approved by BaFin for public offers and listing purposes. The EU Prospectus Regulation (No. 2017/1129) entered into force on 20 July 2017 and has been fully applied from 21 July 2019.

Furthermore, product manufacturers of equity derivative products to be sold to retail investors need to produce a short disclosure document, the favour 'key information document', based on Regulation (EU) No. 1286/2014 of the European Parliament and of the council on key information documents for packaged retail and insurance-based investment products.

Legal opinions

16 | For what types of OTC equity derivatives transactions are legal opinions typically given?

If transactions are entered into under an ISDA Master Agreement or a DRV, parties usually rely on the relevant industry opinion. However, these opinions mostly cover netting of transactions only and do not deal with any specific enforceability or capacity issues of a specific transaction. In the case of an equity derivatives transaction (which, for instance, relates to a share buy-back) the counterparty (not being the issuer) may require a capacity and compliance opinion to ensure the validity of the transaction. Capacity opinions are also given with respect to regulated or other private or public companies or entities that have a restricted, special or public company objective.

Hedging activities

17 May an issuer lend its shares or enter into a repurchase transaction with respect to its shares to support hedging activities by third parties in the issuer's shares?

This is generally possible within the limits of the share buy-back rules. However, careful structuring is required in light of the relevant transaction. If an issuer enters into a repurchase transaction with a counterparty, the company will acquire them again after maturity of the repo and may have a security arrangement in place. Consequently, the company needs to comply with the 10 per cent restriction on holding of treasury shares (including the shares subject to the repo).

The analysis, however, depends on the details of the documentation of the specific transaction: if the shares are subject to a loan granted by the issuer and there is no security arrangement, the borrower is likely to be seen as a shareholder and the issuer acquiring them again upon maturity may also require a shareholders' authorisation.

Securities registration

18 What securities registration or other issues arise if a borrower pledges restricted or controlling shareholdings to secure a margin loan or a collar loan?

If the shares are freely transferable, there are no specific securities registration requirements. However, depending on the details of the documentation, a disclosure of voting rights or financial instruments may apply under the Securities Trading Act, MiFID/MiFIR, MAR and EMIR.

Borrower bankruptcy

19 If a borrower in a margin loan files for bankruptcy protection, can the lender seize and sell the pledged shares without interference from the bankruptcy court or any other creditors of the borrower? If not, what techniques are used to reduce the lender's risk that the borrower will file for bankruptcy or to prevent the bankruptcy court from staying enforcement of the lender's remedies?

The position of the lender in the bankruptcy of a German borrower depends on the type of security interest created over the shares. Usually, the relevant shares and the custody account are pledged in favour of the margin lender. Such German law pledge agreement (assuming the account is located in Germany) is usually structured as a financial collateral arrangement within the meaning of the European Financial Collateral Directive. Under German law, an appropriation right applies to fungible securities falling under the financial collateral regime pursuant to section 1259 of the Civil Code, and an enforcement privilege for financial collateral is provided for in section 166(3) of the Insolvency Code. Consequently, the margin lender will be able to appropriate the shares without the involvement of the insolvency administrator (provided that the requirements of section 1259 of the German Civil Code and section 166(3) of the Insolvency Code are fulfilled). In addition, a German pledge may be enforced by way of a private sale or a public auction.

Market structure

20 | What is the structure of the market for listed equity options?

The market for listed equity options is dominated by Eurex Exchange, the derivatives exchange operated by Eurex Frankfurt AG, a subsidiary of Deutsche Börse AG. The equity option market of Eurex includes more than 500 options on more than 500 underlyings from 13 countries. Participants are able to access all the components of the Euro Stoxx 50 and Stoxx Europe 50 indices, as well as most components in the Stoxx Europe 600, Stoxx Europe Large 200, Stoxx Europe Mid 200 and Stoxx Europe Small 200 indices.

Governing rules

21 | Describe the rules governing the trading of listed equity options.

The main rules governing the trading of listed equity options on Eurex include the Exchange Act (BörsG) as the overall statutory framework, the Exchange Rules, and the Trading Conditions of Eurex as well as the Eurex Contract Specification Rules. The Exchange Rules provide for, among others:

- the general rules on the electronic trading system and general trading rules (eg, in respect of position limits and market integrity);
- the role of the central counterparty;
- the admission of trading participants and their ongoing obligations;
- the suspension or exclusion of participants from trading and the termination of the admission to trading;
- access to the trading system;
- time of trading and price determination; and
- pre- and post-trade transparency.

The Trading Conditions govern the types of contracts and strategies that can be traded, the conclusion and cancellation of trades, the various types of orders, etc. The details of the contracts traded are specified in the Eurex Contract Specifications for Futures Contracts and Options Contracts. The clearing of listed equity options traded on Eurex is governed by the Eurex Clearing Conditions.

Trading of equity options on Eurex range from one to 5,000 shares and is available in euros, Swiss francs, US dollars and pounds sterling. The contracts have a maturity of up to 12, 24 and 60 months. Eurex establishes a daily settlement price of all listed equity options. These prices are determined through a binomial model taking into account dividend expectations, current interest rates or other payments, if necessary. The options can be offered American-style (ie, the option can be exercised on any trading day during the lifetime of the option) as well as European-style, which can only be exercised on the last trading day of the lifetime of the relevant option. The option premium is payable in full in the currency of the respective contract one business day after the trade day.

TYPES OF TRANSACTION

Clearing transactions

22 What categories of equity derivatives transactions must be centrally cleared and what rules govern clearing?

The clearing obligation under Regulation (EU) 648/2012 on OTC derivatives, central counterparties and trade repositories (EMIR) requires that all OTC derivative contracts within scope are subject to mandatory clearing and must be cleared with a central counterparty (CCP) that is authorised under EMIR (or that is recognised under EMIR for non-EU CCPs). Currently, EMIR does not mandate the clearing of equity derivatives. The specific classes of products that are within the scope of the mandatory clearing obligation under EMIR are set out in the Annex to the EMIR Delegated Regulation and cover standardised and liquid products (including certain interest rate swaps and credit default swaps). While it is contemplated that equity derivative products will become clearable in the future, the equity derivatives market is already predominantly exchange-based. As a result, equity derivatives that remain traded OTC are generally bespoke products and, therefore, are unlikely to easily meet the standardisation and liquidity requirements for clearable products under EMIR.

Exchange-trading

23 What categories of equity derivatives must be exchange-traded and what rules govern trading?

In Germany, equity derivatives are currently not required to be traded on an exchange. Following the clearing obligation under EMIR, Directive 2014/65/EU (MiFID II) and Regulation (EU) No. 600/2014 (MiFIR) introduced a mandatory trading obligation for certain derivative transactions. Broadly, the trading obligation applies to a class of derivatives that is traded on at least one admissible trading venue and there is sufficient liquidity in the trading of such class of derivatives. The trading obligation does not currently apply to equity derivatives.

If, however, equity derivatives are traded on an exchange, the exchange rules governing the trading of these derivatives depend on the relevant market segment. On the regulated market, the admission to trading and the trading on the exchange are governed by the Exchange Act and the legal framework of the relevant derivatives exchange, which, in the case of Eurex, include the Exchange Rules, the Trading Conditions and the Eurex Contract Specifications as well as the Clearing Conditions. In respect of non-regulated markets, the exchanges have set up terms and conditions governing the trading on these markets.

Collateral arrangements

24 Describe common collateral arrangements for listed, cleared and uncleared equity derivatives transactions.

Uncleared equity derivatives are subject to the bilateral collateral arrangements of the parties. Usually, parties collateralise their transactions under an ISDA collateral support annex or the equivalent German Master Agreement for Financial Derivative Transactions (DRV) collateral addendum or the DRV collateral addendum for variation margin for compliance with the margin requirements under EMIR. Any transaction will be valued and a shortfall or excess will be determined on a net basis. The parties are required to transfer relevant collateral to cover any shortfall or reduce any excess. Under the DRV collateral addenda, the collateral is transferred by way of an outright collateral transfer, allowing the collateral taker to reuse the collateral.

The collateral arrangements for cleared OTC derivatives and listed derivatives are set out in the legal framework of the relevant clearinghouse. The Clearing Conditions of the German central counterparty, Eurex Clearing AG, provide for two different margin methodologies that may be applied to a relevant liquidation group as well as different margin types depending on the relevant class of transactions. In general terms, both initial and variation margin must be posted.

Exchanging collateral

25 | Must counterparties exchange collateral for some categories of equity derivatives transactions?

As regards OTC equity derivatives that are not cleared by a central counterparty, the general margin requirements under EMIR apply. Under EMIR, variation margin and, subject to a phase-in, also initial margin must be exchanged between financial counterparties (broadly, credit institutions, insurance undertakings, undertakings for the collective investment in transferable securities, alternative investment fund managers, etc) and between financial counterparties and counterparties that are above the clearing threshold (NFC+). This means that most of the non-financial counterparties (ie, corporates) are not subject to the margin requirements of EMIR. The initial margin requirement currently applies to financial counterparties and NFC+ that each have outstanding OTC derivatives trades in an aggregate volume of €750 billion, but this threshold was reduced to €50 billion from 1 September 2021 and was further reduced to €8 billion in September 2022 in accordance with the applicable phase-in timetable. Most derivatives transactions are in scope for the variation and initial margin obligations, although single stock equity options and index options remain out of scope for a transitional period ending on 4 January 2024.

For cleared OTC derivative transactions and listed derivatives margin requirements apply under the applicable clearing conditions. The Clearing Conditions of the German central counterparty, Eurex Clearing AG, provide for two different margin methodologies that may be applied to a relevant liquidation group as well as different margin types depending on the relevant class of transactions. In general terms, both initial and variation margin must be posted.

LIABILITY AND ENFORCEMENT

Territorial scope of regulations

26 | What is the territorial scope of the laws and regulations governing listed, cleared and uncleared equity derivatives transactions?

The laws and regulations governing listed, cleared and uncleared equity derivatives transactions do not have a uniform territorial scope. Whether the relevant German or European legislation applies to cross-border transactions in which non-German or non-EU parties participate hinges on criteria differing depending on the legislative objective of the relevant law. For example, financial licence requirements under the Banking Act apply if the provider of the financial services is providing the services through a physical presence in Germany or – even in the absence of a place of business in Germany – targets the German market to offer its services repeatedly and on a commercial basis to companies or persons having their registered office or ordinary residence in Germany. Licence requirements for proprietary trading activities generally also apply if the trading activities are conducted as a participant of a regulated market or a multilateral trading facility or via direct electronic access to a trading venue. In contrast, the Short Selling Regulation applies irrespective of where and by whom the relevant financial instrument is traded, to all financial instruments admitted to trading on a trading venue in the EU. Some legislation (eg, Regulation (EU) 648/2012 on OTC derivatives, central counterparties and trade repositories (EMIR)) addresses the direct, substantial and foreseeable effect in the EU or whether the purpose of the transaction is aimed at evading the obligations under EMIR.

Registration and authorisation requirements

27 What registration or authorisation requirements apply to market participants that deal or invest in equity derivatives, and what are the implications of registration?

Market participants may require a banking or financial services licence or a 'European passport' based on a licence held in another EU/EEA member state, depending on their activities in the equities derivatives market. If a licence has been obtained in Germany, the relevant entity would be subject to ongoing supervision by the Federal Financial Supervisory Authority (BaFin). Where the European passport is used, for mere cross-border services the relevant entity would be mainly supervised by the competent authority of its home member state, but certain German regulatory requirements may still apply.

Reporting requirements

28 What reporting requirements apply to market participants that deal or invest in equity derivatives?

The issuer is subject to the reporting obligations applying to share buy-backs if derivatives are used for a share buy-back. In addition, parties to the derivatives transaction may be subject to reporting obligations concerning voting rights notifications and related instruments. This depends very much on the precise structure of the transaction. Any party that holds 3 per cent, 5 per cent, 10 per cent, 15 per cent, 20 per cent, 25 per cent, 30 per cent, 50 per cent or 75 per cent of voting rights of an issuer whose shares are traded on a regulated market must notify this fact. The same thresholds, with the exception of 3 per cent, apply to any party that holds financial instruments in relation to such shares. Even financial instruments without physical settlement will often be covered by this regime.

Counterparties to equity derivatives transactions are subject to the EMIR trade reporting requirements and counterparties to securities financing transactions are obligated under the Securities Financing Transactions Regulation to report details to every conclusion, modification and termination of recognised securities financing transactions within the working day following the respective event.

Furthermore, investment firms are subject to the transaction reporting requirements under Regulation (EU) No. 600/2014 (MiFIR) and both financial counterparties and non-financial counterparties must comply with the reporting requirements relating to OTC derivative transactions under article 9(1) EMIR.

Since the Sustainable Finance Disclosure Regulation (Regulation (EU) No. 2019/2088, SFDR)) entered into force in March 2021, financial market participants and financial advisers are subject to certain disclosure and reporting requirements relating to sustainability factors and considerations. The SFDR aims to provide a harmonised framework regarding transparency in relation to sustainability risks, the consideration of adverse sustainability impacts in investment processes and the provision of sustainability-related information with respect to financial products.

Legal issues

29 What legal issues arise in the design and issuance of structured products linked to an unaffiliated third party's shares or to a basket or index of third-party shares? What additional disclosure and other legal issues arise if the structured product is linked to a proprietary index?

There are no specific legal requirements that apply to this type of product except for the requirements for packaged retail and insurance-based investment products, which in particular include the obligation to prepare a key information document (as set out below).

However, the general regulatory requirements are to be considered. The sale of structured products in Germany, even if sold by the issuer itself, may constitute a licensable activity under the Banking Act or the Investment Firms Act (from June 2021). Further, any public offer of such products or any listing on a regulated market would require that a prospectus be drawn up and approved by BaFin (or notified by another EU/EEA competent authority to BaFin under the European Passport) and such prospectus must, among other things, include disclosure of various information in respect of the underlying and its weighting in the basket, or in respect of any underlying index (including as to whether the index constitutes a benchmark under Regulation (EU) 2016/1011 of 8 June 2016 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds and amending Directives 2008/48/EC and 2014/17/EU and Regulation (EU) 596/2014 (the Benchmark Regulation)).

In the case of index-linked products, the issuer may be regarded as an administrator or user of an index depending on whether the index is a proprietary index or provided by a third party. In both cases, additional regulatory requirements under the Benchmark Regulation are triggered, which, in case of the administrator (including third-country administrators whose indices are used in the EU), involves a rather onerous application requirement for authorisation.

Further, the product governance rules of Directive 2014/65/EU (MiFID II), as implemented into the German Securities Trading Act, are to be complied with by a manufacturer and distributor of the structured product (such as the definition of a target market).

Moreover, in case of equity derivative products to be sold to retail investors, product manufacturers need to produce a short disclosure document, the favour 'key information document', based on Regulation (EU) No. 1286/2014 of the European Parliament and of the Council on key information documents for packaged retail and insurance-based investment products.

Liability regime

30 | Describe the liability regime related to the issuance of structured products.

The applicable liability regime depends on the type of structured product and in particular whether it is issued in the form of a structured security or not.

The general liability regime may apply in respect of the structured product (ie, an error of the product or the covenants or representations provided by the issuer of the relevant product). This regime is based on the principles related to breach of contract.

A further liability regime exists in respect of wrong or insufficient disclosure as regards the underlying risk or the mechanism of the relevant structured product. This favoured 'prospectus liability' may be established on the basis of section 8 et seqq of the Securities Prospectus Act, if a prospectus under the EU Prospectus Regulation has been drawn up. A similar regime (though typically less relevant for market standard structured products) applies to instruments that are not securities in terms of the EU Prospectus Regulation but for which a prospectus needs to be drawn up under the Investment Code. If a relevant disclosure, information or marketing document has not been drawn up under any of these two regimes, an issuer may still be liable for any information provided to investors under the prospectus liability regime established by case law.

Finally, detailed and extensive case law exists in relation to the misselling of structured products in Germany. Sellers of structured products need to comply with the principles established by courts in respect of providing appropriate financial advice to investors.

Other issues

31 | What registration, disclosure, tax and other legal issues arise when an issuer sells a security that is convertible for shares of the same issuer?

A company requires shareholder approval or authorisation for issuing convertible instruments. Convertibles are treated as a form of securitised equity derivative and are financial instruments for the purposes of MiFID II, the Securities Trading Act, the Banking Act and the Investment Firms Act (from June 2021). As convertible bonds typically are tradable securities, any public offer or listing on a regulated market is subject to the European Prospectus Regulation.

Depending on the details of the documentation, a convertible may be regarded as a financial instrument that needs to be disclosed under the rules described in 'Reporting obligations'. This depends very much on the precise structure of the transaction. Any party that holds 3 per cent, 5 per cent, 10 per cent, 15 per cent, 20 per cent, 25 per cent, 30 per cent, 50 per cent or 75 per cent of voting rights of an issuer whose shares are traded on a regulated market has to notify this fact. The same thresholds, with the exception of 3 per cent, apply to any party that holds financial instruments in relation to such shares. Even financial instruments without physical settlement will often be covered by this regime. Further, reporting requirements may be triggered under the rules of an exchange where the shares are listed, as well as under MiFIR if the underlying shares are traded on a trading venue, and the issuer or shareholder is a MiFIR investment firm. Moreover, MAR rules on the disclosure of inside information or safe harbour requirements may require adequate publication or reporting by the issuer. Finally, the trade reporting obligations under MiFID/MiFIR may apply.

32 | What registration, disclosure, tax and other legal issues arise when an issuer sells a security that is exchangeable for shares of a third party? Does it matter whether the third party is an affiliate of the issuer?

Exchangeable bonds are regarded as equity derivatives or securities, depending on the scope of the relevant regulations, and no specific rules apply in that respect. They are financial instruments for purposes of MiFID II, the Securities Trading Act, the Banking Act and the Investment Firms Act (as of June 2021). Depending on the details of the documentation, an exchangeable bond may be regarded as a financial instrument that needs to be disclosed, or a relevant trade in such financial instrument may need to be reported, in accordance with the Securities Trading Act, MiFID/MiFIR and MAR. As exchangeable bonds typically are tradable securities, any public offer or listing on a regulated market is subject to the European Prospectus Regulation.

If the third party is an affiliate of the issuer, the issuer may require shareholder approval or authorisation.

UPDATE AND TRENDS

Recent developments

33 | Are there any current developments or emerging trends that should be noted?

The Sustainable Finance Disclosure Regulation (Regulation (EU) No. 2019/2088, SFDR) fully entered into force on 10 March 2021, resulting in financial market participants and financial advisers being subject to certain disclosure and reporting requirements in relation to sustainability considerations.

Furthermore, from June 2021, certain types of investment firms have become subject to a new regulatory framework comprising primarily the Investment Firms Regulation (Regulation (EU) No. 2019/2033, IFR) and the new Investment Firms Act (WpIG) implementing the Investment Firms Directive (Directive (EU) No. 2019/2034, IFD) into German law.

LATHAM & WATKINS

Frank Bierwirth	frank.bierwirth@lw.com
Dirk Kocher	dirk.kocher@lw.com
Axel Schiemann	axel.schiemann@lw.com

Reuterweg 20, Frankfurt 60323, Germany
Tel: +49 69 6062 6000
www.lw.com

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Hong Kong

Derek S H Chua, Michael Hardy and Posit Laohaphan
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Summary

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OVERVIEW

Typical types of transactions

1 Other than transactions between dealers, what are the most typical types of over-the-counter (OTC) equity derivatives transactions and what are the common uses of these transactions?

Typical types of OTC equity derivatives transactions in Hong Kong include the following (together with common uses):

- options and swaps: commonly used for hedging purposes, stake-building or to monetise an equity stake and for synthetic or physical share repurchases; in the convertible debt context, call spread transactions are entered into to effectively increase the conversion price of convertible debt;
- margin loans: commonly used to monetise or leverage large equity stakes held by shareholders (usually involving the granting of security over the underlying shares);
- collars, prepaid forward contract and collar loans: used to monetise a position, and as a hedge to limit the range of possible positive or negative returns; and
- stock borrowing transactions and economic equivalents: often entered into between a shareholder of the issuer and the underwriter of the issuer's convertible debt (and, separately, between such an underwriter and the holders of such convertible debt) in order to enable the holders of such convertible debt to hedge their equity exposure by short selling in the market.

Borrowing and selling shares

2 May market participants borrow shares and sell them short in the local market? If so, what rules govern short selling?

Yes, market participants may borrow shares and short sell them in the local market provided that:

- the securities are on the list of designated securities eligible for short selling published by The Stock Exchange of Hong Kong Limited (SEHK); and
- they comply with the relevant trading rules of the SEHK.

Under the Securities and Futures Ordinance (Cap. 571 of the laws of Hong Kong) (SFO), naked short selling of shares in Hong Kong is prohibited. Under section 170 of the SFO, a person shall not sell securities at or through a recognised stock market unless, at the time that person sells them: (1) that person has or, where that person is selling as an agent, that person's principal has; or (2) that person believes and has reasonable grounds to believe that he or she has or, where selling as an agent, that his or her principal has, a presently exercisable and unconditional right to vest the securities in the purchaser of them. Separately:

- under the Securities and Futures (Short Position Reporting) Rules, any person who has a reportable short position is required to notify the Securities and Futures Commission by making a submission through the Short Position Reporting Service; and

- any short selling is subject to the general provisions on market misconduct in the SFO.

Applicable laws and regulations for dealers

3 Describe the primary laws and regulations surrounding OTC equity derivatives transactions between dealers. What regulatory authorities are primarily responsible for administering those rules?

While there is no single unified regulatory framework on OTC equity derivatives transactions between dealers in Hong Kong, the Securities and Futures Ordinance (Cap. 571 of the laws of Hong Kong) (SFO) is the legislation of primary relevance. Among other things, it sets out:

- the licensing requirements for dealers in Hong Kong and the framework for mandatory clearing, reporting, record-keeping and trading requirements in Hong Kong;
- the authorisation requirements for advertisement, invitation or document in respect of the offering of structured products or equity derivatives products to the public in Hong Kong; and
- civil and criminal liabilities in respect of insider dealing, false trading, price rigging, stock market manipulation, disclosure of information about prohibited transactions and disclosure of false and misleading information inducing transactions.

The Securities and Futures Commission (and, in certain respects, the Hong Kong Monetary Authority (HKMA)) are responsible for administering the SFO. Moreover, the HKMA plays a role in the OTC equity derivatives transactions by regulating authorised institutions and approved money brokers in respect of capital, liquidity and other relevant requirements under the Banking Ordinance (Cap. 155 of the laws of Hong Kong), together with subsidiary legislation, regulations and guidelines. In particular, see 'Exchanging collateral' below regarding mandatory margining requirements.

In addition to the above, OTC equity derivatives transactions that reference shares of a listed company are subject to the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited.

Entities

4 In addition to dealers, what types of entities may enter into OTC equity derivatives transactions?

There are no specific prohibitions on the types of entities that may enter into OTC equity derivatives transactions. Subject to the memorandum and articles of association, charters or other constitutional documents of the relevant entities (as applicable), corporates, funds, private companies as well as individuals may enter into OTC equity derivatives transactions.

Applicable laws and regulations for eligible counterparties

5 Describe the primary laws and regulations surrounding OTC equity derivatives transactions between a dealer and an eligible counterparty that is not the issuer of the underlying shares or an affiliate of the issuer? What regulatory authorities are primarily responsible for administering those rules?

The Securities and Futures Ordinance (Cap. 571 of the laws of Hong Kong) (SFO) is the primary regime governing OTC equity derivatives transactions in Hong Kong between a dealer and an eligible counterparty that is not the issuer of the underlying shares or an affiliate of the issuer. The SFO sets out the licensing requirements of dealers in Hong Kong and the laws relating to advertisement, invitation and offering documents made in respect of the offering of structured products or equity derivatives products to the public in Hong Kong. The Securities and Futures Commission is the regulatory authority primarily responsible for the administering of the SFO.

Securities registration issues

6 Do securities registration issues arise if the issuer of the underlying shares or an affiliate of the issuer sells the issuer's shares via an OTC equity derivative?

No Hong Kong law securities registration issues arise if the issuer of the underlying shares or an affiliate of the issuer sells the issuer's shares via an OTC equity derivative. However, the seller should comply with the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32 of the laws of Hong Kong), the Securities and Futures Ordinance (Cap. 571 of the laws of Hong Kong) and the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited when conducting such sale. Generally speaking, it is uncommon for the issuer of the underlying shares or an affiliate of the issuer to sell the issuer's shares via an OTC equity derivative.

Repurchasing shares

7 May issuers repurchase their shares directly or via a derivative?

An issuer may repurchase their shares either directly or via a derivative. An issuer may engage in four different types of share buy-back:

- on-market share buy-back;
- off-market share buy-back;
- exempt share buy-back; and
- share buy-back by general offer.

The Code on Share Buy-Backs published by the Securities and Futures Commission (SFC) sets out the rules and procedures relating to share buy-backs. In particular, for an off-market share buy-back, approval must be granted by at least three-fourths of the votes cast on a poll by disinterested shareholders in attendance or by proxy at a general meeting of the shareholders of the issuer and such buy-back must be approved by the Executive Director of the Corporate Finance Division of the Securities and Futures Commission or his or her delegate. For on-market buy-backs, the Rules Governing the Listing of Securities on

The Stock Exchange of Hong Kong Limited also set out additional rules and regulations that an issuer must comply with, including timing and price restrictions.

In the case where the issuer enters into a cash-settled equity derivatives transaction referencing its own shares, the buy-back rules set out above do not apply.

The general provisions of the Companies Ordinance (Cap. 622 of the laws of Hong Kong) and the SFO with respect to financial assistance and market misconduct, etc, will also need to be considered.

Risk

8 What types of risks do dealers face in the event of a bankruptcy or insolvency of the counterparty? Do any special bankruptcy or insolvency rules apply if the counterparty is the issuer or an affiliate of the issuer?

There are no special bankruptcy or insolvency rules that would apply to a counterparty if it is the issuer or an affiliate of the issuer.

However, more generally, in the case of a bankruptcy or insolvency of a counterparty, the key risk that a dealer would face is credit risk (its ability to recover any amounts and collateral owed to it by the counterparty). Generally speaking, a secured creditor may take enforcement action in respect of a validly granted and perfected security interest irrespective of whether the counterparty is factually or legally insolvent.

For a counterparty that is a Hong Kong company, the principal insolvency legislation is the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32 of the laws of Hong Kong) (C(WUMP)O) (in the case of an authorised institution, the Banking Ordinance (Cap. 155 of the laws of Hong Kong) is also relevant and for an individual, the principal bankruptcy legislation is the Bankruptcy Ordinance (Cap. 6 of the laws of Hong Kong)). The C(WUMP)O sets out the primary statutory grounds upon which a liquidator of a counterparty being wound up may seek to challenge a transaction, including unfair preference, transaction at an undervalue, extortionate credit transactions, dispositions of property after commencement of winding up and floating charge created within the relevant hardening period.

The moratorium under section 186 of the C(WUMP)O that generally applies upon a winding-up order being made, or a provisional liquidator being appointed, in respect of a counterparty will not prevent a termination right against the counterparty being exercised (or an out-of-court of enforcement of security over the counterparty's assets).

If the counterparty is a 'within scope financial institution' for the purposes of the Financial Institutions (Resolution) Ordinance (Cap. 628 of the laws of Hong Kong), certain obligations of the counterparty may be temporarily suspended and termination rights against the counterparty may be temporarily stayed, but set-off, netting, title transfer and security arrangements are generally protected in relation to partial property transfers and bail-in.

As regards OTC equity derivatives transactions documented using an ISDA Master Agreement, ISDA has commissioned Hong Kong legal opinions regarding the enforceability of, among other things, close-out netting under an ISDA Master Agreement and collateral arrangements constituted under standard ISDA documentation.

Reporting obligations

9 What types of reporting obligations does an issuer or a shareholder face when entering into an OTC equity derivatives transaction on the issuer's shares?

For a listed issuer, the key reporting obligations arise under Part XIVA of the Securities and Futures Ordinance (Cap. 571 of the laws of Hong Kong) (SFO) and the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (SEHK Listing Rules). Under Part XIVA of the SFO, a listed issuer is required to disclose specific material price sensitive information (about the issuer, a shareholder or officer of the issuer, or listed securities of the issuer or their derivatives) to the public as soon as reasonably practicable. A similar requirement is also set out in Rule 13.09(2) of the SEHK Listing Rules, which requires a listed issuer to simultaneously announce the information when the listed issuer is required to do so under Part XIVA of the SFO. Moreover, listed issuers are required to disclose certain 'notifiable transactions' and 'connected transactions' under the SEHK Listing Rules.

Under Part XV of the SFO, directors, chief executives and substantial shareholders of a listed issuer are required to disclose their interests in voting rights in the listed company. Generally speaking, a director or a chief executive of the listed company must disclose all interests and short positions in any shares of the listed company as well as all dealings in respect of such interests and positions. In contrast, the disclosable obligations of a shareholder are triggered when such person holds a long interest of 5 per cent or above and applies to any changes in such interest that cross a whole percentage point above the 5 per cent threshold. More generally, the disclosure obligations:

- take into account parties acting in concert;
- are applicable to OTC equity derivatives transactions on a gross basis (no netting of long and short positions); and
- apply regardless of whether a transaction is cash or physically settled.

Obligations under the Securities and Futures Commission Code of Takeovers and Mergers to disclose certain dealings during an offer period should also be taken into account.

Restricted periods

10 Are counterparties restricted from entering into OTC equity derivatives transactions during certain periods? What other rules apply to OTC equity derivatives transactions that address insider trading?

The Model Code for Securities Transactions by Directors of Listed Issuers (ie, the required standard that The Stock Exchange of Hong Kong Limited requires all listed issuers and their directors to meet, any breach of which is regarded as a breach of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited) provides that, in essence, a director of a listed company is prohibited from dealing in the securities of such company:

- at any time when he or she possesses inside information in relation to those securities;
- on any day on which its financial results are published;
- during the period of 60 days immediately preceding the publication date of the annual results; and
- during the period of 30 days immediately preceding the publication date of the quarterly results (if any) and half-year results.

This restriction on dealings also extends to dealings by, among others, a director's spouse and minor children.

In addition, the Securities and Futures Ordinance (Cap. 571 of the laws of Hong Kong) (SFO) has civil and criminal regimes (Parts XIII and XIV of the SFO) in respect of market misconduct. In particular, the SFO defines various categories of 'insider dealing' in relation to a listed company including:

- a person connected with the issuer who has information that he or she knows is inside information in relation to the issuer:
    - deals in the issuer's listed securities or their derivatives (or those of a related corporation); or
    - counsels or procures another person to deal in such securities or derivatives, knowing or having reasonable cause to believe that the other person will deal in them; and
- a person connected with the issuer and knowing that any information is inside information in relation to the issuer, discloses the information, directly or indirectly, to another person, knowing or having reasonable cause to believe that the other person will make use of the information for the purpose of dealing, or of counselling or procuring another person to deal, in the listed securities of the issuer or their derivatives (or those of a related corporation).

There are various defences available under the SFO for insider dealing such as the 'market information' defence, the 'Chinese wall' defence and where the use of inside information was not for the purpose of securing or increasing a profit or avoiding or reducing a loss, whether for himself or herself, or another person.

In addition to insider dealing, the SFO also contains provisions relating to other forms of market misconduct including false trading, price rigging, stock market manipulation, disclosure of information about prohibited transactions and disclosure of false and misleading information inducing transactions.

Legal issues

11 What additional legal issues arise if a counterparty to an OTC equity derivatives transaction is the issuer of the underlying shares or an affiliate of the issuer?

An OTC equity derivatives transaction entered into between an issuer of the underlying shares and an affiliate of the issuer over the issuer's shares may also rise to 'connected transaction' issues. A connected transaction is a transaction entered into between the listed company and its 'connected person' (which includes, among others, a director, chief executive or substantial shareholder of the listed company or any of its subsidiaries as well as any connected subsidiary of the issuer). Unless such transaction falls within certain exemptions that are available under Chapter 14A of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited, disclosure requirements may apply to such transaction and approvals of the shareholders of the listed company may be required.

More generally, where an issuer is entering into an OTC equity derivatives transaction that provides it with a long position over its own shares, it should be mindful of any share repurchase issues. Further, there are often public policy considerations in relation to issuers entering into derivatives over its own shares. As such, an issuer would generally discuss the transaction structure with The Stock Exchange of Hong Kong Limited before entering into such a transaction.

Tax issues

12 What types of taxation issues arise in issuer OTC equity derivatives transactions and third-party OTC equity derivatives transactions?

Stamp duty will be payable upon physical settlement of an equity derivatives transaction in respect of Hong Kong stock. Since 1 August 2021, the rate of stamp duty payable by each of the seller and purchaser has been 0.13 per cent on the higher of the consideration or the value of shares. In other words, a total of 0.26 per cent on the higher of the consideration or the value of the shares is currently payable in respect of the transfer of Hong Kong stock. An additional amount of HK$5 is payable on each instrument of transfer.

Stamp duty relief is available for securities lending and borrowing transactions provided that such transactions fall within the conditions set out in the Stamp Duty Ordinance (Cap. 117 of the laws of Hong Kong).

Liability regime

13 Describe the liability regime related to OTC equity derivatives transactions. What transaction participants are subject to liability?

Issuances and marketing of structured products are subject to the Securities and Futures Ordinance (Cap. 571 of the laws of Hong Kong) (SFO). Under section 103 of the SFO, a person commits an offence if he or she issues, or has in his or her possession for the purposes of issue, whether in Hong Kong or elsewhere, an advertisement, invitation or document that to his or her knowledge is or contains an invitation to the public to enter into or offer to enter into an agreement to acquire, dispose of, subscribe for or underwrite any structured products, unless the issue is authorised by the Securities and Futures Commission under section 105 of the SFO or an exemption applies (eg, offers solely to persons outside of Hong Kong and offers to professional investors).

For unlisted structured investment products offered to the public in Hong Kong, the Code on Unlisted Structured Investment Products (including the content requirements for offering documents in respect of an offering of Unlisted Structured Investment Products) must also be complied with.

Various offences and civil liabilities set out in the SFO are also relevant to the issuance of structured products. Examples are given below.

Civil liability

- section 108: civil liability for inducing others to invest money;
- section 277: disclosure of false or misleading information inducing transactions;
- section 281: civil liability for market misconduct;
- section 305: civil liability for contravention of Part XIV of the SFO; and
- section 391: civil liability for false or misleading public communications concerning securities and futures contracts.

Criminal offences

- section 107: offence to fraudulently or recklessly induce others to invest money;
- section 298: offence of disclosure of false or misleading information inducing transactions;
- section 300: offence involving fraudulent or deceptive devices;
- section 384: provision of false or misleading information; and
- section 390: liability of officers of corporations for offences by corporations, and of partners for offences by other partners.

Liability for an issuer of structured products may also arise under common law, for example, on the basis of misrepresentations.

Market misconduct such as insider trading can also incur civil and criminal liability, and directors of listed issuers and connected persons are prohibited from dealing in the company's securities in certain circumstances.

Stock exchange filings

14 | What stock exchange filings must be made in connection with OTC equity derivatives transactions?

Listed issuers are required to disclose certain 'notifiable transactions' and 'connected transactions' under the SEHK Listing Rules.

Under Part XV of the SFO, directors, chief executives and substantial shareholders of a listed issuer are required to disclose their interests in voting rights in the listed company. Generally speaking, a director or a chief executive of the listed company must disclose all interests and short positions in any shares of the listed company as well as all dealings in respect of such interests and positions. In contrast, the disclosable obligations of a shareholder are triggered when such person holds a long interest of 5 per cent or above and applies to any changes in such interest that cross a whole percentage point above the 5 per cent threshold. More generally, the disclosure obligations:

- take into account parties acting in concert;

- are applicable to OTC equity derivatives transactions on a gross basis (no netting of long and short positions); and
- apply regardless of whether a transaction is cash or physically settled.

Obligations under the Securities and Futures Commission Code of Takeovers and Mergers to disclose certain dealings during an offer period should also be taken into account.

Typical document types

15 | What types of documents are typical in an OTC equity derivatives transaction?

For OTC equity derivatives transactions, parties typically use standard derivatives documentation published by ISDA, being either the 1992 or the 2002 ISDA Master Agreement (entered separately or incorporated via a long-form confirmation) and its related credit support documentation, and the 2002 ISDA Equity Derivatives Definitions.

For stock borrowing and lending transactions, the standard form Global Master Securities Lending Agreement is commonly used in Hong Kong.

Institutional lenders typically document margin loan transactions using their internal form of loan documentation. Such documentation is usually based on the standard forms published by the Loan Market Association or the Asia Pacific Loan Market Association.

Legal opinions

16 | For what types of OTC equity derivatives transactions are legal opinions typically given?

Opinions relating to capacity and authority of the counterparties are typically given for OTC derivatives transactions. Enforceability opinions are also typically given for transactions that are not based on ISDA documentation (for transactions that are based on ISDA documentation, enforceability opinions are generally only given in relation to material bespoke aspects that are not covered by the ISDA commissioned opinions). Additional opinions and memoranda may also be given regarding specific regulatory issues and enforcement scenarios.

Hedging activities

17 | May an issuer lend its shares or enter into a repurchase transaction with respect to its shares to support hedging activities by third parties in the issuer's shares?

It is not possible for an issuer to lend its own shares in Hong Kong and any repurchase of shares carried out by an issuer must comply with the laws and regulations relating to share repurchases.

Securities registration

18 What securities registration or other issues arise if a borrower pledges restricted or controlling shareholdings to secure a margin loan or a collar loan?

Rule 10.07 of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (SEHK Listing Rules) prohibits a 'controlling shareholder' from, among other things:

- within six months of listing, creating security over any shares of such listed company; and
- in the subsequent six months, creating security over shares of such listed company if, immediately following the enforcement of such security, that person would cease to be a controlling shareholder.

A 'controlling shareholder' is any person who is or group of persons:

- entitled to exercise or control the exercise of 30 per cent or more of the voting power at general meetings of the issuer; or
- in a position to control the composition of a majority of the board of directors of the issuer.

Certain exemptions apply to Rule 10.07. For example, a 'controlling shareholder' may pledge the shares of such listed company owned by him or her in favour of an authorised institution for a bona fide commercial loan, provided that certain conditions and disclosure requirements are complied with.

Separately, under Rule 13.17 of the SEHK Listing Rules, where a 'controlling shareholder' has pledged all or part of its interest in the shares of the listed company to secure such company's debts or to secure guarantees or other support of its obligations, such company must announce certain information including:

- the number and class of shares being pledged;
- the amounts of debts, guarantees or other support for which the pledge is made; and
- any other details that are considered necessary for an understanding of the arrangements.

A 'controlling shareholder' should also be mindful of any contractual restrictions or lock-up arrangement imposed on the shares.

Borrower bankruptcy

19 If a borrower in a margin loan files for bankruptcy protection, can the lender seize and sell the pledged shares without interference from the bankruptcy court or any other creditors of the borrower? If not, what techniques are used to reduce the lender's risk that the borrower will file for bankruptcy or to prevent the bankruptcy court from staying enforcement of the lender's remedies?

Broadly, yes. An enforceable and properly perfected first ranking Hong Kong law governed fixed security interest created by a Hong Kong incorporated borrower over shares located in

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Hong Kong can be enforced by the secured party (for example, by exercising its out-of-court power of sale) notwithstanding the commencement of Hong Kong law governed insolvency proceedings in respect of the borrower. See 'Risk' above regarding transaction avoidance provisions, the impact of the Financial Institutions (Resolution) Ordinance (Cap. 628 of the laws of Hong Kong) and the general moratorium under section 186 of the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32 of the laws of Hong Kong) (which, as indicated there, would not prevent an out-of-court enforcement over the borrower's assets). Under Hong Kong law, a secured party cannot exercise a right of foreclosure in respect of secured property without a court order.

The impact of other jurisdictions should be considered (for example, whether a Hong Kong incorporated borrower may be wound up under the laws of another jurisdiction and the impact of local law requirements on the enforcement of security over Hong Kong shares held in an account outside of Hong Kong).

Market structure

20 | What is the structure of the market for listed equity options?

All listed equity options in Hong Kong are traded on The Stock Exchange of Hong Kong Limited (by or through an exchange participant) and are cleared through The SEHK Options Clearing House Limited, a wholly owned subsidiary of Hong Kong Exchanges and Clearing Limited.

Listed equity options (both puts and calls) are American-style and physically settled.

Governing rules

21 | Describe the rules governing the trading of listed equity options.

The trading of listed equity options are governed by the Rules of The Stock Exchange of Hong Kong Limited (SEHK), the Options Trading Rules of the SEHK and the Operational Trading Procedures for Options Trading Exchange Participants of the SEHK. The clearing of listed equity options is governed by the Options Clearing Rules and the Operational Clearing Procedures of The SEHK Options Clearing House Limited.

TYPES OF TRANSACTION

Clearing transactions

22 | What categories of equity derivatives transactions must be centrally cleared and what rules govern clearing?

All equity derivatives traded on The Stock Exchange of Hong Kong Limited and Hong Kong Futures Exchange Limited are centrally cleared through The SEHK Options Clearing House Limited and HKFE Clearing Corporation Limited, respectively.

OTC equity derivatives are currently not subject to mandatory clearing in Hong Kong.

Exchange-trading

23 | What categories of equity derivatives must be exchange-traded and what rules govern trading?

All listed equity derivatives are traded on The Stock Exchange of Hong Kong Limited or Hong Kong Futures Exchange Limited.

There are currently no requirements for OTC equity derivatives to be traded on an exchange. The Securities and Futures Ordinance (Cap. 571 of the laws of Hong Kong) includes a (not yet in force) general framework for a platform trading obligation and, following a 2018 consultation, a trading determination process has been adopted by the Hong Kong Monetary Authority and the Securities and Futures Commission to determine the products that may in the future be subject to a platform trading obligation.

Collateral arrangements

24 | Describe common collateral arrangements for listed, cleared and uncleared equity derivatives transactions.

For exchange-traded equity derivatives, the rules of The SEHK Options Clearing House Limited (SEOCH) and HKFE Clearing Corporation Limited (HKCC) (as applicable) require participants to provide margin (cash and/or securities) and reserve fund contributions. The types of eligible margin are specified in the rules and procedures of SEOCH and HKCC, and haircuts may vary for each type of eligible margin. Collateral arrangements between participants and their respective clients are negotiated bilaterally.

OTC equity derivative transactions are currently not subject to mandatory clearing in Hong Kong and are therefore typically entered into under standard (non-centrally cleared) ISDA documentation. In particular, an ISDA Master Agreement is generally entered into (either separately or incorporated via a long-form confirmation) together with credit support documents in the form of an ISDA Credit Support Annex (title transfer arrangement) and, in certain cases, a security interest arrangement (in the form of an ISDA Credit Support Deed or bespoke documentation).

Exchanging collateral

25 | Must counterparties exchange collateral for some categories of equity derivatives transactions?

Yes. Pursuant to module CR-G-14 of the Supervisory Policy Manual of the Hong Kong Monetary Authority (HKMA), authorised institutions facing a 'covered entity' (broadly, subject to certain thresholds and exclusions, a financial counterparty, a significant non-financial counterparty or other designated entity) are subject to mandatory margining requirements in respect of, among other things, non-centrally cleared equity derivatives (with non-centrally cleared single-stock options, equity basket options and equity index options being exempt until further notice). These requirements include variation margin and (subject to a phase-in based on average aggregate notional amount thresholds) initial margin (IM).

Separately, the Securities and Futures Commission has introduced similar mandatory margining requirements for licensed corporations. Variation margin requirements became effective on 1 September 2020 (with non-centrally cleared single-stock options, equity basket options and equity index options being exempt until 4 January 2024). With effect from 1 September 2022, the exchange of IM by a licensed corporation is required in a one-year period where both the licensed corporation and the covered entity have an average aggregate notional amount of non-centrally cleared OTC derivatives exceeding HK$60 billion on a group basis.

LIABILITY AND ENFORCEMENT

Territorial scope of regulations

26 What is the territorial scope of the laws and regulations governing listed, cleared and uncleared equity derivatives transactions?

As the Securities and Futures Ordinance (Cap. 571 of the laws of Hong Kong) (SFO) does not contain a general restriction on territorial scope, the territorial application of each provision must be considered on its own terms. For example, while the SFO general prohibition on marketing can apply irrespective of the jurisdiction of incorporation of the person marketing, the prohibition does not apply to offers made solely to persons outside of Hong Kong.

In addition, certain laws and regulations relating specifically to non-centrally cleared OTC equity derivatives have extraterritorial application, including:

- mandatory margining provisions, which, for example, apply to non-centrally cleared derivatives that an overseas incorporated authorised institution (AI) enters into with a covered entity that are booked in the Hong Kong branch of the AI (with provision of substituted compliance). See 'Exchanging collateral' above; and
- mandatory reporting requirements, which, for example, apply to OTC derivative transactions entered into by an overseas incorporated AI and booked in Hong Kong.

As regards exchange-traded derivatives, the rules and procedures of The Stock Exchange of Hong Kong Limited, Hong Kong Futures Exchange Limited, The SEHK Options Clearing House Limited and HKFE Clearing Corporation Limited apply to all of their respective participants.

Registration and authorisation requirements

27 What registration or authorisation requirements apply to market participants that deal or invest in equity derivatives, and what are the implications of registration?

The Securities and Futures Ordinance (Cap. 571 of the laws of Hong Kong) (SFO) prohibits a person from carrying on a business in a regulated activity (or holding himself or herself out as carrying on such a business) unless the person is a licensed corporation or is an authorised institution that is appropriately registered. The regulated activities 'dealing in OTC derivative products or advising on OTC derivative products' (Type 11) and 'providing client clearing services for OTC derivative transactions' (Type 12) in Schedule 5 to the SFO are not yet in operation. However, dealing in and/or advising on equity derivatives may constitute the regulated activities of 'dealing in securities' (Type 1), 'dealing in futures contracts' (Type 2), 'advising on securities' (Type 4), 'advising on futures contracts' (Type 5) and 'securities margin financing' (Type 8), unless an exception can be relied upon.

As regards exchange-traded derivatives, the rules and procedures of The Stock Exchange of Hong Kong Limited, Hong Kong Futures Exchange Limited, The SEHK Options Clearing House Limited and HKFE Clearing Corporation Limited impose requirements and obligations on their respective participants.

Reporting requirements

28 What reporting requirements apply to market participants that deal or invest in equity derivatives?

The mandatory reporting and related record-keeping obligations under the Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) Rules apply to authorised institutions (AIs), approved money brokers (AMBs), licensed corporations (LCs), recognised clearing houses (RCHs) and automated trade services – central counterparties (ATS-CCPs), subject to an exempt person relief for certain AIs, AMBs and LCs with small positions in OTC derivative transactions.

An AI, AMB, LC, RCH or ATS-CCP is required to report (to the trade repository of the Hong Kong Monetary Authority) OTC derivative transactions (as defined in the Securities and Futures Ordinance (Cap. 571 of the laws of Hong Kong)) under all five asset classes (interest rates, foreign exchange, equities, credit and commodities) on a T+2 basis if:

- it is a counterparty to the transaction (for an overseas incorporated AI, the transaction must be booked in Hong Kong and for any ATS-CCP, the counterparty must be a Hong Kong incorporated entity); or
- the transaction is conducted in Hong Kong by:
    - an AI, AMB or LC on behalf of an affiliate; or
    - by the Hong Kong branch of an overseas incorporated AI on behalf of an overseas office.

Legal issues

29 What legal issues arise in the design and issuance of structured products linked to an unaffiliated third party's shares or to a basket or index of third-party shares? What additional disclosure and other legal issues arise if the structured product is linked to a proprietary index?

The analysis in 'Liability regime' regarding sections 103 and 105 of the Securities and Futures Ordinance (Chapter 571 of the laws of Hong Kong) also applies to structured products linked to an unaffiliated third party's shares or to a basket or index of third-party shares. Therefore, in the case of an offering of such products to the public in Hong Kong, authorisation by the

Securities and Futures Commission of any advertisement, invitation or document in respect of the offering of such products is required.

For structured products linked to a proprietary index, the issuer should consider any licensing issues that may arise from the use of such index. The issuer may need to enter into a licensing agreement or obtain other forms of consent from the proprietary owner of the relevant index to reference such index and/or include information relating to such index in the product documentation and offering documents.

An issuer of structured products linked to an unaffiliated third party's shares or to a basket or index of third-party shares should also consider whether adequate disclosure has been provided in relation to underlying shares and, as the case may be, the index. It is also not uncommon for issuers and dealers of such products to include conflicts of interest disclaimers in the product documentation as well as other disclaimers relating to the disclosure and underlying shares or index.

Liability regime

30 | Describe the liability regime related to the issuance of structured products.

Issuances and marketing of structured products are subject to the SFO. Under section 103 of the Securities and Futures Ordinance (Cap. 571 of the laws of Hong Kong) (SFO), a person commits an offence if he or she issues, or has in his or her possession for the purposes of issue, whether in Hong Kong or elsewhere, an advertisement, invitation or document that to his or her knowledge is or contains an invitation to the public to enter into or offer to enter into an agreement to acquire, dispose of, subscribe for or underwrite any structured products, unless the issue is authorised by the Securities and Futures Commission under section 105 of the SFO or an exemption applies (eg, offers solely to persons outside of Hong Kong and offers to professional investors).

For unlisted structured investment products offered to the public in Hong Kong, the Code on Unlisted Structured Investment Products (including the content requirements for offering documents in respect of an offering of Unlisted Structured Investment Products) must also be complied with.

Various offences and civil liabilities set out in the SFO are also relevant to the issuance of structured products. Examples are given below.

Civil liability

- Section 108: civil liability for inducing others to invest money;
- section 277: disclosure of false or misleading information inducing transactions;
- section 281: civil liability for market misconduct;
- section 305: civil liability for contravention of Part XIV of the SFO; and
- section 391: civil liability for false or misleading public communications concerning securities and futures contracts.

Criminal offences

- Section 107: offence to fraudulently or recklessly induce others to invest money;

- section 298: offence of disclosure of false or misleading information inducing transactions;
- section 300: offence involving fraudulent or deceptive devices;
- section 384: provision of false or misleading information; and
- section 390: liability of officers of corporations for offences by corporations, and of partners for offences by other partners.

Liability for an issuer of structured products may also arise under common law, for example, on the basis of misrepresentations.

Other issues

31 What registration, disclosure, tax and other legal issues arise when an issuer sells a security that is convertible for shares of the same issuer?

The offering of convertible bonds to the public in Hong Kong is subject to the prospectus regime under Part 2 Division 1 of the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32 of the laws of Hong Kong) (C(WUMP)O). Unless certain exemptions are available, any documents issued by or on behalf of the convertible bond issuer must be:

- authorised by the Securities and Futures Commission for registration; and
- registered with the Hong Kong Registrar of Companies in accordance with the requirements under the C(WUMP)O.

Typically, convertible bonds are not offered to retail investors. Issuers often issue convertible bonds to institutional and/or high net-worth investors in reliance of the professional investor exemption under the SFO. In addition, issuers may also rely on other exemptions set out in Schedule 17 to the C(WUMP)O, such as:

- the total consideration payable in respect of the issuance is less than HK$5 million;
- the minimum denomination of the convertible bonds being not less than HK$500,000; and
- the convertible bonds are being offered to no more than 50 persons.

In terms of public disclosure, the issuance of convertible bonds by a listed issuer is often considered as material non-public price-sensitive information of the listed issuer. As such, it is common practice for a convertible bond issuer that is listed on The Stock Exchange of Hong Kong Limited (SEHK) to publish announcements on the SEHK at the time of pricing and closing of the convertible bonds. Issuers of convertible bonds which are listed on the SEHK pursuant to Chapter 37 of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited are required to publish the listing documents (eg, the offering circular) on the SEHK website on the listing date.

For Hong Kong dollar-denominated convertible bonds in registered form issued by a Hong Kong incorporated company, stamp duty would be payable in respect of the transfer of such bonds. Hong Kong stamp duty is also payable on any purchase and sale of shares delivered to the investors upon conversion of the convertible bonds for as long as the transfer thereof is required to be registered in Hong Kong.

Disclosure obligations under Part XV of the Securities and Futures Ordinance (Cap. 571 of the laws of Hong Kong) (SFO) would be applicable if an investor holds voting rights in the listed company beyond the applicable thresholds under Part XV of the SFO.

For convertible bond offerings to institutional investors, offering circulars are prepared using publicly available information, annual reports and financial statements of the issuer. Independent auditors of the issuer would typically provide comfort letters to give comfort on the financial information contained in the offering circular.

32 | What registration, disclosure, tax and other legal issues arise when an issuer sells a security that is exchangeable for shares of a third party? Does it matter whether the third party is an affiliate of the issuer?

The issues relating to convertible bonds are equally applicable to exchangeable bonds. Where the underlying shares are shares of a third party that is not an affiliate of the issuer, the relevant offering circular usually only contains limited information on such third party. The investors typically rely on publicly available information of the third party.

UPDATE AND TRENDS

Recent developments

33 | Are there any current developments or emerging trends that should be noted?

SFC consultation on the proposed subsidiary legislation for implementing an uncertificated securities market (USM) in Hong Kong

On 27 Mach 2023, SFC launched a three-month consultation in relation to proposed subsidiary legislation for implementing USM in Hong Kong. The proposed subsidiary legislation will supplement the existing framework for implementing the USM, which was established under the Securities and Futures and Companies Legislation (Amendment) Ordinance in June 2021. The proposal includes:

- the Securities and Futures (Uncertificated Securities Market) Rules, which set out the operational and technical matters and processes under a USM environment;
- the Securities and Futures (Approved Securities Registrar) Rules, which provide for the regulation of approved share registrars; and
- amendments to other existing subsidiary legislation, including the Securities and Futures (Stock Market Listing) Rules, the Securities and Futures (Open-ended Fund Companies) Rules, Schedules 5 and 8 to the Securities and Futures Ordinance and the Companies (Winding-up) Rules.

The consultation is open until 30 June 2023 for interested parties to submit written comments on the proposals.

Securities and Futures Commission (SFC) launched the investor identification regime in March 2023

On 20 March 2023, the SFC launched the investor identification regime for the securities market in Hong Kong (HKIDR). Under this regime, relevant licensed corporations and registered institutions (collectively Relevant Regulated Intermediaries) are required to tag a Broker-to-Client Assigned Number to every on-exchange order and off-exchange trade reportable to The Stock Exchange of Hong Kong Limited (SEHK). In addition, Relevant Regulated Intermediaries are required to submit to SEHK's data repository the names and identity document information of their clients. If investors do not provide the required consent to the collection, storage, processing and use of personal data under the HKIDR, they will only be allowed to sell existing securities holdings but not to buy securities on the SEHK.

OTC securities transactions reporting regime for shares listed on the SEHK

In August 2021, the SFC released consultation conclusions on their proposals to introduce an OTC securities transactions reporting regime (OTCR) for shares listed on the SEHK. Under the OTCR, Relevant Regulated Intermediaries will be required to report OTC securities transactions relating to ordinary shares of a company or real estate investment trusts listed on the SEHK, as well as any deposits to and withdrawals from the Relevant Regulated Intermediaries of physical share certificates in such OTC securities transactions. The OTCR will not apply to other securities such as bonds, listed debt instruments, preference shares, rights, company warrants, derivative warrants, callable bull/bear contracts, OTC derivatives, and exchange-traded funds. According to the latest timeline proposed by the SFC, the OTCR is scheduled to be implemented in the first half of 2023.

Increase in OTC derivatives transactions referencing issuers dual-listed in Hong Kong and the US

There has been a steady increase in OTC derivative transactions that reference companies that are dual-listed on the Hong Kong and US stock exchanges. Such dual listing in Hong Kong may be by way of a primary listing or a secondary listing. Companies that have a secondary listing in Hong Kong may enjoy certain waivers and exemptions granted by the SEHK and the SFC that are not available to companies that have a primary listing in Hong Kong. Parties to OTC derivatives that reference companies that are dual listed in Hong Kong and the US are required to consider the applicability of both the Hong Kong and US legal and regulatory regimes in structuring a transaction, which raises a number of complex issues. As more Chinese companies listed in the US seek a secondary or dual primary listing in Hong Kong, we expect the number of OTC derivatives transactions referencing dual-listed issuers will continue to rise.

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LATHAM & WATKINS

Derek S H Chua derek.chua@lw.com
Michael Hardy michael.hardy@lw.com
Posit Laohaphan posit.laohaphan@lw.com

18th Floor, One Exchange Square, 8 Connaught Place, Central, Hong Kong
Tel: +852 2912 2500
www.lw.com

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Japan

[Keita Tominaga](#)
TMI Associates

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Summary

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OVERVIEW

Typical types of transactions

1 Other than transactions between dealers, what are the most typical types of over-the-counter (OTC) equity derivatives transactions and what are the common uses of these transactions?

In Japan, OTC equity derivatives transactions are not popularly engaged in, as compared to, for example, OTC foreign currency trades; however, contract-for-difference (CFD) transactions for equities are provided by registered financial instruments business operators (FIBOs) to individual investors whose investment objectives are simple investment returns, and trading companies sometimes use OTC equity derivatives transactions to hedge or monetise their equity positions.

Borrowing and selling shares

2 May market participants borrow shares and sell them short in the local market? If so, what rules govern short selling?

A short sale means:

- the sale of listed equity securities that the seller does not own (short position); or
- the sale of listed securities for which borrowed securities are to be delivered (shorting against the box).

Short sales are subject to reporting (enquiry and disclosure obligations are owed by FIBOs) and price (uptick rule obligations are owed by all market participants) requirements. Some transactions are fully or partly exempt from the short sale rules. Brokers and dealers are not permitted to accept any sale that would violate the uptick rule.

Applicable laws and regulations for dealers

3 Describe the primary laws and regulations surrounding OTC equity derivatives transactions between dealers. What regulatory authorities are primarily responsible for administering those rules?

The Financial Instruments and Exchange Act of Japan (FIEA) is applied to OTC equity derivatives transactions. The Financial Services Agency (FSA) is the regulatory authority enforcing this law.

Under the FIEA, persons who enter into OTC equity derivatives transactions as their business must obtain registration as a financial instruments business operator with the FSA (or the local financial bureau (LFB), acting pursuant to entrusted authority).

In addition, FIBOs must comply with the rules of the Japan Securities Dealers Association (JSDA). In the event that a FIBO is not a member of the JSDA, that FIBO must adopt and comply with internal rules that are equivalent to the JSDA rules. In practice, most FIBOs are JSDA members and comply with its rules.

Entities

4 In addition to dealers, what types of entities may enter into OTC equity derivatives transactions?

In addition to FIBOs, companies and individual investors may enter into OTC equity derivatives transactions as long as their investment objectives in such transactions are simply to improve their portfolio.

Applicable laws and regulations for eligible counterparties

5 Describe the primary laws and regulations surrounding OTC equity derivatives transactions between a dealer and an eligible counterparty that is not the issuer of the underlying shares or an affiliate of the issuer? What regulatory authorities are primarily responsible for administering those rules?

With respect to other types of derivatives transactions (with the exception of commodity derivatives transactions), the FIEA is applied to OTC equity derivatives transactions. In addition to the requirements set forth in the FIEA, there also are detailed and specific rules and regulations that FIBOs must comply with, such as:

- an obligation to deliver documents prior to the conclusion of a contract;
- a suitability rule;
- regulations covering advertising;
- a duty of sincerity to customers; and
- a prohibition on compensating customers for loss.

One of the rules under the FIEA effectively prohibits registered FIBOs from cold calling individual investors to solicit OTC equity derivatives transactions. Moreover, FIBOs cannot solicit such transactions from individual investors who have not initiated an enquiry regarding such trades by visiting a branch office in person, by sending an email or by phoning.

The FSA is the regulatory authority and has adopted comprehensive guidelines for supervision of financial instruments business operators, etc. In addition, most FIBOs who deal in OTC equity derivatives transactions are typically members of the JSDA, and the JSDA has also promulgated various rules and guidelines that its member firms are obligated to follow. Also, in the event that a FIBO is not a member of the JSDA, that FIBO must adopt and comply with internal rules that are equivalent to the JSDA rules.

Securities registration issues

6 Do securities registration issues arise if the issuer of the underlying shares or an affiliate of the issuer sells the issuer's shares via an OTC equity derivative?

Under the FIEA, when an issuer seeks to make a public offering of its securities, in principle, it must file a notification with the LFB through an electronic data processing system for disclosure called the Electronic Disclosure for Investors' Network (EDINET). Thus, similarly with respect to public offerings of securities made via OTC equity derivatives, the issuer, in principle, must file a securities notification via EDINET.

The issuance of shares by an issuer is also subject to the procedures set out in the Companies Act of Japan, and issuers cannot sell their shares in a manner that does not comply with these issuance procedures.

Repurchasing shares

7 | May issuers repurchase their shares directly or via a derivative?

Repurchases of shares by issuers are restricted by the Companies Act in Japan and such repurchases, whether directly or via a derivative, may be effected only in certain cases permitted under the Companies Act. In addition, under the Companies Act, there are restrictions on the financial resources used by issuers if they seek to repurchase their shares as well as on amounts permitted to be paid to selling shareholders. The company must have sufficient distributable amounts, as accounted for under the Companies Act, to pay for such repurchases.

Issuer repurchase transactions, again irrespective of whether they sought to effect directly or via an equity derivative, are permitted only if the issuer's board of directors has approved the transaction. In addition, if the approval is given with respect to one or more specific shareholders, other shareholders may then request that their shares be bought back by the issuer. There is a way to avoid offering this right to other shareholders, and to do so the issuer must purchase its shares through either the Tokyo Stock Exchange Trading NeTwork system or a tender offer bid procedure in accordance with the FIEA.

Issuers are subject to the restriction on insider trading under the FIEA when they seek to enter into repurchase transactions, and consequently, issuers may purchase their shares only when they are not in possession of any insider information. In turn, a dealer, as a FIBO, may not accept orders when it is aware that an order violates, or is likely to violate, the insider-trading restriction.

Risk

8 | What types of risks do dealers face in the event of a bankruptcy or insolvency of the counterparty? Do any special bankruptcy or insolvency rules apply if the counterparty is the issuer or an affiliate of the issuer?

When the counterparty goes bankrupt, typically dealers cannot collect all their claims or credit held against the counterparty. On the other hand, the bankrupt counterparty may collect its claims or credit against dealers in the course of the insolvency proceedings, unless both claims are set off.

If a party to an OTC derivatives transaction is a financial institution, then the Act on Collective Clearing of Specified Financial Transactions Conducted by Financial Institutions, etc, applies, and the claims between the parties are collectively cleared (as long as the parties have entered into a basic agreement where collective clearing was agreed). If an OTC equity derivatives transaction is collectively cleared pursuant to this law, and one of the parties to the transaction has a bankruptcy or insolvency event, then the other party to the transaction can collect its claims or credit held against the bankrupt or insolvent counterparty within the limit of the amount of the claims or credit held by the bankrupt counterparty or insolvent against it.

Reporting obligations

9 What types of reporting obligations does an issuer or a shareholder face when entering into an OTC equity derivatives transaction on the issuer's shares?

With respect to issuers, if a secondary distribution of its securities is being made through an OTC equity derivatives transaction, then the relevant issuer must file a securities registration report with the LFB (there are some exceptions to this requirement if disclosures that would be made in such a report have already been made).

With respect to shareholders, there may be obligations:

- to file a Large Shareholding Report with the LFB (if the shareholding ratio of a shareholder in a listed issuer exceeds 5 per cent);
- to file with the LFB a notification regarding a tender offer bid (if the subject issuer files securities reports pursuant to the FIEA and the shareholder is purchasing through an OTC equity derivatives transaction that exceeds the threshold specified in the FIEA); and
- to report to the issuer through its dealer when the shareholding ratio of a shareholder in the issuer exceeds 10 per cent.

Restricted periods

10 Are counterparties restricted from entering into OTC equity derivatives transactions during certain periods? What other rules apply to OTC equity derivatives transactions that address insider trading?

The insider trading restriction under the FIEA applies to OTC equity derivatives transactions. A person who has insider information relating to an issuer (or its subsidiary company) in the course of negotiating any agreement, or in other circumstances set out in the FIEA, is restricted from purchasing or selling securities of that issuer, including via an OTC equity derivatives transaction.

After the insider information has been disclosed to the public in the manner stated in the FIEA, a person may enter into an OTC equity derivatives transaction to purchase (or sell) the shares of the issuer.

In addition, it is advisable that any major shareholder of a listed company should return to the issuer any profits it has earned through transactions conducted within a six-month period.

Legal issues

11 What additional legal issues arise if a counterparty to an OTC equity derivatives transaction is the issuer of the underlying shares or an affiliate of the issuer?

Under the Companies Act, a subsidiary is, in principle, prohibited from acquiring shares of its parent company. Accordingly, if the counterparty is a subsidiary company of the issuer, then it may not enter into an OTC equity derivatives transaction to purchase the parent company's shares.

Tax issues

12 What types of taxation issues arise in issuer OTC equity derivatives transactions and third-party OTC equity derivatives transactions?

OTC equity derivatives raise a number of tax issues, including corporate tax. The following explanation regarding taxation principles applicable to OTC derivative transactions in Japan is a general principle for corporate tax on domestic corporations that hold such transactions. In cases where Japanese controlled foreign corporation (CFC) rules may be applicable, you need a more precise analysis depending on the applicability of the CFC rules. Payments to a non-Japan party may also be subject to withholding tax. Additional issues, such as integration of instruments, may arise depending on the nature of the transaction.

Where a domestic corporation carries out derivative transactions and has derivative transactions that have not been settled at the end of an accounting period out of the said derivative transactions (unsettled derivative transactions), the amount (referred to as an 'amount of gain or loss by deemed settlement') equivalent to gain or loss computed pursuant to the provisions of Ordinance of the Finance Ministry by assuming that the said unsettled derivative transactions were settled at the time shall be included in an amount of gross revenue or gross expense in computation of the income for the said accounting period.

In the case of physical delivery settlement rather than cash settlement (in other words, where a domestic corporation acquires assets other than money based on contracts on derivative transactions (except for certain assets)), the balance between the market value of the said assets at the time of the acquisition and the amount paid for the said assets based on contracts regarding derivative transactions by which the acquisition has been made shall be included in the amount of gross revenue or loss in computation of the income for the accounting period including the day of the said acquisition.

Nonetheless, in cases that satisfy certain tests for the judgment on effectiveness of derivative transactions, etc, for reducing an amount of loss on assets, etc, to be hedged (effectiveness judgment), such portion of the amount of gain or loss by deemed settlement as deemed to be effective to decrease the said amount of loss on assets, etc, to be hedged shall not be included in an amount of gross revenue or loss in computation of the income for the accounting period.

Liability regime

13 Describe the liability regime related to OTC equity derivatives transactions. What transaction participants are subject to liability?

There are various forms of punishment and penalty under the FIEA for its violation. Administrative measures can be imposed by the authorities, generally on FIBOs under the FIEA. Also, an administrative monetary penalty can be imposed on an issuer that did not make due disclosure, or on a person who did not make due disclosure (eg, where a person is obligated to file a large shareholding report) as well as on a person who conducted insider trading or engaged in other unfair trading practices.

The FIEA also contains a criminal sanction that may be imposed on persons who violate certain significant obligations in that law.

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Finally, in addition to these regulatory and criminal liabilities, private rights of action exist arising from unlawful acts and conduct for damages under the Civil Code, as well as under the FIEA for damages recoverable from an issuer, its directors and certain related persons, and suffered by investors relating to a false securities report or other disclosure materials.

Stock exchange filings

14 | What stock exchange filings must be made in connection with OTC equity derivatives transactions?

There are no stock exchange rules that require any filings in connection with OTC equity derivatives transactions.

Typical document types

15 | What types of documents are typical in an OTC equity derivatives transaction?

Generally, if a financial institution is a party to any OTC derivatives transaction, including OTC equity derivatives transactions, the International Swaps and Derivatives Association, Inc (ISDA) Master Agreement and its related documents (such as the Schedule and Confirmation) are used, although parties are free to enter into their own separately negotiated agreement, depending on the circumstances. Regarding CFD transactions, FIBOs usually prepare their own general and standard form of agreement, and use that form for these trades with their customers.

Legal opinions

16 | For what types of OTC equity derivatives transactions are legal opinions typically given?

The usual legal opinion that is relied on covers the validity of collective clearing, and market participants in Japan rely on the standard ISDA opinion.

Apart from this, in the typical OTC equity derivatives transaction, no legal opinions are given, although, again, depending on the circumstances, legal opinions may be required.

Hedging activities

17 | May an issuer lend its shares or enter into a repurchase transaction with respect to its shares to support hedging activities by third parties in the issuer's shares?

Even if treasury shares (as an accounting principle concept) are held by an issuer, the issuer may not lend such shares or enter into a repurchase transaction with respect to such shares because treasury shares are not subject to any rights of legal ownership unless they are issued to a third party (and are in outstanding, rather than treasury, shares).

Securities registration

18 What securities registration or other issues arise if a borrower pledges restricted or controlling shareholdings to secure a margin loan or a collar loan?

When shares are pledged, the pledge is sometimes registered in the stock ledger of the issuer, but in many cases, pledges are not so registered. When a pledge is not registered in the stock ledger of an issuer, the issuer may not pay dividends to the pledge holder and all voting rights regarding the pledged shares are exercisable only by the borrower.

With respect to shares of listed companies, dividends are paid and the voting rights are exercised, in many cases, according to the substantial shareholder list prepared by Japan Securities Depository Centre, Inc, which can reflect any share transfers via a pledge.

Under the FIEA, if either a public offering of securities or a secondary distribution of securities is made, the issuer, in principle, must file a notification with the LFB through EDINET. Thus, if a secondary distribution of securities is made via an OTC equity derivatives transaction, the issuer, in principle, must file a securities notification.

Borrower bankruptcy

19 If a borrower in a margin loan files for bankruptcy protection, can the lender seize and sell the pledged shares without interference from the bankruptcy court or any other creditors of the borrower? If not, what techniques are used to reduce the lender's risk that the borrower will file for bankruptcy or to prevent the bankruptcy court from staying enforcement of the lender's remedies?

The enforcement of a security interest generally is not bound by insolvency proceedings (there are certain exceptions, such as in proceedings under the Corporate Reorganisation Act). It is, therefore, possible for a security interest to be exercised without interference from the bankruptcy court.

To be more precise, it is possible to exercise a security interest by the secured party acquiring pledged shares either itself or by making a third party acquire the pledged shares and then by adjusting any difference with respect to the secured amount. By this process, a security interest holder can exercise its security interest without interference from the bankruptcy court.

Market structure

20 What is the structure of the market for listed equity options?

In Japan, on-the-market equity options are traded on the Osaka Stock Exchange (OSE), a financial instruments exchange licensed by the FSA pursuant to the FIEA.

After a listing notification is filed with the FSA, a financial instruments exchange can list each equity option.

When an investor seeks to make an equity option order, the investor must place its order with a FIBO that is a participating firm at the OSE.

Trading at the OSE is subject to various trading rules with respect to equity options adopted by the exchange.

Governing rules

21 | Describe the rules governing the trading of listed equity options.

Under the FIEA, a financial instruments exchange must specify in its operational rules statutorily mandated items, including:

- matters pertaining to clearing margin;
- the kind and period of sales and purchases;
- the commencement and ending times for sales and purchases;
- factors necessitating trading suspensions; and
- transfer and other settlement methods.

Based on these requirements of the FIEA, the OSE has adopted various rules applying to transactions in listed equity options, such as Nikkei 225 Futures.

A financial instruments exchange also must obtain a licence under the FIEA and be supervised by the FSA.

TYPES OF TRANSACTION

Clearing transactions

22 | What categories of equity derivatives transactions must be centrally cleared and what rules govern clearing?

The scope of mandatory central counterparties clearing is currently limited to certain credit default swaps, and the rules of the Japan Securities Clearing Corporation are applied to central clearing. Mandatory central clearing is not relevant to equity derivatives transactions.

Exchange-trading

23 | What categories of equity derivatives must be exchange-traded and what rules govern trading?

Nikkei 225 Futures, Nikkei 225 Options, TOPIX Futures, TOPIX Options, JPX-Nikkei Index 400 Futures, JPX-Nikkei Index 400 Options and other listed derivative transactions may be traded on a financial instruments exchange according to the relevant exchange's rules. Similar kinds of derivative transactions may also be made from an exchange.

Collateral arrangements

24 Describe common collateral arrangements for listed, cleared and uncleared equity derivatives transactions.

When a person effects a listed equity derivatives transaction, he or she must deposit the clearing margin (which is calculated by deducting the total amount of the net option value from the Standard Portfolio Analysis of Risk Requirement, which is calculated via a risk simulation based on current portfolio values).

Clearing participants deposit clearing margin, which is the aggregate amount summing up the total margin amounts of all customers of the clearing participant.

Exchanging collateral

25 Must counterparties exchange collateral for some categories of equity derivatives transactions?

Yes, starting from September 2016, certain financial institutions must, in principle, exchange collateral when engaging in OTC derivatives transactions, including OTC equity derivatives transactions, with other financial institutions as counterparty. This obligation to exchange collateral is applied to any type of OTC derivatives transactions governed by the Financial Instruments and Exchange Act of Japan. Initially, this regulation is applied to the financial institutions with the larger volume of OTC derivatives and, gradually, the scope of this regulation is extended to financial institutions with smaller volumes of OTC derivatives. The collateral to be exchanged is categorised into variation margin and initial margin. The amount to be exchanged as variation margin must be determined on a mark-to-market basis and must be the current profit price that one party obtains. The amount of initial margin reflects the expected size of the potential future exposure to the other counterparty.

There are no statutes or laws that mandate an obligation to exchange independent amounts.

LIABILITY AND ENFORCEMENT

Territorial scope of regulations

26 What is the territorial scope of the laws and regulations governing listed, cleared and uncleared equity derivatives transactions?

Under the Financial Instruments and Exchange Act of Japan (FIEA), a foreign securities company may neither sell nor purchase securities, or enter into equity derivatives transactions with persons in Japan as counterparty unless that foreign securities company deals with such a person without any solicitation or in other exceptional cases. This prohibition indicates that the FIEA is applied if a party to an equity derivatives transaction is in Japan.

In addition, in cases involving unfair trading, such as insider trading, if the place of the unfair act is in Japan, for example, the order is exercised at the Osaka Stock Exchange (OSE), then the FIEA applies.

Registration and authorisation requirements

27 What registration or authorisation requirements apply to market participants that deal or invest in equity derivatives, and what are the implications of registration?

In principle, those who conduct financial instruments business must be registered as a financial instruments business operator (FIBO) under the FIEA. The term 'financial instruments business' is roughly divided into four categories:

- first-class financial instruments businesses;
- investment management businesses;
- second-class financial instruments businesses; and
- investment advisory and agency businesses.

Each category has separate registration requirements, such as minimum capital requirement, depending on the category.

Of these four categories, dealing in or intermediating OTC derivatives transactions fall within the first-class financial instruments business, which has the most stringent registration requirements. In addition, where there are requirements seeking to demonstrate financial resources, any applicant for these licences is required to have appropriate human resources capabilities and expertise.

Registered FIBOs are eligible to apply to be a participant in a financial instrument exchange. During the course of such an application process, the applicant's capital amount, net asset value, capital adequacy ratio, profit stability and management system will be screened.

In addition, persons who are not registered as a FIBO can, nevertheless, trade at a financial instrument exchange by obtaining special permission for transaction-at-exchange from the Financial Services Agency and a trading qualification from the relevant financial instruments exchange.

Reporting requirements

28 What reporting requirements apply to market participants that deal or invest in equity derivatives?

Under the OSE's rules, market participants must report to the OSE in the event that certain things change with respect to such a participant, including:

- the termination or cessation of business;
- merger;
- insolvency;
- change of business name; and
- change in directors.

In addition, the OSE may, as necessary, demand that a market participant submit requested information materials and inspect a participant's books, documents and other records.

Legal issues

29 What legal issues arise in the design and issuance of structured products linked to an unaffiliated third party's shares or to a basket or index of third-party shares? What additional disclosure and other legal issues arise if the structured product is linked to a proprietary index?

It depends what type of product is being issued, but there are disclosure issues to be made through a security registration report when a public offering of securities or a secondary distribution of securities is conducted. This disclosure issue is not particular to products linked to an index or other derivatives.

Liability regime

30 Describe the liability regime related to the issuance of structured products.

There are various forms of punishment and penalty under the FIEA for its violation. Administrative measures can be imposed by the authorities, generally on FIBOs under the FIEA. Also, an administrative monetary penalty can be imposed on an issuer that did not make due disclosure, or on a person who did not make due disclosure (eg, where a person is obligated to file a large shareholding report) as well as on a person who conducted insider trading or engaged in other unfair trading practices.

The FIEA also contains a criminal sanction that may be imposed on persons who violate certain significant obligations in that law.

Finally, in addition to these regulatory and criminal liabilities, private rights of action exist arising from unlawful acts and conduct for damages under the Civil Code, as well as under the FIEA for damages recoverable from an issuer, its directors and certain related persons, and suffered by investors relating to a false securities report or other disclosure materials.

Other issues

31 What registration, disclosure, tax and other legal issues arise when an issuer sells a security that is convertible for shares of the same issuer?

A security that is convertible into shares may be issued as class shares subject to call, class shares with a put option, or share acquisition rights. When the call option or put option with class shares is exercised, either the shares of the issuer or a certain amount of money are allocated to the class shareholders.

Class shares or share acquisition rights are securities under the FIEA and, accordingly, the issuer of such convertible instruments has the same disclosure and notification obligations by means of a security registration report to a local financial bureau as when a public offering of securities or a secondary distribution of securities is made.

Regarding moving strike convertible bonds, the Japan Securities Dealers Association has a regulatory standard for its members.

32 | What registration, disclosure, tax and other legal issues arise when an issuer sells a security that is exchangeable for shares of a third party? Does it matter whether the third party is an affiliate of the issuer?

An issuer may issue bonds exchangeable for stocks of other companies. Because such exchangeable bonds are securities under the FIEA, an issuer of such exchangeable bonds has the same disclosure and notification obligations by means of a security registration report as when a public offering of securities or a secondary distribution of securities is effected.

UPDATE AND TRENDS

Recent developments

33 | Are there any current developments or emerging trends that should be noted?

No updates at this time.

Keita Tominaga ktominaga@tmi.gr.jp

23rd Floor Roppongi Hills Mori Tower, 6-10-1
Roppongi Minato-ku, Tokyo 106-6123, Japan
Tel: +81 3 6438 5511
www.tmi.gr.jp

Switzerland

Olivier Favre and Tarek Houdrouge
Schellenberg Wittmer

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Summary

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OVERVIEW

Typical types of transactions

1 Other than transactions between dealers, what are the most typical types of over-the-counter (OTC) equity derivatives transactions and what are the common uses of these transactions?

Equity derivatives transactions in the form of OTC derivatives transactions are used in the Swiss market in particular as follows:

- to hedge a long position in a shareholding (eg, by purchasing a put option in the underlying shares). Such derivatives may combine a put and a call option in one transaction (eg, as a collar transaction), allowing the purchaser of the put option to benefit from a lower premium or reducing the premium to zero (eg, in the event of a zero cost collar). They may also be traded as a variable forward transaction;
- to build a long position in the underlying shares (eg, through equity swaps or call options) without purchasing the underlying shares;
- in the context of margin lending (eg, by entering into a prepaid forward combined with an equity swap), where the economics of the transaction are a loan secured by the underlying shares;
- as a hedge to establish a short position (eg, by entering into a short position under an equity swap) as an alternative to a short sale; and
- as part of a capital markets transaction (eg, option of issuer to receive additional shares in the context of a listing of shares in view of stabilising the price).

Borrowing and selling shares

2 May market participants borrow shares and sell them short in the local market? If so, what rules govern short selling?

A short sale by borrowing shares and selling them on the market in view of an expected decrease of the market price is a widely used way of entering into a short position. Short selling is not subject to specific limitations under Swiss law in terms of maximum positions that may be entered into. Short sales are, however, subject to the following.

Shareholder disclosure requirements

The Swiss rules regarding the disclosure of shareholdings pursuant to article 120 of the Swiss Financial Market Infrastructure Act (FMIA) provide that any shareholder of a company listed at the SIX Swiss Exchange or BX Swiss crossing a relevant threshold (either by exceeding or falling below a relevant threshold) must disclose and report such shareholding to the listed company itself as well as to the exchange. The disclosure is then published by the exchange. The relevant thresholds are 3, 5, 10, 15, 20, 25, 33.3, 50 and 66.6 per cent and the shareholdings are calculated by reference to the voting rights represented by the shares in such listed company.

A disclosure must be made as soon as an investor reaches or exceeds one of the thresholds with either its long position in the shares (physical shareholding aggregated with any rights to receive delivery of shares and any other long positions in respect of the shares, eg, arising from a derivatives transaction) or its short positions entered into in respect of the shares (eg, obligations to deliver shares or any short positions arising from a derivatives transaction). For the purposes of this calculation, the long and short positions must not be netted. Where an investor holds both a long position arising from the purchase of shares and at the same time a short position, a separate calculation for such long and short positions must be made. A disclosure must also be made as soon as the investor falls again below any of the thresholds with its long or short positions.

The disclosure obligation is triggered as a result of entering into any agreement giving rise to the long or short positions in the shares that must be disclosed. The disclosure must then be made by the end of the fourth trading day after such date.

Where a threshold is crossed upwards and downwards during the same trading day, this would not trigger a disclosure obligation.

As regards short sales, the borrowed shares are taken into account for the calculation of the long position of the shares. The borrower is subject to a disclosure obligation to the extent that a threshold is crossed with the number of borrowed shares (subject to an exemption applicable to banks and securities dealers for borrowed shares up to 5 per cent). The borrower would not have a disclosure obligation, where the loaned shares are on-sold intra-day (ie, on the same day the disclosure of the stock loan was triggered). To the extent that the intra-day exemption does not apply and the borrower sells the loaned shares to third parties during the term of the loan, the borrower must, in addition to the initial disclosure as a result of entering into the stock loan, make a further disclosure in the event that the borrower crosses downward a threshold as a result of the on-sale. When the short position is closed, the same disclosure obligations apply in reverse order (if crossing upward a threshold with the purchase on the market and then crossing downward a threshold by returning the borrowed shares to the lender subject the intra-day exemption).

Mandatory takeover offers

Whoever acquires, directly, indirectly or acting in concert with third parties, equity securities that, in addition to equity securities already owned, exceed the threshold of 33.3 per cent of the voting rights of a target company (calculated on the basis of the total number of voting rights registered in the commercial register) must make an offer to acquire all listed equity securities of that company. As regards the calculation of the positions to be taken into account for the obligation to make a mandatory takeover offer, only rights in shares conferring voting rights should – as a general rule – be counted. To the extent that borrowed shares may be counted against the threshold would therefore primarily depend on whether any voting rights in respect of the shares may be exercised. This should be analysed and, if necessary, discussed with the Swiss Takeover Board on a case-by-case basis.

Insider dealing and market abuse

On the basis that the shares are listed on the SIX Swiss Exchange or BX Swiss, any party involved in the short sale should be mindful whether it may have at any time knowledge of 'material non-public information' in the sense of the Swiss market abuse legislation and how this would be relevant for it. Under the rules of the Swiss insider dealing and market abuse legislation, any non-public information that would have a material effect on the price of shares admitted to trading on a trading venue in Switzerland, if it were made public, would be classified as 'material non-public information'.

Requirements regarding the transfer of title in shares

The requirement for the transfer of title in Swiss shares depends on the type of shares. Assuming the shares are admitted to trading on a trading venue, they are issued in the form of intermediated securities held through a custodian according to the rules of the Swiss Federal Intermediated Securities Act (FISA). However, if the shares are registered shares with transfer restrictions (*vinkulierte Namenaktien*), the transfer of title would not be completed with the debits and credits of the shares in the custody accounts. A transfer of shares that does not occur on the basis of a trade on the trading venue must be notified to the issuer in view of a registration of the transferee in the shareholders' register to complete the transfer as regards any interaction with the issuer (eg, for the purposes of exercising voting rights). As long as such notification has not occurred, a transferee may receive dividend payments through the custody chain, but he or she may not exercise voting rights.

Applicable laws and regulations for dealers

3 Describe the primary laws and regulations surrounding OTC equity derivatives transactions between dealers. What regulatory authorities are primarily responsible for administering those rules?

OTC derivatives fall into the scope of the regulatory obligations applicable to derivatives transactions according to article 93 et seq. of the FMIA, including obligations to comply with reporting obligations, risk mitigation obligations and bilateral margin requirements for uncleared transactions (the FMIA Obligations). At present, the FMIA Obligations do not include a clearing obligation for equity derivatives transactions, but for other types of OTC derivatives transactions (certain types of interest rate derivatives and some credit derivatives on indices). While the FMIA provides for the statutory basis to implement a venue trading obligation, the Swiss Federal Council has so far not implemented such obligation.

The FMIA Obligations are, to a certain extent, aligned with those of the EU according to the European Market Infrastructure Regulation (Regulation (EU) No. 648/2012; EMIR).

The FMIA Obligations do not include any licensing or registration requirements. However, the Swiss Financial Market Supervisory Authority (FINMA) is the competent regulatory authority in charge of interpreting and administering these rules, to the extent that the FMIA and its implementing ordinance give FINMA a competence to that effect.

The scope of the FMIA Obligations depends on the classification of the trading counterparties as a large financial counterparty (FC+), small financial counterparty (FC–), large non-financial counterparty (NFC+) or small non-financial counterparty (NFC–). Dealers (assuming they are regulated as a bank or investment firm) fall into the category of FCs. They are an FC+ if they cross the threshold of 8 billion Swiss francs in outstanding gross notional amounts of OTC derivatives across all asset classes in the aggregate (counting also hedging transactions, but excluding OTC derivatives that are not subject to the FMIA Obligations, such as physically settled commodity derivatives not traded on a trading venue or on an organised trading facility and excluding physically settled FX forwards and physically settled FX swaps). The calculation must be made on a group-wide basis by aggregating the positions of all FCs in the group (but excluding funds and collective investment schemes in the group). It is made on an average of 30 business days (ie, looking back for 30 business days and taking the average position as of the day the calculation is made). If dealers do not qualify as FC+, they are FC–.

Trades between dealers fall into the scope of the reporting obligation. However, the reporting obligation is one-sided and it falls on the Swiss dealer that is an FC+ if it deals with a Swiss FC–. For a trading relationship between two Swiss FC+, the seller reports and, if it is not clear who the seller is, the ISDA tie-breaker rules are used to determine the reporting party. If a Swiss dealer trades with a foreign counterparty, the reporting obligation falls on the Swiss dealer.

Except where they are cleared with a FINMA-recognised central counterparty, trades between dealers qualifying as FCs are subject to risk mitigation obligations and margin requirements. As under the European Market Infrastructure Regulation (EMIR), the risk mitigation obligations comprise an obligation to exchange trade confirmations on a timely basis, to agree portfolio reconciliation and dispute resolution (PRDR) clauses (eg, by entering into an FMIA Agreement as published by the Swiss Bankers Association) and perform the portfolio reconciliation, to do periodic portfolio compressions and to exchange valuations.

The margin requirements are aligned with EMIR and include an obligation to exchange variation margin and – to the extent that the average aggregated notional amounts (AANA) of the dealers exceed 8 billion Swiss francs – initial margin.

The phase-in of the obligation to exchange initial margin was aligned with the commitments at the global level. By 1 September 2021, the obligation to exchange initial margin entered into force for parties exceeding 50 billion Swiss francs in AANA and parties exceeding 8 billion Swiss francs in AANA became subject to the obligation to exchange initial margin by 1 September 2022. To the extent that the parties do not cross the threshold of 50 million Swiss francs in the initial margin to be exchanged, the obligation does not apply. However, the parties are responsible for putting in place the relevant documentation ahead of crossing the 50 million Swiss francs threshold for the first time.

For options on single shares, share baskets or equity index options, the obligation to exchange variation and initial margin has been postponed until 1 January 2024.

FINMA recognised the regulation under EMIR and under UK EMIR as equivalent for the purposes of complying with the risk mitigation and margin requirements. A Swiss party falling into the scope of these FMIA Obligations is, therefore, free to comply with these requirements by applying EMIR or UK EMIR on a substituted compliance basis. As regards the margin requirements, this also applies to the Commodity Futures Trading Commission margin rules under US law.

Entities

4 In addition to dealers, what types of entities may enter into OTC equity derivatives transactions?

Swiss regulations do not limit the counterparties to OTC equity derivatives transactions. Therefore, such transactions may be entered into with any type of entity as counterparty.

However, some regulated Swiss entities (such as insurance companies, pension funds and collective investment schemes) are subject to certain regulatory requirements for their investments (eg, diversification rules) and must also comply with these rules when entering into equity derivatives.

In addition, the parties to the OTC equity derivatives must comply with the FMIA Obligations.

Applicable laws and regulations for eligible counterparties

5 Describe the primary laws and regulations surrounding OTC equity derivatives transactions between a dealer and an eligible counterparty that is not the issuer of the underlying shares or an affiliate of the issuer? What regulatory authorities are primarily responsible for administering those rules?

Where the counterparty is regulated as a collective investment scheme, a fund manager, an asset manager of a collective investment scheme, an insurance company, a reinsurance company, a pension fund or an investment trust of a pension fund, the counterparty would be an FC and the scope of the FMIA Obligations would be same as for dealers. Other parties are NFCs, as long as they are an 'undertaking' registered with the Swiss Commercial Register or set up as a legal entity, trust or similar undertaking.

An NFC would be deemed to be a large NFC if it crosses at least one of the following thresholds with its outstanding gross notional amounts of OTC derivatives:

- 1.1 billion Swiss francs for equity derivatives;
- 1.1 billion Swiss francs for credit derivatives;
- 3.3 billion Swiss francs for interest rate derivatives;
- 3.3 billion Swiss francs for FX derivatives; or
- 3.3 billion Swiss francs for commodity and other derivatives.

Such calculations exclude hedging transactions, OTC derivatives that are not subject to the FMIA Obligations (such as physically settled commodity derivatives not traded on a trading venue or on an organised trading facility) and physically settled FX forwards and physically settled FX swaps. However, the calculation must be made on a group-wide basis by aggregating the positions of all NFCs in the group. It is made on an average of 30 business days (ie, looking back for 30 business days and taking the average position as of the day the calculation is made). Given the exclusions, NFCs only rarely cross the NFC+ threshold.

Where the counterparty is an NFC–, the margin requirements do not apply. Also, the clearing obligation does not apply in respect of derivatives that would be in scope (eg, certain categories of interest rate derivatives).

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The reporting obligation applies, except for trades between two NFC–. However, on the basis of the one-sided nature of the reporting obligation, the reporting obligation falls on a Swiss FC or NFC+ if it trades with an NFC–. It only falls on an NFC– to the extent that the counterparty is not incorporated in Switzerland (eg, a non-Swiss dealer). The go-live date of such obligation for NFC– has been postponed to 1 January 2028.

The risk mitigation obligations must also be taken into account for trades with an NFC–. Therefore, the trading documentation entered into with NFCs must also include the PRDR wording (eg, by entering into an FMIA Agreement as published by the Swiss Bankers Association) and the transactions must be documented in trade confirmations that are exchanged on a timely basis. However, if the counterparty is an NFC–, the parties must not perform the portfolio reconciliation.

In addition to the above, to the extent that the transaction is entered into by a financial services provider with a Swiss client as counterparty, the financial services provider must comply with rules of conduct as resulting from the Swiss Financial Services Act (FinSA). Such rules apply to the extent that the transaction is entered into in the context of a client relationship with the trade counterparty, irrespective of whether the trade is entered into on an 'execution-only basis' or under a discretionary investment mandate or an advisory contract. Under such rules of the FinSA, the financial services provider must classify clients into the categories of 'professional clients', 'institutional clients' and 'retail clients', provided that retail clients can, under certain conditions, opt out from their status and become 'elective professional clients'. This change of status requires that the retail clients either have investment assets of a minimum of 500,000 Swiss francs and a minimum level of sophistication in financial matters, or a minimum of 2 million Swiss francs of investment assets.

The FinSA point of sale obligations include, among others:

1 obligation to provide disclosures to the client about services, products and costs;
2 obligation to conduct a suitability or appropriateness test (except for trades entered into on an execution-only basis);
3 documentation obligations;
4 accountability obligations;
5 transparency obligations; and
6 best execution obligation.

Note that, in respect of trades with professional clients, the financial services provider can agree with the client an upfront waiver of the obligations of (1), (3) and (4).

Also, the financial services provider can only accept inducements by third parties if they either inform the client about inducements including information on the existence, type and the value of such inducements or – if not known at this moment – about the calculation parameters of such compensations, or forward any inducement received entirely to the client.

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Securities registration issues

6 Do securities registration issues arise if the issuer of the underlying shares or an affiliate of the issuer sells the issuer's shares via an OTC equity derivative?

OTC equity derivatives do not qualify as a security under Swiss law (as defined in article 2 lit. b FMIA) on the basis that they are not fungible and 'suitable for mass trading', which would be deemed to be the case if it is the intention that

- at least 20 end-investors or an unlimited number of investors may buy the products with identical terms; or
- if an application for admission to trading on a Swiss trading venue is made.

As a result, OTC equity derivatives that do not meet either of these criteria are not subject to the prospectus requirements under the FinSA and the issuer is not subject to a requirement to have the documentation approved or registered by a Swiss authority.

The issuer is, however, subject to the FMIA Obligations as discussed above. Assuming that there is no client relationship between the issuer and the counterparty, the FinSA obligations would, however, not apply.

Repurchasing shares

7 May issuers repurchase their shares directly or via a derivative?

Repurchasing own shares, directly or via derivative, is possible under Swiss law but is subject to corporate law requirements, insider trading and market manipulation regulations and, if publicly announced, to public takeover offer rules under the FMIA. The general legal framework includes mainly the FMIA, FMIO, FINMA-FMIO, FINMA Circular 2013/08 on Market Conduct Rules, Ordinance of the Takeover Board on Public Takeover Offers and the Circular No. 1 on Buy-back Programmes of the Swiss Takeover Board (TOB Circular No. 1). For tax reasons, a direct buy-back is normally executed through a 'second trading line'. The second trading line does not create a new share class or constitute a new listing for the shares to be bought back by the issuer. It is just an additional order book with its own Swiss security number. The same shares can be traded under two separate security numbers for a limited time (the second trading line is limited in time).

Swiss corporate law restricts the capacity for a company to acquire and hold its own shares (treasury shares). Under the Swiss Code of Obligations, a Swiss company and its majority-owned subsidiaries can only acquire its own shares if:

- it has sufficient freely available equity corresponding to the purchase price; and
- the total nominal value of own shares does not exceed 10 per cent of the share capital of the company (20 per cent at maximum if acquired in connection with transfer restrictions).

This threshold of 10 per cent may be exceeded, provided that the acquisition is made with a view to reducing the share capital and the reduction is already approved by a shareholders' meeting.

From a regulatory perspective, a buy-back (irrespective of whether executed directly or through a derivative) must meet certain requirements to fall within the scope of the buy-back safe harbours. The total programme limit must not exceed 10 per cent of voting rights and capital, 20 per cent of the free float and 25 per cent of daily volume on the first trading line over a 30-day average prior to the start of the programme. The buy-back must also stay within a price cap. It must not exceed the last independent trading price or, if lower, the best offer price on the first trading line. A buy-back must take into account the rules regarding blackout periods.

Risk

8 What types of risks do dealers face in the event of a bankruptcy or insolvency of the counterparty? Do any special bankruptcy or insolvency rules apply if the counterparty is the issuer or an affiliate of the issuer?

To the extent that the dealers are relying on the enforceability of close-out netting according to the documentation of the OTC derivative (as agreed according to the terms of the relevant Master Agreement, such as an ISDA Master Agreement), the dealer faces the risk that the close-out netting may not be enforceable in the insolvency of the counterparty as agreed in the contract. The analysis depends on the insolvency rules that apply to the type of counterparty concerned. However, close-out netting provisions as stated in the market-standard master agreements for OTC derivatives (eg, an ISDA Master Agreement) are enforceable against a Swiss counterparty, as long as the contract specifies that an automatic early termination that occurs prior to the start of bankruptcy proceedings or, to the extent applicable, prior to entering into a composition agreement with assignment of assets.

Moreover, to the extent that the dealer relies on the enforcement of any collateral that was provided on the basis of a security interest, it is key to the dealer that the security interest is enforceable also in the insolvency of the counterparty.

Security interests that have been validly entered into remain enforceable in the insolvency of the counterparty. However, a right of private sale could no longer be exercised when insolvency proceedings started, except where a safe harbour rule applies. Such safe harbours are available (i) for intermediated securities pursuant to the FISA, (ii) where the collateral is provided as margin under the bilateral margin rules pursuant to the FMIA and (iii) in the insolvency of a bank or securities firm. The statutory rules may be relied on if the collateral has a market value that may be determined on the basis of objective criteria (eg, on the basis of being traded on a trading venue).

As regards reorganisation proceedings applicable to a bank or securities firm, FINMA has the power to order a temporary stay of (1) any contractual termination or the exercise of such right of termination or the exercise of any rights of set-off by a counterparty; (2) the enforcement of collateral; or (3) the 'porting' of derivatives transactions. In any case for up to two business days, if such contractual termination or other right would otherwise be triggered by protective measures or reorganisation proceedings.

To the extent that the reorganisation is successful and the bank meets the legal requirements after the end of the stay period, the termination right lapses. Otherwise, it may be exercised after the end of the stay period. Also, any termination that may be exercised for any reason other than FINMA ordering the protective measures or reorganisation proceedings may continue to be exercised (eg, any event of default resulting from a failure to pay or deliver).

A Swiss bank must, when entering into new agreements or amending existing agreements, agree with the counterparty the application of such resolution stay powers of FINMA, provided that the agreement is subject to a law other than Swiss law or provides for the jurisdiction of courts other than Swiss courts. FINMA defined the types of contracts falling into the scope of such obligation, subject to certain exemptions.

Reporting obligations

9 What types of reporting obligations does an issuer or a shareholder face when entering into an OTC equity derivatives transaction on the issuer's shares?

The issuer or shareholder must comply with the shareholder disclosure rules pursuant to article 120 FMIA, as any other counterparty to an OTC derivative on shares listed on SIX Swiss Exchange or BX Swiss.

In addition, the issuer or shareholder must report the transaction in compliance with the reporting obligations resulting from the FMIA to a trade repository licensed or recognised in Switzerland pursuant to the rules of article 104 et seq. FMIA, to the extent the trade is not reported by the counterparty (eg, where the counterparty is not incorporated in Switzerland).

In the event that the issuer or shareholder is a Swiss securities dealer, further reporting obligations would arise as a result of its status.

Restricted periods

10 Are counterparties restricted from entering into OTC equity derivatives transactions during certain periods? What other rules apply to OTC equity derivatives transactions that address insider trading?

OTC equity derivatives with an underlying admitted to trading on a Swiss trading venue in Switzerland are subject to the Swiss rules on insider trading and market manipulation.

Swiss law prohibits:

1. the use of insider information for the purpose of acquiring or disposing of securities or trading financial instruments with such securities as underlying (eg, derivatives);
2. disclosure of insider information to others; and
3. providing recommendations to others to enter into any transactions pursuant to (1) above.

A breach can result in both regulatory and criminal sanctions.

The FMIO contains a safe harbour regime for repurchases of own shares under a share buy-back programme, subject to compliance with the following blackout periods during which the safe harbour regime does not apply:

- as long as the issuer postpones the announcement of a price-sensitive fact pursuant to the stock exchange rules;
- 10 trading days prior to the public announcement of financial results; and
- the period starting nine months after publication of the latest consolidated financial statements.

Under certain conditions, a securities firm may continue trading during the blackout period, provided that the terms of the trades were fixed in advance and they are not changed more frequently than on a monthly basis or, during a blackout period, taking into account a 90-day waiting period.

Legal issues

11 | What additional legal issues arise if a counterparty to an OTC equity derivatives transaction is the issuer of the underlying shares or an affiliate of the issuer?

The issuer must comply with the requirements of Swiss corporate law, including, for example, the limitations regarding the acquisition of own shares (which applies also to the acquisition of shares in the issuer by a majority-owned subsidiary).

Tax issues

12 | What types of taxation issues arise in issuer OTC equity derivatives transactions and third-party OTC equity derivatives transactions?

OTC equity derivatives which classify as pure derivatives for Swiss securities transfer tax purposes do not qualify as taxable securities within the meaning of the Swiss Stamp Duty Act, which is why transactions with OTC equity derivatives are basically not subject to Swiss securities transfer tax. Exemptions apply to OTC equity derivatives which, due to specific features, are considered debt financing instruments (bonds or money market securities), share-like or fund-like products, as well as Low Exercise Price Options (LEPO) on shares (with a maturity exceeding one year) for Swiss securities transfer tax purposes. These specific types of OTC equity derivatives are in general subject to Swiss securities transfer tax.

Income from OTC equity derivatives is not subject to Swiss withholding tax either, provided that the issuer is at all times resident and effectively managed outside Switzerland for Swiss tax purposes. However, the reimbursement of the Swiss withholding tax levied on the income received from a Swiss underlying should be approached with caution. This is particularly the case if the formal owner of shares in a Swiss company and thus the recipient of dividend payments subject to Swiss withholding tax has entered into an OTC equity derivatives transaction with a counterparty receiving the economic benefit resulting from the shares. In those cases, the Federal Tax Administration regularly assumes, relying on Federal Supreme Court case law, that the formal owner of the shares is obliged to pass on at least part of the dividend payment due to the derivative transaction. This in turn has the consequence that the Federal Tax Administration does not qualify the formal owner of the shares as the beneficial owner of the dividend payment. The beneficial ownership is, however, one of the cumulative requirements to be fulfilled for a withholding tax refund, in both domestic and cross-border trade relationships. Ultimately, because the beneficial ownership is not recognised from a tax

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perspective due to the OTC equity derivatives transaction, the withholding tax refund on the dividend payments to the formal owner of the shares is also denied.

Liability regime

13 Describe the liability regime related to OTC equity derivatives transactions. What transaction participants are subject to liability?

The general principles on contract liability and specific contractual provisions apply to the contractual liability regime related to OTC equity derivatives transactions.

Stock exchange filings

14 What stock exchange filings must be made in connection with OTC equity derivatives transactions?

Under the FMIA and pursuant to the FINMA Circular 2018/02 on the Duty to Report Securities Transactions, Swiss securities firms and remote members of a Swiss trading venue must report transactions in securities admitted to trading on a Swiss trading venue and in OTC derivatives with such securities as underlying, provided that at least one underlying value weighs more than 25 percent. As of 1 February 2023, the information to be reported for derivatives transactions was expanded in certain respects in order to improve the quality of the reported data. It is now, for instance, a mandatory requirement to specify, in addition to the underlying, also the type of derivative (eg, Option, Forward, CFD or Swap) and certain parameters that are relevant for the valuation (eg, call- or put-option, exercise price, exercise or expiration time).

If the underlying shares are listed on SIX Swiss Exchange or BX Swiss, any parties to the OTC derivative must comply with the shareholder disclosure rules pursuant to article 120 FMIA. To the extent that they cross a relevant threshold (either by exceeding or falling below 3, 5, 10, 15, 20, 25, 33.4, 50 and 66.6 per cent of the voting rights represented by the shares in such listed company as the relevant thresholds), they must make a disclosure to the issuer and the exchange by the end of the fourth trading day after crossing the threshold. The information is published by the exchange. A disclosure must be made as soon as an investor reaches or exceeds one of the thresholds with either its long position in the shares (physical shareholding aggregated with any rights to receive delivery of shares and any other long positions in respect of the shares, for example, arising from a derivatives transaction) or its short positions entered into in respect of the shares (eg, obligations to deliver shares or any short positions arising from a derivatives transaction). For the purposes of this calculation, the long and short positions must not be netted. The long and short positions arising from derivatives transactions are counted irrespective of whether they are cash or physically settled.

Typical document types

15 What types of documents are typical in an OTC equity derivatives transaction?

In the interdealer market, the documentation normally includes a Master Agreement for OTC derivatives transactions (usually a 2002 or 1992 ISDA Master Agreement), entered into jointly with the relevant credit support documentation that is suitable for the master agreement and the trading relationship (eg, a 1995 Credit Support Annex governed by English law entered into in respect of an English law governed ISDA Master Agreement, as amended for the purposes of compliance with variation margin requirements under the regulatory regimes applicable to both counterparties or a 2016 VM ISDA Credit Support Annex) and, in respect of the transaction, a transaction confirmation.

Moreover, depending on whether the dealers are subject to initial margin requirements, the dealers may have to take into account the transaction for the purposes of calculating initial margin in accordance with the relevant initial margin documentation entered into between the two dealers.

As regards the relationship between a dealer and a client, the documentation varies depending on the client relationship and the type of transaction. It may include a Master Agreement for OTC derivatives transactions (such as an ISDA master agreement or a Swiss Master Agreement published by the Swiss Bankers Association) and, in respect of the transaction, a transaction confirmation. The security may be provided under a credit support document entered into in connection with the master agreement, to the extent that the client falls into the scope of bilateral margin requirement (ie, if the client is an FC or an NFC+) or if such credit support document is in place on a voluntary basis. Where the client is not falling into the scope of bilateral margin requirements, security may be provided under a pledge agreement used by the bank in the client relationship generally that only provides security unilaterally by the client to the dealer.

If the transaction is a one-off transaction, it may be documented under a 'long form confirmation' incorporating the terms of an ISDA Master Agreement.

Legal opinions

16 For what types of OTC equity derivatives transactions are legal opinions typically given?

To the extent that a dealer is relying on close-out netting for its regulatory capital calculations and the credit risk analysis, it is relying on a netting and collateral enforceability opinion. Under documentation governed by ISDA terms, these are usually the industry opinions available to ISDA members, as supplemented by supplemental opinions in the event that the relevant counterparties or transactions are not covered by the industry opinions.

Hedging activities

17 May an issuer lend its shares or enter into a repurchase transaction with respect to its shares to support hedging activities by third parties in the issuer's shares?

Yes.

Securities registration

18 | What securities registration or other issues arise if a borrower pledges restricted or controlling shareholdings to secure a margin loan or a collar loan?

The pledge by a borrower of its shares to secure a loan does not trigger securities registration or the duty to issue a prospectus. The validity of the pledge over shares is in particular subject to the requirements of Swiss law depending on the type of shares (eg, intermediated securities, uncertificated securities or certificated securities).

Borrower bankruptcy

19 | If a borrower in a margin loan files for bankruptcy protection, can the lender seize and sell the pledged shares without interference from the bankruptcy court or any other creditors of the borrower? If not, what techniques are used to reduce the lender's risk that the borrower will file for bankruptcy or to prevent the bankruptcy court from staying enforcement of the lender's remedies?

Security interests that have been validly entered into remain enforceable in the insolvency of the counterparty. As regards the exercise of rights of private sale, the statutory rules applicable to intermediated securities, to banks or securities firms and to parties falling into the scope of the bilateral margin requirements under the FMIA provide for a safe harbour that may be relied on if the collateral has a market value that may be determined on the basis of objective criteria (eg, on the basis of being traded on a trading venue).

Market structure

20 | What is the structure of the market for listed equity options?

Switzerland does not currently have trading venues incorporated in Switzerland, where ETDs are traded. ETDs are traded with trading venues outside Switzerland and cleared through non-Swiss central counterparties (CCPs). To the extent that such trading venues or CCPs admit direct participants incorporated or domiciled in Switzerland, the trading venues and CCPs require recognition by FINMA.

Governing rules

21 | Describe the rules governing the trading of listed equity options.

These rules are those of the relevant foreign market of the trading venue and CCP.

From a Swiss regulatory perspective, such transactions fall into the scope of the reporting obligation under the FMIA. In the clearing chain, the Swiss party closer to the CCP has such reporting obligation.

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TYPES OF TRANSACTION

Clearing transactions

22 What categories of equity derivatives transactions must be centrally cleared and what rules govern clearing?

Under the rules of the Swiss Financial Market Infrastructure Act (FMIA), equity derivatives do not fall into the scope of the clearing obligation.

Exchange-trading

23 What categories of equity derivatives must be exchange-traded and what rules govern trading?

Under the rules of the FMIA, equity derivatives do not fall into the scope of a venue trading obligation.

Collateral arrangements

24 Describe common collateral arrangements for listed, cleared and uncleared equity derivatives transactions.

As regards ETDs and cleared equity derivatives:

- at present, there are no Swiss CCPs clearing equity derivatives. The clearing chain therefore is entered into, on the level of the CCP, with a foreign entity subject to its rules; and
- the collateral terms between the client and a Swiss dealer are usually agreed in the general terms governing ETDs and cleared equity derivatives.

As regards uncleared OTC equity derivatives:

- the collateral arrangements are agreed with the counterparty concerned on a bilateral basis;
- to the extent that the parties are subject to regulatory margin requirements, the parties may use the market standard document for the exchange of variation margin (eg, a 2016 VM ISDA Credit Support Annex) and, as applicable, the relevant documentation for the exchange of initial margin; and
- to the extent that the parties are not subject to regulatory margin requirements, the collateral documentation often depends on the context of the trading relationship. For instance, if it arises from the wealth management business, Swiss dealers may prefer to enter into a pledge agreement for a one-way collateralisation providing security to them as opposed to entering into a credit support document that would provide for bilateral margining.

Exchanging collateral

25 Must counterparties exchange collateral for some categories of equity derivatives transactions?

To the extent that the parties to the transaction fall into the scope of the bilateral margining obligation under the FMIA (ie, if they are FCs or NFC+), they must exchange collateral in the trading relationship (obligation to exchange variation margin, and, if they cross the relevant thresholds, initial margin).

ETDs and cleared equity derivatives that are cleared with a CCP authorised by the Swiss Financial Market Supervisory Authority do not fall into the scope of such obligations.

As regards the product scope for uncleared equity derivatives, an exemption applies for options on single shares, on share baskets or equity index options. For such exempted products, the obligation to exchange variation and initial margin has been postponed until 1 January 2024. For all other uncleared equity derivatives, the bilateral margin obligations apply in full.

LIABILITY AND ENFORCEMENT

Territorial scope of regulations

26 What is the territorial scope of the laws and regulations governing listed, cleared and uncleared equity derivatives transactions?

The Swiss Financial Market Infrastructure Act (FMIA) Obligations apply to parties incorporated or domiciled in Switzerland. They do not apply to parties incorporated or domiciled outside Switzerland, even if they act through a Swiss branch.

However, a foreign counterparty would be indirectly impacted by the FMIA Obligations as a result of trading with a Swiss counterparty that must comply with the FMIA Obligations, to the extent that the compliance by the Swiss party requires entering into certain agreements with the foreign counterparty (eg, an FMIA Agreement or the relevant credit support documentation to comply with the bilateral margin obligations resulting from the FMIA).

Registration and authorisation requirements

27 What registration or authorisation requirements apply to market participants that deal or invest in equity derivatives, and what are the implications of registration?

To the extent that the equity derivatives are not securities, there are no registration or authorisation requirements for market participants.

If equity derivatives are securities (eg, ETDs), a licence as a securities firm may be required from the Swiss Financial Market Supervisory Authority (FINMA), subject to the conditions under the Swiss Financial Institutions Act, for:

- trading in securities in its own name for the account of clients;
- own account trading in securities, provided that the firm:
    - operates primarily on the financial market; and
    - could thereby jeopardise the proper functioning of the financial market (ie, generates an annual turnover in securities exceeding 5 billion Swiss francs) or is a direct member of a trading venue or operates an organised trading facility; or
- acting as a market maker in securities.

Reporting requirements

28 What reporting requirements apply to market participants that deal or invest in equity derivatives?

If the underlying shares are listed on SIX Swiss Exchange or BX Swiss, parties to the OTC derivative must comply with the shareholder disclosure rules pursuant to article 120 FMIA. To the extent that they cross a relevant threshold (either by exceeding or falling below 3, 5, 10, 15, 20, 25, 33.3, 50 and 66.6 per cent of the voting rights represented by the shares in such listed company as the relevant thresholds), they must make a disclosure to the issuer and the exchange by the end of the fourth trading day after crossing the threshold. The information is published by the exchange.

In addition, the relevant party must report the transaction in compliance with the reporting obligations resulting from the FMIA to a trade repository licensed or recognised in Switzerland pursuant to the rules of article 104 et seq FMIA, to the extent the trade is not reported by the counterparty (eg, where the counterparty is not incorporated in Switzerland).

In the event that the issuer is a Swiss securities dealer, further reporting obligations would arise as a result of its status.

Legal issues

29 What legal issues arise in the design and issuance of structured products linked to an unaffiliated third party's shares or to a basket or index of third-party shares? What additional disclosure and other legal issues arise if the structured product is linked to a proprietary index?

Structured products are, unlike collective investment schemes, not subject to authorisation or supervision by FINMA. To distinguish both products, FINMA takes a 'form over substance' approach and looks primarily at the labelling of the product. The decision to qualify the product as a structured product must be made by the issuer prior to product launch and must be communicated to investors.

The offering, in or from Switzerland, of structured products to retail clients outside a portfolio management mandate or an investment advisory mandate in the long term is only possible if:

- they are issued or guaranteed by either a Swiss bank, a Swiss insurance company, a Swiss securities firm or a foreign institution subject to equivalent prudential supervision; or

- where the issuer does not meet these requirements (eg, it is a special-purpose entity) and they are not so guaranteed, a regulated entity undertakes to put the issuer in a position to meet its obligations or the investors are collateralised with enforceable rights in collateral assets.

If structured products are offered publicly or admitted to trading on a Swiss trading venue, the issuer must prepare a prospectus. A prospectus may be prepared in the form of a programme with final terms documenting an issuance, which is the standard for the issuance of structured products. Only the programme is approved by the Swiss Prospectus Office, while the final terms are just registered.

If structured products are offered to retail clients, the issuer must also prepare a Key Information Document (KID) in compliance with the requirements of the FinSA or the EU PRIIPs Regulation.

In the event that the underlying of the structured products are managed (actively managed certificate, AMC), they would not be classified as collective investment schemes from a Swiss perspective, as long as they are clearly labelled as structured products. However, further regulatory questions arise such as the adequate licensing of the manager or sponsor. In the event that the underlying of the structured products is a collective investment scheme, the question arises whether this would be viewed as an indirect distribution of such underlying in Switzerland. This would be deemed to be so where the weight of any collective investment scheme is more than a third.

Liability regime

30 | Describe the liability regime related to the issuance of structured products.

Whoever discloses information in a prospectus or a KID that is inaccurate, misleading or in violation of statutory requirements, is liable to the investor for damages caused if he or she failed to exercise due care. This also applies in the event the issuer fails to publish a prospectus despite being obliged to do so.

Moreover, an issuer could be subject to criminal sanctions. A fine of up to 500,000 Swiss francs may be imposed on anyone who intentionally makes false statements in the prospectus or withholds material facts or fails to publish a prospectus when the public offer begins. A fine of up to 100,000 Swiss francs may be imposed on anyone who intentionally does not make available (if needed) the KID to a retail client before subscription. A fine of up to 500,000 Swiss francs may be imposed on anyone who intentionally offers structured products to retail clients without complying with article 70 FinSA, including the requirement to be issued, guaranteed or secured. Banks and other financial intermediaries supervised by FINMA, as well as persons working for them, are, however, exempt from this criminal sanction regime.

Other issues

31 What registration, disclosure, tax and other legal issues arise when an issuer sells a security that is convertible for shares of the same issuer?

According to the Swiss Financial Services Act (FinSA), anyone who submits a public offer to purchase securities in Switzerland or applies for admission of securities to trading on a Swiss trading venue in accordance with the FMIA is obliged to publish a prospectus in advance.

Securities include, among others, equity securities and convertible bonds and the duty to publish a prospectus applies not only to primary offerings but also to secondary offerings (there are some exceptions for secondary offerings by supervised financial services providers if a valid prospectus is available and the issuer has consented to its use). There are some exceptions from the prospectus requirement.

For example, there is no obligation to publish a prospectus if a public offer is directed only at professional investors or at fewer than 500 retail investors. An exemption also applies for securities with a minimum investment amount or denominations of at least 100,000 Swiss francs and issues of a total of no more than 8 million Swiss francs per annum.

The FinSA provides for exemptions in connection with admission to trading, for example, in the case of equity securities that, over a period of 12 months, account for less than 20 per cent of equity securities already admitted to trading on the same trading venue.

Before being published, the prospectus must be submitted to a Swiss Prospectus Office (ie, currently SIX Exchange Regulation AG or BX Swiss AG) for their approval. As a significant exception to the requirement of ex-ante approval (but not prior publication) of the prospectus, Appendix 7 of the FinSO provides that for the purpose of rapid market access for bonds (including convertible and exchangeable bonds, warrant bonds, mandatory convertible notes, contingent convertible bonds and write-down bonds) and structured products with a maturity of at least 30 days, the prospectus may be reviewed after its publication (ie, ex-post). The exception requires a bank or securities firm to confirm that the most important information about the issuer and the securities is available at the time of publication.

If no prospectus is required, offerors or issuers must treat investors equally if they provide them with material information about a public offering.

32 What registration, disclosure, tax and other legal issues arise when an issuer sells a security that is exchangeable for shares of a third party? Does it matter whether the third party is an affiliate of the issuer?

No material other issues are to be reported as regards the issuance of exchangeable bonds.

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UPDATE AND TRENDS

Recent developments

33 | Are there any current developments or emerging trends that should be noted?

With the move away from LIBOR rates, equity derivatives transactions with a floating interest rate leg may also include a cash-flow calculated by reference to alternative risk-free rates (eg, SOFR, SONIA or SARON). The compounding methods for such overnight rates result, to the extent that the transaction is documented under ISDA terms, from the compounding methods as specified in the relevant supplement to the ISDA 2006 Definitions or from the ISDA 2021 Definitions, as applicable.

The initial margin documentation that may be used in the Swiss market also includes now industry-standard documentation that may be agreed with SIX SIS Ltd as Swiss custodian for intermediated securities to be exchanged as initial margin.

On 17 December 2021, the Swiss Federal Parliament adopted a bill to amend the Swiss withholding tax act (strengthening the debt capital market). The new law provided for the complete abolition of Swiss withholding tax on domestic interest payments (with the exception of interest payments on bank deposits to domestic individuals). The abolition of Swiss withholding tax on interest payments on bonds would also have applied to those OTC equity derivatives with a bond component (eg, reverse convertibles). If these are issued by a Swiss issuer, the interest component of the payment is currently subject to withholding tax. This would no longer have been the case after the revision. However, the afore-mentioned reform of the Swiss withholding tax act was rejected by the Swiss population in a referendum and is therefore no longer relevant.

Schellenberg Wittmer

Olivier Favre	olivier.favre@swlegal.ch
Tarek Houdrouge	tarek.houdrouge@swlegal.ch

Löwenstrasse 19, Zurich 8021, Switzerland
Tel: +41 44 215 5252
www.swlegal.com

United Kingdom

Jeremy Green, Dean Naumowicz and Sanjev D Warna-kula-suriya
Latham & Watkins LLP

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Summary

OVERVIEW

Typical types of transactions

1 Other than transactions between dealers, what are the most typical types of over-the-counter (OTC) equity derivatives transactions and what are the common uses of these transactions?

Typical issuer equity derivatives products include the following:

- options and forwards pursuant to which an issuer repurchases its shares, by way of capital reduction or to hedge an employee share option programme;
- call options purchased by the issuer of convertible debt, to create equity neutral or non-dilutive convertible debt; and
- convertible bonds allow an issuer to raise capital in the most effective way from the tax, accounting, cash flow, corporate or regulatory perspective.

Typical equity derivatives products that allow a shareholder to acquire a substantial position in a publicly traded equity or to monetise or hedge an existing equity position include the following:

- margin loans allow a borrower to finance an acquisition of shares or to monetise an existing shareholding;
- calls, puts, collars, funded collars and variable prepaid forwards allow a holder to both finance and hedge an acquisition of shares or to hedge and monetise an existing shareholding;
- put and call pairs, cash-settled or physically settled forwards and swaps allow a holder to acquire synthetic long exposure to the underlying shares, which may be transformed into physical ownership of the shares at settlement;
- reverse ASRs and other structured forwards allow shareholders to accelerate dispositions of shares in a manner that minimises its impact on the market price;
- sales of shares combined with a purchase of a capped call from the dealer allow a shareholder to dispose of its shareholding at a smaller discount to the market price and retain some upside in the stock; and
- mandatory exchangeable bonds allow a shareholder to monetise and hedge a large equity position while minimising any negative impact on the market price of the shares.

Borrowing and selling shares

2 May market participants borrow shares and sell them short in the local market? If so, what rules govern short selling?

Short selling of shares is permissible and is governed by the Short Selling Regulation (Regulation No. 236/2012) (SSR). The SSR applies to shares (and other financial instruments) that are admitted to trading on a trading venue in the United Kingdom, including certain OTC derivatives referencing such shares and other financial instruments. Shares whose principal trading venue is located in a country other than the United Kingdom are generally exempt from the obligations and restrictions imposed by the SSR. The FCA maintains on its website a list of such exempted shares.

Uncovered short selling is prohibited by the SSR, subject to certain exemptions for market-making activities and stabilisation activities.

The SSR imposes disclosure requirements in respect of net short positions (that is, the position remaining after deducting any long position that a person holds in relation to securities from any short position that that person holds in relation to those securities). For example:

- where the net short position is equal to at least 0.1 per cent of the issued share capital of the issuer and every 0.1 per cent increase above 0.1 per cent must be disclosed to the Financial Conduct Authority (FCA); and
- where the net short position is equal to at least 0.5 per cent of the issued share capital of the company and every 0.1 per cent increase above 0.5 must be disclosed to the market.

The SSR provides the FCA with the authority to temporarily prohibit or impose conditions on short selling where there are adverse developments that constitute a threat to financial stability or market confidence.

Applicable laws and regulations for dealers

3 Describe the primary laws and regulations surrounding OTC equity derivatives transactions between dealers. What regulatory authorities are primarily responsible for administering those rules?

The principal English laws and regulations (including European laws and regulations that form part of English law) surrounding OTC derivatives transactions (including equity derivatives) are:

- the Financial Services and Markets Act 2000 (FSMA);
- the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (SI 2001/544) (as amended) (RAO);
- the Markets in Financial Instruments Directive (2014/65/EU)) (MiFID II);
- the Markets in Financial Instruments Regulation (600/2014) (MiFIR);
- the Regulation on OTC derivatives, central counterparties and trade repositories (648/2012) (UK EMIR); and
- the Market Abuse Regulation (596/2014) (UK MAR).

The UK regulatory authority with primary responsibility for all of these laws and regulations is the FCA.

The two principal restrictions under the FSMA that have general application to derivatives (including equity derivatives) are the restriction on carrying on a regulated activity under section 19 of the FSMA and the restriction on financial promotions under section 21 of the FSMA. These two restrictions provide that, unless an exemption or exclusion applies:

- a person entering into derivatives transactions by way of business in the UK will ordinarily have to be authorised under the FSMA if the derivative constitutes an option, a future, a contract for differences or rights to or interests in investments as defined in Part III of the RAO; and

- a person must not, in the course of business, communicate an invitation or inducement to engage in investment activity unless that person is authorised, or the content of the communication is approved by an authorised person, or the communication is covered by an exemption.

MiFID II and MiFIR introduced a requirement for certain declared types of the most liquid and standardised derivatives to be traded on a trading venue in the United Kingdom, rather than OTC. In addition, where this requirement applies to a class of derivatives, certain price transparency obligations will also apply. The requirement applies to financial counterparties and certain types of non-financial counterparties, as defined in UK EMIR; however, to date, only certain types of interest rate and credit derivatives have been declared to be subject to this obligation.

Unless an exemption or exclusion applies, UK EMIR applies to all OTC derivative transactions (including equity derivatives) and imposes requirements for transactions to be reported to regulators and either cleared or, if the clearing obligation does not apply to a particular class of derivative transaction, subject to other risk mitigation techniques (including trade confirmation, portfolio reconciliation, daily marking-to-market, exchanging initial or variation margin and capital requirements for financial counterparties). The extent to which these obligations apply depends in part upon the nature of parties to the derivative transaction. UK EMIR distinguishes between financial counterparties (broadly, regulated entities, which would include most dealers) and non-financial counterparties (broadly, any undertaking established in the United Kingdom that is not a financial counterparty). UK EMIR further divides financial counterparties and non-financial counterparties into two sub-categories, depending on whether the derivative trading activity of the entity is above or below a prescribed notional value. The most onerous obligations apply where OTC derivatives transactions are entered into between financial counterparties or between a financial counterparty and a non-financial counterparty, in each case, whose derivative trading activity exceeds the prescribed notional value, unless an exemption or exclusion applies. UK EMIR also applies where a financial counterparty or a non-financial counterparty (in each case, whose derivative trading activity exceeds the prescribed notional value) enters into an OTC derivative transaction with an entity established outside of the United Kingdom if that entity would be an equivalent financial counterparty or non-financial counterparty if it were established within the United Kingdom. EMIR can also apply to OTC derivative transactions between two such non-UK entities if that transaction has a 'direct, substantial and foreseeable effect' within the United Kingdom or where necessary to prevent evasion of any provision of UK EMIR.

UK MAR established a regulatory framework on market abuse and prohibits insider dealing, unlawful disclosure of inside information and market manipulation. It applies to conduct anywhere in the world if it relates to financial instruments within the scope of UK MAR. The financial instruments to which UK MAR applies are very broad and include (without limitation) securities (including depository receipts) that are admitted to trading on a trading venue in the United Kingdom and other instruments the price or value of which depends on or has an effect on the price or value of such securities. Accordingly, broadly speaking, equity derivatives are within the scope of UK MAR.

Entities

4 In addition to dealers, what types of entities may enter into OTC equity derivatives transactions?

There are no general exclusions on the types of legal or natural persons who can enter into OTC equity derivative transactions.

Applicable laws and regulations for eligible counterparties

5 Describe the primary laws and regulations surrounding OTC equity derivatives transactions between a dealer and an eligible counterparty that is not the issuer of the underlying shares or an affiliate of the issuer? What regulatory authorities are primarily responsible for administering those rules?

The FSMA, RAO, MiFID II, MiFIR and UK MAR apply equally to OTC derivative transactions between dealers as between a dealer and an eligible counterparty that is not the issuer of the underlying shares or an affiliate of the issuer.

However, UK EMIR may apply differently to transactions between dealers to transactions between a dealer and an entity that is not a dealer. Unless an exemption or exclusion applies, UK EMIR applies to all OTC derivative transactions (including equity derivatives) and imposes requirements for transactions to be reported to regulators and either cleared or, if the clearing obligation does not apply to a particular class of derivative transaction, subject to other risk mitigation techniques (including trade confirmation, portfolio reconciliation, daily marking-to-market, exchanging initial or variation margin and capital requirements for financial counterparties). The extent to which these obligations apply depends in part upon the nature of parties to the derivative transaction.

In addition, if a party to an OTC equity derivative is (or is closely associated with) a member of the administrative, management or supervisory board or is a certain type of senior executive of the issuer of the underlying shares, UK MAR requires that party to notify the issuer and the FCA of that transaction within three business days of entering into the transaction if the total amount of transactions by that party has reached €5,000 in the calendar year. MAR also prohibits such a person from entering into transactions in the issuer's securities or derivatives in respect of such securities in the 30 days prior to the announcement of interim or year-end financial statements that the issuer is obliged to make public.

If the counterparty to an OTC equity derivative transaction is not a professional client for the purposes of MiFID II, then before trading the dealer may be required to provide a standalone key information document to the counterparty and publish it on the dealer's website in accordance with Regulation 1286/2014 on key information documents for packaged retail and insurance-based investment products.

The UK regulatory authority with primary responsibility for all of these laws and regulations is the FCA.

Securities registration issues

6 Do securities registration issues arise if the issuer of the underlying shares or an affiliate of the issuer sells the issuer's shares via an OTC equity derivative?

There are no securities registration issues that arise if the issuer of the underlying shares or an affiliate of the issuer sells the underlying shares via an OTC equity derivative.

Repurchasing shares

7 May issuers repurchase their shares directly or via a derivative?

An English public company is not permitted to repurchase its shares, other than as expressly permitted by and in accordance with the Companies Act 2006 (CA 2006) and any restriction or prohibition in the company's constitutive documents. It is possible for such a company to purchase its shares directly or via derivative; however, the relevant provisions of the CA 2006 apply differently depending upon whether the repurchase is to take place 'on market' (ie, by the company purchasing shares on the London Stock Exchange or certain other designated recognised investment exchanges) or 'off-market' (ie, by the company purchasing its shares in some other way). An English public company must comply with the CA 2006 when repurchasing its shares, irrespective of whether its shares are listed on the London Stock Exchange or on another exchange anywhere in the world.

A failure to comply with the relevant provisions of the CA 2006 is a criminal offence and renders the repurchase transaction void.

While a repurchase of shares that is conducted in accordance with the relevant provisions of the CA 2006 is itself exempt from the prohibition in the CA 2006 on financial assistance, this prohibition may be relevant in relation to other conduct of the issuer or its subsidiaries in connection with the repurchase.

If the issuer is a company with shares admitted to trading on the London Stock Exchange, any repurchase of shares by that issuer must also comply with the rules of the London Stock Exchange. The rules of the London Stock Exchange include restrictions on the number of and price at which shares can be repurchased by the issuer, as well as disclosure and notification requirements. In addition, if such an issuer is contemplating a transaction that would have an effect similar to that of such a repurchase, the issuer is obliged by the rules of the London Stock Exchange to consult with the FCA to discuss the application of those rules.

In addition, UK MAR contains a safe harbour from the prohibitions on market abuse for issuers conducting repurchases of their own securities, provided that the purpose, disclosure and reporting requirements and various price, volume and other trading restrictions are adhered to when conducting such repurchases. However, the safe harbour does not apply to repurchases conducted via derivatives.

Risk

8 What types of risks do dealers face in the event of a bankruptcy or insolvency of the counterparty? Do any special bankruptcy or insolvency rules apply if the counterparty is the issuer or an affiliate of the issuer?

If the counterparty is an English company, then the risks faced by a dealer in the event of the counterparty's insolvency are the same as for any other commercial transaction with such counterparty. There are no additional insolvency laws applicable solely due to the transaction being an OTC equity derivative transaction entered into with a counterparty that is the issuer or an affiliate of the issuer of the shares to which the derivative relates.

Under English insolvency laws, it is generally the case that contracts and rights that were validly entered into or granted prior to insolvency remain valid and enforceable in the insolvency of an English party to that contract. This means that, generally speaking, the typical close-out netting rights found in OTC equity derivative contracts should be enforceable in the event that a counterparty enters insolvency under English law.

If an English company enters administration, there is an automatic moratorium on the enforcement of security over the assets of that company. In addition, if a company is, or is likely to become, unable to pay its debts it may be able to obtain a moratorium on enforcement of security over its assets. However, in either case, if the security is structured as a 'security financial collateral arrangement' under the Financial Collateral Arrangements (No. 2) Regulations 2003, this moratorium will not apply.

However, transactions entered into prior to insolvency can be challenged in an insolvency in certain circumstances, for example, where those transactions are found to have involved:

- a transfer of an asset to another party for no or insufficient consideration;
- a desire to put a creditor in a better position than it would have otherwise been in an insolvency;
- extortionate credit terms; and
- an intention to put assets beyond the reach of a creditor.

In addition, if the counterparty is a financial institution and becomes subject to special resolution or recovery proceedings under the Banking Act 2009, restrictions on the exercise of close-out netting rights may apply and the Prudential Regulatory Authority or the Bank of England will have various rights to suspend payment and delivery obligations of the counterparty, to impose a short stay on the exercise of termination rights or the enforcement of security (typically 24–48 hours) and to bail in or impose loss sharing on contractual counterparties.

Reporting obligations

9 What types of reporting obligations does an issuer or a shareholder face when entering into an OTC equity derivatives transaction on the issuer's shares?

There are a number of reporting obligations for an issuer or shareholder of an issuer when entering into OTC equity derivatives transactions in respect of the shares in the issuer. These include:

- trade reporting obligations under MiFID II, MiFIR and UK EMIR;
- notifications of any dealings in shares of an issuer by a person who discharges managerial responsibilities within that issuer (and persons closely associated with them) under UK MAR;
- notifications when an issuer repurchases its own shares; and
- disclosure of substantial shareholdings, control of voting rights and economic long positions as required by the Disclosure and Transparency Rules (DTRs).

Additional disclosure obligations may apply in specific circumstances, including when a public offer is or has been made in relation to the shares of the issuer and where the issuer is a regulated institution or part of a sensitive industry.

An issuer that has financial instruments admitted for trading on a regulated market (or for which a request for admission for trading has been made) is further required to disclose, as soon as possible, all inside information that directly concerns the issuer.

Restricted periods

10 | Are counterparties restricted from entering into OTC equity derivatives transactions during certain periods? What other rules apply to OTC equity derivatives transactions that address insider trading?

There are no specific restrictions of general application on entering into OTC equity derivative transactions during particular periods; however, MAR prohibits a person using inside information to acquire or dispose of, or cancel or amend an order concerning, a financial instrument within the scope of MAR (which will include most equity derivatives). MAR also prohibits certain insiders from dealing in financial instruments of the issuer during prescribed closed periods.

Legal issues

11 | What additional legal issues arise if a counterparty to an OTC equity derivatives transaction is the issuer of the underlying shares or an affiliate of the issuer?

If the counterparty is the issuer of the underlying shares and is an English company then it must comply with the maintenance of capital and financial assistance rules set out in the CA 2006.

An English company may only make a distribution of its assets (in cash or otherwise) to its shareholders out of distributable profits. Thus, an arrangement pursuant to which a shareholder (in its capacity as such) receives or is entitled to receive, directly or indirectly, a financial benefit from the issuer of the shares at a time when the issuer has insufficient distributable reserves is likely to be unlawful unless an exemption applies.

In addition, subject to certain exceptions, it is unlawful for an English public company or its subsidiaries to give financial assistance directly or indirectly for the purpose of a person acquiring shares in that company. It is also unlawful for an English public company or its subsidiaries to give financial assistance for the purpose of reducing or discharging any liability incurred by a person for the purpose of the acquisition of shares, unless an exemption applies.

The prohibition on financial assistance is subject to a number of exemptions. These include arrangements under which the assistance is given in good faith in the interests of the company where either the company's principal purpose is not to give assistance for the purpose of the acquisition of its shares (or those of its holding company) or the giving of the assistance is incidental to some larger purpose that it has. Where the shares have already been acquired, the exemption applies if the company's principal purpose is not to reduce or discharge any liability a person has incurred for the purpose of the acquisition or the reduction or discharge of the liability is incidental to some larger purpose of the company (provided, in each case, that it is acting in good faith and in its own interests).

The above rules are complex and need to be considered in the context of both physically settled and cash-settled OTC equity derivatives transactions.

In addition, if a counterparty to an OTC equity derivatives transaction is a subsidiary of the issuer of the underlying shares, the transaction cannot lawfully provide for the delivery of shares to the counterparty. This is because it is unlawful for a subsidiary of an English company to be a shareholder in its parent, subject to certain exemptions applicable to subsidiaries acting as nominee or trustee and to authorised dealers in securities acting in the ordinary course of its business of dealing in securities.

Tax issues

12 What types of taxation issues arise in issuer OTC equity derivatives transactions and third-party OTC equity derivatives transactions?

There are complex rules that dictate the UK corporation tax treatment of derivatives transactions, but broadly speaking the rules (set out in Part 7 of the Corporation Tax Act 2009) are aimed at taxing transactions in accordance with their accounting treatment.

The application of stamp duty and stamp duty reserve tax (SDRT) should also be considered; however, OTC derivatives transactions can usually be structured so as not to attract stamp taxes on sale, either because the transactions fall outside of the ambit of stamp taxes or owing to the availability of specific reliefs and exemptions. For example, cash-settled options and forwards will not attract stamp duty or SDRT, as there is no underlying transfer of (or agreement to transfer) securities. Relevant exemptions include intermediary relief (which provides that no stamp taxes are payable on transfers or agreements to transfer securities to an intermediary or market maker) and stock lending relief.

Liability regime

13 Describe the liability regime related to OTC equity derivatives transactions. What transaction participants are subject to liability?

OTC equity derivatives transactions may attract contractual, statutory and common law liability. Breaches of statutory requirements, such as the CA 2006, can carry criminal or civil liability for a company and its directors, as well as for involved third parties.

Stock exchange filings

14 | What stock exchange filings must be made in connection with OTC equity derivatives transactions?

Subject to certain exemptions, the DTRs require a person to notify the issuer and the FCA of any active or passive acquisition or disposal of voting rights (or deemed acquisition or disposal of voting rights) that results in that person's holding (or deemed holding) of voting rights reaching, exceeding or falling below certain threshold percentages of the total voting rights attaching to the issuer's issued share capital. As a practical matter, this notification obligation applies to acquisitions and disposals of already issued shares (to which voting rights are attached) and also to acquisitions and disposals of derivatives (and other instruments) that create either an unconditional entitlement to receive shares (to which voting rights are attached) or an economically equivalent position. As a consequence, long positions via derivatives – whether cash or physically settled – are potentially notifiable.

The notification thresholds apply when holdings of voting rights reach, exceed or fall below:

- in the case of UK issuers: 3 per cent and each 1 per cent thereafter; and
- in the case of non-UK issuers: 5, 10, 15, 20, 25, 30, 50 and 75 per cent.

To calculate the notification threshold, all holdings of shares and other relevant instruments are aggregated. Long positions held via cash-settled options are calculated on a delta-adjusted basis, but otherwise long positions held via derivatives are calculated on the full number of underlying shares.

The notification requirement may also be triggered by passive movements through these thresholds (for example, where a company purchases its own shares and the person's shareholding is concentrated as a result). The obligation on the person dealing in the shares is to notify the issuer and this creates an obligation on the issuer to notify the market.

The notification requirement is subject to a number of exemptions. The exemptions most commonly relied upon by dealers in the context of OTC equity derivatives are the market-maker exemption (which, subject to certain conditions, allows the dealer to disregard its holdings until they reach 10 per cent) and the trading book exemption (which, subject to certain conditions, allows the dealer to disregard holdings in its trading book until they exceed 5 per cent).

Typical document types

15 | What types of documents are typical in an OTC equity derivatives transaction?

An OTC equity derivatives transaction is typically documented in a confirmation forming part of an International Swaps and Derivatives Association (ISDA) Master Agreement. The confirmation would incorporate the relevant equity definitions, typically the ISDA 2002 Equity Derivatives Definitions. Although ISDA has published a new set of definitions, the 2011 ISDA Equity Derivatives Definitions, these are not currently commonly used by the market.

Depending on the type of transaction, security is taken over shares held in custody by the counterparty. It is common to have bespoke security documentation and standard form custody agreements.

Margin loans are commonly drafted using Loan Market Association documentation as a base, before being customised to take into account the security over listed shares. As is the case for OTC equity derivative transactions, margin loans have typically bespoke security documentation and standard-form custody agreements.

Legal opinions

16 For what types of OTC equity derivatives transactions are legal opinions typically given?

Legal counsel will typically render opinions on the enforceability of security granted for margin loans and structured equity derivatives, where bespoke security and collateral arrangements are being used.

If the counterparty is not a dealer, then it is common for a dealer to request a legal opinion addressing the counterparty's corporate power, capacity and authorisation to enter into the transaction.

In addition, in most jurisdictions, the parties rely on opinions provided to the industry by ISDA, which primarily address the enforceability of close-out netting and collateral under standard form documentation published by ISDA.

Hedging activities

17 May an issuer lend its shares or enter into a repurchase transaction with respect to its shares to support hedging activities by third parties in the issuer's shares?

Under the CA 2006, an English company is limited in what it can do with any shares that it has issued and which it holds in its own name. The company can only hold those shares, sell those shares for cash consideration, transfer those shares for the purposes of an employee share scheme or cancel those shares. In addition, an English company must only acquire its own shares in compliance with the buy-back rules of the CA 2006. For these reasons, an English company will be unlikely to lend its shares or enter into a sale and repurchase transaction with respect to its shares to support hedging activities of third parties.

Securities registration

18 What securities registration or other issues arise if a borrower pledges restricted or controlling shareholdings to secure a margin loan or a collar loan?

The United Kingdom does not have a concept of restricted or controlling shareholdings; however, registration of the share security will be required under the CA 2006 where an English company grants security (including over shares). There is an exception to the registration requirement where the pledge would constitute a 'security financial collateral arrangement' under the Financial Collateral Arrangements (No. 2) Regulations 2003, but in practice this exception is not often relied upon.

If the borrower is a person discharging managerial responsibilities (or a person closely associated with such a person) at the issuer of the shares that are subject to security, then the grant of that security is notifiable under article 19 of UK MAR.

Borrower bankruptcy

19 | If a borrower in a margin loan files for bankruptcy protection, can the lender seize and sell the pledged shares without interference from the bankruptcy court or any other creditors of the borrower? If not, what techniques are used to reduce the lender's risk that the borrower will file for bankruptcy or to prevent the bankruptcy court from staying enforcement of the lender's remedies?

If an English company enters administration, there is an automatic moratorium on the enforcement of security over the assets of that company. In addition, if a company is, or is likely to become, unable to pay its debts it may be able to obtain a moratorium on enforcement of security over its assets. However, in either case, if the security is structured as a 'security financial collateral arrangement' under the Financial Collateral Arrangements (No. 2) Regulations 2003, this moratorium will not apply.

It is not uncommon for the borrower under a margin loan to be a special purpose vehicle that is set up for the purposes of holding the shares and entering into the margin loan. The corporate structure and documentation typically limit the activities that the borrower can carry on in an attempt to reduce the risk of the borrower entering into administration or any other insolvency proceedings.

Market structure

20 | What is the structure of the market for listed equity options?

There is no centralised exchange for UK-listed equity options. There are three major exchanges on which listed equity options can be traded: the London Stock Exchange, Eurex and the Intercontinental Exchange. Listed equity options can also be traded on many other trading venues.

Governing rules

21 | Describe the rules governing the trading of listed equity options.

Each exchange is responsible for making and enforcing the rules applicable to trading on it. The exchanges will provide standardised option contracts that set out the terms of the options.

TYPES OF TRANSACTION

Clearing transactions

22 What categories of equity derivatives transactions must be centrally cleared and what rules govern clearing?

Unless an exemption or exclusion applies, the Regulation on OTC derivatives, central counterparties and trade repositories (648/2012) (forming part of English law) (UK EMIR) applies to all OTC derivative transactions (including equity derivatives) and imposes requirements for such transactions to be reported to regulators and either cleared or, if the clearing obligation does not apply to a particular class of derivative transaction, subject to other risk mitigation techniques (including, trade confirmation, portfolio reconciliation, daily marking-to-market, exchanging initial or variation margin and capital requirements for financial counterparties).

Currently, OTC equity derivatives are not a class of derivative to which the clearing obligation applies.

Exchange-trading

23 What categories of equity derivatives must be exchange-traded and what rules govern trading?

In the UK, equity derivatives are not currently required to be traded on an exchange. In line with the clearing obligation under UK EMIR, the Markets in Financial Instruments Directive (2014/65/EU)/Markets in Financial Instruments Regulation (600/2014) (as each forms part of English law) introduced a mandatory trading obligation for certain derivatives transactions. The mandatory trading obligation applies under similar circumstances to the clearing obligation and does not currently apply to equity derivatives.

Collateral arrangements

24 Describe common collateral arrangements for listed, cleared and uncleared equity derivatives transactions.

In respect of listed and cleared equity derivatives transactions, the parties will usually post both initial and variation margin.

Unless an exemption or exclusion applies, UK EMIR applies to all OTC derivative transactions (including equity derivatives) and imposes requirements for such transactions to be reported to regulators and either cleared or, if the clearing obligation does not apply to a particular class of derivative transaction, subject to other risk mitigation techniques (including, trade confirmation, portfolio reconciliation, daily marking-to-market, exchanging initial or variation margin and capital requirements for financial counterparties).

ISDA has published standard collateral documentation governing the provision of initial margin and variation margin, which are customarily used by market participants. Initial margin is provided by way of the grant of a security interest over securities held in custody in the name of the grantor, whereas variation margin is provided by way of title transfer collateral arrangement from one party to the other.

Exchanging collateral

25 Must counterparties exchange collateral for some categories of equity derivatives transactions?

In respect of listed and cleared equity derivatives transactions, the parties will usually post both initial and variation margin.

Unless an exemption or exclusion applies, UK EMIR applies to all OTC derivative transactions (including equity derivatives) and imposes requirements for such transactions to be reported to regulators and either cleared or, if the clearing obligation does not apply to a particular class of derivative transaction, subject to other risk mitigation techniques (including, trade confirmation, portfolio reconciliation, daily marking-to-market, exchanging initial or variation margin and capital requirements for financial counterparties).

ISDA has published standard collateral documentation governing the provision of initial margin and variation margin, which are customarily used by market participants. Initial margin is provided by way of the grant of a security interest over securities held in custody in the name of the grantor, whereas variation margin is provided by way of title transfer collateral arrangement from one party to the other.

LIABILITY AND ENFORCEMENT

Territorial scope of regulations

26 What is the territorial scope of the laws and regulations governing listed, cleared and uncleared equity derivatives transactions?

The United Kingdom laws and regulations applicable to trading in equity derivatives typically apply to participants irrespective of their location, if their conduct or the financial instrument has a nexus with the United Kingdom.

The United Kingdom laws and regulations applicable to issuers of shares apply by virtue of such issuer being incorporated under the Companies Act 2006 (CA 2006) or such shares being admitted to trading on a trading venue in the United Kingdom.

Registration and authorisation requirements

27 What registration or authorisation requirements apply to market participants that deal or invest in equity derivatives, and what are the implications of registration?

MiFID II and MiFIR introduced a requirement for certain declared types of the most liquid and standardised derivatives to be traded on a trading venue in the EU, rather than OTC. In addition, where this requirement applies to a class of derivatives, certain price transparency obligations will also apply. The requirement applies to certain types of financial counterparties and non-financial counterparties, as defined in UK EMIR; however, to date, only certain types of interest rate and credit derivatives have been declared to be subject to this obligation.

Unless an exemption or exclusion applies, UK EMIR applies to all OTC derivative transactions (including equity derivatives) and imposes requirements for transactions to be reported to regulators and either cleared or, if the clearing obligation does not apply to a particular class of derivative transaction, subject to other risk mitigation techniques (including trade confirmation, portfolio reconciliation, daily marking-to-market, exchanging initial or variation margin and capital requirements for financial counterparties). The extent to which these obligations apply depends in part upon the nature of parties to the derivative transaction, as discussed above.

UK MAR established a regulatory framework on market abuse and prohibits inside dealer, unlawful disclosure of inside information and market manipulation. It applies to conduct anywhere in the world if it relates to financial instruments within the scope of UK MAR. The financial instruments to which UK MAR applies are very broad and include (without limitation) securities (including depository receipts) that are admitted to trading on a trading venue in the United Kingdom and other instruments the price or value of which depends on or has an effect on the price or value of such securities. Accordingly, broadly speaking, equity derivatives are within the scope of UK MAR.

Reporting requirements

28 What reporting requirements apply to market participants that deal or invest in equity derivatives?

There are a number of reporting obligations for an issuer or shareholder of an issuer when entering into OTC equity derivatives transactions in respect of the shares in the issuer. These include:

- trade reporting obligations under MiFID II, MiFIR and UK EMIR;
- notifications of any dealings in shares of an issuer by a person who discharges managerial responsibilities within that issuer (and persons closely associated with them) under UK MAR;
- notifications when an issuer repurchases its own shares; and
- disclosure of substantial shareholdings, control of voting rights and economic long positions as required by the Disclosure and Transparency Rules (DTRs).

Additional disclosure obligations may apply in specific circumstances, including when a public offer is or has been made in relation to the shares of the issuer and where the issuer is a regulated institution or part of a sensitive industry.

An issuer that has financial instruments admitted for trading on a regulated market (or for which a request for admission for trading has been made) is further required to disclose, as soon as possible, all inside information that directly concerns the issuer.

Subject to certain exemptions, the DTRs require a person to notify the issuer and the FCA of any active or passive acquisition or disposal of voting rights (or deemed acquisition or disposal of voting rights) that results in that person's holding (or deemed holding) of voting rights reaching, exceeding or falling below certain threshold percentages of the total voting rights attaching to the issuer's issued share capital. As a practical matter, this notification obligation applies to acquisitions and disposals of already issued shares (to which voting rights are attached) and also to acquisitions and disposals of derivatives (and other instruments) that create either an unconditional entitlement to receive shares (to which voting rights are attached) or an economically equivalent position. As a consequence, long positions via derivatives – whether cash or physically settled – are potentially notifiable.

The notification thresholds apply when holdings of voting rights reach, exceed or fall below:

- in the case of UK issuers: 3 per cent and each 1 per cent thereafter; and
- in the case of non-UK issuers: 5, 10, 15, 20, 25, 30, 50 and 75 per cent.

To calculate the notification threshold, all holdings of shares and other relevant instruments are aggregated. Long positions held via cash-settled options are calculated on a delta-adjusted basis, but otherwise long positions held via derivatives are calculated on the full number of underlying shares.

The notification requirement may also be triggered by passive movements through these thresholds (for example, where a company purchases its own shares and the person's shareholding is concentrated as a result). The obligation on the person dealing in the shares is to notify the issuer and this creates an obligation on the issuer to notify the market.

The notification requirement is subject to a number of exemptions. The exemptions most commonly relied upon by dealers in the context of OTC equity derivatives are the market-maker exemption (which, subject to certain conditions, allows the dealer to disregard its holdings until they reach 10 per cent) and the trading book exemption (which, subject to certain conditions, allows the dealer to disregard holdings in its trading book until they exceed 5 per cent).

Legal issues

29 What legal issues arise in the design and issuance of structured products linked to an unaffiliated third party's shares or to a basket or index of third-party shares? What additional disclosure and other legal issues arise if the structured product is linked to a proprietary index?

Certain entities that manufacture (ie, create, develop, design or issue) or distribute (ie, offer, recommend, or sell) financial instruments and structured products such as securitised derivatives and structured notes from an establishment or appointed representative in the UK must comply with the Markets in Financial Instruments Directive (2014/65/EU)/Markets in Financial Instruments Regulation (600/2014) (each as forming part of English law, MiFID II/MiFIR)-derived product governance, namely, rules set out in the Product Intervention and Product Governance Sourcebook (PROD) and the Conduct of Business Sourcebook (COBS). The PROD and COBS comprise part of the Financial Conduct Authority (FCA) Handbook.

The product governance rules apply to MiFID investment firms (ie, regulated entities to which MiFID II/MiFIR applies) and branches of third-country investment firms that would be a MiFID investment firm if they were headquartered in the United Kingdom. In addition, other firms that manufacture or distribute financial instruments or structured products (but are not MiFID investment firms) must take into account the product governance rules as if they were guidance in the Principles for Businesses in the FCA Handbook.

The product governance rules apply proportionately and may be more onerous if structured products are offered to retail investors, as defined in MiFID II. The product governance rules apply to UK MiFID-investment firms' business activities in the UK , irrespective of whether the investors are in the UK or elsewhere. If a manufacturer or distributor is involved in marketing the products, then it may also need to be authorised under the Financial Services and Markets Act 2000 (FSMA).

The product governance rules require manufacturers to have product approval and review processes in place to, among other things:

- identify with sufficient granularity a target market with the end client in mind;
- ensure that the product is designed to meet the needs of the identified target market;
- ensure that the distribution strategy is compatible with the target market;
- communicate target market and distribution strategies to distributors; and
- conduct regular reviews (at least annually) during the life of the product to ensure that the product and distribution channels remain appropriate for the identified target market.

Distributors must obtain target market and distribution information from manufacturers and assess the appropriateness of financial instruments or structured products for their individual clients and communicate any changes to their distribution strategies.

If financial instruments or structured products are admitted to trading on a regulated market in the United Kingdom or offered to the public, the issuer must prepare a prospectus (subject to limited exceptions) in accordance with the Prospectus Regulation (Regulation No. 2017/1129) (as forms part of English law). Manufacturers and distributors must also provide a key information document (KID) before structured products can be offered to retail investors in the UK. The form and content of a KID are highly prescriptive and must meet the requirements of the Packaged Retail and Insurance-based Investment Products (PRIIPs) Regulation (Regulation No. 1286/2014). The obligation to provide a KID to retail investors in the UK applies to all manufacturers and distributors, including third-country entities and entities that are not MiFID investment firms.

If the structured product references a proprietary index and the product is traded on a trading venue or via a systematic internaliser, the product manufacturer must comply with the Benchmarks Regulation (Regulation No. 2016/1011) (BMR), which regulates the provision and use of benchmarks, as well as the contribution of input data to benchmarks. In this context, 'use of a benchmark' includes issuance of a financial instrument that references an index or a combination of indices, or determination of the amount payable under a financial instrument by referencing an index or combination of indices. In addition, recent amendments to the BMR impose specific requirements in respect of 'UK Climate Transition' and 'UK Paris-aligned' benchmarks relating to climate change and sustainability. The BMR only applies to financial instruments that are traded on a trading venue (or in respect of which a request for admission has been made) or via a systematic internaliser, as well as certain credit agreements and investment funds.

The BMR contains transition provisions, under which benchmark administrators may continue to provide, and supervised entities may continue to use, certain non-compliant benchmarks. In the case of critical and third-country benchmarks, the transition period applied until 31 December 2021.

Liability regime

30 | Describe the liability regime related to the issuance of structured products.

There is a range of statutes containing provisions relating to misleading statements made in offering documentation. There may also be additional common law liability. The relevant statutes include the following:

- the Fraud Act 2006 provides that fraud will be a criminal offence, and this includes dishonestly making a false representation with an intention of making a gain or causing a loss, and dishonestly failing to disclose information where there is a duty to disclose it (with an intention of making a gain or causing a loss);
- section 89 of the Financial Services Act 2012 provides that it is a criminal offence to make statements that are false or misleading in a material respect, which section 90 contains prohibitions on giving misleading impressions;
- the FSMA sets out criminal and administrative sanctions and enforcement procedures for failing to comply with the FSMA's requirements, along with obligations arising under other statutes such as the Prospectus Regulation, the Market Abuse Regulation (596/2014) forming part of English law (UK MAR) and Securitisation Regulation;
- the Enforcement Guidance (EG) Manual in the FCA Handbook describes the FCA's approach to exercising its main enforcement powers under the FSMA and other legislation; and
- the EG Manual also grants the FCA the power to require restitution to remedy harm to investors caused by non-compliance of their statutory obligations.

The FSMA also provides a scheme of civil liability, which includes matters such as the standard of conduct and defences. For example, sections 20(3), 71(1) and 71(2) FSMA include potential civil remedies under breach of statutory duty in respect of the carrying out of controlled activities under FSMA. Section 90 FSMA creates a civil liability regime in respect of statements in listing particulars or prospectuses by creating a right to obtain compensation for any person who has acquired securities to which the particulars apply and suffered a loss as a result of any untrue or misleading statement in the particulars or the omission of any required information. Under section 138(D)(2) FSMA, a contravention by an authorised person of a rule made by the FCA is actionable at the suit of a private person who suffers loss as a result of the contravention, subject to the defences and other incidents applying to actions for breach of statutory duty.

Other issues

31 | What registration, disclosure, tax and other legal issues arise when an issuer sells a security that is convertible for shares of the same issuer?

A number of issues arise in the context of a convertible bond issue, some of which are applicable to the issuer and some to investors.

The issuer needs to ensure it has the necessary authority to allot new shares and consider whether any restrictions exist on its ability to do so, whether in its articles of association or at law. In addition, the issuer must consider how it intends to deal with pre-emption rights given to existing shareholders, which allow them what is effectively a right of first refusal over any new shares being issued. There are a number of structural methods of dealing with pre-emption rights, which generally depend upon the intended number of new shares to be allotted in connection with the issuance of convertible bonds.

Convertible bonds are usually listed eurobonds, so the FCA listing rules for convertible securities will need to be complied with in addition to the rules of the exchange on which the underlying shares are listed to achieve and maintain the listing of the convertible bonds and the underlying shares. If the convertible bonds or the underlying shares are offered to the public and admitted to trading on a regulated market (such as the London Stock Exchange Main Market) or another relevant trading venue (such as the London Stock Exchange Professional Securities Market), then the FSMA, MiFID II, MiFIR and UK MAR will all be applicable. In addition, the disclosure obligations will differ depending upon the exchange on which the convertible bonds are listed. For example, if the convertible bonds are to be listed and traded on the Main Market, the FCA's Prospectus Regulation Rules will require the issuer to publish a prospectus. The level of disclosure required in the prospectus depends on the denomination of the convertible bonds and whether the issue falls under the wholesale regime or retail regime. By contrast, the Professional Securities Market does not require a prospectus to be issued but will require listing particulars to be prepared and approved by the FCA.

A number of tax issues arise in the context of a convertible bond. Withholding tax and capital gains tax will be a consideration, as will the application of stamp duty and stamp duty reserve tax. The nature, location and identity of the bondholders (and whether the bondholder is considered to be connected to the issuer for tax purposes) will also be relevant to the assessment of direct taxes for both the issuer and the investors.

32 | What registration, disclosure, tax and other legal issues arise when an issuer sells a security that is exchangeable for shares of a third party? Does it matter whether the third party is an affiliate of the issuer?

Exchangeable bonds typically involve the bonds being exchangeable into shares that are owned by the bond issuer but were issued by a company that is not a bond issuer. As a consequence, because the bond issuer will not be allotting or issuing new shares in itself, some issues are not relevant, such as the requirements for authorisation for and restrictions on allotting new shares and pre-emption rights.

However, as most exchangeable bonds will be listed eurobonds, the FCA's requirements regarding listing and disclosure will need to be complied with if the bonds are to be listed on the London Stock Exchange.

A number of tax issues arise in the context of an exchangeable bond. Withholding tax and capital gains tax will be a consideration, as will the application of stamp duty and stamp duty reserve tax. The nature, location and identity of the bondholders (and whether the bondholder is considered to be connected to the issuer for tax purposes) will also be relevant to the assessment of direct taxes for both the issuer and the investors.

UPDATE AND TRENDS

Recent developments

33 | Are there any current developments or emerging trends that should be noted?

The United Kingdom ceased to be a member state of the European Union with the coming into force of the Withdrawal Agreement on 31 January 2020 at 11 pm GMT. Under the Withdrawal Agreement, EU law continued to apply in the United Kingdom until that time, when, by automatic operation of law, all European Union law that applied in the United Kingdom was incorporated into the United Kingdom's domestic law, and may be amended by the United Kingdom parliament (or the devolved legislatures) and, therefore, may diverge from the European Union laws on which it was based. Accordingly, references in this chapter to European Union law should be read as referring to such laws as incorporated into the domestic law of the United Kingdom at 11 pm GMT on 31 December 2020.

LATHAM & WATKINS

Jeremy Green	jeremy.green@lw.com
Dean Naumowicz	dean.naumowicz@lw.com
Sanjev D Warna-kula-suriya	sanjev.warna-kula-suriya@lw.com

99 Bishopsgate, London EC2M 3XF, United Kingdom
Tel: +44 207 710 1000
www.lw.com

United States

Witold Balaban, Rafal Gawlowski, Catherine Lee, Reza Mojtabaee-Zamani and Yvette D Valdez

Latham & Watkins LLP

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Summary

OVERVIEW

Typical types of transactions

1 Other than transactions between dealers, what are the most typical types of over-the-counter (OTC) equity derivatives transactions and what are the common uses of these transactions?

Typical issuer equity derivatives products include the following:

- accelerated share repurchase (ASR) products allow an issuer to accelerate the purchase of its shares by entering into a forward on its own stock with a dealer in connection with which the dealer borrows shares in the stock lending market, shorts them back to the issuer and covers its short position over a calculation period by buying shares in the open market;
- bifurcated call spread and unitary capped call products allow an issuer of convertible debt to raise the effective strike price of the convertible debt's embedded call option;
- bond hedge products allow an issuer of convertible debt to issue synthetic debt through the combination of the bond hedge and convertible debt;
- a variety of share repurchase products entered into at the time of pricing a convertible debt issuance, including all the above-listed products, allow the underwriter to facilitate hedging by convertible debt investors and the issuer to repurchase its stock;
- issuer borrow facilities, structured as issuer share loans or zero strike call options between an issuer and the underwriter of the issuer's convertible debt allow the underwriter to facilitate hedging by convertible debt investors;
- registered forwards between an issuer and the underwriter of its common equity allow the issuer to lock in equity financing for future acquisitions or other purposes, while retaining flexibility to cash settle the forward with the underwriter rather than issuing stock;
- convertible notes, convertible preferred stock and tangible equity units allow an issuer to raise capital in the most effective way from the tax, accounting, cash flow, corporate or regulatory perspective; and
- sales of shares combined with a purchase of a capped call from the underwriter allow an issuer to raise equity financing at a smaller discount to the market price and limit dilution.

Typical equity derivatives products that allow a shareholder to acquire a substantial position in a publicly traded equity or to monetise or hedge an existing equity position include the following:

- structured margin loans allow a borrower to finance an acquisition of shares or to monetise an existing shareholding;
- calls, puts, covered calls, collars, collar loans and variable prepaid forwards allow a holder to both finance and hedge an acquisition of synthetic long exposure to a stock or to hedge and monetise an existing shareholding;
- put and call pairs, cash-settled or physically settled forwards and swaps allow a holder to acquire synthetic long exposure to the underlying stock, which may be transformed into physical ownership of the stock at settlement;
- 'reverse ASRs' allow shareholders to accelerate dispositions of shares in a manner that minimises its impact on the market price;

- sales of shares combined with a purchase of a capped call from the underwriter allow a shareholder to dispose of its shareholding at a smaller discount to the market price and retain some upside in the stock; and
- mandatory exchangeables, such as trust-issued mandatories, holder's own balance sheet mandatories or borrowed balance sheet mandatories, allow a shareholder to monetise and hedge a large equity position while minimising a negative impact on the share market price.

Borrowing and selling shares

2 May market participants borrow shares and sell them short in the local market? If so, what rules govern short selling?

Many equity derivative transactions depend on a liquid stock borrow market to allow participants to hedge their exposure under the transaction. For example, arbitrage funds investing in convertible notes and dealers hedging the upper warrant in a call spread may both need at certain points during the transaction to establish a hedge position by short selling shares borrowed from stock lenders. The convertible notes indenture and warrant agreement almost always have certain protections for those arbitrage funds and dealers to handle situations in which the stock borrow market becomes illiquid or shares may be borrowed only at a high cost. Such situations may occur where M&A activity has been announced and has increased demand for borrowed shares, or where issuers have conducted significant repurchase activity and reduced the available free float.

To sell short in the US, the seller's broker must locate a security to borrow to cover the sale, as 'naked' short selling is prohibited. Short sales of securities in the US are subject to the general anti-manipulation rules under the Securities Exchange Act of 1934 (the Exchange Act) and Regulation SHO. As the Securities and Exchange Commission (SEC) has noted, the vast majority of short sales are legal, but abusive practices to create actual or apparent active trading in a security or to depress the price of a security for the purpose of inducing the purchase or sale of the security by others are prohibited. Regulation SHO requires generally that:

- short sale orders being placed with a broker-dealer be marked as such;
- subject to certain limited exceptions, if a stock on any trading day declines by 10 per cent or more from the stock's closing price for the prior day, short sale orders may be displayed or executed for the remainder of that day and the following day only if the order price is above the then-current national best bid;
- broker-dealers must have reasonable grounds to believe that a stock may be borrowed before executing a short sale order; and
- brokers and dealers that are participants in a registered clearing agency must close out any positions within a specified period after a seller fails to deliver securities to the buyer when due.

In addition, section 16(c) of the Exchange Act prohibits insiders from selling common stock that they do not own (section 16 of the Exchange Act does not apply to holders of equities in 'foreign private issuers', which are issuers listed in the US filing their annual reports on Form 20-F). This prohibition not only covers traditional short selling, but also applies to derivative transactions that are 'put equivalent positions' (for example, sale of a call or purchase of a put, or both).

Finally, the SEC is considering amendments to the applicable short selling rules in the wake of recent highly publicised short squeezes. While no amendments have been specified yet, it is possible that there will be further restrictions in the near future.

Applicable laws and regulations for dealers

3 Describe the primary laws and regulations surrounding OTC equity derivatives transactions between dealers. What regulatory authorities are primarily responsible for administering those rules?

The primary laws surrounding OTC equity derivative transactions between dealers (and between market participants generally) have traditionally been the Securities Act of 1933 (the Securities Act) and the Exchange Act, and in particular the registration requirements of section 5 of the Securities Act, the anti-fraud and anti-manipulation provisions of sections 9 and 10(b) of the Exchange Act and the short-swing profit rules applicable to insiders under section 16 of the Exchange Act. While the SEC administers the rules promulgated under those sections, private rights of action may attach, some of which are prosecuted by active plaintiffs' bars. Inter-dealer transactions must comply with these rules in the same manner as trades with non-dealer counterparties. For example, dealers must ensure that their long hedge positions do not cause them to become section 16 'insiders' by virtue of holding more than 10 per cent of an issuer's common stock. Section 16 is not applicable in the case of 'foreign private issuers'.

Since its passage in 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) has imposed additional requirements on market participants. Title VII of the Dodd-Frank Act established a regulatory regime for swaps and security-based swaps. Depending upon the type of equity derivative, such a trade may be a swap, a security-based swap, or both. Swaps are subject to the jurisdiction and regulatory oversight of the Commodity Futures Trading Commission (CFTC) and security-based swaps are subject to the jurisdiction and regulatory oversight of the SEC. Certain OTC equity derivatives, such as physically settled swaps and forwards and equity options, are excluded from the 'swap' and 'security-based swap' definitions and, as a result, are not subject to the Dodd-Frank Act requirements.

Most of the requirements governing swaps and security-based swaps apply to swap dealers or security-based swap dealers, which are entities that deal in such instruments above a de minimis threshold. These requirements include registering with the CFTC or SEC, as applicable, maintaining certain levels of capital, reporting the details of transactions to data repositories, maintaining certain records, collecting and posting margin, clearing and execution requirements applicable to certain trades and complying with certain business conduct standards.

In addition to Title VII of the Dodd-Frank Act, the Volcker Rule, which is set forth in Title VI of the Dodd-Frank Act, generally prohibits 'banking entities' (as defined therein) from, among other things, engaging in proprietary trading in financial instruments, such as securities and derivatives, unless pursuant to an exclusion or exemption under the Volcker Rule. Accordingly, the Volcker Rule's proprietary trading prohibition may, in the absence of an applicable exclusion or exemption under the Volcker Rule, restrict certain underwriting, market-making and risk-mitigating hedging activities when a 'banking entity' is acting as dealer. The Bank Holding Company Act of 1956, as amended, may also place additional restrictions on banks acting as dealers that should also be taken into consideration.

Foreign broker-dealers that wish to transact with US entities without having to register under the Exchange Act may also need to comply with the 'chaperoning' requirements under Rule 15a-6 under the Exchange Act.

Other applicable regulations include those imposed by securities exchanges; rules enforced by the Financial Industry Regulatory Authority, Inc (FINRA), a self-regulatory organisation for its broker-dealer members; rules enforced by the National Futures Association, a self-regulatory organisation for swap dealers and certain other CFTC registrants; rules implemented by the International Swaps and Derivatives Association, Inc (ISDA); and, as applicable, various regulatory margin and capital requirements imposed by the SEC, the CFTC or a prudential regulator, such as the Federal Reserve Board or the Office of the Comptroller of the Currency.

Notwithstanding that most swap and security-based swap regulatory obligations fall on dealers, regulations do require that all counterparties obtain and maintain a 'legal entity identifier' prior to entering into, and throughout the life of, any OTC equity derivatives transaction that is a swap or a security-based swap.

Entities

4 In addition to dealers, what types of entities may enter into OTC equity derivatives transactions?

The entities most commonly facing dealers in equity derivative trades are public company issuers and various types of counterparties holding or acquiring publicly traded shares (such counterparties generally have to own at least US$10 million of assets). Publicly traded issuers frequently utilise equity derivatives to hedge their equity-related obligations, such as call spreads and capped calls to hedge against potential dilution from conversions of convertible securities. Issuers may also be involved in setting up a stock borrowing facility to facilitate certain hedging activities by its convertible noteholders, or executing through a forward contract an accelerated share repurchase of its common stock to achieve certain financial and strategic goals. Counterparties with large equity stakes often enter into equity derivative transactions to monetise or hedge their holdings, or both. Examples of pure monetisation transactions include certain margin loan structures, while prepaid forward contracts and funded collars can be used to simultaneously monetise the position and hedge against future price fluctuations. Counterparties may also use equity derivatives to accumulate large equity stakes in public companies or to gain synthetic exposure to such equities.

Applicable laws and regulations for eligible counterparties

5 Describe the primary laws and regulations surrounding OTC equity derivatives transactions between a dealer and an eligible counterparty that is not the issuer of the underlying shares or an affiliate of the issuer? What regulatory authorities are primarily responsible for administering those rules?

In practice, because most non-dealer counterparties to equity derivative transactions are typically listed issuers, hedge funds, private equity funds, and other sophisticated and well-funded market participants, there are few additional requirements for them to transact with the investment banks and their broker-dealer affiliates that normally act as dealers in such transactions. These non-dealer counterparties will normally easily qualify as 'eligible contract participants', as defined in the Commodity Exchange Act and 'accredited investors', as defined under the Securities Act. In certain instances, particularly where the counterparty is a wealthy natural person rather than an investment fund or other legal entity, the dealer may need to conduct additional due diligence to ensure that the counterparty meets those requirements. Dealers may also have to determine that a recommended transaction is 'suitable' for its customer under FINRA rules. Finally, antitrust rules may also come into play where a third party is using the derivative to accumulate a large stake in the issuer.

Securities registration issues

6 Do securities registration issues arise if the issuer of the underlying shares or an affiliate of the issuer sells the issuer's shares via an OTC equity derivative?

Yes. If the dealer in the OTC equity derivative sells the issuer's shares into the public market in connection with an equity derivative to which either the issuer or any of its affiliates is a party, then that sale must either be registered or exempt from registration under the Securities Act. The procedures for registering a dealer's short sales or conducting such sales pursuant to an exemption from registration are set out in a series of SEC no-action letters dealing with certain hedging and monetisation transactions.

Determining a party's affiliate status is critical to structuring any OTC equity derivative. Under the Securities Act, an 'affiliate' of an issuer is a person that directly, or indirectly through one or more intermediaries or contractual arrangements, controls or is controlled by, or is under common control with, the issuer. Whether 'control' exists depends on the facts and circumstances, and typically involves an analysis of a person's aggregate shareholdings in the issuer, presence on the issuer's board of directors, veto rights over certain corporate actions, and other factors. 'Control' over an entity does not require a majority of the voting power over such entity; rather, market participants typically consider there to be a rebuttable presumption of 'control' at 10 per cent of the issuer's voting power, and a nearly irrefutable presumption of 'control' at 20 per cent of the issuer's voting power (although the presumption can be overcome based on certain facts and circumstances – for example, if the relationship between the issuer and the 20 per cent holder is openly hostile). The same general thresholds and presumptions apply to voting power on the board of directors. However, a combination of significant voting power as a shareholder and control of board seats may suggest 'control', even though both are below 10 per cent.

Repurchasing shares

7 May issuers repurchase their shares directly or via a derivative?

Yes, and both types of repurchase transactions are common. There are relatively few requirements for issuers to repurchase their own equity (although under state law, contracts by an issuer to repurchase its shares while insolvent are generally voidable or void), and US issuers tend to repurchase more of their own shares than do issuers in Europe and Asia. In addition to typical 'agency' transactions where a broker-dealer will repurchase shares in specified amounts at specified prices in the open market for a commission, ASR transactions are popular with US issuers. These transactions allow issuers to repurchase their shares at a discount to the average market price over a specified calculation period by 'selling' the volatility in their stock to the dealer. The issuer benefits by buying its shares back at a discount, and the dealer profits to the extent it is able to purchase the shares during the calculation period at less than the discounted price (which depends on the stock remaining volatile during the course of the trade). The issuer also benefits because the dealer typically delivers around 80 to 85 per cent of the shares underlying the transaction shortly following execution, which has an immediate impact on the issuer's earnings per share. Other structures, such as capped and collared forwards, capped calls and issuer put options are also common.

These transactions (including hedging activities of the dealer in connection with an ASR) are structured to avoid the anti-manipulation provisions of section 9 of the Exchange Act and the anti-fraud provisions of Rule 10b-5 under section 10(b) of the Exchange Act. Rule 10b-18 under the Exchange Act offers a safe harbour from certain types of manipulation claims for an issuer if the issuer repurchases its shares in accordance with certain manner, timing, price and volume conditions. ASRs are typically structured such that the dealer's hedging activity would comply with Rule 10b-18 if the safe harbour were available to it. Trades involving certain of the issuer's 'affiliated purchasers' (as defined in Rule 10b-18) may also be structured to meet the requirements of Rule 10b-18.

In addition, section 10(b) of the Exchange Act and Rule 10b-5 thereunder are anti-fraud provisions concerning purchases and sales of securities. Regulation M under the Exchange Act (Regulation M) addresses certain activities that could be viewed as artificially impacting the price of an offered security. It prohibits an issuer or selling security holder engaging in a 'distribution' of its securities, and participants in such distribution and affiliated purchasers, from bidding for or purchasing the securities being distributed or related securities during a 'restricted period' applicable to the distribution.

Issuers that have received financial assistance under the Coronavirus Aid, Relief and Economic Security Act (the CARES Act), passed on 27 March 2020, may be restricted from repurchasing their shares. Subtitle A of Title IV of the CARES Act prohibits certain companies (and their affiliates, in certain cases) that have received direct loans or loan guarantees under such programmes from repurchasing their own shares or shares of their parent entity that are listed on any national securities exchange. The prohibition exempts preexisting contractual obligations, and is effective for as long as the loan remains outstanding and for a one-year period after the loan is repaid or loan guarantee expires. Prior to seeking any funding under the CARES Act, Issuers who are party to or considering entering into share repurchase transactions, including ASRs and capped calls, should consider the implications of such funding on their share repurchase programmes.

On 14 December 2022, the SEC adopted amendments to Rule 10b5-1 insider trading plans and related disclosures under the Securities Act, and the amendment became effective on 27 February 2023. The amendments have imposed new conditions on the availability of the Rule 10b5-1 affirmative defense to insider trading and require enhanced disclosures regarding the adoption, modification and termination of Rule 10b5-1 plans and other trading arrangements, issuers' insider trading policies and procedures, and certain equity awards granted close in time to the release of material non-public information, which would affect the manner US issuers conduct share repurchase programmes, including ASRs. Further details of the amendments are discussed in section 1.10.

In addition, the SEC has also proposed amendments that would require, if adopted, issuers including foreign private issuers and certain registered closed-end funds, to disclose detailed share repurchase activities. Under the proposed rules, in order to qualify for the affirmative defence under Rule 10b5-1 and the non-exclusive safe harbour under Rule 10b-18, an issuer or any affiliate purchaser of such issuer is required to file a new Form SR in connection with any repurchases of the issuer's equity securities that are registered under section 12 of the Exchange Act within one business day of such repurchases.

Risk

8 What types of risks do dealers face in the event of a bankruptcy or insolvency of the counterparty? Do any special bankruptcy or insolvency rules apply if the counterparty is the issuer or an affiliate of the issuer?

The main risks that dealers face are the imposition of the 'automatic stay' under the US Bankruptcy Code that would prevent them from collecting against their counterparty; the inability to rely upon the bankruptcy default provisions (called ipso facto provisions) in the ISDA Master Agreement as the basis for terminating and closing out the transaction; and the counterparty's potential status as a 'bankruptcy affiliate' of the issuer. Under section 362 of the US Bankruptcy Code, if a bankruptcy petition is filed in respect of the counterparty, an automatic stay goes into effect that prevents other parties from collecting on pre-bankruptcy claims and taking other actions against the counterparty, including foreclosing on any collateral. The automatic stay is generally intended to help the debtor counterparty preserve its assets, to maximise the assets' value and to ensure that creditors are repaid in an orderly and equitable manner. In addition, under section 365 of the Bankruptcy Code, if a bankruptcy petition is filed in respect of the counterparty, parties to contracts with the counterparty are prevented from exercising contractual rights to terminate or modify such contracts based on the counterparty's bankruptcy or financial condition. If these provisions were applied to equity derivative contracts, the automatic stay and the inability to terminate the contract would expose the non-debtor dealer to the risk of price movements in the underlying stock, which could force non-debtor dealers into financial distress, causing them to default on their contracts with other parties. To mitigate the risk of a domino effect, certain classes of protected contracts are exempted from these provisions (both the automatic stay and the prohibition on the enforcement of ipso facto defaults), including `securities contracts' (which term includes margin loans) and `swap agreements'. In addition to concerns about the automatic stay and bankruptcy termination rights, dealers entering into transactions with certain large shareholders may face the risk that their counterparty could be a 'bankruptcy affiliate,' meaning an 'affiliate' (as defined in the Bankruptcy Code) of the issuer of the equity that is the subject of the equity derivative contract. Under section 510 of the Bankruptcy Code, claims arising under a contract with the issuer of the subject equity or its affiliate (in this case a 20 per cent or more equity holder) for the purchase or sale of equities of the issuer could be subordinated to the level of equity in the issuer's or the affiliate's bankruptcy.

Reporting obligations

9 What types of reporting obligations does an issuer or a shareholder face when entering into an OTC equity derivatives transaction on the issuer's shares?

Sections 13 and 16 of the Exchange Act are the typical sources of reporting obligations for OTC equity derivatives trades. Section 13(d) and (g) of the Exchange Act impose reporting requirements on beneficial owners of 5 per cent or more of any registered class of equity securities of a US-listed issuer, and section 16 of the Exchange Act imposes reporting requirements on insiders (beneficial owners of 10 per cent or more of any such class of equity securities or a director or executive officer of a US-listed issuer other than a foreign private issuer). Under Rule 13d-5 of the Exchange Act, if two or more persons agree to act together for the purpose of acquiring, holding, voting or disposing of equity securities, such persons will be considered a group and their holdings will be aggregated for the purpose of determining beneficial ownership. Moreover, under Rule 13d-3, a person is deemed to beneficially own all shares that the person has the right to acquire within 60 days, including through the exercise or conversion of a derivative security. These sections are generally intended to provide the investing public notice when certain investors have accumulated large blocks of securities of an issuer but they also determine whether a person is an insider for the purposes of section 16 of the Exchange Act (eg, beneficially owns 10 per cent or more of any class of equity securities of a US-listed issuer other than a foreign private issuer).

A shareholder must disclose its ownership within 10 days of becoming a 5 per cent beneficial owner on schedule 13D, which requires the shareholder to disclose, among others, the source of the funds used to make the purchase and the purpose of the acquisition, and must report material changes to its ownership 'promptly' thereafter. In lieu of a schedule 13D, certain 'passive investors' (along with other types of investors) may file a short form schedule 13G with a certification that, among others, the securities were acquired in the ordinary course of business and were not acquired for the purpose of changing or influencing the control of the issuer. A shareholder must report its ownership on becoming a section 16 insider on a form 3 and must report any subsequent changes to its ownership on a form 4. Under Rule 16a-4 of the Exchange Act, the acquisition or disposition of any derivative security relating to equity securities of the issuer must be separately reported on a form 4. Reporting is required even if the derivative security can be settled only in cash. Starting from 27 February 2023, bona fide gifts of equity securities are no longer reported on Form 5, but instead would have to be reported on Form 4 and filed before the end of the second business day following the date of the gift. Starting from 1 April 2023, Form 4 and Form 5 filers are required to indicate by checkbox that a reported transaction was intended to satisfy the affirmative defense conditions of Rule 10b5-1(c).

An issuer selling options or warrants to acquire its shares or securities convertible into its shares in a transaction that is not registered under the Securities Act must report such sales in its quarterly and annual reports and on a current report on form 8-K. The issuer's quarterly and annual reports must also disclose its purchases of shares in connection with a derivatives transaction (for example, an ASR). In addition, if the issuer enters into a material contract in connection with an OTC derivatives transaction, the issuer must disclose certain information about the material contract on a form 8-K.

Additionally, a US-listed issuer must disclose the use of Rule 10b5-1 and other trading arrangements by an issuer, and its directors and officers for the trading of the issuer's security quarterly on a form 10-Q. A US-listed issuer as well as a foreign private issuer also must disclose its insider trading policies and procedures annually on a form 10-K or Form 20-F, as applicable, and also in proxy and information statements on Schedules 14A and 14C.

CFTC swap data reporting regulations may also apply to an issuer or a shareholder that is entering into an OTC equity derivatives transaction that is a swap with a non-US counterparty that is not itself registered with the CFTC as a swap dealer. Security-based swaps are subject to analogous requirements under the SEC's recently implemented security-based swap data reporting regulations.

On 10 February 2022, the SEC proposed rule amendments governing beneficial ownership reporting under Exchange Act sections 13(d) and 13(g) that, if adopted, would significantly shorten the period for making initial filings and amendments, 'deem' holders of certain cash-settled derivatives (other than cash-settled security-based swaps) to 'beneficially own' the underlying securities if such derivatives were held in the context of changing or influencing control of the issuer of the underlying securities and expressly require any Schedule 13D filer to disclose interests in all derivatives in connection with the issuer's equity securities (including any cash-settled options or security-based swaps). In addition, the SEC is proposing to change the rules in connection with 'group formation' applicable to two or more persons and provide related exemptions. While the proposed rule amendments have not been adopted as of this writing, it is expected that the SEC will take the final action soon.

Restricted periods

10 Are counterparties restricted from entering into OTC equity derivatives transactions during certain periods? What other rules apply to OTC equity derivatives transactions that address insider trading?

Issuers and controlling shareholders avoid entering into transactions during certain 'blackout periods' when they may be in possession (or be thought to be in possession) of material non-public information regarding the issuer or its securities. The principal insider trading laws derive from section 10(b) of the Exchange Act and Rule 10b-5 thereunder. Issuers typically restrict insiders from trading during certain windows when the issuer is likely to be in possession of material non-public information, such as prior to release of earnings. Certain affiliates that may have access to inside information by virtue of holding board seats or through other means may also subject their personnel to the issuer's window period policies to avoid the potential appearance that they may be trading on material non-public information during 'blackout'. However, insiders often enter into Rule 10b5-1 'plans' while not in possession of material non-public information, which generally are structured to allow dealers to trade securities on the insider's behalf while the insider may be in possession of material non-public information, as long as the insider is not able to influence how those trades are effected at that time. Many OTC equity derivatives are themselves structured as 10b5-1 'plans'. Trading effected in compliance with a 10b5-1 plan provides an affirmative defence to a claim of insider trading, but is not a safe harbour.

Under the amended Rule 10b5-1, effective on 27 February 2023, insiders and issuers are subject to various limitations with respect to a 10b5-1 plan:

- directors and officers are subject to a cooling-off period of the later of (i) 90 days after the adoption or modification of the 10b5-1 plan and (ii) the earlier of (x) two business days following a Form 10-Q or Form 10-K filing (or in a Form 20-F or Form 6-K filing for foreign private issuers) and (y) 120 days after the adoption or modification of the 10b5-1 plan, and persons other than directors, officers or issuers are subject to a 30-day cooling-off period;
- multiple overlapping 10b5-1 plans are prohibited; and
- only one single-trade 10b-5 plan is allowed per 12-month period.

The amended Rule 10b5-1 does not require a cooling-off period for an issuer when it enters into or modifies a 10b5-1 plan to trade in its own securities. However, the SEC indicated that further consideration is warranted whether a cooling-off period should be required for issuers in the share repurchase context.

Additionally, the amended Rule 10b-5 requires directors and officers to include a representation in their Rule 10b5-1 plan certifying that they are not aware of any material non-public information and that they are adopting the plan in good faith. The amended Rule 10b-5 also requires the person who enters into the Rule 10b5-1 plan to act in good faith throughout the operation of the plan (instead of just when adopting the plan).

Legal issues

11 | What additional legal issues arise if a counterparty to an OTC equity derivatives transaction is the issuer of the underlying shares or an affiliate of the issuer?

Securities acquired directly or indirectly from an issuer or an affiliate of the issuer in a transaction not involving any public offering will be 'restricted securities' in the hands of the acquirer under Rule 144 under the Securities Act, and must be resold after specified holding periods to meet the safe harbour under Rule 144. In addition, any securities sold by an affiliate of an issuer or sold for the account of an affiliate of the issuer (even if the affiliate purchased them in the open market) become what are commonly known as 'control securities' for the purposes of Rule 144 (although the term is not defined in the rule). Additional volume, manner of sale and filing requirements apply to sales of control securities to meet the Rule 144 safe harbour requirements. Securities may be both restricted securities and control securities.

If a counterparty to an OTC equity derivatives transaction is an insider under section 16, then the insider must disgorge to the issuer any profits derived from any purchase and sale of any equity security of the issuer, any derivative security, or any security-based swap agreement involving any such security if the transactions occurred within a period of less than six months, subject to certain exemptions. Amendments, resets or extensions of derivative securities in many cases may be deemed purchases or sales that are subject to reporting obligations and profit disgorgement under section 16.

Tax issues

12 | What types of taxation issues arise in issuer OTC equity derivatives transactions and third-party OTC equity derivatives transactions?

OTC equity derivatives raise a number of tax issues. First, the Internal Revenue Service (IRS) may re-characterise the transaction in a manner that is different from its stated form, including by treating the transaction as a transfer of beneficial ownership of the underlying equity for US tax purposes. In addition, complex rules govern the timing and character of payments for tax purposes. Payments to a non-US party may also be subject to withholding. Additional issues, such as integration of instruments, may arise depending on the nature of the transaction.

Liability regime

13 Describe the liability regime related to OTC equity derivatives transactions. What transaction participants are subject to liability?

Market participants are typically most concerned with section 10(b) of the Exchange Act and Rule 10b-5 thereunder. Derivative trades between dealers and issuers or controlling shareholders are often structured such that the dealer is acting as 'principal' for its own account, rather than as the agent of the counterparty. Nevertheless, market participants often deem the dealer's hedging activity to be attributable in some form to the counterparty, as the dealer is engaged in the market activity to facilitate a transaction with the counterparty. Therefore, if the counterparty is in possession of material non-public information at the time of the trade, both counterparty and dealer may have liability for any resulting purchases and sales by the dealer in connection with its hedging activity. Similarly, trades will often be structured such that the dealer's purchases would be made in compliance with Rule 10b-18 if the Rule 10b-18 safe harbour were available to it.

Dealers and counterparties must also ensure that the dealer's hedging activities in connection with trades with issuers and their affiliates do not result in an unregistered offering of securities in violation of section 5 of the Securities Act. Questions may also arise as to whether the freely tradeable shares that a dealer purchases in the open market to hedge a transaction with an affiliate of the issuer may thereby become tainted as 'control securities' under Rule 144, as they were purchased to some degree for the benefit of an affiliate. This analysis flows from the paradigm under the US securities laws that transactions, rather than securities, are registered, and once freely tradeable securities may become tainted if repurchased by an affiliate. These issues require careful trade-by-trade analysis.

Corporate insiders entering into equity derivative transactions may also be forced to disgorge short-swing profits from trades within six months of one another, and dealers must be careful not to become section 16 insiders themselves in connection with their hedging activity.

Stock exchange filings

14 What stock exchange filings must be made in connection with OTC equity derivatives transactions?

An issuer typically must file a listing application with the relevant stock exchange if it may issue new shares in connection with its entry into a derivative contract. This filing requirement arises most commonly in convertible note offerings, in which the shares deliverable to investors upon conversion of the convertible notes, as well as the shares deliverable to call spread dealers upon exercise of the upper warrants, must be approved for listing.

Typical document types

15 What types of documents are typical in an OTC equity derivatives transaction?

OTC equity derivatives transactions are typically documented on a 'confirmation' that incorporates the terms of the ISDA Master Agreement and the ISDA 2002 Equity Definitions. While the Master Agreement is normally subject to minimal negotiation and is adopted as a 'form' without any schedule, the confirmations in complex OTC equity derivative trades are typically 'long-form' confirmations that make extensive modifications to the standard terms of the Equity Definitions. For example, the standard terms of the Equity Definitions will be inadequate for trades that are based on volume-weighted average prices rather than closing prices. For funded collars, variable prepaid forwards and other transactions in which the counterparty pledges securities, the confirmations may also contain the collateral terms.

Parties to OTC equity derivatives transactions that are swaps may also be required by their dealer counterparties to adhere to ISDA protocols or execute similar bilateral documentation for the purpose of complying with various CFTC swap regulatory requirements. Security-based swap dealers may also require that their security-based swap counterparties adhere to analogous ISDA protocols or enter into similar bilateral documentation to comply with the newly implemented SEC security-based swap regulatory regime.

Legal opinions

16 For what types of OTC equity derivatives transactions are legal opinions typically given?

Legal counsel will typically render opinions for margin loans, call spreads and capped calls, prepaid forwards, registered forwards and zero-strike call options. Legal opinions are not typically given for ASR transactions, but may be given by local counsel where the counterparty is a foreign entity. For trades involving lending or pledging of restricted securities or securities held by affiliates of the issuer, counsel will typically be required to give 'de-legending' opinions to allow the securities to be transferred under contractually agreed conditions.

Hedging activities

17 May an issuer lend its shares or enter into a repurchase transaction with respect to its shares to support hedging activities by third parties in the issuer's shares?

Yes. Registered borrow facilities in connection with convertible notes offerings are one example. Certain convertible note investors that are arbitrage funds will hedge by shorting the shares simultaneously with the purchase of the convertible bond and by purchasing credit protection on the bond through a credit default swap. If there is insufficient stock borrow available for short selling, issuers would have difficulty marketing the convertible notes to such investors. Therefore, in a registered borrow facility, the issuer issues a number of shares corresponding to the number of shares underlying the convertible bond and lends them to a dealer, which offers those shares in an SEC-registered offering, thereby creating a short position for the dealer. The dealer then transfers this short position to arbitrage funds via cash-settled total return swaps, which in turn allows the arbitrage funds to establish their short position for the convertible notes. For Delaware issuers, the loan fee paid to the issuer by the dealer will be equal to the par value of the shares to comply with state law requirements that the share lending fee for newly issued shares must cover the aggregate par value of the shares.

These transactions must be carefully structured to comply with Regulation M, Rule 10b-5, section 5 of the Securities Act and other applicable restrictions. Moreover, the impact of the market activity by the dealer and the convertible note investors needs to be adequately disclosed.

Securities registration

18 What securities registration or other issues arise if a borrower pledges restricted or controlling shareholdings to secure a margin loan or a collar loan?

Most large, complex margin loans and collar loans must be structured around a number of issues relating to the character of the pledged securities and the pledgor. Controlling share-holders often acquire their holdings through private investment agreements rather than a public offering (making such securities 'restricted securities') and also may be affiliates of the issuer by virtue of their large shareholdings or right to board representation (making such securities 'control securities'). Like any other person, a foreclosing lender that wishes to sell securities must either register the sales or comply with an exemption from registration. Although, as described below, lenders may be able to sell the pledged securities pursuant to a registration statement or through other exit options, Rule 144 under the Securities Act is the key safe harbour that lenders seek to rely on to sell the pledged shares publicly without registration.

If the securities are restricted, the seller must satisfy the relevant holding period under Rule 144 prior to the sale – six months since the securities were acquired from the issuer or an affiliate (or in some cases 12 months if the issuer has not satisfied certain filing requirements). If an affiliate pledges restricted securities 'with recourse', the lender or pledgee may include the time that the affiliate or pledger held the securities prior to the pledge in calculating the holding period. The meaning of the phrase 'without recourse' is subject to much debate and interpretation. Particularly where the pledgor is a special purpose entity, market participants generally consider that a guarantee by a parent entity would be required for the pledge to be considered 'with recourse'.

Because the pledged securities often were not issued in a public offering and are not initially freely tradeable, they are typically held either in physical, certificated form, or in demateri-alised form as restricted book entries on the books of the transfer agent, in each case with legends describing the transfer restrictions. In addition to the securities laws restrictions, these securities are often subject to various 'lock-up' provisions in the related investment agreements that must be drafted to carve out the pledge and foreclosure sale by the lender. Lenders will seek to pre-establish procedures with the issuer and its transfer agent to ensure that, in the event of a foreclosure, the shares can be quickly de-legended (if permissible at the time of foreclosure) and transferred to a potential purchaser or purchasers, preferably through the facilities of The Depository Trust Company.

Lenders may also sell under an effective registration statement and may require borrowers to pledge their rights under any registration rights agreement with the issuer, although this is not typically a favoured method. The availability of the registration statement can never be assured; there is a risk of underwriting liability and potential unavailability of due diligence defences, and lenders may learn about material non-public information not disclosed in a prospectus from affiliate borrowers. Registration rights agreements may also impose lock-up restrictions on parties to the agreement in certain circumstances.

If no 'public exit' is available, lenders may have to dispose of the collateral via private placement, although it will be subject to a liquidity discount and the purchaser will acquire restricted stock.

Lenders often contractually limit the number of shares they can hold on foreclosure (blocker provisions) and the manner in which they can sell those shares (bust-up provisions) to ensure that they do not themselves become an affiliate of the issuer.

Borrower bankruptcy

19 If a borrower in a margin loan files for bankruptcy protection, can the lender seize and sell the pledged shares without interference from the bankruptcy court or any other creditors of the borrower? If not, what techniques are used to reduce the lender's risk that the borrower will file for bankruptcy or to prevent the bankruptcy court from staying enforcement of the lender's remedies?

Under section 362 of the US Bankruptcy Code, an automatic stay takes effect immediately on a debtor's bankruptcy filing and prevents creditors from foreclosing on collateral for pre-bankruptcy claims. However, section 362 enumerates certain classes of protected contracts in respect of which the automatic stay does not apply. 'Securities contracts', which are defined to include 'any margin loan', are one such class. The term 'margin loan' is not defined in the US Bankruptcy Code, however. Market participants often worry that only those transactions that have been historically characterised as margin loans (ie, buying stock on margin through a broker) qualify as margin loans for the purposes of the definition of securities contracts, and that the more structured and complicated transactions known to equity derivatives participants as margin loans may not be eligible for protection. Careful structuring of a margin loan to make it more like a 'classic' margin loan (eg, ensuring compliance with margin regulations applicable to banks or brokers, ensuring that each lender in a multi-lender facility has individual rights with regard to its portion of the collateral) may afford market participants some comfort that their remedies against a borrower would not be subject to the automatic stay. Judicial interpretation of the phrase 'margin loan' in the context of the US Bankruptcy Code is lacking, so there is uncertainty as to the outcome of any litigation of this issue.

In the light of this uncertainty, market participants are careful to structure margin loans to minimise the risk of a borrower bankruptcy in the first instance. Lenders typically require a would-be borrower to create a new 'bankruptcy-remote' special purpose vehicle (SPV) to serve as the pledgor and borrower. This technique has the benefit of assuring the lender that the borrower has no legacy indebtedness or obligations that could be the impetus for a bankruptcy filing. Lenders also often demand certain separateness and limited purpose provisions in the loan documents and SPV's organisational documents. These provisions generally require the SPV to maintain a separate and distinct existence from any other entity (decreasing the likelihood that the SPV's bankruptcy will be consolidated with that of its parent or affiliates) and prevent the SPV from incurring other indebtedness or obligations and from engaging in any other activities (other than the borrowing and related pledge) that could result in the SPV having any other creditors that could file the SPV for bankruptcy. It has also become standard for a lender to require that the SPV appoint an independent director to be an objective evaluator of fiduciary duties without any biases in favour of the parent, whose affirmative vote is required to, among other things, permit the SPV to file for bankruptcy.

Market structure

20 | What is the structure of the market for listed equity options?

The largest US exchange by volume is the Chicago Board Options Exchange (CBOE), which normally accounts for around one-quarter of the total market share. In recent years, approximately 88 per cent of the total options contracts traded have been equity options, and approximately 12 per cent have been index options. Most of the main options exchanges trade all (or nearly all) equity options, with only the CBOE trading a significant number of index options (approximately 43 per cent in 2017). Securities underlying listed options must be 'optionable' under the rules of the applicable options exchange, meaning that they must meet certain criteria relating to share price, liquidity and other factors.

Although listed options have standardised features, such as the number of underlying shares, strike prices and maturities, certain listed options incorporate various characteristics of OTC equity options. 'FLEX options' allow investors to customise certain terms, such as the exercise prices, exercise styles and expiration dates, while maintaining the benefits of listing and clearing. 'LEAPS options' have longer maturities than typical shorter-dated options, with exercise dates of up to three years in the future.

All listed equity options are issued, guaranteed and cleared by a single clearing agency – the Options Clearing Corporation (OCC) – which is a registered clearing agency with the SEC. The OCC is the largest equity derivatives clearing organisation in the world.

Governing rules

21 | Describe the rules governing the trading of listed equity options.

The trading of listed equity options is largely governed by the laws applicable to broker-dealers under the Exchange Act and FINRA rules, as well as the rules and by-laws of the OCC and options exchanges.

Broker-dealers are subject to a number of rules when trading listed equity options for their own account or the account of others, including position and exercise limits for listed equity options imposed by FINRA and exchange rules with respect to proprietary and customer positions. FINRA rules also require FINRA members to enter into agreements with listed options customers containing certain minimum terms, send confirmations and obtain explicit authorisation from a customer before exercising discretionary power to trade in options contracts for the customer.

Exchange rules and systems regulate the manner of trading on the exchange, including the manner in which orders may be submitted to the exchange, market maker quoting, display of orders and the priority of order interaction. Exchanges also establish a range of requirements and prohibitions on members' proprietary and agency activities on the exchange. For example, exchange (and FINRA) rules prohibit trading ahead of customer orders.

Unlike OTC equity options, in which the parties may elect how to determine what adjustments should be made to account for certain corporate events involving the underlying security

– such as stock splits or combinations, mergers and acquisition activity or dividend payments – all adjustments for listed options are made by OCC.

TYPES OF TRANSACTION

Clearing transactions

22 What categories of equity derivatives transactions must be centrally cleared and what rules govern clearing?

All listed equity options must be centrally cleared, and the Options Clearing Corporation (OCC) is the only clearinghouse for listed equity options traded on all US exchanges.

Equity derivatives that are Commodity Futures Trading Commission (CFTC)-regulated swaps (such as swaps referencing broad-based securities indices or US government securities) must be centrally cleared if the CFTC has issued an order requiring clearing of that category of swap. Certain index credit default swaps (CDS) are currently required to be cleared.

Equity derivatives that are security-based swaps are subject to analogous rules under the Exchange Act. The SEC has recently implemented its security-based swap regulatory regime under the Dodd-Frank Act. As a result, while no equity derivatives that are security-based swaps are currently required to be cleared, the SEC could begin issuing mandatory clearing orders on a going-forward basis.

Exchange-trading

23 What categories of equity derivatives must be exchange-traded and what rules govern trading?

Listed equity options must be traded on an options exchange.

Any equity derivative that is a CFTC-regulated swap that is subject to mandatory clearing and has been determined to be 'made available to trade' must generally be executed on a designated contract market, which is a futures exchange registered with the CFTC, or a CFTC-regulated swap execution facility. Currently, equity derivatives subject to mandatory clearing and trade execution requirements include certain index CDS.

Equity derivatives that are security-based swaps are subject to analogous rules under the Exchange Act. However, notwithstanding that the SEC's security-based swap regulatory regime is now effective, the SEC has yet to finalise rules implementing these requirements. As a result, no equity derivatives that are security-based swaps must be executed on an execution facility or exchange.

If one or both of the parties to an equity derivatives transaction that is a swap or security-based swap is not an 'eligible contract participant' (as defined in the Commodity Exchange Act), then the transaction must be exchange-traded.

Collateral arrangements

24 Describe common collateral arrangements for listed, cleared and uncleared equity derivatives transactions.

Swaps and security-based swaps

Counterparties to uncleared equity derivatives that are swaps or security-based swaps typically document their collateral arrangements using a Credit Support Annex published by ISDA that supplements the ISDA Master Agreement. Under rules issued by US banking regulators and the CFTC, swap dealers (and security-based swap dealers, in the case of the US banking regulators' rules) are (in some cases) and will be (in others) required to collect and post initial and variation margin with certain counterparties in specified amounts, and subject to requirements concerning collateral types, segregation and documentation. The SEC recently implemented similar rules for security-based swap dealers that are not subject to the US banking regulators' rules, compliance with which rules became required beginning in October 2021.

Equity options

For listed equity options, an investor must deposit cash or securities or both as collateral in its brokerage account when writing an option. Options buyers generally do not post margin, but they are required to pay a premium. Initial and maintenance margin requirements for options writers are established by the options exchanges and Financial Industry Regulatory Authority, Inc (FINRA) rules and vary by option and position type. Broker-dealers carrying customer options accounts may impose higher margin standards than those required by FINRA and the exchanges. The OCC imposes margin requirements on its clearing members with respect to each account maintained at the OCC.

There are no margin requirements imposed by US regulators, exchanges or clearinghouses for OTC equity options, and therefore any collateral arrangements are established bilaterally between the counterparties.

Exchanging collateral

25 Must counterparties exchange collateral for some categories of equity derivatives transactions?

Swaps and security-based swaps

Uncleared swaps and security-based swaps

Swap dealers and security-based swap dealers are, in certain cases, required to collect and post margin pursuant to rules that have been issued by the US banking regulators (which apply to swaps and security-based swaps entered into by bank dealers and certain other 'prudentially regulated' dealers) and the CFTC (which apply to swaps entered into by non-bank swap dealers). The SEC has recently finalised its uncleared security-based swap margin rules that will apply to security-based swap dealers that are not prudentially regulated by a US banking regulator.

The uncleared swap and uncleared security-based swap margin rules of the CFTC and US banking regulators are in effect for variation margin, and are subject to a phased-in compliance schedule for initial margin, lasting until 1 September 2022, with the precise date for a given counterparty pair depending on the size of their respective derivative portfolios.

Under the CFTC's and US banking regulators' rules, certain counterparties of swap dealers and security-based swap dealers to uncleared swap and uncleared security-based swap transactions may be required to collect or post initial and variation margin. Specifically, all transactions where one counterparty is a swap dealer (or a security-based swap dealer, in the case of the US banking regulators' rules) and the other counterparty is either a swap dealer (or security-based swap dealer, as applicable) or financial end user require variation margin to be exchanged bilaterally. Additionally, if the counterparty facing a swap dealer (or a security-based swap dealer, in the case of the US banking regulators' rules) is a swap dealer (or security-based swap dealer, as applicable) or a financial end user with 'material swaps exposure', the parties will be required to exchange initial margin bilaterally (subject to regulatory minimums). If the counterparty facing a swap dealer (or a security-based swap dealer, as applicable) is not a financial end user, the US banking regulators' rules require that the swap dealer or security-based swap dealer collect initial and variation margin, as appropriate; the CFTC's rules, on the other hand, do not affirmatively require the collection of initial and variation margin from non-financial end users. Certain swap transactions that are subject to an exemption from the CFTC's mandatory clearing requirement are exempt from the initial and variation margin requirements. Finally, if neither counterparty is a swap dealer (or security-based swap dealer, in the case of the US banking regulators' rules), the margin rules do not apply.

Special rules also apply to certain cross-border transactions, in which certain exemptions are provided for foreign banks (but not their US branches), though these exemptions are subject to many conditions and limitations.

For uncleared security-based swaps with a security-based swap dealer that is regulated by the SEC and not by a US banking regulator, compliance with the SEC's uncleared security-based swap margin rules began in October 2021.

Cleared swaps and security-based swaps

For cleared swaps and security-based swaps, the counterparty must comply with the collateral exchange requirements of the particular clearing organisation and the clearing member through which the counterparty obtains access to that clearing organisation, which has requirements that are themselves subject to CFTC and SEC requirements.

Equity options

For listed equity options, there is no requirement for the counterparties to exchange collateral, although a listed equity options writer is required to post collateral to its broker-dealer.

Any collateral arrangements for OTC equity options are established bilaterally between the counterparties.

LIABILITY AND ENFORCEMENT

Territorial scope of regulations

26 What is the territorial scope of the laws and regulations governing listed, cleared and uncleared equity derivatives transactions?

In general, US securities laws have a broad extraterritorial reach, and any trades with US-listed underlying equities will have to consider the implications of US securities laws even where the counterparties and governing law of the derivative contract are otherwise non-US. US-listed underlying equity in a derivative contract may also create a sufficient nexus to give rise to US bankruptcy considerations. Absent other activities in the US, however, listing equity on a US exchange generally would not subject the issuer to US net income taxation. In addition, certain specific rules may apply to swaps and security-based swaps under the Commodity Exchange Act and Exchange Act, and investors in listed equity options generally must comply with requirements imposed by broker-dealers to comply with Securities and Exchange Commission (SEC) and Financial Industry Regulatory Authority, Inc (FINRA) requirements, regardless of their location.

Registration and authorisation requirements

27 What registration or authorisation requirements apply to market participants that deal or invest in equity derivatives, and what are the implications of registration?

A dealer entering into equity derivatives that are Commodity Futures Trading Commission (CFTC)-regulated swaps (such as swaps referencing broad-based securities indices or US government securities) must register as a swap dealer if certain of their activities in a dealing capacity exceed stated thresholds (namely, US$8 billion over a rolling 12-month period, or US$100 million with 'special entity' counterparties, as defined in the rules). A counterparty that is not required to register as a swap dealer may nonetheless be required to register as a major swap participant and to become subject to rules similar to those applicable to swap dealers if its swap activity exceeds thresholds of current exposure and potential future exposure that are set out in rules; there are currently no registered major swap participants.

Similar registration requirements apply to counterparties to equity derivatives that are SEC-regulated security-based swaps, which registration requirements became effective on 6 October 2021.

A person who acts as a broker or dealer (as defined in the Exchange Act) with respect to options that are securities must register with the SEC as a broker-dealer and must generally become a member of FINRA. Broker-dealers that facilitate transactions in listed equity options may also be required to become members of the Options Clearing Corporation (OCC) and an options exchange.

Reporting requirements

28 What reporting requirements apply to market participants that deal or invest in equity derivatives?

Equity derivatives that are CFTC-regulated swaps are required to be reported to a swap data repository (SDR). In most cases, the SDR is required to publicly disseminate certain anonymous information about the swap. Swap dealers are also subject to various financial and other reporting requirements.

Similar reporting requirements apply to equity derivatives that are SEC-regulated security-based swaps as of October 2021.

FINRA member broker-dealers are required to report large options positions held by the broker-dealer or any of its customers to the Large Options Positions Reporting System, which is hosted by the OCC. Broker-dealers are also subject to various financial and other reporting requirements.

Legal issues

29 What legal issues arise in the design and issuance of structured products linked to an unaffiliated third party's shares or to a basket or index of third-party shares? What additional disclosure and other legal issues arise if the structured product is linked to a proprietary index?

Structured products linked to an unaffiliated third party's shares or to a basket or index of third-party shares raise issues about the appropriate level of and responsibility for disclosure about the issuers of those shares, baskets or index components. With respect to individual shares or baskets of shares, the SEC staff issued a no-action letter that permits third-party unaffiliated issuers to link to other issuers' shares with minimal incremental disclosure, provided that such issuer satisfies what is referred to as the 'reading room analysis'. If there is adequate publicly available information about the issuer of the linked shares and sufficient market interest in the shares, the prospectus for the structured product may provide a brief description of the nature of the issuer of the underlying stock, and its performance, and may refer investors to that issuer's filings with the SEC for additional information. This 'reading room' principle also extends to baskets. Typically, each basket component is analysed to determine whether it complies with the requirements of the no-action letter, but some issuers may determine that components that comprise only a small part of the basket need not strictly satisfy the requirements. For structured products linked to a broad-based index of third-party stocks, most issuers conclude that disclosure about each component would not be meaningful to investors and do not apply the reading room analysis.

Broad-based indices, whether third party or of a proprietary nature, raise additional disclosure issues in light of regulatory concerns surrounding the complexity and transparency of such indices and the accountability of their sponsors. Structured product issuers must ensure that the index disclosure adequately describes the index methodology, as well as any embedded costs and fees and any conflicts of interest. Proprietary indices with limited histories have also attracted regulatory scrutiny. FINRA has a long-standing position that back-tested or 'pre-inception performance' data cannot be used in communications with retail investors because it does not comply with FINRA retail communications rules. However, for institutional communications, FINRA permits such data to be provided so long as it is clearly identified as being for institutional use only, the index reflects a rules-based methodology, the back-tested data shows a range of market environments, is distinguished from actual historical performance and discloses any limitations of the back-tested methodology. In addition to complying with FINRA's conditions, disclosure relating to any proprietary index and its performance is subject to the SEC's standards that such disclosure must not misstate or omit material information. All communications must be presented in a way that is fair and balanced to afford institutional investors the opportunity to make an informed investment decision.

Finally, in addition to disclosure considerations, other legal issues may arise. For example, when a structured product is linked to an index, discretion in the calculation of that index must be carefully analysed, in particular to avoid potential issues under the Investment Company Act and the Investment Advisers Act, as well as ERISA and tax issues. Structured products linked to shares of a US third-party corporation (or a basket or index that includes such shares) may give rise to special withholding issues for non-US holders. In addition, if the methodology for rebalancing the underlying shares in a basket or index (regardless of whether shares of a US corporate equity are included) permits a degree of discretion, changes in the composition of the basket or index may be a taxable event to a US holder of the structured product. Separately, the parties to structured products linked to discretionary baskets or indices may be required to report the transaction to the IRS. If a global distribution is contemplated, EU benchmark regulation and IOSCO principles for financial benchmarks may also be implicated when linking to third-party or proprietary indexes.

Liability regime

30 | Describe the liability regime related to the issuance of structured products.

Issuers and other deal participants involved in offerings of structured products face potential liability for material misstatements or omissions, as well as for failing to register the sale of the structured product with the SEC (if required) or complying with one of the exemptions from registration. In addition, potential liability under state securities laws and common law fraud may arise in connection with offers or sales of securities.

In particular, for SEC-registered offerings:

- section 11 of the Securities Act provides a cause of action if any part of a registration statement contained an untrue statement of a material fact or a material omission at effectiveness. Potential defendants include the issuer, directors, signing officers, named experts and underwriters; and
- section 12 of the Securities Act provides a right of rescission to investors against any person who offers or sells a security by means of a prospectus or oral communication that includes an untrue statement of a material fact or a material omission, or if a security is offered or sold in violation of the Securities Act's registration requirements.

For both SEC-registered and unregistered offerings:

- Rule 10b-5 claims of an untrue statement of a material fact or an omission of a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading may also arise; and
- Rule 10b-5 claims require fraudulent intent, or scienter (unlike claims under section 11 or section 12).

Given increasing technology-driven efficiencies, awareness of regulations and potential liability in other jurisdictions where such products may be offered or sold is also important.

Other issues

31 What registration, disclosure, tax and other legal issues arise when an issuer sells a security that is convertible for shares of the same issuer?

The majority of convertible security issuances are in the form of convertible notes, which are convertible at the option of the holder under certain circumstances. Typically, conversions may be settled in cash, stock or a combination thereof at the issuer's election, depending on the accounting treatment the issuer desires. Foreign issuers who have listed American depositary shares (ADSs) in the US may also raise capital through securities convertible into their listed ADSs. In some cases, issuers choose to employ call spread or capped call derivative overlays to synthetically increase the conversion price of the notes and reduce potential dilution. The derivative overlays can be structured such that the premium paid by the issuer (normally not tax-deductible) will be treated as tax-deductible additional interest expense on the convertible debt, and the derivative instruments will receive equity accounting treatment rather than being treated as marked-to-market derivatives.

Most convertible notes are offered on an unregistered basis only to large 'qualified institutional buyers' that are not affiliates of the issuer under Rule 144A of the Securities Act, making them 'restricted securities' that generally cannot be resold to the general public unless one year (or six months if certain of the issuer's filing requirements are met) has elapsed since the original issuance. Issuers typically agree to remove restrictive legends to allow public sales after one year, although the market for convertible notes is dominated by such qualified institutional buyers and may be traded among such entities under Rule 144A prior to de-legending. In certain circumstances, issuers will issue convertible notes in a 144A offering simultaneously with a registered equity offering, in which event issuers must structure the transactions such that the unregistered convertible notes offering is not 'integrated' with the registered equity offering.

In a registered offering, the issuer must simultaneously register the offering of the underlying equity if the convertible securities are convertible within one year (almost always the case). In both a registered and an unregistered offering, an exemption from registration is generally available for the issuance of the underlying securities on conversion under section 3(a)(9) of the Securities Act. In an unregistered offering, the shares received on conversion are restricted securities, but the holding period of those shares may be 'tacked' to the holding period of the convertible securities for the purposes of Rule 144's holding period requirement. On 22 December 2020, the SEC proposed an amendment to Rule 144 that would, in certain circumstances, eliminate tacking of the Rule 144 holding period for securities received upon conversion or exchange of a convertible or exchangeable security. The amendment would only apply to unlisted issuers and 'market-adjustable securities', which the SEC defines as convertible or exchangeable securities that contain conversion rate or price adjustment terms that would offset declines in the market price of the underlying securities (other than adjustments for issuer initiated changes like stock splits and dividends). The proposed change would not apply to the majority of convertible deals, where the initial conversion rate and price are fixed, subject only to anti-dilution adjustments.

Convertible notes issuances may generate short selling by certain investors in the notes to hedge their position, as well as market activity by dealers under the call spread or capped call transactions, which must be disclosed in connection with the offering. Issuers may have to comply with stock exchange rules requiring shareholder approval where the number of shares into which the convertible security are convertible would exceed 20 per cent of the shares outstanding, unless certain exemptions are met.

Mandatory convertibles are treated as forming the same class as the underlying shares and therefore may not be offered under Rule 144A and are generally offered on a registered basis. In this case, the issuer must simultaneously register the offering of the underlying equity.

For tax purposes, a mandatorily convertible note may be characterised as equity, rather than debt. If so, among other consequences, the issuer would not be allowed to deduct interest expense and coupon payments would be subject to withholding when paid to a non-US holder. Even without re-characterisation, an issuer's deduction of interest payments may be limited for mandatory convertibles and certain optional convertibles, and, in the case of a US issuer, may be limited or disallowed, based on the use of the proceeds. Further, US holders may need to recognise dividend income and non-US holders may have to pay withholding tax, even if no payment has been made, if conversion ratio is adjusted and certain conditions are met.

32 What registration, disclosure, tax and other legal issues arise when an issuer sells a security that is exchangeable for shares of a third party? Does it matter whether the third party is an affiliate of the issuer?

Exchangeable securities are exchangeable into securities of an entity different from the issuer of the exchangeable security and are often issued by a capital-raising entity that is a subsidiary of the issuer of the publicly traded common equity.

Exchangeables may also be offered on a registered basis or an unregistered basis if an exemption from registration is available. For the exemption from registration under section 3(a)(9) of the Securities Act to be available for the issuance of the underlying securities issued upon exchange, the issuer of the exchangeable security must be a wholly owned subsidiary of the underlying shares issuer and its parent must fully and unconditionally guarantee its obligations. Absent such an arrangement, the exchange must be registered at the time of the exchange or qualify for a different exemption. If the underlying shares are 'free stock' (underlying shares that are not restricted and not owned by an affiliate of the issuer), the exchange does not have to be registered, whether the exchangeable securities are offered on a registered basis or pursuant to Rule 144A. Where these conditions are not met, the only practical alternative is to offer the exchangeable security under Rule 144A, effect the exchange on a private placement basis and register resales of the underlying shares, as tacking under Rule 144 is not permitted in this situation.

Mandatory exchangeables may be offered on a registered basis, which requires registration of the underlying shares unless they are free stock. Mandatory exchangeables may be offered under Rule 144A only in certain circumstances where the underlying shares are free stock, the mandatory exchangeable can only be settled in cash and other technical requirements of Rule 144A are met.

For tax purposes, an issuer's deduction of interest may be disallowed for mandatory exchangeables and certain optional exchangeables if the exchange is for shares of a third party (especially if the third party is an affiliate of the issuer). Further, interest payments may be subject to withholding when paid to a non-US holder. Unlike the conversion of a convertible security, an exchange will generally be a taxable event for the holder and the issuer.

UPDATE AND TRENDS

Recent developments

33 | Are there any current developments or emerging trends that should be noted?

The SEC recently adopted amendments to the affirmative defence in Rule 10b5-1(c), which have been effective since 27 February 2023. The amendments updated the requirements for the affirmative defence by imposing cooling-off period on persons other than issuers, requiring certain certifications from the directors and officers, prohibiting overlapping Rule 10b5-1 plan, limiting single-trade Rule 10b5-1 plans to one trading plan per 12-month period and extending good faith obligation throughout the duration of the plan. The amended Rule 10b5-1 also requires issuers to disclose Rule 10b5-1 plans on a quarterly basis and insider trading policies on an annual basis. Additionally, Form 4 and Form 5 filers must comply with the amendments to indicate by checkbox that a reported transaction was intended to satisfy the affirmative defence conditions of Rule 10b5-1(c). Although the current Rule 10b5-1 does not require a cooling-off period for an issuer, the SEC indicated that it will continue to consider whether a cooling-off period should be required for issuers. The amendments are expected to have significant impacts on the use of Rule 10b5-1 plans in many securities transactions.

Additionally, SEC also adopted a final rule to shorten the standard settlement cycle for most securities transactions from T+2 to T+1, with 28 May 2024 as the implementation date. The shortened standard settlement cycle will have follow-on effects on various other rules or market practices that are themselves tied to the standard settlement cycle.

Finally, starting 13 April 2023, Form 144 is required to be filed electronically on EDGAR, rather than through a paper submission.

LATHAM & WATKINS

Witold Balaban	witold.balaban@lw.com
Rafal Gawlowski	rafal.gawlowski@lw.com
Catherine Lee	catherine.lee@lw.com
Reza Mojtabaee-Zamani	reza.mojtabaee-zamani@lw.com
Yvette D Valdez	yvette.valdez@lw.com

1271 Avenue of the Americas, New York, NY 10020, United States
Tel: +1 212 906 1200
www.lw.com

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