bilateral local currency swap agreements with more than twenty central banks, including the European Central Bank, to provide backstops for CNY liquidity in case needed.[4] Today, we see CNY products (such as offshore CNY bonds, aka "dim sum bonds") traded freely among non-Chinese residents. Once offshore, CNY is now fully convertible. As a further liberalisation, in mid-2014, China's State Administration of Foreign Exchange ("SAFE") issued the "Provisions on the Administration of Foreign Exchange for Cross-Border Security",[5] and the "Administration of Foreign Exchange for Cross-Border Security Implementation Guidelines".[6] These new SAFE rules relaxed restrictions for granting of guarantees and onshore security for offshore financing. Notwithstanding these developments, cross-border CNY flows are still managed.

[1.005] In order to move to the next stage of internationalising the CNY, lessons from the 1997 Asian financial crisis show the importance of having strong and diversified capital markets to ensure long-term economic and currency stability.

[1.006] In line with this goal, China has been rapidly developing its asset securitisation industry, which is an integral and fundamental part of developing and diversifying its debt capital markets industry. To date, China's securitisation market is already the largest in Asia[7] and second largest in the world.[8]

2. CHINA SECURITISATION LEGAL FRAMEWORK

[1.007] Asset securitisations in China were traditionally structured under two key models: (i) the pilot securitisation framework ("PSF"); and (ii) the asset backed specific plan ("ABSP").

[1.008] In 2012, a new type of asset-backed securitisation notes regulated by the National Association of Financial Market Institutional Investors ("NAFMII") was issued.

PSF (for financial institutions only)

[1.009] The PSF (资产证券化试点) (sometimes also referred to as the credit asset securitisation framework) was launched in April 2005, and is regulated by the PBOC and China Banking Regulatory Commission ("CBRC").[9]

[4] See G. Ma, "Why China's haste to internationalise the renminbi?", 11 April 2014, available at: http://www.bruegel.org/nc/blog/detail/article/1301-why-chinas-haste-to-internationalise-the-renminbi/

[5] 跨境担保外汇管理规定。

[6] 跨境担保外汇管理操作指引。

[7] "China Becomes Asia's Biggest Securitisation Market", Wall Street Journal (24 September 2015). Available at: https://www.wsj.com/articles/china-becomes-asias-biggest-securitisation-market-1443082192.

[8] "Consumer-related issuers set to lead asset-backed securities growth", South China Morning Post (21 December 2016). Available at: http://www.scmp.com/business/banking-finance/article/2056334/consumer-related-issuers-set-lead-asset-backed-securities.

[9] Interim Measures on the Pilot Scheme for Securitisation of Credit Assets (信贷资产证券化试点管理办法) effective on 20 April 2005.

[1.010] A key element for the success of a securitisation is the legal isolation (typically achieved through a legal "true sale")[10] of the underlying assets from the originator into a bankruptcy remote vehicle. The PSF model achieves this by way of entrustment under the PRC Trust Law.[11] Eligible trustees are confined to trust companies with the relevant trust license issued by CBRC. In addition, trust plans[12] are regulated by CBRC.

[1.011] Article 15 of the PRC Trust Law provides:

> "*The trust shall be differentiated from other property that is not put under trust by the settler. Where, after a trust is created, the settler dies or is dissolved or cancelled according to law, or is declared bankrupt, and the settler is the sole beneficiary, the trust shall be terminated, and the trust property shall be his legacy liquidation property; where the settler is not the sole beneficiary, the trust shall subsist, and the trust property shall not be his legacy or liquidation property; but if the settler is one of the co-beneficiaries and dies or is dissolved, or cancelled according to law, or is declared bankrupt, his right to benefit from the trust shall be deemed his legacy or liquidation property.*"

[1.012] Article 16 of the PRC Trust Law provides:

> "*The trust property shall be segregated from the property owned by the trustee (hereinafter referred to as his "own property", in short), and may not be included in, or made part of his own property of the trustee. Where the trustee dies or the trustee as a body corporate is dissolved, removed or is declared bankrupt according to the law, and the trusteeship is thus terminated, the trust property shall not be deemed his legacy or liquidation property.*"

[1.013] The combination of Articles 15 and 16 confirm that entrusted assets will not form part of the bankruptcy estate of the defaulted settler or trustee. This protects the concept of "legal isolation" of assets and "bankruptcy remoteness" of the trustee vehicle, both required for a successful securitisation.

[1.014] So far, the PSF model has been the most successful model. For example, in 2006, strong international ratings from major credit rating agencies were achieved for a cross-border commercial mortgage backed securitisation ("CMBS") transaction.[13] In August 2014, two leading international credit

[10] By legal true sale, we refer to the situation where after such sale, the sold assets will no longer form part of the originator's estate even after the insolvency of the originator. We do not refer to accounting true sale (e.g. off-balance sheet treatment) or tax true sale.

[11] Trust Law of the People's Republic of China (Zhu Xi Ling [2001] No. 50) (中华人民共和国信托法), effective on 1 October 2001.

[12] 信托计划, see Measures for the Administration of Trust Companies' Trust Plans of Assembled Funds (2009 Revision) (信托公司集合资金信托计划管理办法(2009修订))。

[13] A securitisation originated by Dynasty Property Investment (Holdings) Limited. However, around the same time, the State Administration of Foreign Exchanges (SAFE) and Ministry of Construction (MOC) jointly issued their "Notice on Matters Related to Regulating Foreign Investments in Real Estate Market

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rating agencies assigned strong international ratings to a domestic auto loan securitisation transaction in PRC for the first time.[14]

[1.015] A large part of the success of the PSF model lies with the robust legal framework available through the PRC Trust Law, which is a State Law. Through an entrustment under the PRC Trust Law, legal true sale and legal isolation of the underlying assets is achieved.

[1.016] However, the PSF model is exclusively for CBRC-regulated financial institutions only (e.g. commercial banks, finance companies, etc). Non-financial institutions are not eligible to use this model.

ABSP (for non-financial institutions)

[1.017] Non-financial institutions seeking to issue asset-backed financial instruments had to use the model previously known as the Specific Asset Management Plan (专项资产管理计划) ("SAMP"),[15] which was launched in December 2003. The SAMP model was recently renamed the Asset Backed Specific Plan model (资产支持专项计划) ("ABSP"). This is regulated by the CSRC.

[1.018] Unlike the PSF model which uses a special purpose trust, under the ABSP model, ABSPs set up by securities companies will acquire assets from the originator. The transfer of assets is based on contract, rather than entrustment.

[1.019] A difficulty of the ABSP model is the lack of certainty on the characterisation of the transfer agreement, creating uncertainty for legal true sale. Indeed, major international rating agencies have expressed reservations:

> "*In the event that the project manager goes bankrupt, creditors of the bankrupted project manager may have a pari passu claim as the ABSP investors over the ABSP assets.*"[16]

[1.020] CSRC has tried to clarify the legal position.[17] Notwithstanding this, due to public law concerns about the legal status of the ABSP model, the ABSP model has been less successful than the PSF model.[18] As at August 2016, it

(MOC Circular 171 in 2006) (关于规范房地产市场外资准入和管理的意见) (建设部[2006]第171号文件). This regulatory change resulted in the original structure spearheaded by the Dynasty CMBS being a one-off structure.

[14] Moody's assigned its rating of Aa3 (sf) and Fitch assigned its rating of AAsf to the Class A Notes issued by Driver China One Trust, an auto loan asset backed security (ABS) transaction sponsored by Volkswagen Finance (China) Co., Ltd (VWFC).

[15] The Interim Measures on the Administration of Client Assets Management Business by Securities Companies (证券公司客户资产管理业务试行办法), effective on 1 February 2004.

[16] Moody's, Structured Thinking: Asia Pacific, 3 December 2014, p.20.

[17] See: K. Ong and A. Liu, "The influence of public law on the development of China securitisation", (2015) Capital Markets Law Journal 329 at p.334 and 335 for discussion on these clarifications.

[18] For further discussion on the public law issues, see: See: K. Ong and A. Liu, "The influence of public law on the development of China securitisation", (2015) Capital Markets Law Journal 329.

was noted that issuance volumes for securitisation notes by Chinese corporates have been low, with: "only 82 deals worth a combined CNY26.29 billion issued since 2012". The low issuance was attributed to a "lack of bankruptcy remoteness protection offered by the traditional ABN structure, which more resembles senior secured debt than securitisation paper".[19]

NAFMII (for non-financial institutions)

[1.021] According to the Guidelines on Asset-backed Notes for Non-financial Enterprises on the Interbank Bond Market (银行间债券市场非金融企业资产支持票据指引) issued on 3 August 2012 ("NAFMII ABS Guidelines"), NAFMII has the mandate to regulate asset-backed notes originated by non-financial institutions which can be traded on the interbank market.

[1.022] This new type of asset-backed notes uses the trust structure (like the PSF model), but can be used for non-financial institutions. Previously, Chinese corporates issued securitisations under the ABSP, as corporates cannot issue under PSF because they are not regulated by PBOC and CBRC. Since the NAFMII ABS Guidelines were introduced, multiple ABS transactions have been done under this framework.[20]

[1.023] While the introduction of NAFMII ABS Guidelines is positively welcomed, there have been doubts on its viability. The concerns are generally related to the public law status of NAFMII ABS Guidelines.[21] NAFMII is a self-regulated body of investors in the inter-bank bond market (unlike regulators like PBOC, CBRC or CSRC).

[1.024] It was observed that "transactions under the NAFMII Guidelines are unlikely to be ring-fenced securitisation transactions and are more likely to be secured lending transactions with certain asset backed features",[22] and "[t]ransactions registered so far are akin to secured lending transactions with certain asset backed features. This product is unlikely, in its current form, attract foreign investors due to the lack of ring-fencing and tranching of risks".[23]

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[19] Moody's: "New type of asset-backed note for China market is a credit positive", 29 August 2016 (published at: https://www.moodys.com/research/Moodys-New-type-of-asset-backed-note-for-China-market--PR_354193).

[20] By the end of 2012, at least six NAFMII ABS projects were successfully launched (see Sheppard Mullin Richter & Hampton LLP, "Asset-backed note: a brand new financing instrument for non-financial enterprises in China", Lexology (5 December 2012). Available at: https://www.lexology.com/library/detail.aspx?g=09a41989-2f3d-41b1-994c-62a50aa2979a).

[21] For further discussion on the public law issues, see: See: K. Ong and A. Liu, "The influence of public law on the development of China securitisation", (2015) Capital Markets Law Journal 329.

[22] Clifford Chance briefing note, "Recent Developments in Assets Securitisation in the PRC" (August 2012).

[23] Clifford Chance briefing note, "An Update on Recent Developments in Assets Securitisation in the PRC" (June 2013).

[1.025] Nonetheless, Moody's noted that "as trust structure ABN become more widely accepted by investors in the interbank bond market, it will … expand the scope for corporates to raise funds through this channel".[24] The NAFMII model is still evolving, and it remains to be seen whether this will become a dominant securitisation model in China.

3. ONSHORE PRC SECURITISATION RATED AAA (INTERNATIONAL RATING SCALE)

[1.026] The credit rating of securitisations can be capped by rating agencies for different reasons. For instance, the market and originator portfolio data may only cover a short time period without going through any stress cycle. The data provided may not be in good detail for rating agencies to fully understand and analyse for their credit rating. The portfolio may have concentration to a particular region or obligor. In Asia, the major reason for rating cap imposed on securitisation transactions is the sovereign credit rating.

[1.027] Currently, Fitch, Moody's and S&P assign China long term sovereign ratings at A+ (stable outlook), A1 (stable outlook) and AA- (negative outlook) respectively. For Moody's, China's local currency country ceiling of Aa3, capturing the systemic risks associated with the political, institutional, legal and economic factors prevalent in China, caps Moody's rating on China securitisation at Aa3(sf). For Fitch, the early stage of the securitisation market development as well as China's country ceiling of A+ caps Fitch's rating on China securitisation at AA(sf). Moody's and Fitch are adopting similar securitisation rating cap approach due to the sovereign risk in the other markets as well.

[1.028] In April 2017, S&P assigned a AAA(sf) rating to the CNY2.5 billion class A notes issued by Fuyuan 20171 Retail Auto Mortgage Loan Securitisation Trust. The transaction is backed by a static pool of auto loan receivables originated by Ford Automotive Finance (China), a wholly owned subsidiary of Ford Motor Credit Company. This is the first time a China securitisation is rated AAA on an international rating scale. The same transaction was rated by Fitch at AA(sf).

[1.029] S&P explained in the pre-sale report why this transaction can be rated AAA(sf). First, the credit enhancement and the liquidity reserve fully funded at closing provides adequate support for the notes to pass S&P rating stress cash flow scenarios correlated with a "AAA" rating level. The class A notes benefit from the fully sequential and turbo principal repayment mechanism, and excess spread can be used to further pay down the class A note principal.

[24] Moody's: "New type of asset-backed note for China market is a credit positive", 29 August 2016 (published at: https://www.moodys.com/research/Moodys-New-type-of-asset-backed-note-for-China-market--PR_354193).

The report also mentions S&P's comfort with the originator's established track record and stable underlying policies, as well as the limited exposure period (25-month weighted average remaining loan term) of the underlying collateral pool.

[1.030] Split credit rating is quite common for corporate and securitisation ratings. As long as such split rating exists, the transaction pricing as well as the investor credit analysis and investment consideration for such transactions will still be affected by the lower assigned rating. We expect that China's securitisation market will continue to expand in terms of new issuance volume, outstanding amount and diversity of asset classes. However, China's securitisation market history is still relatively short and the robustness of its legal framework may not be comparable to other more developed securitisation markets. Hence we believe that the AAA(sf) impact of S&P rating on China securitisation is likely to be limited unless one of either Moody's or Fitch also can rate China securitisation at Aaa(sf)/AAA(sf) with very supportive and convincing rationale for investors.

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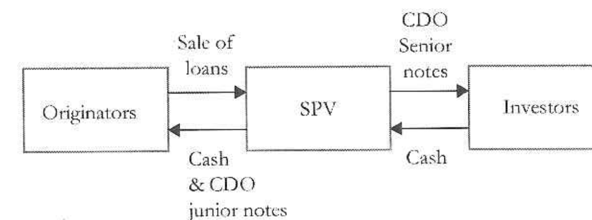
4. LOCAL GOVERNMENT BOND REPACKAGING (OFFSHORE) COMPLETED BY BOC SHANGHAI

[1.031] Bond issuance by local government financing vehicles (LGFV) was boosted by the economic stimulus program that was initiated by the central government in 2008. LGFV bonds have a broad range of maturities, with 6-7 years the most common, and higher financing cost than local government bonds. Not all LGFV bonds are rated.

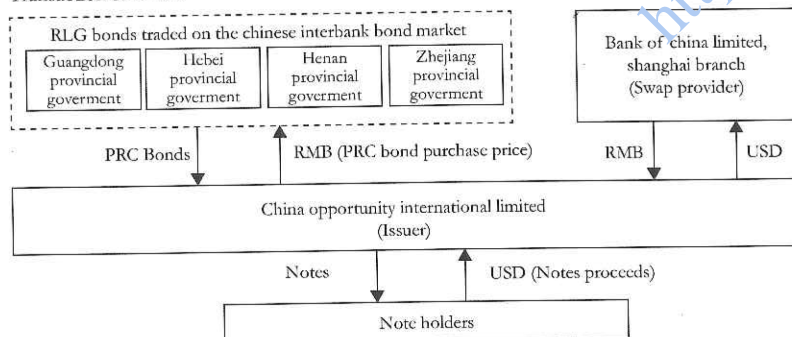
[1.032] To support the development of local government bond markets, a collateralised debt obligation (CDO) structure can be employed to assist weaker local governments to access the bond market. CDOs are bonds issued and backed by the predicted cash flows from specific loans. CDO can involve setting up a special purpose vehicle which buys loans from different originators and sells the notes, backed by the portfolio of the bought loans, to the investors. This is called a cash CDO, and investors can enjoy the diversification benefit of a larger number of loans in the transaction, rather than single credit exposure to any underlying loan.



[1.033] For China's local government and LGFV debt, the CDO structure could be packaged in different ways. For instance, the local government can pool various LGFV debts and package them into a CDO to be sold to investors. Alternatively, the central government can pool various local government debts and package them into the CDO. Even a portfolio comprising both LGFV and local government debts can be pooled to back a CDO. The bottom line is that the correlation among each underlying debt should be limited in order to have diversification benefit, which should lead to high bond ratings and hence lower bond coupons.

[1.034] For the initial CDOs to be issued, it is advisable to pool more debts by stronger local government and LGFVs in order to give a higher credit comfort to investors. As investors are getting more familiar with the local government and LGFV credit, the proportion of stronger local government and LGFV debt in the pool can be gradually reduced. Alternatively, full or partial government credit can be employed for the CDO or an external guarantee like the SBLC can be sought.

[1.035] A USD632 million bond repackaging transaction called "China Opportunity International Limited – Series 2017-1" was completed on 9 March 2017. The bonds were backed by a collateral pool of nine fixed rate bonds worth CNY4,310 million issued by Guangdong Provincial Government, Hebei Provincial Government, Henan Provincial Government and Zhejiang Provincial Government. The transaction carries a 2.05% annual interest rate and a scheduled maturity date of 8 November 2018. Bank of China was the originator for this transaction, and there is a cross currency swap with Bank of China Shanghai Branch to mitigate the currency mismatch between the CNY denominated collateral pool and USD denominated notes.



Transaction Structure
Source: Standard Chartered Bank, Moody's

Collateral Pool

Bond Issuer	Bond Issuer Code	Amount (RMB million)	Annual Fixed Interest Rate	Maturity
Guangdong Provincial Government	1563026	320	3.02%	10/12/2018
Guangdong Provincial Government	1563033	230	2.83%	11/3/2018
Heibei Provincial Government	1543026	800	3.17%	9/21/2018
Heibei Provincial Government	1543022	870	3.18%	9/18/2018
Henan Provincial Government	1560022	840	3.02%	11/4/2018
Henan Provincial Government	1560018	400	3.02%	11/4/2018
Zhejiang Provincial Government	1552017	470	2.98%	9/18/2018
Zhejiang Provincial Government	1552025	300	2.94%	10/16/2018
Zhejiang Provincial Government	1552021	80	2.94%	10/16/2018
Total		**4,310**		

Source: Standard Chartered Bank, Moody's

[1.036] At closing, the transaction was assigned A1(sf) by Moody's. The underlying local government and their bonds were not rated by Moody's, but Moody's assessed the credit quality of the four local governments and said the collateral average credit quality is consistent with the A1 rating. On 25 May 2017, the transaction was downgraded to A2(sf) due to the its linkage with the China sovereign rating, which was downgraded by Moody's from Aa3 to A1 on 24 May 2017.

[1.037] The successful completion of the local government bond repackaging transaction provides a good template for the other originators with credit exposure to local government debt a way to mitigate the associated credit risk and recycle the capital tied up in the local government bonds. The placement of the transaction offshore proves that there is an offshore investor base with interest and credit comfort in the local government debt. The diversity of the originators and the volume of such transactions in the near future depends

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2. INTERNATIONALISATION OF THE CHINESE DEBT MARKET

[2.002] Following the internationalisation of the Chinese currency, RMB and keeping pace with its booming economy, China has been taking a step-by-step approach to internationalise its debt market.

(i) Panda Bond

[2.003] In 2005, China invited multi-lateral financial institutions such as International Finance Corporation ("IFC") and Asian Development Bank ("ADB") to issue Panda Bond which is the debt denominated in RMB issued by foreign entities in the Chinese debt market. Panda is the native animal of China, regarded as a national treasure because of its long living history. The Panda Bond market was further liberalised in the fourth quarter 2015, allowing any foreign issuer with credit rating at least AA+ assigned by one or more Chinese credit rating agencies to tap the market. Multi-lateral financial institutions with high international credit ratings are exempted from getting Chinese domestic ratings for their issuance.

[2.004] The Panda Bond market was very small in the period of 2005-2014. The accumulated issued amount was RMB 6 billion only. Its breakout recorded in the last quarter of 2015 had an issued amount of RMB13 billion. Relaxation of debt issuing requirements in the exchange market in 2016 further stimulated the fast development of the Panda Bond market. A total amount of RMB 132.04 billion was issued in the year of which RMB 83.84 were issued on the two exchanges. The market slowed down substantially in 2017 due to rise in financing cost. The total issued amount declined to RMB71.9 billion of which RMB 11.60 billion were issued in the exchange market.

(ii) Dim Sum Bond

[2.005] The Dim Sum Bond emerged in 2011 is the off-shore RMB bond debuted in Hong Kong and subsequently in other international financial centres. Dim Sum is the Chinese snacks served in the Chinese restaurants in Hong Kong and the Guangdong Province. The Dim Sum Bond market provides opportunities to international and Chinese debt issuers to tap the off-shore RMB pool for simpler procedures and lower financing costs.

[2.006] The Dim Sum Bond market slowed down in 2016 after the relaxation of the Panda Bond market in late 2015 and the depreciation of RMB. The total outstanding amount recorded in Hong Kong was RMB368 billion in 2015, but the amount declined to RMB 318 billion in 2016 and further dropped to RMB 210.2 billion in 2017.

(iii) Bond Connect

[2.007] On July 3, 2017, China and Hong Kong jointly announced the launch of the "Bond Connect" program. This is a mutual market access scheme implemented by two phases, allowing investors outside of China, i.e. international investors, and investors in China to invest and trade debts in China and Hong Kong. The first phase is the "Northbound Trading", under which investors outside of China can directly invest and trade debts in the China interbank market through the Hong Kong Stock Exchange and settle trades via Central Moneymarkets Unit ("CMU"), the clearing and custody system operated by the Hong Kong Monetary Authority. The second phase to be implemented will be the "Southbound Trading", which will allow investors in China to directly invest and trade international debts available in Hong Kong. The date for implementing the "Southbound Trading" phase is yet to be announced. Before the launch of the "Bond Connect", investors outside of China have been conditionally allowed to invest in Chinese debts through the Qualified Foreign Institutional Investors ("QFII") and RMB Qualified Foreign Institutional Investors ("RQFII") schemes. Each of the qualified institutional investors and investment funds is assigned a quota for securities investment and trading. The process of opening account and settlement of trades in the two schemes is quite tedious as compared with the "Bond Connect" which does not set any investment and trading limit for investors, and the process of trading and settlement for debts is much simplified.

[2.008] Since its launch, Bond Connect has been reported a daily trading volume of more than RMB3 billion and over 50% of the investors are international institutions. As at end of 2017, 247 international investors from 19 countries and regions entered the CIBM through "The Bond Connect".

3. THE CHINESE CREDIT RATING AGENCIES

[2.009] There are eight nation-wide Chinese credit rating agencies, namely: (i) China Chengxin; (ii) Lianhe; (iii) Dagong; (iv) Shanghai Brilliance; (v) Golden; (vi) Pengyuan; (vii) Shanghai Far East; and (viii) China Bond Rating (see below for the full list):

List of Chinese credit rating agencies

I. China Chengxin credit rating group:
   i. China Chengxin Securities Rating Company Limited
   ii. China Chengxin International Rating Company Limited
   iii. China Chengxin (Asia Pacific) Credit Ratings Company Limited

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- II. China Lianhe credit rating group:
  - i. China United Rating Company Limited
  - ii. China Lianhe Rating Company Limited
  - iii. Lianhe Ratings Global Limited
- III. Dagong credit rating group:
  - i. Dagong Global Credit Rating Company Limited
  - ii. Dagong Global Credit Rating (Hong Kong) Co., Limited
  - iii. Dagong Europe Credit Rating
- IV. Shanghai Brilliance Credit Rating Company Limited
- V. Pengyuan Credit Rating Company Limited
  - i. Pengyuan Credit Rating Company Limited
  - ii. Pengyuan Credit Rating (Hong Kong) Company Limited
- VI. Golden Credit Rating Company Limited
- VII. Far East Credit Rating Company Limited
- VIII. China Bond Rating Corporation Limited

[2.010] All of the above, *except* China Bond Rating, adopt the issuer-pay model to provide credit rating services to debt issuers and debt issues (collectively, the "rated entities"). China Bond Rating is the only one adopting the investor-pay model for debts issued in the Chinese inter-bank market.

[2.011] International experiences have shown that the investor-pay model can hardly work in the international debt market as it cannot help convey credit rating information of debt issues at launch promptly and widely to investors due to the practice of providing credit rating information to subscribers of the credit rating agencies. As such, the investor-pay model deflects debt market development in a fast pace. On the other side, the issuer-pay model has the advantage of passing down information of credit rating of debt issues quickly at launch, hence, helping new debt issues sell to a wider range of investors on a level playing field. However, the issuer-pay model is criticised on its embedded conflicts of interest. One of the found causes led to the global financial crisis in 2008 was over-rating on debts by the dominating international credit rating agencies which have adopted the issuer-pay model since 1970s. For the purpose of minimising conflicts of interest embedded in the issuer-pay model and any possible misconduct in credit rating agencies, securities regulators of the major financial centres require credit rating agencies to observe and follow the regulations of credit rating introduced in 2010.

[2.012] As the investor-pay model has proven not efficient for debt market development, it seems there is no good reason for forming China Bond Rating. However, the investor-pay model works in the Chinese inter-bank market. It is because participants of the China inter-bank market are banks, securities houses, credit rating agencies, investors and corporations, which are

members of National Association of Financial Market Institutional Investors ("NAFMII"), a self-regulated organisation approved by the State Council of China, and the owner of China Bond Rating. Being members of NAFMII, they pay membership fees to NAFMII to get access to the inter-bank market and receive market information, including credit ratings assigned by China Bond Rating.

[2.013] Two out of the eight Chinese credit rating agencies have joint ventures with foreign credit rating agencies or foreign investors. China Chengxin joint ventured with Fitch and IFC to form China Chengxin International Credit Rating in 1999, but the joint venture was dissolved due to the withdrawal of Fitch in 2004. The Chinese debt market took off in 2005 when Chinese enterprises and corporations were allowed to issue short term notes, i.e. commercial paper with tenor less than 365 days, in the inter-bank market. Since then, influx of short term note issues had provided enormous business to the credit rating agencies. Moody's seized the opportunity to enter the Chinese credit rating market by taking up 49% share stake of China Chengxin International Credit Rating in 2006. Fitch returned to the Chinese market the same year by taking up 49% share stake of its new joint venture with Lianhe to form the China Lianhe Credit Rating. The two joint venture credit rating agencies are confined to rate debts issued in the interbank market only. As for debts issued in the exchange market, China Chengxin and China Lianhe have their wholly owned establishments, China Chengxin Securities Rating and China United Rating, to do the rating business. In early 2017, China Chengxin enhanced its business through internal re-organisation that China Chengxin International Credit Rating took over China Chengxin Securities Rating in Shanghai, and the latter acquired all the shares of China Chengxin (Asia Pacific) Credit Ratings established in Hong Kong in 2012 from China Chengxin Credit Management. As a result of the merger, Moody's share stake in China Chengxin International Credit Rating reduced to 30%. In January 2018, Fitch once again withdrew from the Chinese credit rating market. It sold out its share stake in China Lianhe Credit Rating to Singapore's government investment fund, GIC.

[2.014] The Chinese government regards credit rating a sensitive business. Credit rating business had been included in China's restricted businesses list that no foreign entities were allowed to form wholly owned companies to provide credit rating services in China, but foreign credit rating agencies were permitted to form joint venture credit rating agencies with the Chinese credit rating agencies provided that the foreign equity interest was no more than 49%. In 2007, the joint venture policy was further tightened that no more joint venture with foreign participant was permitted. This policy was up-lifted in July 2017 after the meeting of Chairman Xi Jinping

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of China and President Donald Trump of the USA in April 2017. China announced that it would allow the American credit rating agencies to set up wholly owned credit rating companies in China after 16 July 2017. Will Moody's, Fitch and Standard & Poor's set up their wholly owned companies in China to provide credit rating services is yet to be seen. In the case of Moody's, whether or not the joint venture contract allows it to compete for business with the joint venture companies is questionable. If Moody's plans to set up its wholly owned subsidiary in China, either the terms of the joint venture contract needs to be changed or Moody's has to sell out its share stake in its joint venture company. The other consideration is how much business it can generate under the current circumstances where the established relationship between the Chinese credit rating agencies and the Chinese debt issuers are deep and wide. Anyway, Fitch's selling out its share stake in China Lianhe Credit Rating gives the market a strong indication that it will come back to China to provide credit rating services on its own feet. It is reasonable to guess Standard & Poor's and Moody's will do the same.

4. MARKET SHARE

[2.015] The Chinese credit rating industry is dominated by China Chengxin and Lianhe, which have been capturing more than half of the market share.

Table 1: Market share of issue rating in the interbank market (2015-16)

Credit Rating Agency	2016		2015	
	Number of Issues	Market Share	Number of Issues	Market Share
China Chengxin	1128	35.06%	987	32.36%
Lianhe	890	27.67%	727	23.84%
Golden	459	14.27%	336	11.01%
Dagong	392	12.19%	545	17.87%
Shanghai Brilliance	348	10.82%	455	14.92%
Total	3217	100%	3050	100%

Source: NAFMII, Stock Exchanges, data compiled by China Chengxin

Table 2: Market share of corporate debt ratings in the exchange market (2015-16)

Credit Rating Agency	2016		2015	
	Number of Issues	Market Share	Number of Issues	Market Share
China Chengxin	283	34.51%	77	22.06%
Lianhe	231	28.17%	98	28.08%
Shanghai Brilliance	125	15.24%	58	16.62%
Dagong	115	14.02%	54	15.47%
Pengyuan	34	4.15%	34	9.74%
Golden	29	3.54%	28	8.02%
Shanghai Far East	3	0.37%	0	0.00%
Total	820	100.00%	349	100.00%

Source: NAFMII, Stock Exchanges, data compiled by China Chengxi

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Table 3: Market share of asset-backed securitisation rating (2015-16)

Credit Rating Agency	2016		2015	
	Number of Issues	Market Share	Number of Issues	Market Share
China Chengxin	200	47.73%	59	34.3%
Shanghai Brilliance	90	21.48%	34	18.02%
Lianhe	73	17.42%	43	25%
Dagong	49	11.69%	31	19.77%
Shanghai Far East	3	0.72%	-	-
Pengyuan	2	0.48%	3	1.74%
Golden	2	0.48%	2	1.16%
Total	419	100%	172	100%

Source: NAFMII, Stock Exchanges, data compiled by China Chengxi

Table 4: Market share in the inter-bank market and the exchange market, 2017 (Number of issues)

Market Share (No.)	Rating Agency	Commercial Paper (CP)	Commercial Paper of Securities Companies	Medium Term Note (MTN)	Enterprise Bond	Corporate Bond	Financial Bond	Perpetual Bond
	China Chengxin	164	12	239	85	211	187	78
	Lianhe	117	1	171	57	169	139	73
	Dagong Global	83	na.	126	36	72	34	43
	Shanghai Brilliance	74	6	86	44	60	31	36
	Golden Credit	23	na.	33	51	10	19	7
	Pengyuan	na.	na.	na.	127	13	na.	na.
	Total	461	19	655	400	535	410	237

Source: NAFMII, Stock Exchanges, data compiled by China Chengxin

Table 5: Market share in the inter-bank market (Issue %)

Issues in %	Rating Agency	Commercial Paper (CP)	Short-term Financing Bond of Securities Companies	Medium Term Note (MTN)	Enterprise Bond	Corporate Bond	Financial Bond	Perpetual Bond
	China Chengxin	35.57%	63.16%	36.49%	21.25%	39.44%	45.61%	32.91%
	Lianhe	25.38%	5.26%	26.11%	14.25%	31.59%	33.90%	30.80%
	Dagong Global	18.00%	na.	19.24%	9.00%	13.46%	8.29%	18.14%
	Shanghai Brilliance	16.05%	31.58%	13.13%	11.00%	11.21%	7.56%	15.19%
	Golden Credit	4.99%	na.	5.04%	12.75%	1.87%	4.63%	2.95%
	Pengyuan	na.	na.	na.	31.75%	2.43%	na.	na.
	Total	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%

Source: NAFMII, Stock Exchanges, data compiled by China Chengxin

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partner. Some of the terms used for partnership contract in Islamic jurisprudence are as follows:

[4.004] *Mudarabah* is a term used when one party contributes the capital and the other provides the labour and share profits according to the agreed terms. It stands in the form of profit sharing partnership trust agreement. The agreement is generally between the two parties for a joint venture project in which one party provides the finance and is often referred to as investor (*Rab-al-maal*) while the other party provides his time and services and is often referred to as active partner or working partner (*Modraeb*). Under this agreement the percentage of distribution of profit must be fixed in advance and shared according to the pre-arranged ratio. The investor will provide 100 percent of the capital for the project but will not take any management role as he is prohibited from intervening in the day-to-day operation of the partnership. The working partner, on the other hand, is not obliged to participate in the losses (if any) of the partnership. If the partnership results in a loss the investor will stand to lose his capital wholly or partly as the case may be while the working partner will stand to lose his wages or benefit for services rendered to the partnership. Some jurists take the view that the agreement can provide that in the event of a loss the investor has a right to investigate the loss and if it is proven that the loss arose as a result of lack of proper service or skill employed by the working partner, the investor will have the right to claim to be indemnified for the losses by the working partner. This partnership instrument is sometimes conveniently referred to as Trustee Profit Sharing Agreement.

[4.005] Shariah banks may, under the principle of *Mudarabah*, accept customers' deposits for a fixed period and place these in a general investment account. In such a case the customer is the investor or capital provider and the bank is the working partner or referred to as entrepreneur. The contract will provide the ratio on which the profit will be distributed. However, in the event of a loss, the customer is liable to bear all the losses. Under *Mudarabah*, if the bank accepts deposits for investment on the same principle, the bank may invest the funds for financing projects. In such cases the bank provides the capital as the investor to the working partner or the entrepreneur or initiator of the project with profits shared according to the agreed ratio. In the event of a loss, the bank has to bear the whole risk.

[4.006] *Musharakah* stands in the form of joint venture cum profit sharing partnership where two or more persons and/or institutions invest their capital jointly with the profits distributed between them. It gives a profit sharing as well as a decision making right to the partners. Losses (if any) are divided according to the ratio of capital contribution by the partners. This partnership

agreement is sometimes conveniently referred to as Joint Venture Profit Sharing Agreement.

[4.007] Shariah banks may invest the deposits received from their customers in financing projects under the *Musharakah* concept. Under this principle the bank and the entrepreneur of the project will provide the capital in the agreed proportion and share the profits accordingly with rights of participation in the management of the project. Losses will be shared according to the ratio of capital contribution. Shariah banks may provide letter of credit facilities under this principle. In such cases, the customer must deposit his agreed portion of capital for the transaction which the bank will accept under the principle of *Al-Wadiah Yad Dhamanah* (custody and guarantee). Thereafter, the bank establishes the credit facilities and pays the negotiating bank from the customers' deposits as well as its own funds to meet with the joint venture terms with the bank and the customer sharing the profits from the venture as per the agreement.

[4.008] *Ijarah* stands in the form of a contract to lease or hire movable or immovable property. Such contracts do not dispose of the goods themselves as these may provide for an option to purchase clause as may be done in conventional hire purchase agreements. The lessor must have absolute ownership of the leased property and the lessee is responsible for maintaining the leased property.

[4.009] *Bai Bithaman Ajil* stands as a contract of sale by credit where the payment for goods sold is deferred. The deferred payment is paid by way of agreed instalments. It is similar to a *Murabahah* sale although the payment for such sale is by way of a lump sum. In practice, a *Bai Bithaman Ajil* involves a Shariah bank purchasing the assets requested by the customer and then reselling it to the customer at an agreed price. The latter represents the actual price which the bank purchased the asset from the customer together with a margin of profit for the sale transaction. This transaction allows the customer to settle the agreed purchase price in instalments as per the terms of the agreement.

[4.010] *Wadia* means custody. It stands as a contract which allows the owner of the asset to deposit it with another, who in turn, will be able to make use of it with the owner's consent. There are different modes of contract of *Wadia* that Shariah banks generally undertake. For example, under the principle of *Al-Wadia Yad Dhamanah*, assets deposited are guaranteed to be returned to the owner as *Dhamanah* means guarantee.

[4.011] The bank receives the deposit from the owner under a current or savings account. The contract permits the bank to utilise the funds in a current account with liberty for the customer to withdraw it – wholly or partly – at

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any time during bank working hours. The customer will not receive any profit from the bank for having utilised the money. The bank guarantees the return of the money and, during the period of the contract, will provide services of current account as are generally undertaken by conventional banks. If the deposit is received under a savings account, the terms of the contract would be similar to a current account save that the contract will provide that the bank will be at liberty to pay some of the profits generated from the use of these funds from time to time.

[4.012] *Qard Al-Hassan* is a non-interest bearing loan agreement. Such loans for the deserving have been strongly emphasised in the Quran and the Almightly has promised manifold rewards for such lenders. Under this contract the borrower does not pay any interest or profit for the utilisation of the funds. However, he is at liberty – at his own option – to reward the lender for having utilised the funds.

[4.013] *Al-Ujur* generally means charges for fees and commission for services rendered to customer.

[4.014] *Bay-al-Dayn* is a contract for sale of debt due and owing. For example under this mode of contract the sum due and owing from the customer pursuant to *Bai-Bithaman-Ajil* or *Murabahah* contracts may be sold to third parties, and such debts can be securitised. Shariah banks may issue bills of exchange which are often referred to Islamic Accepted Bills (*IAC*) under this principle.

[4.015] *Wakalah* is an agency contract which in principle will authorise the agent to act on behalf of the principal. Shariah banks may provide letters of credit under the principle of *Wakalah*. In such cases the customer may have to deposit a sum with the bank which may be equivalent to the letter of credit applied for. The deposit will be received by the bank under the principle of *Al-Wadiah Yad Dhamanah*. Thereafter the letter of credit is issued and the bank pays its obligation to the negotiating bank from the customer's deposit. The bank will charge fees (*Al-Ujr*) for the services which it rendered to the customer.

[4.016] *Kafalah* is a contract of guarantee or letter of guarantee in the conventional sense. Shariah banks may, under this principle, be guarantors for certain obligations of customers and may issue a Bank Guarantee or a Letter of Guarantee. To do so it may require customers to deposit a sum of money equivalent to the bank guarantee sought for. The bank may receive the deposit under *Al-Wadiah Yad Dhamanah* principle and may charge a fee (*Al-Ujr*) for the services provided to the customer.

[4.017] *Bay al-Ayyinah* is a contract for sale of cash or money in the conventional sense: a loan or loan facilities. However, scholars are divided on the lawfulness of such transactions.

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[4.018] *Sukuk Bond* is a form of security which generally means a promise to pay for money advanced. The Concise Oxford Dictionary defines a bond in relation to commerce as a 'certificate issued by a government or a public company promising to repay borrowed money at a fixed rate of interest at a specified time.' *Sukuk* means a certificate and a *Sukuk* bond is a certificate which has underlying assets attached to it to honour the promise of repayment. This contrasts significantly with a conventional bond which is – in essence – only a bare promise to pay without any underlying assets relating to the bond certificate.

[4.019] Islamic bonds are referred to as *Sukuk* and basically stand as a sort of investment certificate with a guarantee of returns. These are becoming an increasing attractive proposition to develop infrastructure facilities especially in developing nations. *Sukuk* bonds are issued by employing various Islamic trading concepts such as *Ijarah, Mudarabah* or *Musharakah*, via the employment of a special purpose vehicle. The latter is a company which will hold the assets of the promisor/borrower and utilise the revenue generated to pay the *Sukuk* bond holders profits as well as to repay the loan. For its services, this special purpose vehicle will be paid a fee. The *Sukuk* bond is an innovation presently in vogue with its relatively straight forward concepts and methodologies although the documentation has, by design, been made complex and voluminous. The latter is inconsistent with Shariah trading concepts which are not meant to have complex documentation that anticipates uncertainties, contingencies to avoid all risks as far as human ingenuity will allow, or to provide fixed rates of returns in breach or purported breach of *riba* rules.

3. MEDJELLE, ISLAMIC BANKING AND ITS GROWTH

[4.020] Islamic trading concepts have been increasingly used as financing instruments to provide banking facilities over the past few decades. It was started by Ahmad El Najjar in Mit Ghamr, Egypt in 1963, which concept was subsequently expanded to Malaysia and the Middle East and followed by other countries including the United Kingdom. The jurisprudence relating to Islamic trading concepts have been documented in the *Medjelle* – an Ottoman code – which is said to have codified Islamic law as early as the 19th century. As such, *Medjelle* is of utmost importance in the study, practice and administration of Islamic banking.

[4.021] The growth of Islamic finance and/or banking has been phenomenal. In Malaysia, the regional hub, it is said to be growing some 50 percent faster than conventional banking. Unlike conventional banking, Islamic finance or banking have underlying assets to support the transaction. It is by far and large an asset based transaction and – as a consequence – is said to be more stable. Thus, there is no reason why the '*Sukuk model*' cannot be successfully

implemented in any country which issues bonds given that it possesses some elements of 'conventional' bonds.

[4.022] Furthermore, there are other modes of financing under the Shariah – such as leasing or hire purchase – which can be readily implemented with no real stress to the current regulatory parameters of most countries as it is based on contractual documents. It is pertinent to note that Islamic law and jurisprudence relating to contract have much similarity to the common law concepts. As such, those familiar with the common law concepts – practitioners and jurists throughout the Commonwealth – will have no difficulty appreciating its application and workings. It is therefore not surprising that Islamic finance and/or banking is now available in more than 75 countries through the involvement of more than 300 financial institutions worldwide. This is expected to grow further as the Islamic finance industry is said to be worth more than US$2 trillion with a continuous growth rate of about 15 percent annually.

4. DEVELOPMENT OF ISLAMIC BANKING

[4.023] Thirty years ago there was no mention of Islamic banking in any law course, and widely used textbooks were primarily focused on the study of Islamic commercial law. However, since then, with due credit to the ingenuity of common law lawyers and with the assistance of Shariah jurists, the finance industry has converted Islamic trading concepts into Islamic financing concepts by using common law documentation. When financiers were licensed to provide facilities like those provided by conventional bankers, they acquired the name of Islamic Banks, even though Shariah jurisprudence does not recognise banking activities in the conventional sense. Islamic financers or bankers are traders and/or venture capitalists who must primarily earn their profits by trading activities which are approved and/or permitted within the concept of Islamic jurisprudence. They do not simply extend loans and collect interest which are the ordinary businesses of conventional banks.

[4.024] The distinction between trader, financier and banker in the Shariah sense is important. Islam allows any person to trade using one of the trading instruments employing the concepts of *Mudarabah, Musharakah* (partnership) or *Ijarah* (leasing). If the same person wants to finance the buying of products or investments in business, he can do so by using one or more of these concepts. If he does so he is referred to as a financier. When the same financier receives deposits and provides other facilities such as cheques and corporate guarantees – just as what conventional banks do – they are referred to as Islamic banks. What Islamic jurisprudence does not permit, or what Islamic jurist have reservations about, is in relation to the conversion of trading concepts to provide loans and to receive rewards in the disguise of profit.

[4.025] When dispute arises as to whether an Islamic finance facility is Shariah compliant, the English courts have taken a non-interventionist approach. That is to say, they are not concerned with whether a document is Shariah compliant as long as these are valid under the English law. In *Shamil Bank of Bahrain v Beximco Pharmaceuticals Limited* [2003] EWHC 2118, the court refused to apply Shariah principles even though it was a *Murabahah* transaction which terms of agreement had specifically stated that: 'Subject to the principles of Glorious Shariah, this agreement shall be governed by and construed in accordance with the laws of England.' What was surprising in the *Shamil Bank* case was that while the said documents were approved by the bank's Shariah experts consisting of distinguished scholars from Egypt, Turkey, Saudi Arabia and Bahrain, the bank was not prepared to argue unequivocally for the court to construe the documents according to the principles of Shariah. This is captured, *inter alia*, in paragraphs 23 to 25 of the judgment which reads as follows:

> *The claimants also say that the words 'subject to the principles of Glorious Shariah' do not constitute a choice of law at all but are a reference to, or a reflection of, the fact that the bank seeks to conduct its affairs according to Shariah principles under the supervision of the board. They also say that even if Shariah law were to apply, then in accordance with the opinion of Dr. Lau, their expert, the exchange agreements, under which these claims are made, are enforceable. They say, in any event, if they are wrong about all that, at least the capital that has been advanced by the bank is due and owing under the exchange agreements even if the compensation and other amounts on top are not.*
>
> *They say that the words Glorious Shariah principles are a reference to religious principles rather than to a choice of a coherent system of law. There is, they submitted, the greatest controversy, as shown by the evidence, between experts and indeed between Islamic courts, as to the 'true' principles. And, given that controversy, it is highly improbable that the parties intended an English court to determine difficult questions of the Shariah principles. As Dr. Lau points out in his first expert report, Shariah law is made up of conflicting pronouncements and there is a considerable debate as to what is and what is not permissible under it. The situation is complicated by the fact that much of the classical law emerged at a time when many financial concepts simply did not exist. It is because of these systemic uncertainties and controversies that Islamic banks submit themselves to the supervision and scrutiny of religious supervisory boards.*
>
> *It was submitted that this statement is supported, to an extent, by the fact that Mr. Justice Khan's confident assertions, as to the principles of Shariah law, were overruled, effectively, by the Shariah appellate branch of the High Court of Pakistan which annulled his judgment in the Khaki case. It is also, they say, supported, to an extent, by Mr. Justice Khan's report itself.*

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In Shariah, there is no opinion of any person, body or jurist which binds a court which has to decide a Shariah issue. The dispute must be resolved by the court in the light of its' own view of the position under the Shariah law.

[4.026] Basically, the *Shamil Bank* case will support the proposition that as long as the Islamic Facility Agreement does not breach the law relating to contractual obligation of the country, the courts will recognise and enforce the terms. The courts will not entertain any defence to say that the facility is not Shariah compliant.

5. NEED FOR A LEGAL FRAMEWORK

[4.027] A legal framework for Islamic banking is necessary not only to promote but also to strengthen contractual obligations as well as to protect consumers. In addition, it is necessary to minimise the confrontation of legal issues and to provide certainty for the financier as well as the customer for obligations which they have entered into. It is well established that Islamic and conventional banking are not one and the same to be regulated by the same legal framework to achieve the objectives of the banker and the customer. In consequence, of the so-called sharing, there is a veritable explosion of case laws. To arrest uncertainty arising from case law, and to harmonise operational and administrative issues, attempts have been made in Malaysia and in other countries to provide a proper legal framework – at least on an *ad hoc* basis – for the smooth operation of Islamic banking side by side with conventional banking without the need to be regulated by the same legal framework that governs conventional banks. The legal issues and problems arise in court basically because Islamic banking documents presuppose Shariah compliance. However, the law used to enforce the legal rights is based on a common law system. The issues which often become the subject matter of litigation are related to whether the product is Shariah compliant as evident from the *Shamil Bank* case.

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[4.028] The other interesting legal aspect touches upon the constitution of countries which is the subject of a notable judgment in India. In *Dr Subrahmaniam Swamy v State of Kerala* [2011] Indlaw KER 44, the petitioner challenged the State Government for promoting Islamic banking as violative of the provisions of the Indian Constitution. In essence, the petitioner argued that the Constitution was secular and that any activity of the state in promoting or assisting any religion was inconsistent with the principles of secularism. The Kerala High Court rejected the petitioner's argument and essentially concluded that commercial activities which may have some religious foundation will not breach the constitution or doctrine of secularism. This decision is comforting for Islamic bankers in India. However, further challenges may

come in other forms unless there is separate legal framework for operation of Islamic banking in India. As it stands, it appears that the Reserve Bank of India has not fully endorsed the operation of Islamic banking in India.

6. CONCLUSION

[4.029] It is significant to note the Holy Quran does not allow lending activities as done by conventional banks. The Holy Quran only allows trading activities. In short, the term '*Islamic Banking*' is not synonymous with or identical to conventional banking. Although 'Islamic Banking' appears to be a misnomer, it has by way of documentation – through the ingenuity of contemporary Islamic jurists, economists and bankers with the assistance of common law lawyers – converted the trading concepts into financing and banking concepts, which has in turn allowed Islamic bankers to conduct whatever businesses their conventional banking counterparts have been traditionally doing.

[4.030] When one peruses a loan facility document such as the provision of finance to purchase a property prepared by a conventional bank, it will reflect that they are lenders. However, when one peruses a document for the same purpose by a Shariah bank, it will reflect that they are traders or venture capitalists achieving more or less the same end result for the customer. When the trading concepts were first introduced by the financial institutions, there was hardly any legal framework to support the documents. As more and more challenges were taken to the courts, the regulators came out with *ad hoc* measures and/or productive framework, not only to address legal issues, but also to ensure greater transparency in all aspects.

[4.031] The foregoing emphasises the need for a transparent and well received legal framework which universal acceptance is essential to ensure the further growth of Islamic banking products. Islamic finance has become a big business venture globally and no financial centre of international repute can afford to be left out. It is therefore in the interest of all parties – from the provider to the user of capital and those who regulate such activities – to ensure the establishment and effective enforcement of an appropriate legal framework is put in place to ensure the continued global growth of Islamic banking.

benefit of their controlling shareholders is more prevalent in civil law jurisdictions[3] and is significant for two reasons, namely: (a) the importance of the centrality of legal protection for minority shareholders; and (b) the assertion that legal regulation can outperform private contracting. In short, strong legal regulation and effective enforcement are critical to sound and effective corporate governance.

3. DOES IT MATTER IN PRACTICE?

[7.004] These findings have significant policy implications as good corporate governance practices contribute towards the overall well-being of a financial system as witnessed from both the Asian Financial Crisis in 1997 as well as the Global Financial Crisis in 2008. The former brought to the foreground the common occurrence of weak corporate governance that allowed companies to engage in excessive over-leverage, some of which were aided by implicit state guarantees; while the latter exposed significant shortcomings with the *laissez-faire* attitude towards deregulation in the financial services industry in the United States of America. A common thread through these crises was that the concepts of transparency, disclosure and accountability were largely ignored as investors assumed short-term outlooks to derive increasing profits from the steadily rising financial markets.

[7.005] In the lead up to the Asian financial crisis, companies across the region were guilty of neglecting the principles of good corporate governance, the difference being perhaps in the degree of neglect. This is evident from instances of corporate abuse through related party transactions, incidence of capricious decision-making, shifting of assets within the corporate group, undertaking of transactions without proper disclosure and poor financial management by directors. The repeal of the *Glass-Steagall Act* of 1933 – which separated the commercial and investment banking activities of financial institutions – by the *Gramm-Leach-Bliley Act* in the United States of America in 1999 is often viewed as a key contributor towards the Global Financial Crisis. With the support of the then Federal Reserve Chairman Alan Greenspan as well as the then Treasury Secretary Professor Lawrence Summers, this reform allowed banks to use their deposits to invest in derivatives. By doing so, it allowed the larger banks to deploy their resources towards the creation of increasingly sophisticated and complex derivatives which coincide with the growth of subprime mortgages as financial institutions sought to increase their rates of

[3] *See for example* La Porta F., Lopez-de-Silanes F., Shleifer A., & Vishny R.W., (2002) '*Investor Protection and Corporate Valuation*', (2002) Vol 57 No 3 Journal of Finance 1147; Johnson S., La Porta R., Lopez-de-Silanes F., and Shleifer A., '*Tunnelling*', (2001) Vol 90 No 2 American Economic Review 22; and Johnson S., Boone P., Breach A., and Friedman E., (2000) '*Corporate Governance in the Asian Financial Crisis*', (2000) Vol 58 No 1 Journal of Financial Economics 141.

returns. When the housing bubble burst, it precipitated the banking crisis in 2007 which subsequently spread to Wall Street as by 2008 a number of the major banks – with their over-reaching tentacles into the financial markets – had become 'too big to fail'.

4. DEFINING CORPORATE GOVERNANCE

[7.006] The term 'corporate governance' was succinctly defined in *The Cadbury Report* as 'the system by which companies are directed and controlled,'[4] which was explained as follows:

> "Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place."[5]

[7.007] Although somewhat simplistic, it highlights the importance of processes that companies should institute and implement to ensure that effective practices transcend the various levels of the organisation. These were viewed as necessary responses to what was then seen as the lack of managerial oversight which led to the spectacular corporate collapses of the Bank of Credit and Commerce International, Coloroll, the Polly Peck Group and Maxwell Communication Corporation in the late 1980s and early 1990s. These collapses did not only result in substantial financial losses to shareholders, employees, creditors, investors as well as the government – they were also seen as posing considerable challenges to the integrity and reputation of the City of London as an international financial centre.

[7.008] Significantly, the Cadbury Report recommended that compliance should be based on a voluntary *Code of Best Practice* – designed to achieve the necessary high standards of corporate behaviour – supplemented by appropriate levels of disclosure as this would:

> "... prove more effective than a statutory code. It is directed at establishing best practice, at encouraging pressure from shareholders to hasten its widespread adoption, and at allowing some flexibility in implementation. We recognise, however, that if companies do not back our recommendations, it is probable that legislation and external regulation will be sought to deal with some of the underlying problems which the report identifies. Statutory measures would impose a minimum standard and there

[4] *See* Report of the Committee on The Financial Aspects of Corporate Governance also commonly known as *The Cadbury Report* (1 December 1992) at paragraph 2.5 available at http://cadbury.cjbs.archios.info/report (accessed 15 October 2017).

[5] *Ibid* at paragraph 2.5.

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would be a greater risk of boards complying with the letter, rather than with the spirit, of their requirements."[6]

[7.009] It must be noted that the scope of the Cadbury Report was specifically to address issues arising from the financial aspects of corporate governance,[7] and in the circumstances the committee opined that it would be most appropriate to adopt a principles-based 'comply or explain' approach. In a nutshell, companies were expected to comply with the core corporate governance principles identified in the voluntary *Corporate Governance Code* and if they do not comply, they needed to explain why not. The underlying aims of this approach was to ensure transparency as it was hoped that market forces and pressure from investors would ensure compliance rather than explaining non-compliance.

[7.010] This principles-based self-regulatory approach rapidly gained favour across global capital markets. The idea of a voluntary *Code on Corporate Governance* that focuses on structures, processes and practices has been actively promoted since the publication of the Cadbury Report in 1992 and the present UK Corporate Governance Code, which was published in September 2014, now sits at the forefront having being followed in almost every sophisticated corporate law system in the world.[8]

5. DIFFERENT MODELS FOR CORPORATE GOVERNANCE

[7.011] The evolution of the 'comply or explain model' has continued over the years, assisted by the publication of the *Principles of Corporate Governance* by the Organisation for Economic Co-operation and Development (the "OECD Principles") in 1999, providing a sound template upon which the various Codes of Corporate Governance across jurisdictions could be harmonised. Recognising that good corporate governance is not an end in itself and in response to various developments in the financial markets as well as with the global economy, the OECD Principles were updated and revised in 2004 and 2015, respectively.[9]

[6] *Ibid* at paragraph 1.10

[7] *Ibid* at paragraph 2.8 which states that 'The Committee's objective is to help to raise the standards of corporate governance and the level of confidence in financial reporting and auditing by setting out clearly what it sees as the respective responsibilities of those involved and what it believes is expected of them.'

[8] *See e.g.* European Corporate Governance Institute – Index of Codes available at http://www.ecgi.org/codes/all_codes.php (accessed 15 October 2017)

[9] The OECD Principles provide an indispensable and globally recognised benchmark for assessing and improving corporate governance and have been adopted as one of the Financial Stability Board's key standards for sound financial systems. They have been used by the World Bank Group in more than 60 country reviews worldwide and they also serve as the basis for the guidelines on corporate governance of banks issued by the Basel Committee on Banking Supervision: *see* G20/OECD Principles of Corporate Governance available at https://www.oecd.org/corporate/principles-corporate-governance.htm (accessed 15 October 2017).

[7.012] While most countries have adopted the principles-based approach, it is not the only model as some jurisdictions such as the United States of America practices a rules-based approach. The latter has enshrined its applicable standards of corporate governance in the *Sarbanes-Oxley Act* thereby making compliance mandatory.[10] A key objective of passing this legislation was to restore public confidence in the markets following the scandals which surfaced from the collapse and subsequent bankruptcies of Enron, WorldCom, Adelphia, Tyco and Global Crossing in the preceding two years which resulted in billions of dollars in financial losses as well as the loss of thousands of jobs.

[7.013] However, the irony is that it was with this almost draconian legislation firmly in place when its shortcomings were glaringly exposed with the collapse of Lehman Brothers in the United States of America, triggering the Global Financial Crisis of 2008 with its well-known impact on the American and world economies. Another knee-jerk reaction followed with more draconian legislation passed in the form of the *Dodd-Frank Act* of 2010[11] as the black letter law approach, with its severe sanctions for contraventions of the rules, was perpetuated.

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[7.014] Did the self-regulatory and principles-based approach on the other side of the Atlantic fare any better? That is very hard to conclude as was crudely illustrated by the collapse of the Royal Bank of Scotland which necessitated the biggest bank bail-out ever by the British government.

[7.015] So, what are the choices if any? Despite the differences in approach, both the principles-based as well as the rules-based models share a common objective, namely, to enhance the quality of the processes that support the practice of good corporate governance through lessons learnt from the corporate collapses from the late 1980s through to early 2002. However, is one model to be preferred over the other?

[7.016] In his speech at the 2003 Washington Economic Policy Conference, Mr William Donaldson, the then Chairman of the Securities and Exchange Commission, noted that 'corporate scandals have exacerbated the roughly US$7 trillion collapse in the aggregate market value of American corporations over the past few years' and opined that:

> "... a "check the box" approach to good corporate governance will not inspire a true sense of ethical obligation. It could merely lead to

[10] The full title for the *Sarbanes-Oxley Act* which was enacted in July 2002 and commonly known by its acronym 'SOX' is *Public Company Accounting Reform and Investor Protection Act*. The full text of SOX is available at https://www.sec.gov/about/laws/soa2002.pdf (accessed 15 October 2017).

[11] The *Dodd-Frank Wall Street Reform and Consumer Protection Act* which was enacted in January 2010 is available at https://www.sec.gov/about/laws/wallstreetreform-cpa.pdf (accessed 15 October 2017).

an array of inhibiting, "politically correct" dictates. If this was the case, ultimately corporations would not strive to meet higher standards, they would only strain under new costs associated with fulfilling a mandated process that could produce little of the desired effect. They would lose the freedom to make innovative decisions that an ethically sound entrepreneurial culture requires.

As the board properly exercises its power, representing all stakeholders, I would suggest that the board members define the culture of ethics that they expect all aspects of the company to embrace. The philosophy that they articulate must pertain not only the board's selection of a chief executive officer, but also the spirit and very DNA of the corporate body itself - from top to bottom and from bottom to top. Only after the board meets this fundamental obligation to define the culture and ethics of the corporation - and for that matter of the board itself - can it go on and make its own decisions about the implementation of this culture.

This definition of culture - of what kind of company they want to be - will influence all their decisions, including what criteria they use when selecting a CEO, what criteria the CEO will use to select other management, how the board will function, what characteristics new directors should demonstrate, what the committees or instruments of the board should be, and what kind of leadership structure should be installed. This is, in my view, not a one-size-fits-all exercise."[12]

[7.017] Just simply checking the box is not enough and it is trite that the foundations of good corporate governance must rest upon an effective system of checks and balances as highlighted succinctly by *Monks and Minow*:

"In essence, corporate governance is the structure that is intended (1) to make sure that the right questions get asked and (2) that checks and balances are in place to make sure that the answers reflect what is best for the creation of long-term, sustainable, renewable value."[13]

[7.018] With moral hazard appearing to increase on the part of investors, especially with government intervention following the global financial crisis, how do we effectively respond to the cultural and structural challenges that are raised above? How do we get corporate boards to move away from the 'shareholder primacy' model – where only profits matter as charity has no seat at the board – to one that encompasses a more diverse range of interests which include shareholders, employees, consumers, the community and the

[12] Available at https://www.sec.gov/news/speech/spch032403whd.htm (accessed 15 October 2017).

[13] *See* Monks R.A.G, & Minow N., *Corporate Governance*, John Wiley & Sons (2011) at page xxii.

environment? Should we – and would it be too onerous – to impose upon boards of directors a duty to consider, and to implement, robust standards for good corporate social responsibility as a safeguard against reputational risks?

[7.019] While voluntary compliance with good corporate governance practices based on the principle of 'comply or explain' has gained wide recognition as possibly one of the best and most comprehensive examples of 'self-regulation', questions have nonetheless arisen with respect to whether it is the most effective way of ensuring that corporations act responsibly. 'Soft' law is beneficial only where there is active compliance by business elites, diligent monitoring by capital market actors, and effective control by regulatory elites. On a critical analysis, have these Codes contributed significantly to improved corporate governance practices? If they have not, is it time – at least in certain areas – to rethink and re-evaluate the case for enhanced reliance on 'hard law' so as to provide clearer expectations to ensure compliance? In short, should corporate governance be by rule or by principle or indeed by some hybrid of the two?

6. WHAT'S NEXT?

[7.020] Amongst the key causes of the global financial crisis are the failures of ethical and effective leadership of corporations, characteristics of which make them difficult to regulate let alone ponder over the impossibility of legislating on such issues. Principles of corporate governance need to be more carefully contextualised and diversified, especially in the transnational domain. Simultaneously, the status of and relations between citizenship, states, transnational corporations and non-governmental organisations in a transnational regulatory domain needs much closer consideration. Only with these issues addressed can there be a more balanced and fruitful discussion of corporate governance mechanisms take place, especially when it comes to assessing the merits of 'soft' versus 'hard' law in a given political economy.

[7.021] In the circumstances, despite the complexities, the appeal of the flexibility of Codes which encompasses both soft and hard law becomes increasingly evident. Guidance on this vexed issue may be obtained from the recently released *King IV Report* which as highlighted by Mervyn E King SC, the Chair of the King IV Committee:

"King IV has moved from "apply or explain" to "apply and explain", but has reduced the 75 principles in King III to 17 basic principles in King IV, one of which applies to institutional investors only. 16 of these principles can be applied by any organisation, and all are required to substantiate a claim that good governance is being practiced. The required explanation allows stakeholders to make an informed decision as to

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whether or not the organisation is achieving the four good governance outcomes required by King IV. Explanation also helps to encourage organisations to see corporate governance not as an act of mindless compliance, but something that will yield results only it is approached mindfully, with due consideration to the organisation's circumstances."[14]

[7.022] The four good governance outcomes is defined in King IV to be the exercise of ethical and effective leadership by the governing body towards the achievement of an ethical culture, good performance, effective control and legitimacy.[15] Taking cognizance of the paradigm shifts in the corporate world, the foundation stones upon which King IV are built include 'ethical leadership, the organisation in society, corporate citizenship, sustainable development, stakeholder inclusivity, integrated thinking and integrated reporting.'[16]

[7.023] The appeal of King IV lies substantially in its universal applicability stating as it does that 'good leadership, which is underpinned by the principles of good governance, is equally valuable in all types of organisations … it talks of organisations and governing bodies, rather than simply companies and boards of directors.'[17]

7. MISGOVERNANCE IN SOUTH AFRICA – A TRILOGY OF CASE STUDIES

[7.024] The recent scandals in South Africa surrounding three different entities with significant international repute, namely - *Bell Pottinger*, *McKinsey* and *KPMG South Africa* - has highlighted the importance of good corporate governance and of the potentially devastating repercussions that follow the failure to recognise evolving community expectations of good corporate citizenship as well as to meet exacting standards.

[7.025] Bell Pottinger was once one of the most dominant British public relations firm but filed for administration following revelations that it had run a racially divisive social media campaign for, and which targeted wealthy white South African business rivals of the Gupta family in South Africa,[18] which resulted in

[14] *See* The Institute of Directors in South Africa NPC, '*King IV: Report on Corporate Governance for South Africa 2016*' at page 7 available at http://c.ymcdn.com/sites/www.iodsa.co.za/resource/resmgr/king_iv/King_IV_Report/IoDSA_King_IV_Report_-_WebVe.pdf (accessed 15 October 2017).

[15] *Ibid* at page 11. 'Corporate' refers to organisations that are incorporated to form legal entities separate from their founders and therefore applies to all forms of incorporation whether as company, voluntary association, retirement fund, trust, legislated entity or others.

[16] *Ibid* at page 4.

[17] *Ibid* at page 6.

[18] *See* Withers I., '*Bell Pottinger succumbs to South Africa scandal as agency falls into administration*', THE ECONOMIST 12 September 2017.

it being expelled from the Public Relations and Communications Association on 5 September 2017[19] and losing major clients including HSBC plc.

[7.026] With offices across the world, McKinsey prides itself on operating as 'One Firm' although local rules in different jurisdictions often meant that the international firm had to have a local partner. It did highly lucrative work for Eskom Holdings, a state-owned electricity monopoly which is presently at the centre of several 'state capture' allegations in South Africa.[20] An interim report, commissioned by Eskom and produced by G9 Forensic, detailed how Eskom's own legal advisers warned it not to enter into an agreement with McKinsey because the proposed revenue model might be illegal.[21] The quantum involved is substantial with some US$121 million in fees already paid to McKinsey and Trillian Capital Partners Limited, a company linked to the Guptas, and a further US$590 million due under the contract. Significantly, it was reported that McKinsey does not appear to be contesting this allegation unequivocally, merely stating that it would repay the consultancy fees if the High Court ruled that Eskom officials had acted unlawfully.[22] This was subsequently affirmed by a media statement which stated that:

> "To provide reassurance to the citizens of South Africa, we will support a review by the High Court of the validity of the Turnaround Programme contract. McKinsey will pay back the fee in full if the Court determines Eskom acted unlawfully. We invite Eskom and Trillian to submit themselves to this process too. *In the expectation it will be repaid, we have already set aside the full fee McKinsey earned* on the Turnaround Programme in a ring-fenced account ready to comply with the Court's decision[23] (*emphasis added*)."

[7.027] McKinsey stated that its internal investigations confirmed that it never had a formal contract with Trillian, although they had worked together for a few months at Eskom, and that the latter withheld information about its connections to a Gupta family associate. Nonetheless, McKinsey publicly recognised a number of grave oversights and apologised for 'several errors of judgment'

[19] *See* PRCA, *PRC announces expulsion of Bell Pottinger*, available at http://news.prca.org.uk/prca-announces-expulsion-of-bell-pottinger (accessed 16 October 2017).

[20] The term 'state capture' refers to a type of systemic political corruption in which private interests significantly influence the decision-making processes of the state to their own advantage.

[21] *See* Legalbrief Forensic, *How McKinsey, Trillian planned for Eskom's billions*, available at http://legalbrief.co.za/diary/legalbrief-forensic/story/how-mckinsey-trillian-planned-for-eskom-billions/print (accessed 16 October 2017).

[22] *See* '*Why McKinsey is under attack in South Africa*', THE ECONOMIST 12 October 2017.

[23] *See* McKinsey & Company South Africa, *McKinsey & Company statement on Eskom* (17 October 2017), available at https://www.mckinsey.com/south-africa/our-work/mckinsey-investigation-statement?cid=sas-psc-gaw-mkf-mck-oth-1710-lka (accessed 18 October 2017).

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as well as 'violations of our professional standards'; and admitted that 'we should not have started working alongside Trillian in December 2015 before we had completed our due diligence and had answers to our questions.' In addition, it announced the departure of Mr Vikas Sagar – a partner who was suspended since July 2017 when news of the potential scandal initially surfaced – and that it would not begin any work for any South Africa state-owned company ('SOC') unless this was thoroughly reviewed and formally approved by a newly formed and independent South Africa SOC Risk Committee.

[7.028] The case of KPMG South Africa ('KPMG SA') raises many unanswered questions and highlights the importance of good corporate governance.[24] It also raises an important policy issue, namely, whether global auditing firms have becomes 'too big to fail' thereby created a real risk of systemic contagion. In a nutshell, it is alleged that KPMG SA – in breach of its professional obligations and proclaimed values – were complicit in the facilitation of corruption and attempts at state capture in South Africa. Of particular concerns were KPMG SA's involvement in facilitating tax evasion and corruption by the Gupta family over an extended period of time; the handling of conflicts of interest and independence as well as a perceived lack of integrity when dealing with Gupta entities; the attendance of four of its partners at a Gupta family wedding; the concession that it ignored both due process and the integrity test as well as paid scant attention to the institutional and systemic damage that its report for the South African Revenue Service would entail; and the delays in supplying the Independent Regulatory Board of Auditors ('IRBA') with answers and documents which the IRBA had asked for to facilitate its assessment of whether there was a major error in the audit process by the firm.

[7.029] Although a number of the senior leadership team of KMPG SA – including its Chairman, Chief Executive Officer and Chief Operating Officer – resigned and were replaced, it was subsequently confirmed before the Parliament's Standing Committee of Public Accountants that these ousted partners were all provided with substantial 'golden handshakes'. Taken together, this further enhanced the lack of trust and confidence in KPMG SA leading to the loss of a number of prominent companies, including some that are listed on the Johannesburg Stock Exchange, as clients.[25] Despite this, worse may yet

[24] *See* KPMG International Media Statement, *KPMG South Africa leadership changes and key findings arising from KPMG International's Investigation* dated 15 September 2017 available at https://home.kpmg.com/za/en/home/media/press-releases/2017/09/kpmg-international-media-statement.html and KPMG International, *Statement on South Africa Investigation* dated 23 September 201 available at https://home.kpmg.com/za/en/home/home/press-releases/2017/09/kpmg-international--statement-on-south-africa-investigation.html (accessed 15 October 2017).

[25] These include the Foshini Group which has two ex-KPMG SA partners on its board of directors; Sasfin Holdings Ltd; Sygnia Ltd and Hulisani Ltd.

be to come as complicity in illicit financial flows – if proven – attracts significant financial and non-monetary penalties across all OECD jurisdictions which could in turn threaten the viability of KPMG as a 'Big Four' global accountancy firm.

8. CONCLUSION

[7.030] Codes of corporate governance have come a long way since the publication of the Cadbury Report about a quarter of a century ago. It must be remembered that the committee chaired by Sir Adrian Cadbury was tasked simply to deal with the financial aspects of corporate governance and that we have in the intervening period since then expanded considerably on the scope of such codes. On the other hand, the United States of America adopts a 'black letter law' approach with a legislative framework setting out the requirements and resulting penalties for non-compliance. It is trite that there is no 'One Size Fits All' as regards 'soft' or 'hard' law since market development and maturity may differ across jurisdictions compounded by cultural and/or socio-economic considerations. Accordingly what may work well in one country may not necessarily produce similar results in another.

[7.031] That said, what is clear is that there must be adherence to some basic common sensical practices which transcends national boundaries especially since there is a common denominator in the corporate governance debate namely that companies always involve the use of 'other people's money' for which there is a legitimate right to expect that this will be applied responsibly by those empowered to do so.[26] As the tentacles of the modern corporation reach further outwards so too must there be a commensurate level of corporate behaviour that meets the expectations of the various stakeholders which continue to evolve.

[7.032] The practice of corporate governance – together with its associated Codes as well as legislation – have evolved over the past 25 years during which time numerous corporate excesses have been witnessed, leading to the Asian financial crisis in 1997 as well as the global financial crisis in 2008. Although a number of fora has been set up to raise and discuss some of the issues, as well as to propose changes, it must be expressly recognised that despite all best intentions we must recognise the fragilities of humans which have invariably been the dominant or root cause of the crises that we have experienced to date.

[26] *See for example* Commonsense Corporate Governance Principles available at http://www.governanceprinciples.org (accessed 15 October 2017).

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some of the technical legal reasons underpinning the market's reliance upon the Cayman Islands and the BVI to establish effective securitisation structures, as well as to introduce the reader to some of the lesser-known structuring solutions and new innovations that our jurisdictions have to offer.

2. THE OFFSHORE LEGAL FRAMEWORK

A "creditor-friendly" jurisdiction

[8.002] The phrase "creditor-friendly" has become synonymous with the Cayman Islands and the BVI. Our jurisdictions are lightly and effectively regulated by flexible and modern laws designed to facilitate, and regularly revised to stay apace with the evolving requirements of, the most sophisticated financial transactions. Each enjoying the same common law roots, strong rule of law, respected court systems and genuine, isolated political independence that facilitates the neutrality of a truly offshore jurisdiction, Cayman and BVI have evolved so successfully as global financial centres thanks to their continuing ability to offer flexible structures that can be put in place efficiently and cost effectively, provide seamless and integrated global service to the satisfaction of the world's most sophisticated client base, demonstrate compliance with the most stringent demands of rapidly changing global financial regulation and instill market confidence by handing down judgments that prove the resilience of principles and structures that are stress-tested by challenge in the courts.

Ease of establishing an off-balance sheet structure

[8.003] For a securitisation to be off-balance sheet, and to avoid consolidation of the originator and the SPV for tax, regulatory or accounting purposes, the SPV will need to be incorporated as an independent "orphan" SPV owned by trustees rather than a subsidiary of the originator, and the originator will want to avoid exerting excessive influence or control over the SPV. Both Cayman and BVI offer the ability to establish a charitable or non-charitable trust structure that can be operated completely independently of a bank's balance sheet. Under a quirk of the common law (which applies in the BVI and Cayman), charitable trusts are not treated as being beneficially owned by anyone; hence the name "orphan" SPV. Furthermore, both jurisdictions allow the appointment of either individual or corporate directors, and neither impose any residency requirement on such directors. Most offshore legal advisers will have associated fiduciary business arms that can set up the orphan trust structure and provide independent directors to ensure that the business and affairs of the SPV can be carried out effectively whilst operating independently of the transaction originator.

[8.004] It will be critical both from the perspective of the investor and the originator that the courts cannot pierce the veil of incorporation. The originator especially if it is a financial institution, will want to ensure that the SPV remains off-balance

sheet and is not consolidated for accounting and regulatory purposes. Generally speaking, in Cayman and BVI, the existence of the SPV as a separate and independent entity from its shareholders will be upheld,[2] and the courts will only generally be willing to pierce the corporate veil where the structure is fraudulent,[3] illegal, improper, or a mere façade or sham concealing the true facts.[4]

Obviating insolvency risk

[8.005] It is critical to the success of any securitisation transaction to ensure that the SPV is as insolvency remote as possible, especially where its obligations to pay interest and principal on the securities are not secured by reference to the underlying assets or guaranteed by the originator or an affiliate. This is easier to achieve in BVI and Cayman than in other jurisdictions for a number of reasons.

- Cayman and BVI SPVs can be newly incorporated and structured to be bankruptcy remote as the only assets they will own are the income producing assets, purchased from the proceeds of the relevant issuance (which may be private or listed and is often rated), and the only liabilities they will incur (after payment of the set up costs and making provision for any fees associated with collapsing the structure) are the payment obligations on the income streams. Economically, the investors in the SPV are taking credit risk on the income streams. When the securities are paid out at maturity, the SPV will be wound up and any surplus will be returned to the trust for distribution to charity. With careful advance planning, this is typically a very modest amount.
- Sometimes, the credit and marketability of the SPV issuance may be improved by a guarantee or some other type of third party credit support. In circumstances of a whole business securitisation, the cash flows derive from the entire range of operating revenues generated by a whole business, not from the repayment of debt of other pre-contracted cash flows or receivables, and a secured loan structure is used. The ease of taking effective security in Cayman and the BVI, coupled with the secured party's ability to enforce any such security without recourse to the courts or any liquidator is another reason why the jurisdictions are popular among originators and investors. Despite the general market practice of preferring Cayman Islands SPVs, this may be particularly true in the BVI, which operates a comprehensive regime for the registration of security interests that, once registered, enjoy statutory priority as a matter of BVI law.
- BVI and Cayman Islands companies generally have the power to carry out any lawful object, and all powers, rights and privileges of a natural

[2] *Salomon v Salomon & Co Ltd* [1896] UKHL 1.

[3] *Lazarus Estates Ltd v Beasley* [1956] 1 QB 702; *Prest v Petrodel Resources Ltd* [2013] UKSC 34.

[4] *Woolfson v Strathclyde Regional Council* 1978 SC 1 (HL) 90.

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person. This renders issues of *ultra vires* acts inapplicable; however, it is possible to incorporate an SPV with limited capacity by restricting its objects in the memorandum of association to such actions as are required to facilitate the subject transaction. Actions taken outside such objects will be subject to challenge and may be declared void by the courts, as well as attracting potential liability for losses incurred by any director acting outside of the scope of the memorandum, which effectively operates to frame a director's equitable fiduciary duties. Limiting an SPV's objects in this way will also ensure that the directors can agree to undertakings restricting the business and affairs of the SPV that, having being hard-wired into the SPV's constitution, are far less likely to attract challenge as an unlawful fettering of a director's discretion.[5] Even if a foreign court is called upon to determine whether the SPV has incurred a liability outside of its objects, most common law jurisdictions recognise that corporate capacity is a matter for the law of the jurisdiction of incorporation.[6]

- Another way to protect the integrity of the SPV's operations is to impose restrictions on sale of the sales in the SPV, limiting the trustee's ability to make structural changes (such as merger, consolidation, continuation, widening of the objects clause or even voting to terminate the trust or put the SPV into voluntary liquidation) that may otherwise undermine the value of the securities. The courts in both jurisdictions have a proven track record of upholding the principles of freedom of contract and such restrictions and limitations are generally acceptable under Cayman and BVI law.
- In a securitisation transaction, all parties to the transaction – the trustee, the note holders, indenture trustee and all other service providers - will usually agree in the transaction documents that they will not take any action against the issuer or any steps to petition for its insolvent liquidation. Whether any such contractual agreement stands up to the scrutiny of the courts will depend upon the jurisdiction of incorporation of the issuer. Both the BVI and Cayman Islands courts usually uphold general freedom of contract principles; however, in the Cayman Islands, confidence in the effectiveness of non-petition wording is further bolstered by express statutory recognition whereby:

  > "*The Court shall dismiss a winding up petition or adjourn the hearing of a winding up petition on the ground that the petitioner is contractually bound not to present a petition against the company.*"[7]

[5] E.g. under the common law rule in *Russell v Northern Bank Development Corp Ltd* [1992] 1 WLR 588 (HL).

[6] *Banco de Bilbao v Sancha* [1938] 2 KB 176.

[7] Companies Law (Revised) (Cayman Islands), section 95(2).

  The Cayman Islands Grand Court recently used this provision to dismiss the hearing of an application in a case where Harneys was able to secure our client the first ever strike out of a winding up petition on the basis that the petitioner was contractually bound not to present it.[8] Miss Justice Mangatal struck out the petition as an abuse of process, rendering the statutory recognition of contractual non-petition agreements unambiguous in its terms and mandatory in its application.
- Similarly, the courts are also usually willing to recognise limited recourse provisions in transactions; mechanics whereby the SPV's liabilities will be extinguished to the extent that they exceed its assets, thereby avoiding any risk of insolvency arising.

3. CHOICES OF SPV VEHICLE

[8.006] Whilst the basic form of corporate entity in Cayman and BVI - respectively, the exempted company and the BVI business company – are both perfectly effective securitisation SPVs, each jurisidiction also fields some highly specialised types of entity that may be particularly well suited to transactions in the structured finance space. The Cayman segregated portfolio company ("SPC") and the BVI restricted purpose company ("RPC") have already been used successfully in the sector, and recent legislative innovation has added two further sophisticated structuring options to the offshore inventory.

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Cayman Islands segregated portfolio companies

[8.007] Any Cayman Islands exempted company may be incorporated as an SPC under Cayman corporate law, and an existing exempted company may be registered as an SPC subsequent to incorporation. The concept of an SPC is that the relevant company, which remains a single legal entity, may create separate segregated portfolios ("Portfolio") with the assets and liabilities of each Portfolio being statutorily ring-fenced, both from the assets and liabilities of each other Portfolio the company has created and from the general assets and liabilities of the company (namely, any income and property that is not specifically attributable to a particular Portfolio). The main benefit of using an SPC for establishing segregation of assets and liabilities, rather than alternative methods such as contractual limited recourse wording, is that the ring-fencing is embedded in statute rather than contract and so has the benefit of statutory recognition, at least in the place of incorporation of the SPC which here would be the Cayman Islands. Potential conflicts of law issues arising in connection with any foreign court (in particular in the bankruptcy context) failing to recognise segregation are usually mitigated by coupling the SPC structure with standard contractual

[8] [2016 (1) CILR 273] *In the Matter of Rhone Holdings L.P.*

limited recourse mechanics. However, the other important benefit of the SPC regime is that as a statutory regime under the Companies Law, it also binds non-consensual third parties and so extends the ring-fencing concept to parties who would otherwise not be covered by contractual ring-fencing. SPCs have traditionally been used widely in the investment funds and insurance sectors; however, since an SPC can be utilised to create multiple tranche debt issuing vehicles, they are also ideal for use in securitisation structures. Take, for example, a collateralised debt obligation transaction. This will require the incorporation of an SPV that will issue securities divided into several classes or tranches of varying size, credit rating and priority ranking (categorised as senior, mezzanine or subordinated), relating to the relative stability of the underlying financial assets. The highest-ranking security will get paid out first but will receive the lowest return, and the lowest ranking – or riskiest – security will attract the highest return. The right to be paid out first is regulated by inter-creditor arrangements with strict subordination provisions, but in the event the subordination is compromised, senior credit providers still have to rely on the cooperation of junior providers to comply with their contractual obligations to turnover any early repayments. Here, where an additional level of statutory ring-fencing is preferred to add another level of protection to the usual provision of separate security and/or limited recourse wording, the SPC provides ideal comfort for the different constituencies of credit provider. Further, in the rare instance in which the initial purchase of financial assets is funded by the issuance of preference shares by the SPV, such shares can be designated to a specific Portfolio, allowing the holder to receive dividends or other distributions even if the balance sheets of other Portfolios in the SPC are not healthy enough to permit a dividend lawfully to be declared.

Cayman Islands limited liability companies

[8.008] Recent legislative developments in the Cayman Islands have availed investors of a further structuring option in the Cayman Islands.[9] Since July 2016, the limited liability company ("LLC") – a vehicle closely aligned to the Delaware limited liability company – has also been available in the Cayman Islands. An LLC is similar to a company in that it is a body corporate with a separate legal personality from its limited liability members and is capable of exercising all the functions of a natural person. Where it differs is in its constitution, which is represented by an LLC agreement negotiated by the parties rather than memorandum and articles of association complying with the law. In this respect, it is a creature of contract rather than statute; whilst the law contains numerous default operational provisions, these will only apply in the absence of express agreement, which is subject to far fewer minimum safeguards than

[9] See the Limited Liability Companies Law (2018 Revision) (Cayman Islands).

statute prescribes for companies. Furthermore, its powers are vested fully in its members, with discretion to delegate the management of the LLC's business and affairs to a manager, rather than a requirement to appoint a director. This results in a vehicle that may enter into and perform transactions with the operational flexibility that makes exempted limited partnerships attractive, yet preserves for the parties the advantages of separate legal personality and limited liability that are so critical to an effective securitisation structure. An LLC may be incorporated by a single member whose liability to contribute to its assets is limited to the amount of its agreed contribution, with the option (but no requirement) to appoint managers. Neither members nor managers are subject to any residency requirements or other restrictions preventing the LLC from being owned and managed independently of the transaction originators and achieving off-balance sheet treatment. Indeed, it may be easier for the originators to avoid exerting control over an LLC SPV, as its business and operations may be conducted by independent parties according to the terms of a contract, rather than by directors bound by equitable fiduciary duties to act in the interests of the company. The absence of any requirement for SPV directors may also simplify the establishment of the structure by obviating the need for directors' and officers' insurance and reducing the scope of indemnities usually required from originators by independent directors. Delaware limited liability companies have long proved a popular choice for securitisation transactions in the North American market, and we welcome their addition to the Cayman repertoire.

BVI restricted purpose companies

[8.009] On one hand one of the first jurisdictions to scrap the *ultra vires* law and adopt the default position at law that, outside of the regulated space, a BVI business company will have unlimited capacity and full rights, powers and privileges to undertake any legal business, the BVI is also the progenitor of a very different type of entity, the restricted purpose company ("RPC") introduced by the BVI Business Companies Act 2004. An RPC is one of those things that "does what it says on the tin": it has an old-fashioned objects clause and the business operations of an RPC are strictly regulated thereby. We like to think of them as "Victorian companies"; essentially, with an RPC, one turns back the clock and operates the business and affairs of the company in accordance with the old *ultra vires* rule. However, with an RPC, there is one key difference: under the common law *ultra vires* rule, any act taken by a company outside of its objects clause was voidable. Any act taken by an RPC outside of its objects clause is, as a matter of BVI law, void. What this means is that one can utilise an RPC to create a vehicle whose sole purpose, for example, is to issue notes. The memorandum can be tailored to prohibit the company from undertaking any other sort of business whatsoever, encumbering any of its assets, incurring any third party debt, or altering such objects

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