I. Brazil

The following is an update on the major significant legal developments in the banking and financial service areas in Brazil and the main related capital market issues during the year 2002 that we deem relevant.

A. NEW MODALITIES OF CREDIT DERIVATIVE TRANSACTIONS IN BRAZIL

Under the terms of Resolution 2933, established February 28, 2002, the Brazilian Monetary Council authorizes financial and other institutions accredited with the Brazilian Central Bank (Banco Central do Brasil–Bacen) to carry out certain credit derivative transactions according to terms and conditions to be established by Bacen.¹

According to the regulations in force, the financial and other institutions authorized to act as the receiver of credit risks are the multi-service, commercial, and investment banks;
the Federal Savings Banks; loan, finance, and investment companies; and real estate loan and leasing companies. In the specific case of leasing companies, the transaction may only occur if the underlying asset relates to credits derived from leasing transactions.

The parties involved in this kind of transaction are the party transferring the risk and the party receiving the risk. The first acquires, by means of a credit derivative contract, the protection against a certain credit risk by making the mutually agreed payment. The second assumes, under the same credit derivative contract, the risk inherent in the respective underlying asset and undertakes to pay the mutually agreed upon compensation to the party transferring the risk if any event foreseen in the contract occurs.

Therefore, credit derivatives are the contracts wherein the parties allocate credit risk of transactions without the underlying asset being transferred at the time of transaction.

According to the Brazilian Monetary Council and Bacen, an underlying asset is any credit derived from loan, financing, or leasing transactions; credit instruments; securities; guarantees; sureties; credit derivatives and other instruments; and financial or commercial agreements subject to credit risk that are negotiated and performed domestically.2 As a general rule, the party transferring the risk must hold the credit risk. Nevertheless, there is an exception to this general rule where the transaction involves an underlying asset that usually trades in organized markets and the asset's pricing can be confirmed.

If the underlying asset is in a portfolio, the credit risk transfer party will make available to Bacen all records that attest to the existence of the risk of the underlying asset at the time the credit derivative is contracted. The risk transfer amount is limited to the value of the underlying asset. Additionally, Resolution 2933 expressly forbids any assignment, disposal, or transfer of the underlying asset, whether directly or indirectly, during the term of the credit derivative contract indexed thereby.

In Circular 3106, promulgated April 10, 2002, Bacen established that two types of credit derivative were allowed: (i) credit swap; and (ii) total return rate swap.3 According to the definition contained in article 2 Circular 3106 swap transactions are transactions performed between the party transferring the risk and the party receiving the risk for forward settlement and that imply, upon occurrence of "credit deterioration events" or simply credit events, total or partial restoration of the reference value set forth in the contract in favor of the party transferring the risk. It is, therefore, a mechanism that allows someone with a high-risk credit portfolio to hire the services of a financial institution so that such risk is transferred to a willing third party. In exchange, the third party is adequately remunerated for assuming the risk.

The first modality of credit swap occurs when the party receiving the risk is remunerated based on a protection rate, or a prefixed margin. The second swap modality is the total return rate swap, which occurs when the party receiving the risk is remunerated based on the flow of charges and underlying asset-related considerations received. For example, in the case of a loan, the compensation for assuming the risk refers to payment of interest on the debt's principal.

Credit events are those events, expressly provided for in a contract, which are related to the underlying asset or its obligors that, irrespective of intention, cause the payment, by the party receiving the risk, of protection hired by the party transferring it. The following situations, at least, must be contractually established as credit events:

2. Id.
a. Declaration in bankruptcy or insolvency of obligors of the underlying asset;
b. File for composition with creditors (*concordata preventiva*) of the obligors of the underlying asset;
c. Judicial or extrajudicial liquidation of the underlying asset from the obligors;
d. Reorganization of the obligors' liabilities, when representing loss in value or deterioration of quality of the underlying asset receivable;
e. Change in control, amalgamation, or merger of the obligors, when representing loss in value or deterioration of quality of the underlying asset receivable;
f. Moratorium of the underlying asset from the obligors;
g. Default of the underlying asset;
h. Mandatory acceleration of payment of the underlying asset, if provided for in contract;
i. Judicial denial or dispute of the underlying asset.

For the transfer of credit risk of an underlying asset to be considered effective, the following minimum requirements must be met:

a. the contract provides for credit events, including the above-mentioned situations;
b. the transfer of the underlying asset must be legally possible, in the cases where the credit derivative contract so provides upon the occurrence of a credit event;
c. there can be no co-obligation of the party transferring the risk in relation to the portion of the underlying asset of the transaction;
d. there can be no clause allowing for unilateral cancellation of the contract by the party receiving the credit risk, except in the case of non-payment by the party transferring the risk of the remuneration owing to the party receiving it;
e. there can be no clause that allows the party receiving the risk not to comply with the obligation to promptly pay the amount owed to the party transferring the risk upon the occurrence of a credit event.

The regulation expressly prohibits the following transactions:

a. the trade of options connected to the credit swap and total return rate swap modalities;
b. the trade of credit derivatives between controlling, connected, controlled, individual or legal entities, including “similar entities.”
c. the assumption of credit risk by those persons listed in item (b) above; and
d. the trade of credit derivatives whose flows are not denominated in the same currency or by the same index as the underlying asset.

Similar entities as used in this chapter are companies located in Brazil and abroad, which are held in any form by financial and other institutions accredited by Bacen. These similar

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4. *The Brazilian Corporation Law* (§ 1 of article 243 of Law no. 6404, of December 15, 1976) determines that if a company holds an ownership equal to or higher than 10% of the other’s capital, without controlling it, those companies are “connected companies.”

5. The definition of “controlled company” is found in § 2 of article 243 of the Brazilian Corporation Law. Controlled company is the company in which the company controlling it, directly or by means of other controlled companies, holds the right that ensures, on a permanent basis, prevalence in corporate decisions and the power to vote the majority of company’s management.
entities may be held in many forms, including by virtue of voting or partners’ rights agreements that ensure separately or cumulatively: (i) prevalence at corporate decisions; (ii) power to elect or remove the majority officers; (iii) effective operating control, characterized by the common administration or management; and/or (iv) controlling interest represented by the sum of interests held by the institution, the officers, controlling and associated companies, as well as by those directly or indirectly acquired by means of investment funds. Furthermore, transactions between financial and other institutions accredited by Bacen and companies located abroad, wherein the same controlling company there is interest held by the same controlling persons of those institutions. Or control when said controlling persons are resident and domiciled in Brazil, as well as transactions carried out by means of companies in Brazil, associated or subject to common financial control and other institutions accredited by Bacen. That is, the concept of “similar entities” encompasses the companies mentioned here, for which swap transactions are also forbidden.7

The swap transactions carried out by the party transferring the risk, so long as it is the party holding, the underlying asset directly or indirectly by means of a credit derivative transaction, may, at the option of the financial institution, be taken into account in the calculation of the institution’s own Required Net Worth (Patrimônio Líquido Exigido—PLE), in view of the level of transfer of credit risk of the underlying asset8.

The party transferring the risk9 may benefit from the credit derivative transaction, to the extent of the risk being transferred, so long as it directly holds the underlying asset or

6. Interest is: (a) a company holding an ownership equal to or higher than 10% of the other’s capital, whether directly or indirectly; (b) officers or respective spouses or partner(s) and relatives—up to second degree relatives, of a company holding individually or collectively 10% or more of the other’s capital, whether directly or indirectly; (c) partners or shareholders with an interest of or higher than 10% in a company’s capital who hold 10% or more of the other’s capital, directly or indirectly; (d) companies having common officers. The definition of “interest” is found in § 2 of article 18 of Resolution no. 2723, of May 31, 2000, of the Brazilian Monetary Council.

7. Companies referred to here as “similar entities” are listed in articles 3 and 18 of the Resolution no. 2723 of May 31, 2000, as amended by Resolution no. 2743, of June 28, 2000, both of the Brazilian Monetary Council.

8. Financial and other institutions accredited by the Central Bank of Brazil must keep a net worth adjusted as provided by regulation in force, compatible with the level of risk in their asset structure. Such adjusted net worth is called Required Net Worth (PLE). Only credit cooperatives are not subject to such requirement. The applicable Regulations attached as Annex IV of Resolution no. 2099, of August 17, 1994, of the Brazilian Monetary Council, and subsequent amendments. As far as credit derivatives are concerned, for the purpose of using the prerogative institutions have to take into consideration in the calculation of the PLE swap transactions it carried out, the percentage pondering factor to be applied to the amount protecting the underlying asset for purpose of calculating the PLE; as used in the formula below:

\[
FP = \left( \frac{PRP \times FPP}{PRA} \right) + \left[ 1 - \left( \frac{PRP}{PRA} \right) \right] \times FPA
\]

where:

- \(FP\) = percentage pondering factor applicable to the amount protecting the underlying asset;
- \(PRP\) = remaining time of credit derivative (business days);
- \(FPP\) = percentage protection pondering amount equal to 50%;
- \(PRA\) = remaining time of underlying asset (business days);
- \(FPA\) = percentage pondering factor relatively to the underlying asset, as per Asset Classification Table, mentioned in article 2, § 1 of the Regulations attached as Annex IV to Resolution no. 2099 of August 17, 1994, of the Brazilian Monetary Council, and subsequent amendments.

Exposure to risk of the underlying asset in excess of the protection amount must be pondered by its original factor, as per said Asset Classification Table. In case a clause providing the minimum values or percentages of the underlying asset loss for total or partial restoration is included in the contract, it must be proven additional separation from the PLE of amount equivalent to the values or to the minimum established percentages.

9. As to credit derivative transactions, the party transferring the risk must abide by the regulation in force regarding the exposure limit per client.
indirectly holds it by means of a credit derivative transaction. But, due respect should be given to the minimum requirements for the effectiveness of the transfer of the credit risk of the underlying asset, as previously discussed. The party transferring the risk is also required to take into account the credit derivative transaction, to the extent of risk being transferred, in the exposure limit related to the party receiving the risk.

On the other hand, the party receiving the risk is exposed to the underlying asset's risk to the extent of the risk being assumed,\(^{10}\) and must, in relation to the risk exposure, abide by the rules in force applicable to the exposure limits per client and establish specific provision.\(^{11}\)

In the case of credit derivative transactions, financial institutions must publish explanatory notes in their financial statements containing at least the following information:\(^{12}\)

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10. The party receiving the risk must comply with the provisions contained in the Regulations attached as Annex IV, of Resolution no. 2099 dated August 17, 1994 and issued by the Brazilian Monetary Council, and subsequent amendments. Such Regulations establishes that the Required Net Worth (PLE) must be maintained at an amount compatible with the level of risk of active transactions carried out by financial and other institutions accredited by the Central Bank of Brazil.

11. In order to establish a specific provision for the risk assumed, the party receiving the risk must follow the same criteria used for the establishment of doubtful settlement credits provision set forth in Resolution no. 2682 of December 21, 1999, of the Brazilian Monetary Council.

12. According to the provisions in article 6 of Circular no. 3082 of January 30, 2002, of the Central Bank of Brazil, it is mandatory to publish explanatory notes in financial statements with qualitative and quantitative information regarding derivatives, specially the following: (i) the use; (ii) objectives and strategy for risk management, particularly the hedge policy; (iii) risks related to each strategy of market performance, internal control and parameters used to manage such risks and results in relation to the proposed goals; (iv) assessment and measurement criteria, significant methods applied to the ascertainment of market value; (v) amounts recorded in assets, liabilities and compensation accounts separated by category, risk and strategy of market performance, and those aimed at hedging and dealing; (vi) amounts grouped per asset, reference index, trade place (exchange or over-the-counter) and maturity ranges, specially the reference, cost, market, and portfolio risk values; (vii) loss and profit in the period, separating those recorded in the profit (loss) and account separate from the net worth; (viii) estimated net value of profit and loss recorded in account separate from net worth on the date of accounting statements expected to be acknowledged in the next twelve months; (ix) values and impact on the profit (loss) in the period which were not classified as hedge, as well as those transferred from net worth as a result of accounting acknowledgement of loss and profit in item object of the hedge; (x) main transactions and forward commitments object of the hedge of cash flow, specially the time anticipated for the financial effect; and (xi) amount and type of margins offered as security. Derivative instruments are considered those whose whose range values as a result of changes in interest rates, price of security, price of merchandise, exchange rate, stock exchange index, price index, credit index or rating, or any other similar specific variable whose initial investment is non-existent or too small as compared to the contract value and that are settled on a later date. Hedge is one or more financial derivative instruments aimed at compensating, totally or partially, the risks arising out of exposure to variance of market value or cash flow of any asset, liability, commitment or anticipated transaction, whether or not entered in the accounting books, or even groups or part of such items with similar characteristics and whose response to the risk object of the hedge occurs similarly. Financial derivative instruments designed to offset risks resulting from the exposure to variances of market value of the item object of hedge must be classified in the hedge category. Financial derivative instruments designed to compensate variance in anticipated future cash flow of the institution must be classified under the cash flow hedge. Transactions with financial derivative instruments designed for hedge must meet cumulative the following conditions: (a) have documentary identification of risk object of the hedge, with detailed information about the transaction, specially the risk management and method used to assess the effectiveness of hedge from the beginning of transaction; (b) prove effectiveness of hedge since the beginning of and during the transaction, with indication that the variances in market value or cash flow of the hedge instrument make up for the variances in market value or cash flow of item object of the hedge from 80% to 125%; (c) provides the need to renew or contract a new transaction in the case of those in which the financial derivative instrument matures before the item...
a. the institution’s policy, purposes and strategies;
b. the volumes of credit risks received and transferred (book and market values), total and for the period;
c. the impact (increase or decrease) on the calculation of the PLE;
d. the amount and features of the credit transactions transferred or received in the period as a result of the facts provided in contract; and
e. a separation by type (credit swap and total return rate swap).

Regardless of being the receiver or transferor of risk, the financial institutions must make adequate records of their policy and procedures applicable to credit derivative transactions—as well as established exposure limits—available to Bacen. Bacen must be duly informed of any credit derivative contract for which the accumulated amount of transactions on one single side equals, or exceeds, 10 percent of the reference equity of any of the institutions acting as parties to the contract. The financial institutions must also inform the Department of Registration and Financial System Information (Departamento de Cadastro e Informações do Sistema Financeiro—Decad) of the name of the person in charge of the credit derivative transactions.

B. On-line Transactions on the Securities Market

On September 10, 2002, the Brazilian Securities and Exchange Commission (CVM) issued rules to regulate transactions and investments made on the worldwide net (Internet). Electronic brokers will be required to abide by these rules when placing purchase and sale orders and when trading securities on stock exchanges or organized over the counter entities over the Internet. These rules were set forth by Instruction CVM no. 376, of September 11, 2002 and will be discussed below. Importantly, the rules also apply to other members of the securities distribution system, whenever those members intermediate securities transactions through an electronic broker.

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13. Such communication must be forwarded within up to five business days of the date of execution of the credit derivative contract, to the member of the Department of Registration and Financial System Information with jurisdiction over to the institution that has reached an amount equal to or higher than 10% of the Reference Equity.

14. According to article 3 of the Resolution no. 2933, of February 28, 2002, of the Brazilian Monetary Council, performance of credit derivative transactions is conditioned upon the appointment by the financial institution of an officer it deems technically skilled to be the contact for the Central Bank of Brazil.

15. The following are securities subject to Law no. 6385, of December 7, 1996: (i) shares, debentures and subscription warrants; (ii) coupons, rights, subscription receipts and division certificates in connection with securities referred to in item (i); (iii) securities deposit certificate; (iv) debentures certificates; (v) quotas in securities investment funds or funds of investment in any kind of asset; (vi) commercial notes; (vii) forward contracts or other derivative contracts, whose underlying assets are securities; (viii) other derivative contracts, irrespective of the underlying assets; and (ix) if publicly offered, any other securities of collective investment agreements that create right of ownership, partnership or compensation, including those resulting from provision of services, which earnings result from the efforts of the entrepreneur or third parties.

16. Instruction CVM no. 376, of 9/11/2002, was published in the Federal Official Gazette issue of September 11, 2002, and shall be effective as of November 9, 2002, that is, sixty days after its publication. In addition to the rules contained in such Instruction, the other rules issued by CVM that regulate brokerage houses trading securities and stock apply to the trade performed by electronic brokers.
According to the definition found in Instruction CVM 376/02, an electronic broker is a securities brokerage house, accredited by the CVM to intermediate or carry out broker securities transactions on stock exchanges or organized over-the-counter market running systems that receives securities purchases and sale placement orders via the worldwide web. A homepage is defined as a set of files exhibited or made available on the worldwide web that may be physically accessed by means of an electronic address. A link is a highlighted text or graphic component in a homepage that affords access to other pages or sections or components of the same homepage. And finally, internet protocol (IP) is the four-octet code that identifies all devices connected to the worldwide web.\footnote{In the worldwide web, known as the Internet, each computer is identified by a number, called the IP (the initials for Internet Protocol) address. That IP address consists of a set of eight bits (four octets). These octets, if shown, are separated by dots. For instance: 11001100.11111111.10001110.00001010.}

Electronic brokers must include in their homepages clear and accurate information that is easily understandable by investors. This information includes:

a. detailed information on the use of the on-line securities trade system;
b. any discounted rates offered to clients or a specific category of clients, the costs of trading on the Internet and the fees charged by stock exchanges or trusts in the organized over-the-counter market;
c. the detailed procedures followed by the electronic broker concerned when filling purchase and sale orders received over the Internet. A note to the effect that the orders may not be automatically processed by the system must be included, as well as in relation to the priority in relation to orders incoming from other communication channels, based on the trade volume and other parameters;
d. the features of the security systems, including the use of passwords and electronic signatures;
e. the electronic means used to acknowledge receipt of an order and confirm strict compliance with the instructions given by investor, including any other information with which investors should be furnished;
f. the information, such as best price and placement lists, on the securities used in the electronic trade systems of the stock exchange or trust of the organized over-the-counter market on which the broker will be filling the orders received over the Internet. Additionally, the time such information will be made available must be indicated on the broker's homepage;
g. if purchase and sale orders are passed on, the electronic broker in charge of the orders received over the Internet must be informed thereof;
h. the maximum time investors will have to perform transactions without being automatically disconnected; and
i. a link to the CVM homepage.

For informational purposes, electronic brokers must include in their homepages a section or link containing the following information:\footnote{Brokers' homepages must conspicuously (in capital letters) show the following note: "Communications made over the worldwide web are subject to interruptions, which could cause the orders or trade to be invalid."}

SUMMER 2003
a. A description of the structure and operation of stock exchanges, trusts of the organized over-the-counter market, and securities clearance and custody entities and a description of the securities available for purchase and sale over the Internet;

b. The risk of price fluctuation and possible loss of the principal amount inherently found on the securities market, especially those risks resulting from derivative positions; the operating risks of using the Internet and electronic trade systems for purchasing or selling securities; the risks resulting from the failure to deliver the assets within the established time; and actions taken by the clearance and custody houses to reduce those risks;

c. The special auction procedures, due respect being given to rules issued by the CVM, stock exchanges, or trusts of the organized over-the-counter market, to which investors’ orders are subject; and

d. Information about the authority of self-regulatory entities, especially the power to call off deals that have been previously completed, should such deals be later determined to have violated legal provisions; information about concurrent securities trade in open outcry and in the electronic trade system, indicating the instances where one market may interfere with another; other information of relevance, as the brokerage house’s management may determine.

Every March, electronic brokers are required to carry out technical audits of their systems to estimate their capacity indicators and prepare the corresponding report. That report is forwarded, within ten days of its completion, to the stock exchange or trust of the organized over-the-counter market of which the electronic broker is a member. Electronic brokers must design a contingency plan for their systems aimed at protecting investors in the event of Internet service interruption and during periods of high market volatility or peak demand. In addition to the technical audits, which will be carried out by the broker itself, self-regulatory entities (stock exchanges or trusts of the organized over-the-counter market running electronic trade systems receiving orders over the Internet) must carry out audits of the systems used by brokers, semi-annually, and issue the corresponding reports. Such audits determine the regular provision of necessary information to clients and the compliant recording thereof at the brokerage house, as provided for by existing legislation. Regulatory entities then forward copies of that report to the CVM within fifteen days of its completion.

Electronic brokers must use the highest standards of net security since it is up to them to ensure the security and secrecy of information on securities purchases, sale orders, and the securities portfolios of all clients, as well as to notify clients thereof. Each electronic

19. Included in the capacity indicators are: (i) the number of investors authorized to trade on the Internet, divided by the maximum number of orders the electronic broker’s system is capable of recording within one minute; (ii) the average time between recording the order in the electronic broker’s system and its input in the electronic trade system of the stock exchange or trust of the organized over-the-counter market; and (iii) the average time between recording the order in the broker’s system and electronically sending acknowledgement of recording to the client.

20. The stock exchange or trust of the organized over-the-counter market must reserve space on their homepages for publication of capacity indicators determined in the electronic broker’s technical audit report.

21. Exclusively by means of justified prior notification to CVM, stock exchanges or trusts of the organized over-the-counter market may interrupt or limit temporarily the use of an electronic broker’s homepage to trade securities.
broker is liable for the operability of that broker’s system, even if that system is maintained by a third party. For special auction procedures and derivative market transactions, alternative means to support clients must be in place. Clients will be informed of those alternative means at the time of registration and will also be informed of the circumstances where the alternatives may be used.

Electronic brokers will keep magnetic records of all securities purchase and sale orders received over the Internet for five years, including whether or not such orders were filled. Additionally, brokers will provide each investor placing orders, immediately and electronically, with the following information: (a) the receipt and recording of the order into the electronic system of the stock exchange or the organized over-the-counter market; (b) confirmation that the order was filled; and (c) the cancellation of the securities purchase and sale, if any, with the reasons for such cancellation.

Brokers offering their clients, or users of their homepages, pseudonym message publication services, must make available to the CVM, also for five years, magnetic files containing: (i) the full contents of messages published on their homepages; (ii) the pseudonyms used by the authors of messages; and (iii) the IP of the PCs originating those messages. It is up to the broker to establish in-house procedures to curb manipulation of prices and the distribution of misinformation, or information that is deleteriously incomplete, through their message publication services.

Every critical fact disclosed by companies listed on stock exchanges or organized over-the-counter markets, in the preceding five business days, must be inserted on the homepage.

C. NEW RULES IN BRAZIL APPLICABLE TO FINANCIAL INSTITUTIONS

At its meeting on November 28, 2002, the Brazilian Monetary Council approved the new regulation to govern the requirements and procedures related to the organization of financial institutions. It permits the transfer of equity shareholding and corporate reorganization, as well the revocation of permits to operate financial institutions and other equivalent entities that need prior approval of Bacen to operate in the country.

22. Users of an electronic broker’s homepage containing analysis of corporation performances or securities must have their full names properly indicated by the broker in each analysis published. It is up to the brokerage house to check for authenticity of any personal information provided by users that is published in conjunction with their analysis. Analysis sent by users of the homepage must be published in a separate section from those published by legal entities.

23. Procedures established by a brokerage house to curb manipulation of prices and misinformation or information that is deleteriously incomplete must be communicated to CVM by November 9, 2002.

24. An electronic broker must include, in a conspicuous manner (capital letters) these critical facts in the initial section of its homepage, followed by the following note: “Search critical facts disclosed in the last five (5) business days.” Critical facts may be classified by title, with a link to the full text thereof, as disclosed by the company in announcement to the stock exchange or trust of the organized over-the-counter market where the company-issued securities were traded.

25. Financial institutions may only operate in the country if previously accredited by Bacen, pursuant to the main section of article 18 of Law no. 4595, of December 31, 1964, which, among other provisions, lays down rules applicable to the monetary, banking and credit policies and institutions and creates the National Monetary Council. Financial institution is defined by article 17 of Law no. 4595/64 as any legal entity, either of the public or private law, whose core or secondary business is to raise, intermediate or invest its own or third parties’ financial resources, in national or foreign currency, and keep in custody third parties’ valuables. At the criminal
The regulation is a Schedule to Resolution no. 3040 of November 28, 2002.26

Financial institutions, or equivalent entities, subject to the regulation and expressly indicated therein, are the following: multiple, commercial, development, and investment banks; credit, finance, and investment companies; savings and loan companies; mortgage companies; development agencies; leasing companies; securities brokers; securities dealers; and exchange brokerage companies. Bacen will enforce the conditions required for the organization of these entities and authorize their operation in Brazil.

The operation of financial institutions and equivalent entities will be conditioned on prior express approval by Bacen. This assumes not only that the company was organized pursuant to applicable legal and regulatory rules, but also that it has a permit to operate.

The financial institution or equivalent company must inform Bacen of the name of the technically qualified person overseeing the organization process and of the new company's organization group. Representatives of the future controlling group and future holders of a qualifying interest must participate in the new institution's organization group.

The controlling group is a concept derived from the definition given to controlling shareholder by the existing law governing corporations.27 Thus, under the terms of corporate legislation, a controlling shareholder is an individual or legal entity, or group of persons bound by a voting agreement, or under common control, that: (a) is the holder of partner's rights that entitle the holder, on a permanent basis, majority of vote in decisions at shareholders' meetings and authority to elect the majority of the company's management members, and (b) effectively exercises the authority to conduct the business of the company and guide the corporate bodies.28

For purposes of that regulation, a qualifying interest is any individual or legal entity holding, which directly or indirectly, comprises 5 percent or more of the shares or quotas representing the company's total capital. In order for a financial institution or equivalent entity to be organized, the interested parties must satisfy the following conditions:

a. publication of a statement of purpose,29 by the individuals or legal entities that are not yet participants in the financial institution's or equivalent's controlling group,

sphere, article 1 of Law no. 7492, of June 16, 1986, which defines crimes against the National Financial System, sets forth as follows:

"Art. 1 Financial institution, for the purpose hereof, is the legal entity of the public or private law whose core or secondary business, whether or not cumulatively, is to raise, intermediate or invest third parties' financial resources, in national or foreign currency, and keep in custody third parties' valuables.

Sole paragraph. The following are equivalent to financial institutions:

I—legal entities raising or operating insurance, exchange, layaway sales, capitalization or any kind of savings, or third parties' resources;
II—individuals performing any of the business mentioned in this article, even if occasionally."

26. Resolution no. 3040 came into force on November 28, 2002, date of its publication on the Federal Official Gazette, and will give effect as of June 2, 2003, except as regards to transactions that imply transfer of control of institutions organized as of said publication date or cancellation of authorization to operate, which is immediately effective.

27. Pursuant to main section of article 116 of Law no. 6404, of December 15, 1976 (the Corporations Law).

28. Id.

29. Bacen may, if deemed necessary, require publication of the statement of intent by the individuals or legal entities that are already members of the controlling group of the financial institution or equivalent entity. When reviewing satisfied conditions, Bacen will take into account the kind and size of the institution concerned. Development agencies are exempted from the publication of the statement of purpose.

VOL. 37, NO. 2
under the terms and conditions established by Bacen. Bacen is charged with disseminating that statement of purpose by any means it may deem appropriate;

b. submission of an economic-financial feasibility study and a business plan for the first three years of operation, as well as definition of the corporate governance procedures to be followed, including a detailed description of the incentive and salary policy structure;

c. a list of the institution's controlling group;

d. evidence of an economic-financial capacity compatible with the size, kind, and purpose of the engagement. At the discretion of Bacen, this condition may be satisfied either individually by controlling shareholder, or by the controlling group;

e. a document prepared by the members of the controlling group and holders of a qualifying interest, expressly authorizing the Federal Revenue Department to furnish Bacen with copies of the income tax returns containing a list of property and rights as well as actual debts and liens for the preceding three fiscal years, to be used exclusively in the authorization process, and authorizing Bacen to access information related thereto contained in any public or private registration and information system; and

f. the nonexistence of limitations that might, to the best of Bacen's knowledge, adversely affect the reputation of controlling members.30

The economic-financial feasibility study must contain at least the following information: (a) economic and financial analysis of the market segments in the region where the institution plans to perform and its projected share in these segments, including the main competition in each segment; (b) anticipated profitability, including the expected return in each of the market segments selected; and (c) financial projections showing the equity evolution for the period, including a list of sources of fund raising that render evolution possible.

The business plan, in turn, should include at least: (a) detailed information on the proposed organizational structure, with precise definitions of duties attributed to the several levels in the institution; (b) an internal control structure, showing mechanisms that ensure proper supervision by the management and effective use of internal and external audits as control tools; (c) the setting of strategic goals; (d) the definition of core products and services to be offered, including target public; (e) a list of the technologies to be used in placing products and the extent of the service network; (f) the setting of a deadline for initial operation after authorization by Bacen; and (g) a description of the criteria used in the selection and profile of management members, as well as identification thereof, upon request from Bacen.

Upon confirmation by Bacen that all conditions established in the regulation have been satisfied, communication will be forwarded to the interested parties, who then have ninety days, from the date of receipt of such communication, to make a formal application for a permit to operate.31 If properly justified, Bacen may grant an extension of up to nine days.

30. The controlling members are also subject to other legal and regulatory rules, when applicable, regarding the conditions for the discharge of management duties in financial institutions.
31. Should the interested party fail to meet that time the company organization process will be shelved by Bacen.

SUMMER 2003
after which the organization process will be automatically cancelled if adequate measures have not been taken. Authorization to operate will be granted after Bacen's approval of the organization documents, with due respect being given to the legislation in force. All members of the controlling group and holders of qualifying interest are required to present sufficient evidence to Bacen as to the source of funds to be used.

The institution will start operating within the time indicated on the business plan, but Bacen may extend such time if properly justified by the members of the management. Before the beginning of operations and after securing the authorization to operate, the institutions are required to present Bacen a certified statement of their infrastructures' compliance with the business plan previously presented, and in the case of financial institutions, adhesion to the mechanism of credit holders' protection against financial institutions. After the startup, and for the first three fiscal years of operations, institutions must include proper evidence in the management report, which accompany the financial statements, that the transactions carried out are proper to the strategic goals established in the business plan. The independent auditors' report must include a note regarding the financial statements, giving their opinion on the information contained in the management's report. If, during the first three fiscal years of operation, it is determined that the transactions do not comply with the stated strategic goals, the institution concerned must present reasonable justification thereof. This justification will be reviewed by Bacen, at which point additional conditions may be imposed, including a fixed deadline.

Transfer of the company's controlling shares and any direct or indirect change in the controlling group that may result in the effective management of the business are conditioned on authorization by Bacen, if they are derived from: (a) a shareholders' or quota-holders' agreement; (b) inheritance and acts of will, such as donation, acceleration of inheritance, and creation of usufruct; and (c) action by an individual or a legal entity, separately or collectively, or by group of persons representing common interest. However, the simple transfer of controlling shares to a legal entity will not be conditioned on approval by Bacen, to the extent that there is no admission of new individuals to the group of ultimate controlling members of the institution.

32. Should the management of a financial institution or equivalent entity request that Bacen extend the deadline for the commencement of operations, Bacen may require additional documentation and statement to update the permit to operation process regarding that institution or entity.

33. Bacen's authorization of financial institutions or equivalent entities operation is conditioned upon the adhesion, by the interested party, to the mechanism that protects holders of credits against financial institutions, under the terms of existing laws and legislation. The minimum guaranteed deposit system in Brazil was created by the National Monetary Council by Resolution no. 2197, of August 31, 1995, which authorized the organization of a non-profitable private entity to run said credit holder protection mechanism. That entity is the Credit Guarantee Fund—FGC, whose by-laws and regulation are consolidated and attached to Resolution no. 3,024 of October 24, 2002. The FGC is a non-profitable civil association of the private law, whose participants are the multi-service, commercial and investment banks; the Federal Savings Bank (Caixa Econômica Federal), credit, finance, and investment companies; real estate and mortgage companies; and savings and loan associations operating in the Country that: (i) receive demand, term or savings deposits; (ii) accept bills of exchange; and (iii) raise money by issuing and placing real estate and mortgage notes. In line with the provisions in the applicable regulation, FGC's purpose is to offer guarantee to credits against institutional participants therein in the event of involuntary intervention, extrajudicial liquidation or bankruptcy, or acknowledgement by Bacen of the institution insolvency that, under the terms of existing legislation, is not subject to intervention, extrajudicial liquidation or bankruptcy.

VOL. 37, NO. 2
Reorganizations, including change of corporate purpose; creation or extinction of operating portfolio by multi-service banks; and amalgamation, spin-off, or merger are also conditioned on Bacen approval.

Additionally, the regulation lists other events that must be reported to Bacen within the times yet to be established by that body, including:

a. admission of shareholder or quotaholder, holding qualifying interest or rights resulting therefrom, arising out of legal acts performed, directly or indirectly, with other shareholders or quotaholders of the institution;

b. increase of interest by shareholder or quotaholder by 5 percent or more of the company's capital, whether cumulatively or not; and

c. party assuming the status of qualifying-interest-holder, shareholder, or quotaholder.

A direct interest that results in control of an institution organized since November 29, 2002, may only be held by individuals, financial institutions, or their equivalent, or other legal entities whose sole corporate purpose is the corporate interest in financial institutions or equivalent entities.35

Revocation of the authorization to operate will be required upon the performance of actions that result in the extinction of a company or a change in its corporate purpose, which causes the institution to lose its status as a company member of the National Financial System. Extinction resulting from composition, full spin-off, or merger, to the extent that the resulting or succeeding company is accredited by Bacen, does not imply cancellation.

In addition to the indispensable requirements for the revocation of authorizations to operate, which are listed below, Bacen also may condition said revocation to the liquidation of liabilities typical of the financial institution or equivalent entity. The following are the indispensable requirements for revocation:

a. publication of a statement of purpose, under the terms and conditions established by Bacen;

b. decision at a shareholders' or quotaholders' meeting, as the case may be; and

c. attachment of proper documentation to the respective cancellation application, under the terms and conditions set forth by Bacen.

After exhausting all applicable measures within its authority, Bacen may revoke the authorization for financial institutions or equivalent entities to operate upon determination, at any time, of one or more of the following situations: (a) operating inactivity, without acceptable justification; (b) the institution cannot be found at the address furnished to Bacen; (c) unjustifiable discontinuation, in excess of four months, of provision to Bacen of financial statements required under legislation in force; and/or (d) failure to meet the deadline set on the business plan submitted to Bacen for initial operation. Prior to cancellation for any of the above reasons, Bacen will announce, by any means it may deem appropriate, its intention to revoke the authorization to operate, so that it is possible for the general public to present objections within thirty days.

Bacen may or may not approve applications related to any of the issues dealt with in the regulation and, in the course of review of those issues, may also request presentment of

34. Date of publication of Resolution no. 3040 on the Federal Official Gazette.
35. This rule does not apply to development agencies and public financial institutions that are or may become object of privatization.
additional documents and/or information it may deem necessary to make a reasoned decision. Additionally, Bacen may request an interview with the members of the controlling group, holders of qualifying interest, and appointed officers. Bacen may summarily disapprove applications in the case of irregular registration information, if such irregularity remains uncured for some time yet to be established by Bacen, and/or in the event of mis-information and/or misrepresentation.

II. Turkey

A. Introduction: A Recovering Economy and Sounds of a War

The Turkish government is trying to balance local requirements, stand-by arrangements with the IMF, and harmonization with European Union (EU) standards. The Government plans to continue structural reforms, such as completing financial sector reforms, supporting more dynamic private sector development, and creating a smaller and more efficient public sector for 2002 and beyond. The stand-by arrangement with the IMF has improved the economic fundamentals of the country. Inflation was reduced to below 30 percent, exchange and interest rates have come down, and the stock market index has increased. In November 2002, an election was held in which the Government changed.

The new Government claims that they will reduce public-sector participation in the economy, take measures to strengthen fiscal transparency, and provide good governance. They also claim privatization is one of the most important issues in the government program and, hard to believe, plan to privatize about forty entities, including Turkish Airlines, Turkish Telecom, Petkim, Tekel, state lottery, and more.

During 2002, the Government, believing that it will facilitate economic recovery, expected to be invited by the EU for full membership. However, implicitly from a polite declaration by the EU, it appears that full membership of Turkey, if it happens, will take years.

While some slight but good signs of recovery surfaced during the end of 2002, the market was shocked by an alert of a potential war. The U.S. conflict with Iraq brought Turkey to the verge of undesirable neighborhood relations and economic conditions. If war were to take place, even if the allied forces win it, amongst its other adverse impacts, it would be a catastrophe for the economy that has started to crawl towards recovery and Turkey would suffer more than any other nation.

The following is an update of significant legal developments in the banking and financial services areas and related capital markets issues in Turkey during the year 2002.

B. Banking sector

In early 2002, amendments to the Banks Act continued with the goal of facilitating and strengthening the economy. Amendments were made by the Law No. 4743 that (i) sets forth provisions for the restructuring of debts in the financial sector, including tax exemptions for restructured debts; and (ii) amends the Banking Code with respect to management of banks, auditing of banks, revising the functions of the Savings Deposit Insurance Fund, a state agency, that assumed the administrations of a number of banks, introducing measures to avoid adverse impacts of the economic crisis on the capital structures of banks, and providing confidence and stability by imposing external auditing firms to prepare financial statements.

VOL. 37, NO. 2
Furthermore, regulations with respect to the by-laws of the Banks Association; principles and procedures concerning the restructuring of the banking sector in accordance with the Banking Act in order to provide confidence and stability in the banking sector and to avoid adverse impact of the economic crisis on capitals of banks; consolidated and unconsolidated calculation and implementation of the foreign exchange/equity ratio to balance them; evaluation of capital adequacy of banks in order to cause them to maintain sufficient equity to cover current and potential risks; conditions of the approval by the Banking Regulation and Supervisory Agency of framework agreements concerning financial restructuring with respect to extension, renewal of loans, granting new loans, discounting interests, transfer or assignment of loans, and such with those who are in financial bottleneck and who are in debt to banks and special financial institutions; preparation of interim financial statements of private deposit banks; account keeping, in order to cause banks to keep standard and transparent accounting principles and to have consolidated and unconsolidated financial statements at regular intervals; principles of independent auditing of private banks; (following the first auditing) principles of auditing of private banks by a second independent auditing firm; authorization and revoking of authorization of independent auditing firms, and establishment and activities of asset management companies that can buy or sell receivables and other assets of banks and special financial institutions, collect debts and sell them after restructuring such receivables and assets were put into effect.

C. Capital markets

A number of regulations were issued with respect to the following: establishment and activities of private pension companies and managing the pension mutual funds; individual retirement scheme and principles, and procedures to conclude contracts concerning retirement schemes; brokers who engage in concluding contracts concerning retirement schemes, selling and marketing life and personal accident policies in connection with individual retirement; establishment and operations of pension mutual funds based on principles of risk dispersion and fiduciary ownership; recording and follow up of capital market instruments and rights attached to such instruments (Serial IV, No. 28); principles regarding investment consultancy and applicable to consultant firms (Serial V, No. 55).

D. Public finance and debt management

The Law No. 4749 about Public Finance and Debt Management was enacted, setting forth the provisions regarding public finance and debt management, including borrowings by the State and the Treasury guarantees such as re-payment, investment, counter and country guarantees for loans obtained by entities such as state owned enterprises and agencies, state banks, municipalities, and alike; tax exemptions for borrowings and Treasury guarantees under the law; and procedures related with public finance and debt management.

III. European Union

A. Pension funds

Political agreement was reached in June 2002 on a Pensions Fund Directive proposed in October 2000 (COM(2000)507). The proposed Directive will establish:
a. a global prudential framework imposing ongoing prudential control and adequacy of assets requirements;
b. a mechanism for co-operation and notification between Member States; and
c. rules for investment of funds.

The Directive is expected to be finally adopted in mid-2003.

B. Distance Marketing of Consumer Financial Services

After considerable delays, this Directive (2002/83/EC) was finally adopted on the 23rd of September 2002, to be implemented in member states by the 9th of October 2004.

This Directive lays down common rules for selling contracts for credit cards, investment funds, pension plans, etc. to consumers by phone, fax or internet. Its main features are:

a. the prohibition of abusive marketing practices seeking to oblige consumers to buy a service that they have not solicited ("inertia selling");
b. rules to restrict other practices such as unsolicited phone calls and e-mails ("cold calling" and "spamming");
c. an obligation to provide consumers with comprehensive information before a contract is concluded; and
d. a consumer right to withdraw from the contract during a cooling-off period, except in cases where there is a risk of price fluctuations in the financial market.

The Directive provides in recital 13 that Member States should not be able to adopt provisions other than those laid down in the Directive in the fields which it harmonises.

C. Investment Services

In November 2002 the Commission published a proposal (COM(2002)625 Final) for a new Directive on Investment Services and Regulated Markets. This, it is hoped, will:

a. reinforce the "single passport";
b. ensure that investors enjoy a high level of protection; and
c. establish a comprehensive regulatory framework.

The new Directive will extend to investment advice and will clarify the ancillary services investment firms can provide. The Commission expects that the proposed Directive will be adopted at the end of 2004.

D. Consumer Credit


a. harmonised rules on a "maximum basis" (i.e., Member States should not be allowed to impose more stringent rules);
b. enlargement of the scope of consumer credit transactions (although home loans remain excluded);
c. improved transparency and comparability of credit offers;
d. rules on the mutual duties of consumers and lenders;

VOL. 37, NO. 2
e. improved freedom of circulation of quality solvency data across borders;
f. rights of withdrawal;
g. registration of lenders and credit intermediaries;
h. liability of lenders if the suppliers of goods and services act as their credit inter-
mediaries; and
i. protection of personal guarantors.

E. Transparency Obligations for Securities Issuers

The Commission is currently working on a draft Directive on transparency obligations
for securities issuers. The second consultation on this proposal was concluded in July 2002.
The Commission is expected to publish a proposal on the subject in February 2003.

The main points to emerge from the consultation process were:

a. the importance of consolidating into a single text all relevant disclosure require-
ments;
b. the need to upgrade periodic disclosure obligations in line with international ac-
counting standards;
c. the need to allow publication of information on the internet as well as newspapers;
d. the importance of each member state having a single responsible regulatory au-
thority; and
e. majority support for a flexible regulatory structure involving the Commission and
the European Securities Committee.

F. Market Abuse Directive

On December 3, 2002 the Council adopted the Directive on Insider Dealing and Market
Abuse. It is due to be implemented within eighteen months of its publication in the Official
Journal.

The Directive is intended to:

a. reinforce market integrity;
b. contribute to the harmonisation, on a minimum basis, of the rules for market abuse
throughout Europe;
c. establish a strong commitment to transparency and equal treatment of market par-
ticipants; and
d. require closer co-operation and a higher degree of exchange of information between
national authorities.

The Directive covers both insider dealings and market manipulation. The same frame-
work applies to both categories of market abuse. This will simplify administration and
reduce the number of different rules and standards across the European Union. The Di-
rective covers all financial instruments admitted to trading on at least one regulated market
in the European Union, including primary markets.

The Directive applies to all transactions concerning those instruments, whether those
transactions are undertaken on regulated markets or elsewhere. This is to avoid unregulated
markets, Alternative Trading Systems, and others being used for abusive purposes concerning those financial instruments.

The Directive requires each Member State to designate a single administrative regulatory and supervisory authority with a common minimum set of responsibilities to tackle insider trading and market manipulation.

The Directive guarantees the freedom of expression and the freedom of the press. Only journalists, who deliberately or negligently pass on false information and then profit, financially or otherwise, from having done so, will be covered by the Directive.

The Directive also establishes transparency standards requiring that people who recommend investment strategies to the public or to distribution channels disclose their own relevant interests. In practice, this provision will in particular apply to financial analysts, and to one specific sub-category of financial journalists, those recommending investments to the public.

The Market Abuse Directive is a framework Directive as foreseen under the European Council's March 2001 Stockholm Resolution on securities legislation (on the basis of a report from a group of Wise Men chaired by Alexandre Lamfalussy). The framework was approved by the European Parliament in February 2002 (see IP/02/195). The Directive lays down the essential principles. The technical details will be treated apart, through implementing measures to be taken by the Commission under the scrutiny of European Securities Committee (ESC), which is composed of representatives of Member States, and of the European Parliament. In particular, for the first time, the ESC will act as a regulatory committee when examining Commission’s draft implementing measures in 2003.

G. PROSPECTUSES


The political agreement reflects the compromise between the various states, all voicing different views. Disagreements arose about whether issuers should have the freedom to choose the competent authority to approve the prospectus. While Germany and the UK wanted freedom of choice for the issuer, France and other Mediterranean countries wanted control to remain with the member state issuing the capital. A compromise was reached whereby issuers of non-equity securities with a denomination per unit of at least 5,000 euros (generally high level bonds), should have the freedom to choose the home member state.

The political agreement includes the suggestion that member states be able to apply their national regimes to small offers made by small and medium sized enterprises and offers made by credit institutions in general. Other types of offers excluded from the obligation to publish a prospectus include offers of securities with a total consideration of less than 2.5 million euros and offers of securities which have already been listed on a regulated market in another member state. The political agreement also includes proviso that each member state will have a transitional period of five years to implement the proposal.

As a common position has now been agreed, the proposal for the Directive on Prospectuses must now go before the European Parliament for a second reading. It is expected that the adoption of the Directive will occur in June 2003. Implementation will then be required by June 2008.
IV. India

A. Pertinent Amendments to India’s Negotiable Instruments Act

In India, the Negotiable Instruments Act, 1881 (Act) provides the legal framework for promissory notes, bills of exchange, and checks.\textsuperscript{36} The bouncing of checks due to insufficiency of funds in the drawer’s account is a criminal offence under the Act.\textsuperscript{37} As a result, it is common practice for lenders to obtain post-dated interest and principal repayment checks from debtors.\textsuperscript{38}

However, the enforcement procedure in check bouncing cases was cumbersome, and the courts were unable to dispose of such cases expeditiously. Moreover, the punishment provided under the Act for such offences was inadequate. The Act has recently been amended by the Negotiable Instruments (Amendment and Miscellaneous Provisions) Act, 2002 (Amendment Act) inter alia to provide for electronic checks and to ensure speedy disposal of check dishonour cases.\textsuperscript{39}

The material changes introduced by the Amendment Act are discussed in the following sections.

B. Introduction of Electronic Checks

A check can be issued in electronic form and can be signed digitally under the asymmetric crypto system. Further, a check can be cleared electronically by using a truncated check (electronic image of a check), thereby avoiding movement of checks in physical form. A certificate issued by the paying banker at the foot of a truncated check will be prima facie proof of payment of that check.\textsuperscript{40}

The Information and Technology Act (IT Act), which inter alia applies to digital signatures and electronic transactions, was not applicable to negotiable instruments under the Act.\textsuperscript{41} The IT Act has now been amended to include electronic and truncated checks within its purview.\textsuperscript{42}

C. Dishonor of Checks

The notice period for the payee to inform the payer about a dishonored check has been increased from fifteen days to thirty days.\textsuperscript{43}

Previously, under the Act, courts did not take cognizance of a check dishonor complaint unless it was filed within forty-five days of the drawer’s failure to make payment after

\textsuperscript{36} India Cen. Acts, Act No. 26 (1881), Negotiable Instruments Act, Dec. 9, 1881.
\textsuperscript{37} Id.
\textsuperscript{38} Id.
\textsuperscript{40} Id.
\textsuperscript{42} Negotiable Instruments Amendment Act, supra note 39, at ch. II., No. 2.
\textsuperscript{43} Id. at ch. II., No. 7.
intimation of the dishonor. The Amendment Act provides for acceptance of the complaint
even after this period, if the complainant gives satisfactory reasons to the court about the
delay. In case the offender is a company, the nominee directors of the government or govern-
ment controlled financial institutions have been excluded from liability and prosecution.

D. Summary trial

A Magistrate can now conduct a summary trial of a check dishonour case. The trial should
be concluded within a six month period commencing from the date of filing the complaint. Any delay has to be recorded by the court.

The summons and complaint can be served on the accused by speed post or by courier. If the accused refuses to accept the summons for any reason, service will be regarded as complete.
The complainant can give evidence by an affidavit and need not appear in court in
person.
The punishment for dishonor of checks due to insufficiency of funds in the drawer's
account has been increased from one year to two years confinement, with or without a fine
up to twice the amount of the dishonored check. Furthermore, offences in respect of
dishonor of checks can be compounded.

V. Canada: Developments in Canadian Capital Markets and
Financial Services

Many of the most noteworthy legislative and regulatory developments relating to the
capital markets in Canada during 2002 reflected developments in the United States. These
arose in the wake of Enron and other corporate scandals and resulted in a heightened focus
on corporate governance and public company accounting and disclosure practices. The
year 2002 also saw significant initiatives relating to investment funds, some consolidation
in the financial services sector, and the initial public offering of The TSX Group Inc., which
owns both the Toronto Stock Exchange and the TSX Venture Exchange. The following is
a brief update on some of these developments.

A. Reforming Canadian Corporate Governance Practices

During 2002, the Sarbanes-Oxley Act of 2002 of the United States (SOX) was enacted
and the New York Stock Exchange (NYSE) and the NASDAQ proposed changes to their
listing standards, which were largely aimed at increasing control and scrutiny over com-
panies' governance practices. Several of the requirements of SOX also apply to Canadian

44. Information Technology Act, supra note 41.
45. Negotiable Instruments Amendment Act, supra note 39, at ch II., No. 9.
46. Id. at ch. II., No. 8.
47. Id. at ch. II., No. 10.
48. Id.
49. Id.
50. Id. at ch. II., No. 7.
51. Id. at ch. II., No. 10.
issuers that are registered or required to file periodic reports with the United States Securities and Exchange Commission (SEC). Canadian issuers listed on the NYSE and NASDAQ will also have to disclose to their U.S. investors how their practices differ from the United States rules. However, these U.S. developments arose in the midst of various Canadian initiatives, several of which were underway before SOX was enacted. There are suggestions that when these Canadian initiatives are implemented, Canadian companies that are caught by SOX, will be granted exemptions and permitted to follow Canadian rules in lieu of all of the requirements of SOX.

1. Toronto Stock Exchange Corporate Governance Guidelines

Since 1995, the Toronto Stock Exchange (TSX) has required listed companies to disclose their corporate governance practices annually and describe how they compare to the TSX’s Corporate Governance Guidelines. On April 26, 2002, the TSX published draft revisions to its guidelines. The revised guidelines were substantially based on the recommendations of the Final Report of the Joint Committee on Corporate Governance (November 2001). In response to the enactment of SOX and issues raised by the Ontario Securities Commission (OSC), the TSX subsequently proposed further revisions to the draft guidelines published in September and again in November of 2002. While the proposed revisions are still pending final approval, some of the key changes will require a TSX listed issuer to: (i) make full and complete disclosure of its governance system on an annual basis, and where its system is different from the Guidelines, to disclose clearly the reason for each difference; (ii) adopt a formal code of business ethics by its board of directors to govern the behavior of directors, officers, and employees; (iii) have at least two unrelated directors on its board (the Guidelines continue to recommend a majority of unrelated directors); (iv) have an audit committee composed of a majority of unrelated directors (the draft Guidelines recommend that the audit committee be composed of only unrelated directors), with all members of the audit committee being financially literate and at least one member having accounting or related financial expertise; and (v) certify compliance with its TSX listing agreement on an annual basis.

2. Ontario Bill 198

One of the most significant developments relating to the Canadian capital markets in 2002 was the passage in the Ontario Legislature of substantial amendments to Securities Act (Ontario) contained in Bill 198, An Act to Implement Budget Measure and Other Initiatives of the Government (Bill 198). Most of Bill 198 was proclaimed into force on April 7, 2003 and imposes tougher penalties for breaches of Ontario securities laws and grants the OSC

53. See id.
54. See id.
57. Proposed Revisions, supra note 55.
new power to make rules (similar to those provided to the SEC by SOX) governing the composition and conduct of audit committees and requiring issuers to implement systems for internal controls and disclosure procedures, including certification thereof by Chief Executive and Chief Financial Officers.\textsuperscript{59} Other important amendments, which are pending further consideration and not yet in force, would introduce new offences for market manipulation and securities fraud and introduce new civil liability for secondary market disclosure where misrepresentations have been made in public documents and oral statements.

3. Public Accounting Initiatives

In October 2002, the Canadian Securities Administrators (CSA), the Office of the Superintendent of Financial Institutions, and the Canadian Institute of Chartered Accountants (CICA) jointly announced the creation of the Canadian Public Accountability Board (CPAB) to oversee auditors of publicly listed companies in Canada.\textsuperscript{60} CPAB has authority to sanction chartered accounting firms that audit public companies.\textsuperscript{61} The oversight system will require more rigorous inspection of auditors of public companies, new quality control requirements for these firms, and tougher auditor independence rules.\textsuperscript{62} Auditing firms will also be subject to annual reviews by a new National Inspection Unit.\textsuperscript{63} While Canada's major auditing firms have voluntarily agreed to implement the new requirements, the CPAB requirements will apply to all other auditing firms within three years.\textsuperscript{64}

Also in 2002, the Public Interest and Integrity Committee of the CICA proposed new independence standards for auditors and other assurance providers. These standards include additional rules of professional conduct relating to auditor independence.\textsuperscript{65} The CICA also issued draft guidelines relating to the accounting treatment of special purpose entities and guarantees.\textsuperscript{66}

4. Increased Shareholder Activism

Canadian institutional investors, which historically have been more reticent than their U.S. counterparts, displayed growing activism in 2002. On June 27, 2002, a group of institutional investors with over Cdn.$500 billion in assets formed the Canadian Coalition for Good Governance with the goal of improving corporate governance of Canadian companies. The Coalition has agreed to share information and take the initiative to hold management accountable for growing long-term shareholder value.

B. Regulatory Changes Affecting Canada's Capital Markets

There were several changes to securities regulation in 2002, many of which made progress in harmonizing Canadian securities laws in the various provinces and territories across the country. The following are a few of the most significant developments.

\textsuperscript{59} Id.
\textsuperscript{60} Press Release, Media Backgrounder, Canadian Public Accountability Board (July 17, 2002), at http://www.cpab-ccrc.ca/-/pdf/2%20Board.pdf.
\textsuperscript{61} Id.
\textsuperscript{62} Id.
\textsuperscript{63} Id.
\textsuperscript{64} Id.
\textsuperscript{65} See Letter from Donald G. Wray, Chair, Public Interest and Integrity Committee of the Canadian Institute of Chartered Accountants to David A. Brown, Chair, Ontario Securities Commission (Sept. 23, 2002), available at http://www.cica.ca/multimedia/Download_Library/News/Professions_Response_to_Enron/Response_OSC_02Oct4.pdf.
\textsuperscript{66} Id.
1. Continuous Disclosure Obligations

National Instrument 51–102 Continuous Disclosure Obligations was published for comment on June 21, 2002, but is not expected to come into force until 2004.67 If adopted, the draft instrument will harmonize certain continuous disclosure obligations among the provinces and territories.68 The draft instrument sets out the obligations of reporting issuers with respect to all of their continuous disclosure documents, including, among others, financial statements, management discussion and analysis, and information circulars.69 One of the most significant proposed changes would shorten the filing deadlines for annual and interim financial statements for senior issuers from 140 days to 90 days and 60 days to 45 days, respectively.70 National Policy 51–201 Disclosure Standards, adopted in July 2002, provides the CSA’s guidance on the best practices for timely disclosure of material information.71

2. Continuous Disclosure and Other Exemptions Relating to Foreign Issuers

If adopted, draft National Instrument 71–102 Continuous Disclosure and Other Exemptions Relating to Foreign Issuers, also published for comment on June 21, 2002, will allow eligible foreign issuers to satisfy Canadian securities requirements by filing in Canada documents that comply with those of the SEC or other designated foreign jurisdictions.72 The draft instrument overlaps to some extent the exemptions that already are available under the U.S./Canada Multijurisdictional Disclosure System.73

3. Communication with Beneficial Shareholders

National Instrument 54–101 Communication with Beneficial Owners of Securities of a Reporting Issuer came into force on July 1, 2002.74 The new instrument is intended to continue the shareholder communications regime of the former policy and permits issuers to communicate directly with their beneficial security holders who do not object to the release of their names and related information.75

4. New Rules for the Exempt Market

In April and March, respectively, British Columbia and Alberta adopted Multilateral Instrument 45–103 Capital Raising Exemptions.76 This instrument provides four new exemptions from the prospectus and registration requirements in those jurisdictions: a private issuer exemption; a family, friends, and business associates exemption; an accredited investor exemption; and an offering memorandum exemption that permits issuers to sell securities in any amount, provided they deliver an offering memorandum in prescribed form and

68. Id.
70. Id.
71. Id.
72. Id.
75. See id.
obtain a risk acknowledgement from investors. Securities regulators in all other provinces and territories, except Ontario and Quebec, have proposed adopting a revised version of the rule.

C. Investment Funds

1. Mutual Fund Governance

On March 1, 2002 the CSA released for comment their long awaited concept proposal entitled “Striking a New Balance: A Framework for Regulating Mutual Funds and their Managers.” The CSA proposal recommends five pillars upon which mutual fund regulation should be based, namely: (i) registration for mutual fund managers, (ii) mutual fund governance, (iii) product regulation, (iv) disclosure and investors rights, and (v) enhanced regulatory presence.

The CSA proposal shifts the regulatory focus from the mutual fund itself to the mutual fund manager and its relationships and activities. The key pillar of the proposal would require each mutual fund family to establish one or more independent governance bodies that will act solely in the best interest of investors and will be largely free from conflicts of interest. A framework document that refines these proposals is expected to be published for comment by the CSA before the summer of 2003.

2. Mutual Fund Regulation

On September 27, 2002 the CSA released for comment draft rules that would require more detailed and timely disclosure of investment fund holdings and investment strategies. Proposed National Instrument 81-106 Investment Fund Continuous Disclosure introduces a narrative annual quarterly management report of fund performance, shortened filing periods for annual and interim financial statements, and the elimination of mandatory delivery of financial statements instead giving investors the right to choose whether to receive financial statements and management reports of fund performance. According to the CSA, these measures would enable investors and their advisors to better assess an individual fund’s performance, position, and future prospects, by presenting throughout Canada a consistent format for financial and non-financial information for all types of investment funds.

In 2002 the CSA also made significant changes to National Instruments 81-101 and 81-102 Mutual Funds relating to the ability of publicly offered mutual funds to invest in other investment funds. The new rules will permit a publicly offered mutual fund to invest an unlimited amount in one or more other Canadian mutual funds provided that there is no duplication of management fees and no fees are payable in connection with the investment.
3. Financial Institutions

In 2001, significant amendments came into force to the legislation governing federally regulated financial institutions, which, among other things, created new ownership rules for federally regulated financial institutions, allowed banks and insurance companies to organize under regulated holding companies, and expanded the range of permitted investments by these entities. These new ownership rules opened the path for mergers of Canadian federally regulated financial institutions.

The year 2002 saw the first significant merger of financial institutions since these amendments with the combination of Clarica Life Insurance Company and Sun Life Financial Services of Canada, which created the largest insurer in Canada. In December 2002, Manulife Financial Corporation announced an unsolicited takeover bid to acquire Canada Life Financial Corporation. In February 2003, the Canada Life board of directors approved an alternative acquisition by Great West Lifeco, an affiliate of Power Financial Corporation. In February, Manulife decided not to extend its offer. Canada Life's shareholder will vote on the combination with Great West Lifeco on May 5, 2003, which, if approved, would create an even larger insurer.

Although there was some discussion during the summer months of 2002 regarding possible merger applications by some of the "big five" Canadian banks, these subsided. Currently, the banks are awaiting reports by parliamentary committees on the public interest in mergers. Since any merger of Canada's banks would require approval of the Minister of Finance, it seems that any formal merger applications of Canada's largest banks will wait until a change in Canada's federal political leadership in late 2003 or 2004.

The year 2002 also saw the establishment of The Centre for the Financial Services OmbudsNetwork (CFSON) and the Ombudsman for Banking Services and Investments (OBSI). OBSI will merge the current Canadian Banking Ombudsman and ombudsman services that were under development by the Investment Dealers Association, the Mutual Fund Dealers Association, and the Investment Funds Institute of Canada. The membership of OBSI includes Canadian banks and other deposit-taking organizations, investment dealers, mutual fund dealers, and mutual funds managers. CFSON provides Canadian consumers of all financial services with a single point of access to independent complaint resolution by linking OBSI with two other services handling complaints for the life and health and the property and casualty insurance industries.

In 2002, Quebec passed Bill 107, which establishes the Agence nationale d'encadrement du secteur financier in that province. This Agency will be a superstructure responsible for the administration of all Quebec laws governing the financial services market, including the Securities Act (Quebec), as well as providing assistance to consumers and implementing consumer protection and compensation programs.

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85. CANADIAN SECURITIES ADMINISTRATORS, NOTICE OF PROPOSED AMENDMENTS TO NATIONAL INSTRUMENT 81-102 MUTUAL FUNDS AND TO NATIONAL INSTRUMENT 81-101 MUTUAL FUND PROSPECTUS DISCLOSURE (July 19, 2002).
86. Id.
88. Id.
E. MISCELLANEOUS ON-GOING DEVELOPMENTS

In 2002 there were several ongoing developments aimed at fundamentally reforming the framework of securities regulation in Canada, including the following.

1. Uniform Securities Law Project

In recognition that there is a regulatory burden in Canada resulting from each of the provinces and territories having different securities legislation, the CSA embarked on the Uniform Securities Law Project with the objective of eliminating these differences by developing a uniform statute and rules for adoption across Canada. A proposed framework of a uniform securities law was published in 2003.90

2. The Five Year Review

In May 2002, the draft report of the Five Year Review Committee was published.91 The report was the product of two years of research and deliberation concerning the state of securities legislation in Ontario.92 Several of the amendments to the Securities Act (Ontario) brought about by Bill 198, mentioned above, were recommended in the Committee's draft recommendations.93 In addition, among its many recommendations, the Committee called for a single, coordinated securities regulator for Canada and the introduction of a system of independent governance for mutual funds.94

3. The OSC's Fair Dealing Model

The OSC announced its Fair Dealing Model, which is a proposed new way of regulating the relationship between the financial services industry and individual investors.95 The Fair Dealing Model, which the OSC believes is unique in the world, would, among other things, require more complete information on how service providers are compensated and collapse the distinction between trading and advisory activities.96

4. British Columbia's Proposals for Securities Regulation

The British Columbia Securities Commission came out with its own proposals, which are largely an attempt at deregulation. Under these proposals, codes of conduct for dealers and advisers would replace detailed rules and a continuous market access system would eliminate the requirement for a prospectus in some circumstances. It remains to be seen whether British Columbia, or any other jurisdiction, will adopt any of these recommendations.

As one can see from the foregoing, in 2002 there were numerous actual and proposed legislative and regulatory developments relating to the Canadian capital markets. This heightened pace of regulatory change is expected to continue in 2003.

91. See id.
92. See id.
94. Id.
95. Id.
96. Id.
VI. Australia

A. Introduction

The past year has been a very significant one for regulation of financial services in Australia. Five years of government consultation on financial services regulation finally culminated in the Financial Services Reform Act 2001 which commenced this year and is the subject of ongoing refinement through regulations and policy. Superannuation also came under the microscope with a renewed focus on the regulation and supervision.

B. Financial Services Reform

The Financial Services Reform Act 2001 (FSR Act) commenced on March 11, 2002, with a two-year transition period. This legislation completely overhauls the regulation of financial markets and licensing, distribution and disclosure for financial services and products, including investment funds, superannuation, insurance, and bank deposit products. In this article, we focus on financial services and products and not on financial markets.

1. What is regulated?

Financial services regulated by the FSR Act include giving financial product advice, dealing in financial products, making a market for a financial product, and providing custodial or depository services. Dealing itself includes applying for, acquiring, issuing, varying or disposing of financial products, underwriting securities or managed investment schemes, and arranging any of those things.

Financial products include most securities (e.g., shares and debentures), unit trusts, insurance, derivatives, superannuation, bank deposit accounts, non-cash payment facilities (such as cheques, travellers cheques, direct deposit), and foreign exchange. The definitions are wide and not limited to these categories but extend to any facility, through which a person makes a financial investment or manages a financial risk. Key exemptions include credit, reinsurance, health insurance, and surety bonds.

2. Licensing

The FSR Act requires every person who carries on a business of providing financial services in Australia to hold an Australian financial services license, including any person who induces an Australian resident to use their financial services. Key licensing exemptions include:

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99. Id.


101. See id. §§ 766A and 766C.

102. See id. § 764A.

103. Id. § 763A and 765A.

104. Id. § 911 and 911D.
(a) providing services to related companies;
(b) providing services regulated by the Australian Prudential Regulation Authority (APRA) or an overseas regulatory authority approved by the Australian Securities and Investments Commission (ASIC) (ASIC has given limited guidance in this area, but equivalent regulation and supervision are key factors) where the service is provided only to wholesale clients (a defined concept);
(c) dealing by an overseas service provider arranged by an Australian licensee; and
(d) representatives of an Australian Financial Services licensee.

3. Licensee obligations

Obligations applying to Australian financial service providers include:

(a) competent responsible officers;
(b) appropriate compliance procedures;
(c) competent representatives;
(d) express liability for the acts or omissions of their representatives;
(e) appropriate internal and external dispute resolution mechanisms for retail clients; and
(f) efficiency, honesty, and fairness.\(^{105}\)

Licenses, which are not prudentially regulated by APRA, must also have adequate:

(a) financial resources—the requirements which vary according to the services provided include positive net assets and solvency and sufficient cash resources to cover the next three months’ expenses with adequate cover for contingencies. Minimum net tangible assets and/or minimum surplus liquid funds may also apply to custodians, market participants, licensees holding client money or property, licensees who enter into financial obligations with clients, and foreign exchange dealers;
(b) technological and human resources;
(c) risk management systems;
(d) compensation arrangements for retail clients by March 11, 2004—details of this requirement are yet to be finalised.\(^{106}\)

4. Conduct and disclosure

Various conduct and disclosure obligations will apply to licensees and financial product issuers that have retail clients. Some commenced on March 11, 2002, but most will commence when a licensee or product issuer opts into the new regime, which must occur before March 11, 2004. They include:

(a) a financial services guide before providing services, describing services able to be provided, remuneration, and associations with product issuers;
(b) warnings for general advice, limited advice, and replacement product advice;
(c) an obligation to know your client and provide advice suitable for their needs, objectives, and circumstances when giving personal advice;
(d) a statement of advice, for personal advice, setting out the advice, the basis for it, remuneration capable of influencing the advice, and associations;

\(^{105}\) Id. § 912.
\(^{106}\) Id. § 912.
(e) a product disclosure statement for a product before it is issued or recommended; and
(f) other product obligations, including significant event reporting, periodic reporting, holding application monies on trust, transaction confirmations, cooling off, and advertising restrictions.\textsuperscript{107}

5. \textit{Product disclosure statements}

The FSR Act introduces a new disclosure regime for financial products (other than securities) sold to retail clients. The new regime imposes significant disclosure obligations for the first time for many financial products and replaces existing prospectus requirements for investment funds and prescriptive requirements for superannuation and life insurance.\textsuperscript{108}

The product disclosure statement requirements are based on the concept of guided disclosure. In other words, there is a list of items, which must be included in the statement if applicable. There is also a requirement to include any other information that might reasonably be expected to have a material influence on the decision of a reasonable retail client to make a decision whether to acquire the product unless it would not be reasonable for a retail client to expect to find the information in the statement.\textsuperscript{109} Unlike the previous regimes for superannuation and life insurance, the new regime does not impose many prescriptive requirements on the appearance of the statement or the information it contains. However, statements are required to be 'clear, concise, and effective' and this requirement has given ASIC, as regulator, considerable scope to suggest some prescriptive rules.\textsuperscript{110}

One of the most controversial disclosure requirements for product disclosure statements is the requirement for investment products to include information about the extent to which labor standards or environmental, social, or ethical considerations are taken into account in making investments. ASIC has proposed guidelines on how to comply with this requirement, which can be expected to have a profound impact on the investment industry over the longer term.

C. IMPROVING THE SAFETY OF SUPERANNUATION

Concerns about regulation of superannuation trustees have been sparked by the collapse of several funds operated by a commercial trustee company. While fund collapses have occurred previously, they had been confined to single small employer funds rather than funds outsourced to a commercial operator. In response, the Government set up a working group to consider regulation of superannuation trustees and funds, and has accepted several recommendations, including:

(a) all superannuation trustees be required to be licensed by APRA (in addition to any requirement to obtain an Australian financial services licence) and comply with financial requirements—currently only trustees of funds offered to the general public are required to be licensed by APRA;
(b) registration of superannuation funds;
(c) preparation and lodgment of risk management plans which are audited each financial year; and

\textsuperscript{107} Id. Part 7.7 and Part 7.9.
\textsuperscript{108} Id. Division 2 of Part 7.9.
\textsuperscript{109} Id. §§ 1013D-1013E.

SUMMER 2003
(d) giving APRA the power to impose prudential standards and increasing enforcement powers.\textsuperscript{111}

\textbf{D. Family Law Changes}

Superannuation funds have also had to deal with legislation, which enabled married couples who separate, to divide superannuation entitlements as part of the overall property settlement. This complex legislation commenced on December 28, 2002, and has caused significant administrative burdens for superannuation funds and trustees.\textsuperscript{112}
