



Impact on Bond Market of Belgian Financial Regulator's Tightening of Investor Protection Against Unfair Contract Terms

On February 6, 2017, Belgium's financial regulator, Belgian Financial Services and Markets Authority ("FSMA"), moved to fortify the protection of investors, publishing a position paper ("Position Paper") on the application of Belgium's rules on unfair contract terms¹ ("Rules") to offers of investment instruments in Belgium. The Position Paper provides guidelines and recommendations in connection with the FSMA's review and eventual approval of such documentation.

In particular, the Position Paper indicates that various commonly used clauses applicable to financial instruments offered to investors who qualify as "consumers" in Belgium may be construed as "abusive." This could result in such clauses, or even the entire contract between the issuer and the investor, becoming null and void.

Scope of Application

The Position Paper takes a broad scope of protection for consumers under the Rules. Consumers are defined as natural persons acting for purposes outside of their trade, business, craft, or profession. The Position Paper, however, does not specify whether the Rules apply to private banking clients qualifying as consumers.

The Position Paper sets out the following, in particular:

- The Rules apply to any financial instrument offered to consumers in Belgium. Such an offer may be public or non-public, regardless of whether or not it is subject to a prospectus approved by the FSMA or passported to Belgium.
- Application of the Rules is irrespective of the minimum investment per investor and the denomination of the instruments (whether €1,000 or €100,000).
- All financial instruments are implicated by the Position Paper, not only structured notes, but also plain vanilla bonds.

Legal Value of the Position Paper

The Position Paper does not have the force of law. It only reflects the FSMA's interpretations and recommendations. Thus, the Position Paper is not binding on the courts, which would ultimately assess the fairness, or otherwise, of contested terms in case of a dispute.

Nonetheless, the FSMA will adhere to the Position Paper in reviewing prospectuses and advertisements

¹ These rules appear in Article VI.83 of the Belgian Economic Law Code.

relating to public offers of financial instruments. The Position Paper's impact remains unclear in relation to non-public offers and public offers not subject to the FSMA's supervision.

Terms and Conditions Not Governed by Belgian law

Pursuant to the Belgian Economic Law Code (Article VI.84), a governing law clause referring to the law of a non-EEA Member State may be declared null and void, provided that the applicable law of the relevant Member State of the EEA would provide a higher degree of protection for the consumer. In practice, this means that Belgian law is likely to be applicable if the terms and conditions are governed by the law of a non-EEA Member State.

In principle, issuers are free to submit the terms of financial instruments to the law of an EEA Member State other than Belgium. In such event, and pursuant to the Rome Regulation, in proceedings before the Belgian courts, the law of that Member State (including any implementing measures) should apply rather than Belgian law. In exception to this, the Belgian courts may apply Belgian law where considering Article VI.83 to be an "overriding mandatory provision" under Belgian law. The Position Paper does not indicate, however, whether the Rules are to be considered as an "overriding mandatory provision" of Belgian law.

Base Prospectus Approved by Another EEA Member State

The Rules apply to offers based on a base prospectus approved by the competent authority of another Member State of the EEA and addressed to Belgian consumers. The FSMA recommends that unfair contract terms be declared non-applicable to Belgian consumers in the relevant final terms. Hence, any base prospectus will have to specify that the issuer may opt out of all unfair contract terms (category B information).

If the final terms do not provide for an opt out from unfair contract terms, the FSMA will require that advertisements relating to a public offer addressed to Belgian consumers contain a declaration stating that: (i) the issuer undertakes to comply with the provisions of the Belgian Economic Law Code; and (ii) the unfair contract terms shall not apply. However, the binding nature of such statement is questionable, as it

creates no direct contractual relationship between the issuer and consumer.

In addition, the FSMA requires that the summary and the terms and conditions included in the prospectus contain an intelligible overview of parties' rights, to enable consumers to understand the scope, economics, and consequences of the relevant clauses.

Types of (Voidable) Clauses Implicated by the Position Paper

The Position Paper covers the following types of (voidable) clauses:

Unilateral Alteration of the Essential Characteristics of the Investment Instrument (Article VI. 83,4° Belgian Economic Law Code). Terms will be deemed "abusive" where providing for the issuer's unilateral alteration of the "essential characteristics" of the financial instruments. The Position Paper considers the following characteristics as "essential:" (i) the yield; (ii) the underlying asset; (iii) the full or partial repayment at maturity; (iv) the counterparty; and (v) the term. This list is not exhaustive, however, and the FSMA may broaden it over time.

The Position Paper authorizes "contract terms providing for characteristics of the financial instruments to be changed on a majority vote of the holders of the investment instruments," referring to changes authorized by bondholders' meetings. However, such provisions only permit defined majorities of bondholders to bind all bondholders; they do not permit terms of the bonds to be amended "unilaterally."

In addition, terms allowing the issuer to unilaterally alter the essential characteristics of the investment instrument may also be authorized if certain conditions are met. This would be in the event of *force majeure* or circumstances that significantly alter the economics of the contract and for which the issuer is not accountable. In practice, on the bond market, such circumstances primarily concern provisions relating to "change of law" or "events of bankruptcy." Furthermore, if implementing unilateral terms in response to such circumstances of *force majeure*, the issuer must take all reasonable care to maintain the continuance of the product under similar conditions. Thus, modification of the product's characteristics must not be substantial.

Early Termination of Fixed-Term Investment Instruments (Article VI.83,10° Belgian Economic Law Code). Terms could also be abusive where providing for the early termination of fixed-term investment instruments (typically, an issuer's call option). An issuer's call option is only authorized in the case of *force majeure* or in the absence of *force majeure*, if several conditions are met, including the obligation to indemnify the investors. "*Force majeure*" is defined as a party's "insurmountable inability to meet its commitments, for which that party is not accountable." In practice, this provision is likely to lead to the suppression of issuer's various call options, as follows:

Tax Calls. Bond terms typically provide that in case of a significant change to the tax treatment of the bonds impacting the investors ("tax event"), the issuer must gross-up the interest payments such that the change will be neutral for investors (subject to various exceptions). To avoid such gross-up in these circumstances, the issuer generally has the possibility to reimburse the bonds at par plus accrued interest ("tax call"). In other words, the tax call is intrinsically linked to the issuer's gross-up obligation, and together, they offer a balanced solution accepted by the market.

However, the FSMA considers that a tax event may not be considered as a case of *force majeure* and will only authorize a tax call to the extent that the issuer would repay the bonds at par or at their market value, whichever is highest. Given the difficulty of determining a bond's "market value" at any given time, there is a risk that the tax call and the gross-up obligation of the issuer would simply disappear together from certain bond's terms. This is not necessarily in the interest of investors.

Clean-Up Calls. Bond terms typically provide that investors may exercise a put option in case of a change of control of the issuer. If a high percentage of the bondholders (typically 80 or 85 percent) exercise the put, the issuer generally has the option of reimbursing the remaining bonds at par plus accrued interest ("clean-up call"). The clean-up call's rationale is that the bonds are likely to become illiquid and difficult to trade, given the market's reduced size. However, the FSMA would not authorize such a call, which is considered to create a significant imbalance between the rights and the obligations of the parties, to the detriment of consumers.

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Other Issuer's Calls. In offers to Belgian consumers, an issuer's call will no longer be authorized where the issuer is allowed to reimburse the bonds at any time, provided it pays a make-whole amount based on the present values of the remaining payments of principal and interest. Even though investors are completely indemnified, such a call is at the issuer's full discretion and will therefore not pass FSMA scrutiny.

Substitution of Another Party for the Issuer (Article VI.83, 31° Belgian Economic Law Code). In principle, it is prohibited to provide terms for the option to substitute another party for the issuer. Legal restructuring (dissolution, winding-up, or mergers) within the same group of companies, however, is authorized, provided that: (i) the substitute has a similar long-term rating and guarantees and holds harmless the investors from any disadvantageous financial consequences (e.g., arising out of tax or regulatory differences); (ii) there are no payments arrears (or indications of such arrears or payment problems); and (iii) the substitute will be held to any guarantee issued in terms of the issuer's payment obligation towards the investors.

Grandfathering

The Position Paper will not apply to prospectuses approved by the FSMA or any other competent authority prior to the publication of the Position.

Lawyer Contacts

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