

INFORMATIVE NOTE

BANKING AND FINANCE
LAW

PLMJ

A.M.PEREIRA, SÁRAGGA LEAL, OLIVEIRA MARTINS, JÚDICE E ASSOCIADOS
SOCIEDADE DE ADVOGADOS, RL

FINANCIAL SECTOR STABILITY LEGISLATIVE AND REGULATORY ACTIONS

Within the context and as a reaction to the international financial turmoil, governments and regulators of the financial markets have been implementing extraordinary measures and taking other steps aimed at enhancing the regulatory environment of the sector and increasing investors' protection. The wide-ranging aim of these initiatives is to mitigate the detrimental effects of the current liquidity crisis, to promote financial stability and to restore investors' confidence in the financial markets.

PLMJ has been closely accompanying recent developments in the legislation and regulations governing the Portuguese financial sector and intends through this News Bulletin to begin a series of initiatives to peruses and reflect along with its clients on the "new" legislative and regulatory environment for the Portuguese financial sector.

Last September, PLMJ published a summary of the legislative measures on short selling introduced in Portugal. With this News Bulletin, we propose to briefly recall the measures taken recently in the financial sector.

In only a few weeks, the Portuguese government has passed and announced a package of extraordinary measures aimed primarily at enhancing the financial liquidity and solvency of credit institutions based in Portugal and other measures aimed at enhancing stability and confidence in the Portuguese financial market, notably:

I. Extraordinary Measures for Enhancing Financial Liquidity and Solvency

- . Availability of an extraordinary guarantee granted by the Portuguese State to credit institutions with head offices in Portugal, of up to a maximum of € 20,000 mln;
- . Portuguese credit institutions recapitalization scheme of up to of € 4,000 mln;
- . Increase of the limit of the deposit guarantee fund from € 25,000 to € 100,000;
- . Increase of the Tier I Capital requirement applicable to credit institutions to 8%.

II.Measures for Enhancing Stability and Confidence in the Financial Sector

- . Broader duties of information and transparency within the financial sector;
- . Flexibility of certain regulatory rules applicable to investment funds and real estate funds' supervision by the CMVM;
- . Approval of the legal framework for nationalization of shares in companies, with the purpose to safeguard the general interest;
- . Proposals for the approval and disclosure of the remuneration policies followed by management and supervisory bodies of companies having a "public interest";
- . Review of the sanctions applicable within the financial sector.

We will now take a brief look at each of these measures.

I. Extraordinary Measures for Enhancing Financial Liquidity and Solvency

. Extraordinary Portuguese State Guarantee: € 20,000 mln.

. Law nr. 60-A/2008, of 20 October, and Ministerial Order 1219-A/2008, of 23 October contemplate the legal and regulatory regime governing the extraordinary issuance of State guarantees, in order to enhance financial stability and financial market liquidity.

. Owing to the extraordinary circumstances that gave rise to this measure, the issuance or renewal of these guarantees will be transitory in nature and continue only until 31 December 2009.

. The guarantee, which has been made available to Portuguese credit institutions (complying with the legally prescribed solvency criteria), seeks to cover the performance of the obligations undertaken by the latter in the course of their financing or refinancing operations, including renewals, up to a 20,000 mln. Cap.

. The guarantee's cover is limited to financing arrangements or issuance of unsubordinated debt in euros outstanding for at least

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3 months and no longer than 3 years (5 years in exceptional cases). Money market deposit transactions, subordinated debt operations and any operations already covered by other guarantees or security are expressly ruled out, as are finance operations in jurisdictions where internationally accepted transparency standards are not followed.

. The application for the guarantee must be submitted to the Bank of Portugal, enclosing the information and documents required pursuant to the Law 60-A/2008, of 20 October, and Ministerial Order 1219-A/2008, of 23 October, and will be considered as having been received by the Public Debt and Treasury Management Institute. Then, these bodies will send a grounded proposal to the government, along with an analysis of the contribution made by the entity in question to the financing of the economy.

. The guarantee will be granted on the basis of the previous payment of a fee by the credit institution, to be determined according to the criteria outlined in a Schedule to Ministerial Order 1219-A/2008, of 23 October, without prejudice of any possible adjustments in view of counter-guarantees provided to the state.

. Without prejudice to the monitoring of the execution and management of the guarantee conferred on the state as established in the legislations under analysis, the state may request repayment of the covered amounts, should a claim be made under the guarantee due to default of the applicant credit institution, case in which the state may follow the following routes, as far as necessary in order to safeguard its patrimonial interest:

- (i) Convert its claim into share capital in the applicant credit institution, including by virtue of the issuance and subscription of preferential shares;
- (ii) Impose good corporate governance principles, distribution of dividends and payment of remuneration to the directors and auditors of the applicant credit institution;
- (iii) Impose compulsory administration by temporarily appointing one or more directors benefiting from the guarantee in accordance with Article 143 of the Portuguese general banking act.

. This measure has had a positive impact on the banking sector and to date a number of major Portuguese credit institutions have admitted that they may resort to the guarantee if necessary. Nevertheless, the legislation may raise some relevant legal issues to be taken into account by applicants.

. (Re)capitalisation of the credit institutions: 4,000 million euros

. The Portuguese Parliament approved effective as of 25th November, a law establishing measures to improve the financial soundness of Portuguese credit institutions, similarly to what has already been made in other jurisdictions, and following the recommendations issued by the European Commission in this respect

. The Act foresees two different regimes:

- (i) An increase in the level of own funds of credit institutions already having an acceptable solvency and stability, seeking to bring them into line with their European counterparts;
- (ii) Direct state intervention in the recovery and remedial processes

for credit institutions which, under Article 141 of the General Credit Institutions and Financial Companies Regime, have or are at risk of having an own funds, solvency or liquidity level inferior to the mandatory levels required.

. These measures are subsidiary and temporary in nature and will only apply to the capitalisation operations of Portuguese-based credit institutions carried out before 31 December 2009.

. (Re)capitalisation can be carried out through distinct transactions, including:

- (i) Acquisition of the credit institution's own shares;
- (ii) Increase of the share capital of the credit institution by means of issuance of ordinary shares, preferential shares not carrying voting rights and shares conferring special rights;
- (iii) Other capital securities which are admissible by law or the articles of the company;
- (iv) Joint venture agreement or other contracts with similar effects.

. The issuance of the above mentioned financial instruments may also be directed to the shareholders of the credit institution, the general public or both, with a full or partial underwriting or placement guarantee assumed by the state.

. At the grounded proposal of the Bank of Portugal, a capitalisation operation may take on the nature of a debt issuance (convertible to or exchangeable for ordinary or preferential shares) without breaching the limits set out in the Portuguese Companies Code.

. The financial institutions that benefit from this aid will have certain obligations imposed on them, such as financing the economy, including families and SMEs, implementing good corporate governance practices and, adopting dividends and remuneration policies as well as increasing contributions to the deposit guarantee fund (conditions to be set by order of the Ministry of Finance).

. Access to state investment within the scope of this legislation is separate from the recourse of the credit institutions to state guarantees under Law 60-A/2008, of 20 October.

. Access to state investment for increasing own funds depends on the involvement of several bodies and special rules as to the convening, functioning and resolutions of the shareholders meeting. These provisions raise important issues which need to be carefully weighed up by the credit institutions in question.

. Deposit Guarantee Fund limit increased from € 25,000 to € 100,000

. The government has increased the Deposit Guarantee Fund coverage from the € 25,000 imposed by the European Community to € 100,000.

. It has also reduced the period for repaying the deposits from 3 months to 1 month, with the right of the customer to receive a €10,000 portion within 7 days.

. These measures were introduced by Decree-Law 211-A/2008, of 3 November, which has already come into force.

. Setting an objective for Portuguese based credit institutions, of a minimum 8% Tier I Capital

. The government announced in a press conference held on 2 November 2008 that credit institutions should meet a minimum amount of own funds (Tier 1 Capital) of 8%, as opposed to the 4% actually required at present or the 7% which roughly corresponds to the current practice.

. This measure was taken in line with a European Commission Communication on the application of state aid rules in the context of the current global financial crisis (No. 2008/C 270/02) with a view to enhancing the soundness of banking sector institutions.

. As to the remaining regulatory measures, it is also worth mentioning that on 14 October the Bank of Portugal published Notice No. 6/2008, which authorises credit institutions to disregard the potential profits and losses from their bond portfolios, as well as other equally significant regulations in this respect.

II. Measures for Enhancing Stability and Confidence in the Financial Sector

. Increased duties of information and transparency in the financial sector

. The entry into force – on 12 October 2008 – of Decree-Law 211-A/2008, of 3 November, which amended a range of legislation governing the financial sector, sought to increase the duties of information and transparency vis-à-vis supervisory authorities and customers of financial institutions.

. Although regulations already existed on this matter, including special duties of information for marketing structured savings instruments (ICAE) (Bank of Portugal Notice No. 6/2002) and rules applicable to intermediation activities related to complex financial instruments (Securities Code) in line with the provisions of the DMIF (apart of course from the information included in the public offer prospectus for financial instruments), the Parliament sought to “level out” the duties of information about complex financial products which are placed on the Portuguese market.

. Although no special law has yet been passed on the issue and marketing of complex financial products – a regime which may raise a number of issues, including its compatibility with Community Directives on the supply of financial instruments in the EU – the general framework of Decree-Law 211-A/2008, of 3 November provides that (i) the advertising for complex financial products will now be subject to prior approval from the supervisory authority responsible for such an instrument and (ii) the placement of any such instrument must be preceded by an information prospectus written in clear, concise and comprehensible language before subscription can proceed.

. This legislation also broadens the duty of information and assistance to banking institution customers, primarily at the consumer credit pre-contractual stage.

. Some of the provisions contained in the legislation are awaiting regulatory developments. We would also like to draw attention to

the public consultation document (Public Consultation No. 3/2008) of the Bank of Portugal regarding the Regulatory Decree Bill which sets out a number of rules to be followed by credit institutions prior to opening current accounts and deposit accounts, in the latter case whether these are savings or deposit accounts. These provisions also cover the information which must be contained in the documents supplied for opening the current account or deposit account and highlight the contractual nature of these financial applications.

. As regards institutional regulation, it stipulates an increase (or more detail) in the information to be provided to the Bank of Portugal by the credit institutions, particularly in relation to (i) the risks incurred, including the exposure level of different types of financial instruments; (ii) the risk management and control practices to which they are or may be subject; (iii) the methods used in valuing their assets, in particular those which are not traded in high liquidity and transparency markets.

. The guidelines for the information required for monitoring by CMVM (Securities Market Commission) of the entities set out in Article 363 of the Securities Code follow identical lines.

. From another viewpoint, public corporations (*sociedades abertas*) will now have to disclose, under Article 16 of the Securities Code, any holdings held in companies based in non EC member states, as well as the financial intermediaries authorised to act on their own behalf and the assets held by these companies or by a controlled company, which are domiciled or managed by an entity based in these jurisdictions.

. Greater flexibility in the CMVM (Securities Market Commission) regulatory mechanisms applicable to real estate investment bodies and investment funds;

. The above mentioned legislation also provides for the temporary waiver of compliance with certain matters related to investment fund management, at the request of the interested parties; (i) the portfolio composition regime, its limits, techniques and instruments for investment fund management; (ii) the terms and conditions for financing investment funds; (iii) carrying out operations with related funds and entities; (iv) the mergers, spin offs, mergers, splits, transformation, liquidation, division of funds and other events. This is yet another extraordinary measure aimed at conveying greater fund management flexibility in the context of the current financial crisis.

. Conversely, Article 1(2) of the same legislation confers powers on the CMVM to impose additional duties on investment funds and their respective managers, depositaries or marketing entities, in exceptional situations, including upheavals in the financial instruments market.

. These measures and the special powers conferred on the CMVM aim naturally to protect the market balance and the interests of the participants in view of the current crisis.

. The increased competences of the National Financial Supervisory Committee, composed of the Bank of Portugal, the ISP (Insurance Institute of Portugal) and the CMVM (Securities Market Commission) were expected, and it is also to be expected that after the enactment

of all the measures applicable to the financial sector, these bodies will guarantee consistency and proportionality in the Portuguese regulatory structure as well as better regulation objectives.

. Approval of the legal regime for state expropriation of private companies shares in the public interest

. Law 62-A 2008, of 11 November, impelled by the nationalisation of BPN, has already been published and sets out the legal regime for state expropriation by way of nationalisation under Article 83 of the Constitution.

. As has been widely discussed, the nationalisation of BPN sought to avoid the imminent breach in the institution's payments, which threatened the interests of the depositors and the stability of the Portuguese financial system as a whole, owing to the extent of its accumulated losses.

. Attached to the legislation are the principles which state expropriation must follow when nationalising, in whole or in part, private company shares when, for extraordinary and well-grounded reasons, this becomes necessary to safeguard the public interest.

. Any cases of state expropriation will take the shape of a decree-law, in other words, they will be scrutinised by the national parliament.

. Regime approving and disclosing the remuneration policy for officers and directors of "public interest" companies

. This legislative bill, which is currently at the discussion stage in Parliament, lays down new rules on remuneration policies, including an obligation to submit a statement regarding the remuneration policy for the officers and directors of "public interest" companies for the approval of the shareholders meeting, a practice which until now has only been recommended for companies quoted on the stock exchange.

. Under this legislation, the following must also be included in the above-mentioned declaration (and disclosure): (i) mechanisms which allow for the interests of the company bodies to be aligned with the interests of the company; (ii) criteria for defining the variable portion of the remuneration; (iii) the existence of plans for allocating shares or options to directors or supervisory bodies; (iv) the possibility of the variable remuneration portion, if any, being paid in whole or in part after the preparation of the financial statements for the entire term of office; and (v) the existence of mechanisms to limit variable remuneration in the event that the results show a significant reduction in the performance of the company in the previous financial year or when this is expected in the current financial year.

. Review of the financial sector penalty regime

. A legislative bill has been presented to Parliament by the government with a view to enhancing the penalty regime for the financial sector in criminal and administrative offence matters, modernising - and bringing into line - the penal framework and the amounts of the fines to the size and characteristics of the current financial sector.

. We would suggest an analysis that pays close attention to the legislative proposal, not only as regards the extended penal framework and fines, but also with regard to the prerogatives conferred on the supervisory bodies.

To sum up, the "package" of these legislative and regulatory measures, which have already been passed, or are in the process of being approved, is extensive, covers different subjects and raises a substantial number of relevant issues which should be carefully reviewed and discussed by all players in the Portuguese financial sector. Naturally, the approval of these measures and the reinforcement of supervisory bodies' competences are not the be-all and end-all for financial stability and investor confidence in the Portuguese financial market. Apart from depending on international developments and the result of the "new" market regulation paradigm, it also depends on a true behavioural effort of all players, on the effective compliance with good corporate governance practices, primarily in respect of an efficient internal supervision of the institutions in question as well as on a greater investment in investor education. A true transparent market culture cannot be achieved merely by way of increased regulations and supervision.

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