

2020 AIIB Legal Conference Report

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1 Introduction – Funding International Organizations: Innovations of Law and Practice

On 3 and 4 December 2020, the Asian Infrastructure Investment Bank (AIIB) held its fourth annual Legal Conference, the first one to be held virtually. The Legal Conference consisted of four webinars which helped participants gain a greater understanding of the legal challenges and opportunities that international development organizations (IDOs) encounter in the course of their funding operations by examining the law and practice governing their funding mobilization. The Legal Conference assembled a very accomplished set of speakers with a diverse array of experiences: experts representing other international financial institutions (IFIs), experts from governments or agencies, leading practitioners from global law firms and distinguished representatives from academia. The audience itself also consisted of a highly accomplished group of individuals, well represented across different sectors.

Over two days, four panels, each chaired by a member of AIIB's legal department, addressed the following topics: (I) the role of international organizations (IOs) in the development of local capital markets; (II) the legal status of IOs; (III) innovations in resource mobilization; and (IV) innovations in structure and development.

2 The Role of International Organizations in the Development of Local Capital Markets

The first panel discussed a number of critical matters with respect to the role of IOs in the development of domestic capital markets.

The rapid growth of debt capital markets in emerging economies shows the great potential of these markets and reflects the growing domestic liquidity. However, the economic challenges presented by the COVID-19 pandemic and

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the resulting increase in currency risks underline the need for further development of liquid and self-sustaining local capital markets. It was highlighted that debt markets are crucial sources of capital funds, especially for the purpose of closing the financing gap in sectors like infrastructure. One of the key functions of IFIs is to stimulate and encourage the development of domestic capital markets. There are several ways in which IFIs contribute to the development of domestic capital markets: through the credit enhancement of bonds, IFIs enable first time issuers to access capital markets by offering credit enhancement to their issuances, whereas by issuing onshore local currency denominated bonds themselves, IFIs diversify their funding sources of local currency which they can further deploy in investment operations by offering local currency loans to their clients.

The benefits of IFI presence in local capital markets were discussed at length by the panel. First, the important demonstration and signaling effect: IFI borrowing in local currency stimulates the development of local capital markets as the bonds of a triple A issuer serve as an alternative pricing benchmark to the local government bond market. Second, the reform of the local regulatory framework: IFIs, as trend setters, work closely with local authorities and regulators with a view to establishing functioning and more transparent securities markets with improved issuer and investor friendly processes which include, among others, favorable issuance and disclosure rules, credible money market indexes, functional settlements systems that can guarantee sound delivery versus payment procedures in order to mitigate any risks in the settlement of local currency transactions, flexible account opening processes with local banks, registrars and custodians, properly functioning depositories, an appropriate investor base, clear rules for admission to trading, specifically adapted to cater for IFIs' status, and comprehensive use of proceeds requirements. Third, IFI lending in local currency has become an important tool in mitigating currency exposures of borrowers who seek to manage their foreign currency risks. It has also contributed to the expansion of the investor base by introducing new investors to several local capital markets, including those seeking exposure to a specific currency who were previously excluded due to regulatory restrictions, as well as those who seek to gain exposure to a certain currency without being exposed to local credit risks. With respect to local currency projects, their financing through onshore local currency issuances allows for longer maturities, while IFI participation improves their creditworthiness.

The discussion, finally, shifted to the contribution of IFIs to the development of China's debt capital markets, with a brief reference to Panda Bonds, which are Ren Min Bi (RMB) denominated bonds issued by international issuers in China's domestic capital markets. It was noted that a lot of foreign

exchange controls that China has had in place for a long time were eased thanks to the presence of IFIs, allowing therefore other international investors to finally access Chinese debt capital markets. Among other benefits, those of particular importance are product innovation, more transparent regulatory frameworks and more robust disclosure regimes for issuers. A number of key developments from the recent past of China's debt capital markets were mentioned. In 2015, the regulatory framework was reformed allowing three new types of foreign investors to access China's domestic capital markets, the Interbank Bond Market: IOs, foreign central banks and sovereign wealth funds, while in 2016, the scope of permitted international investors expanded further to include foreign institutional investors, mainly commercial banks, insurance companies, securities firms, fund management companies, asset management companies and their investment funds products. In 2015, China's Interbank Foreign Exchange Market allowed IOs to become members of the foreign exchange trading system and introduced simplified procedures for foreign institutional investors in relation to foreign exchange registration procedures, currency conversion, funds remittance and repatriation. Finally, in November 2020, the restrictions for qualified financial institutions to invest in the Interbank Bond Market, as well as the futures market were also eased. IOs have also been a driving force in product innovation in China's debt capital markets. The International Bank for Reconstruction and Development was the first IFI to issue a Singapore dollar (SDR) denominated bond in 2016, which was also the first ever SDR denominated bond offering in China and the first SDR denominated bond which settled in RMB. It was finally also noted that Chinese regulators take a more pragmatic approach to introducing new rules by testing a new approach first through oral guidance to issuers, which is then transformed into a draft on which market participants are invited to provide comments before a rule, accompanied by guidance in the form of Q&As and operational manuals, is finally crystalized in writing and released.

3 The Legal Status of International Organizations

The second session focused on the legal status of IOs. Distinguished legal practitioners shared their views on issues related to IOs' privileges and immunities, as well as economic sanctions, focusing on the approach of certain jurisdictions in relation to IO capital raising and IO legal capacity and authority to enter into derivatives transactions.

One panelist elaborated on the privileges and immunities of IOs in light of a recent U.S. Supreme Court decision where it was considered whether immunity

from suit granted to IOs is analogous to the immunity from suit granted to foreign governments in the United States (U.S.). It was noted that the concept of immunity for IOs is not rooted in equality, as is the case for state immunity, but rather in operational necessity, including the desire to avoid state interference and undue litigation costs. The immunities provided to IOs, and in particular immunity from suit and legal process, protect IOs from unilateral control by a member nation over the activities of the IO within its territory. Because IO immunity is rooted in operational necessity, it is often referred to as functional immunity, and in practice it resembles restrictive immunity, which is confined to suits involving foreign states' public assets and does not extend to cases arising out of foreign states' strictly commercial acts.

The question was raised as to how a particular IO assesses its possible exposure to be sued in the U.S. It was noted that, as a first step, the source of the IO's immunity should be determined. Once the source of the immunity has been determined, the next inquiry is about the scope of such immunity and whether a potential waiver exists. It was noted that, in fact, many IOs expressly waive immunity from suit in connection with their fundraising activities. However, the prevailing practice is that waiver language is narrowly construed to allow only the type of suit by the type of plaintiff that would benefit the IO over the long term. This means in practice that courts will typically infer a waiver in the context of commercial transactions, including suits brought by debtors, creditors and bondholders, on the theory that otherwise private parties would be hesitant to transact with IOs.

The discussion then shifted to the analysis of U.S. regulations regarding capital raising by IDOs. It was noted that one of the principal challenges that need to be addressed for financings in the U.S. relate to IDO compliance with the various securities laws administered by the U.S. Securities and Exchange Commission (the SEC). The two main pieces of legislation were adopted in the aftermath of the Great Depression as a result of what appeared to be abuses in offerings of securities during the late 1920s and are the following: the Securities Act of 1933 (the Securities Act), which addresses mainly offerings of securities by corporations, trusts or other types of organizations, and the Securities Exchange Act of 1934 that addresses a broad range of matters, such as regulation of stock exchanges, financial intermediaries, like broker dealers, and information provided by issuers after their issuance of securities. The Securities Act provides a comprehensive regulatory scheme for capital raising in the U.S. through a broad and overarching requirement that every public offer and sale of a security must be registered with the SEC unless there's an exemption. The SEC registration process is quite rigorous and can be difficult to complete, both for corporate issuers and for foreign governments. To allow for fewer

delays, the SEC has created an innovative system known as shelf registration, under which issuers can register a large amount of securities and have the SEC clear a generic prospectus, allowing issuers to sell securities whenever they see a market window. This approach provides issuers with immense flexibility in deciding when to sell securities, but also reduces the need for a long form prospectus containing a great detail of information about issuers by allowing short form prospectuses that cleverly incorporate by reference annual and other interim reports that have already been filed with the SEC. It should be noted, though, that the SEC has never actually issued generally applicable rules for these issuers, requiring in effect each issuer to ask for permission to set up a debt shelf registration statement for ongoing and continuous offerings of debt securities. However, over the years, the SEC has improved and introduced enhanced features of shelf registration for corporate issuers, by allowing them, for example, to register securities with the SEC virtually on demand – a streamlined filing process under which there is no delay between filing a registration statement and the ability to use it to sell securities (the Automatic Shelf Registration). The Automatic Shelf Registration allows eligible issuers to avoid delays, which further provides a large measure of certainty to corporate issuers in hitting market windows not available to IDOs under the schedule B shelf registration route. Another enhancement is the ability to pay the SEC registration filing fee on a “pay as you go” (with each offering) basis, rather than all up-front. The “pay as you go” system is currently not available for foreign governments or IDOs, but is a feature which would certainly be good to have and could facilitate registered offerings by the SEC. One last challenge which was discussed was the SEC registration process itself and the amount of time it often requires to complete. Although a number of IDOs are exempt from SEC registration by the U.S. Congress, since 1996 the SEC has crafted new exemptions to facilitate capital raising and also expand investment opportunities for other U.S. investors. It was highlighted that this is an area which could be further explored and expanded, especially in order to include new IDOs that are well supported by numerous countries and carry out an important mission.

The panel then discussed issues relating to the legal status and immunities applicable to IFIs from a Chinese (PRC) law perspective, with a particular focus on how a PRC court will look at the jurisdictional and capacity/authority issues relating to IDOs. It was noted that unlike other jurisdictions such as the United Kingdom or the U.S., where the legal personality of certain IDOs is recognized by specific legislation, under PRC law there is no domestic regulation which specifically applies to or regulates IDOs or their establishment. In this case, PRC courts will usually start from the principle of IDO immunity, looking to first assess whether the IDO has waived such immunity. PRC courts

have always adopted absolute immunity, which means that only if there is a clear waiver of immunity by the relevant IDO, the PRC court will further proceed with its assessment of the legal capacity of the IDO. If there is no express waiver of immunity, the PRC court will not be able to assert jurisdiction over a claim against an IDO. In case of a clear waiver of immunity, if the PRC court identifies a foreign element in the relevant transaction, it will apply international treaties which have been acceded to by China. The PRC court will also look at the constitutional documents of the IDO in order to determine whether it has the legal personality and capacity to enter into a transaction.

Finally, the panel discussed the issue of economic sanctions in IDO funding and operations. Economic sanctions can be imposed by the United Nations (U.N.) under chapter 7 of the U.N. Charter. Most IOs abide by U.N. economic sanctions as they feel that this is incumbent on them as a member of the U.N. system. Some IOs are part of the U.N. system, having an agreement with the U.N. system in place to give them enough autonomy, however when it comes to issues like U.N. economic sanctions, they would observe them. Most IDOs observe U.N. economic sanctions as a matter of due deference to the fact that they have as shareholders U.N. members. Alongside U.N. economic sanctions, most IDOs observe also national economic sanctions, in particular the U.S. economic sanctions system, which is probably the largest and most robust, the European Union economic sanctions system and the economic sanctions imposed by the U.K. Treasury. It was explained that U.S. sanctions essentially work because they govern access to the U.S. financial system. If there is a sanctions consideration, the U.S. banking system cannot be used for purposes of making funds transfers, whether on the fundraising side or on the lending side. Any transaction in U.S. dollars is quite likely to involve the U.S. financial system. U.S. sanctions apply to U.S. persons, which in general encompass U.S. citizens, U.S. permanent residents, and any person who is physically located in the U.S. In case an IDO has a member which is on U.S. sanctions list, U.S. sanctions considerations should be analyzed with respect to the capital of such IDO. Capital structures at IDOs involve paid in capital and callable capital. The question then becomes how an IDO could receive capital from a shareholder that is on a sanctions list, what precautions does one need to take in order to make sure that that transaction or transfer is not frozen or otherwise interfered with, or what is the situation with IDOs which might be asked by a shareholder to return capital.

U.S. sanctions are also relevant in the funding process itself because underwriters have high standards with respect to their counterparties. The underwriting agreement for a bond issue includes a series of representations and warranties to be provided by the issuer, a few of which relate to U.S. economic

sanctions: Is the issuer doing business with any sanctioned entity (be it a sovereign, an individual or a corporation)? Or how are the issuance proceeds going to be used? Then, of course, due consideration is given to the swaps that are entered into in the context of a bond issuance, as swap counterparties have their own standards with respect to economic sanctions. And when it comes to project operations, economic sanctions considerations have practical implications on a variety of aspects starting with project design missions and the ability of IDO personnel to travel and spend money in the country that the IDO staff are being sent to.

4 Innovations in Resource Mobilization

The discussion then shifted to innovations in resource mobilization for IDO funding, focusing on a few paradigms of organizational structures, such as the Global Fund to Fight AIDS, Tuberculosis and Malaria, as well as the GAVI alliance. The examples of treaty-based organizations without equity base and with a relatively narrow scope of activities and the examples of entities established pursuant to a resolution of a conference or organizations established in the form of trust funds were highlighted to give prominence to the fact that new business models are adopted for the implementation of new funding modalities.

The case of the Green Climate Fund (GCF) as a unique funding vehicle was then examined. GCF is the world's largest climate change fund. It was established in 1992 under the U.N. Framework Convention on Climate Change (the Convention). Based on its business model, developed countries shall contribute financial resources to meet the costs incurred by developing countries in complying with their obligations under the Convention. GCF has 24 member countries, 50% of which are developed countries. The mandate of GCF is set out in its governing instrument and consists of the following pillars: a shift towards low emissions by providing support to developing countries to limit or reduce greenhouse gas emissions and further adapt to the impact of climate change; the provision of adequate financing to catalyze climate investment in the public and private sector; and the promotion of environmental, social and economic country-driven programs in full transparency and accountability. The Board of GCF is entrusted with the full responsibility and authority to manage resources and govern GCF. In terms of capital raising, GCF functions on a contributions-based system, with voluntary contributions from developed countries in accordance with their obligations under the Convention but has also the authority to raise additional funding from other sources, as financial

contributions can also be received from countries which have not acceded to the Convention, and other public or private entities. Contributions are not earmarked for specific purposes. Another interesting feature is that contributions in the form of loans should be accompanied by a grant contribution to GCF to cover administrative costs, and a grant contribution to be used as cushion for non-performing loans. In order to raise funds, GCF usually holds a series of consultation meetings with various donors, which is followed by a formal pledging conference where countries pledge to contribute funds to GCF. These commitments, which are purely political, are then crystalized into contribution agreements which are negotiated and executed with the support of GCF's Secretariat so that compliance with GCF's policies can be ensured. Any special conditions imposed by donors must be approved by the Board. Contribution agreements are backed by actual cash resources under the form of promissory notes, and once a minimum level of contributions has been received, GCF is able to commit those resources to fund projects and programs, known as the GCF Commitment Authority. The above explain the uniqueness of GCF's funding modalities. Of course, it was noted, GCF resources are supplemented by more conventional income sources, such as returns on equity investments, investment income earned from trust funds, as well as reflows from outgoing loans through interest and principal payments.

Most IDOs finance their activities through bond issuances in the international capital markets, as donations from member countries are mostly deployed through the establishment of trust funds. Thanks to IDO activity, bond markets have developed considerably over the last years allowing for a wider variety of products and specialized forms of themed bonds, a recent example of which are bonds that have been launched to finance the fight against the COVID-19 pandemic. Climate awareness bonds were an innovative product 15 years ago and their development was rather slow during the first few years. Nowadays, a variety of themed bonds are available to investors. Main types of themed bonds are green bonds, social bonds and sustainability-linked bonds, where financial and structural characteristics can vary depending on whether the issuer achieves predefined sustainability or ESG (environmental social governance) objectives. The International Capital Markets Association (ICMA) plays a key role in the development of these frameworks by creating principles and guidelines. The main topic of discussion is whether a market driven entity like ICMA should be in the driving seat of developing new ways of structuring bonds, or whether more robust legislation should be put in place to regulate such investment activities and ensure the credibility of new structures.

Finally, the panel briefly elaborated on initiatives taking place in the context of smart infrastructure, the idea of using corporate funds and venture capital to

develop integrated smart city projects to manage energy consumption, building use and traffic control. The role of IDOs in the deployment of new technologies that are being implemented globally in infrastructure projects was highlighted by one of the speakers. As new technologies become more embedded into projects, IDOs should safeguard policies which protect affected people against environmental, social and health risks by discussing policy initiatives with governments and the people that they serve, as the choices made regarding regulation have a significant impact on the technology and vice versa. The panel concluded by agreeing that effective policy and smart regulation will help achieve the necessary balance between the implementation of new technologies in smart city projects and the protection of citizens' privacy, freedom of expression and national security.

5 Innovations in Structure and Development

The last session focused on innovations in funding structures. The example of the U.S. Agency for International Development (USAID) was analyzed first. USAID has been providing U.S. foreign development assistance, mainly through contracts and grants, for the last 60 years. During that time, due to the dramatic shift in the world economy and the world stage, new ways of channeling financial flows into sectors in need have been developed. Solicitation and stepping into the world of private sector by creating synergies and alliance models through co-investing are some of these examples. The reality of operating within the confines of government restrictions pushes government agencies like USAID to find creative ways to use such limitations in the right way, such as by promoting more inclusive and sustainable business practices in corporations, or by catalyzing investment and mobilizing financing. Engaging with communities, with non-governmental organizations (NGOs) as well as with local companies has allowed USAID to detect financing gaps which it tries to fill by providing funding in exchange for projects which meet certain development goals, even when such projects are not going to be profitable. Traditional methods are also used side by side with innovative structures: the provision of technical assistance to projects in order to reduce barriers to entry, de-risk investments, investments in a value or supply chain, pooling government funding with private sector funding for different small and medium sized enterprises and multistakeholder alliances, the so called *co-creation*, by bringing stakeholders together for research and development agreements with the private sector, or even the *gift authority*, which allows USAID to pull

money from various donors like the Gates Foundation and create a bigger pool of funding that is slightly less restrictive to do things with.

The panel then moved on discussing other funding structures by using as an example the financial instruments deployed by the European Investment Bank (EIB), which mainly invests funds coming from a third party or takes a guarantee from third parties to support its activities with a particular focus on the European Union (EU). The budget of the EU has its plans and five-year cycles, the *budgetary periods*, and is implemented either at member state level, under a shared management model, or through the European Commission (EC) which can further entrust some of the budget to other entities, EIB being one of them. The EC has created a guarantee instrument called the European Fund for Sustainable Development, focusing, among others, on the following thematic investment windows: sustainable energy and connectivity; micro, small and medium-size enterprises financing; sustainable agriculture; rural development and agribusiness; sustainable cities; and digital for development. The innovative feature of this structure is that instead of using funded instruments, the main instrument used is guarantees, which means that the funding doesn't have to come up-front. There is normally a funding of some kind of a provisioning race, depending on the riskiness of the operations that would be covered by the guarantee. Another innovative feature of the above financing structure, and interesting from an accounting point of view in terms of balance sheet treatment, is the requirement for a co-investment by the implementing partner, requiring the latter to put in own resources each time the EC provides a budgetary guarantee in order to align the interests of the implementing partner through a skin in the game requirement.

The question of how does an entity access funds under these instruments was then discussed. The process was described as fairly complicated and includes the following: the first step is an assessment of the ability of the entity to manage EU funds – a fairly sophisticated piece of legislation called the Financial Regulation comes into play, which comprises the financial rules applicable to the budget of the EU, the basic principle of which is the following: if the EC intends to allow an entity to implement part of the budget under this indirect management, it must be sure that that entity can offer the same level of protection as applies when the EC implements the budget directly. The entity needs to go through a pillar assessment of a deep dive into procedures and contractual standards, even further complicated by the fact that some of the rules that sit behind these elements are not actually in place very long.

The focus on implementation of the EU budget has shifted over the last few years to cover not only the cost of *what* the EU invests in, but also *how* should the EU invest. And this policy is really evident now throughout the applicable

legislation and the governance structures, and it goes beyond the more obvious policy areas such as quality or sustainable development into areas that have not been foreseen before. When implementing the EU budget, entities which find themselves in a long list of dishonorable situations varying from bankruptcy to breach of tax obligations, professional misconduct, fraud, child labor, or having committed an irregularity, which is a very wide concept in EU law, introducing an additional complexity, are excluded.

6 Conclusion

The contribution of IOs in the development of domestic capital markets is undisputable. IFIs stimulate and encourage the development of domestic capital markets through the credit enhancement of local currency denominated bonds which are issued by third parties, or by issuing onshore local currency denominated bonds themselves. In most cases such onshore issuances are accompanied by a reform of the local regulatory framework to make it issuer friendly for foreign issuers. Usually, the process is long but rewarding as it leads to an enlarged investor base and better functioning as well as more transparent securities markets.

Privileges and immunities as well as economic sanctions are relevant issues with respect to IO capital raising. Immunity from suit granted to IOs in the U.S. is analogous to the immunity from suit granted to foreign governments in the U.S., but the concept of immunity for IOs is not rooted in equality, as is the case for state immunity, but rather in operational necessity, including the desire to avoid state interference and undue litigation costs. Many IOs expressly waive immunity from suit in connection with their fundraising activities, but the waiver language is narrowly construed to allow only the type of suit by the type of plaintiff that would benefit the IO over the long term. From a U.S. regulatory perspective, the Securities Act is mostly relevant for IO capital raising in the U.S. Every public offer and sale of a security must be registered with the SEC unless there's an exemption. To allow for fewer delays, the SEC has created an innovative system known as shelf registration. Most IOs issue securities in the U.S. via the Schedule B Shelf Registration route. Economic sanctions are another important topic in the context of IDO funding. Most IOs abide by U.N. economic sanctions, alongside a number of national economic sanctions, in particular the U.S. economic sanctions system, the EU economic sanctions system and the economic sanctions imposed by the U.K. Treasury.

Innovations in resource mobilization for IDO funding show the demand for greater flexibility in order to meet the growing capital raising needs of IOs.

There are more and more examples of treaty-based organizations without equity base and with a relatively narrow scope of activities, or cases of entities established pursuant to a resolution of a conference, or even organizations established in the form of trust funds. Product innovation is another element which underlines IOs' need for new funding modalities. Themed bonds are a developing area with room for market creativity and very adaptable to the surrounding circumstances – the recent case of COVID-19 pandemic bonds being a prime example.

Innovations in funding structures also include solicitation and stepping into the world of private sector by creating synergies and alliance models through co-investing. Engaging with communities, NGOs and local companies allows IOs to detect financing gaps which they then try to fill by using innovative structures alongside traditional methods: the provision of technical assistance, de-risking investments, pooling government funding with private sector funding or even pooling money from various donors. The financial instruments deployed by EIB constitute another innovative funding structure. EIB mainly invests funds coming from a third party or takes a guarantee from third parties to support its activities. The European Fund for Sustainable Development, which is an instrument deployed by the EC, uses guarantees instead of funded products. Another innovative feature is the requirement for a co-investment by the implementing partner, requiring the latter to put in own resources each time the EC provides a budgetary guarantee. However, in some cases, the process of deploying such innovative products is described as complicated as these instruments are usually established through detailed and sophisticated pieces of legislation which may prove that their theoretical conception is easier than their application in practice.