

Riga, 7 June 2018

The FICIL's Position Paper on the Security and Protection of Investment

1. Executive Summary

In 2017 the amount of foreign direct investments increased in Latvia. Foreign Investors Council in Latvia (hereinafter - FICIL) has followed closely the activities of Latvian policy makers and assessed the role thereof on improvement of the investment environment in Latvia.

FICIL welcomes the activities performed so far in view of increasing the efficiency and authority of court system, including development of tendency for examination of cases within reasonable deadlines.

The comparative assessment of court systems of the 28 Member States of the European Union conducted by the European Commission (*Justice Scoreboard* report 2017) states that the examination of civil, commercial and administrative cases, as well as cases of other categories in the courts of first instance on average take a shorter time (in days) than average length of examination of such cases in the European Union.

Similarly, business environment of Latvia is ranked 19th among 190 countries in the "Doing Business" report of the World Bank for 2018.¹

At the same time FICIL expects that the work on improvement of efficiency in court proceedings and legislation process will be actively continued. Foreign investors have noted in *Sentiment Index* of 2017² that they would also like to see greater progress in matters concerning quality of commercial legislation and court system in Latvia. More than 75% of interviewed investors do not feel improvement or feel only partial improvement in these areas over the course of last year.

In this position paper FICIL has highlighted some of the most significant tasks to be implemented to continue solving the problems related to safety and protection of investments in Latvia, especially in developing quality of the legislative process. Recommendations have been split for the respective competences of the Parliament and the Government. In addition to general recommendations, the report contains specific recommendations in key areas of law / sectors: commercial law, competition law and construction law.

¹ Available: <http://www.doingbusiness.org/~media/WBG/DoingBusiness/Documents/Annual-Reports/English/DB2018-Full-Report.pdf>

² Available: <https://www.ficil.lv/presentations/ficil-sentiment-index-2017/>

2. Recommendations

2.1. Quality of legislation

FICIL has observed that the current legislation process allows for proposals of certain interest-groups to become legal acts without a due consideration and analysis. FICIL believes that one of the priorities should be alignment of the legislation process at the level of reviewing the draft law by the Parliament that would exhaust possibilities to push rushed and unconsidered proposals for approval by the Parliament. In spite continuous efforts of FICIL, there are several recent examples of legislative proposals, submitted for review in second or third reading of a draft law in the parliament, which are adopted and become laws. Such recent examples include:

a) Amendments of 16 June 2016 to the Law on Taxation in Free Ports and Special Economic Zones. Along with technical amendments (inclusion of Latgale Special Economic Zone), significant and previously undiscussed changes were introduced, worsening the situation for companies receiving real estate tax deductions from municipalities; and

b) Amendments to the Law on Privatization of Land in Rural Areas, adopted on 18 May 2017, introducing additional requirements (including language knowledge requirements) for persons who wish to acquire agricultural land in Latvia.

To prevent the mentioned problems, amendments to the Rules of Procedure should be proposed, including recommendations provided below. The purpose of the recommendations is to promote such legislative practices which have positive impact on the investment environment in Latvia and improve the overall quality of legal acts.

2.1.1. Improving the quality of laws. The President of Latvia has sent a letter on 18 August 2017 to the legal commission of the Latvian Parliament, stressing the necessity to improve legislative process and the quality of laws. The suggested improvements and proposals are strongly supported by FICIL, as they ensure transparency of the legislation process. FICIL would like to especially highlight the following suggestions:

- a) Imposing an obligation on all submitters of draft laws (including the President, parliament commission, not less than 5 deputies) to prepare a clear, written annotation for each draft law;
- b) Implementation of best practices – an obligation to prepare written grounds for each proposal submitted before the second or third reading of the draft law, including also information on consultations that have taken place during preparation of the proposals;
- c) Preparation of a written report regarding each draft law, which would include information about course of draft law's preparation, most important proposals brought forward during the legislation process, purpose of the law, and other substantial information;
- d) Adoption of a clear prohibition to include proposals to the third reading in the Parliament, unrelated to the purpose of the draft law,.

2.1.2. Effective use of presidential rights. The Constitution of the Republic of Latvia provides for a right of the President to request re-examination of a law, adopted by the Parliament and such right is being used quite frequently. Nevertheless, FICIL would like to stress that returning law for re-examination means battling the consequences of rushed and unconsidered legislative process. It is

important to understand that this constitutional right should only be used as the last tool to ensure control over the work of the legislator. It is more important to ensure comprehensive and qualitative review of the draft law during the legislation process by the Parliament (by requesting and reviewing suggestions and recommendations of the relevant institutions, experts and non-governmental organizations). Foreign investors see that there are possibilities for future development in this regard. In previous years, FICIL has actively suggested legal acts for re-examination by the President (and the Parliament).

- 2.1.3. Inadmissibility of retroactive effect of laws. It has been addressed by FICIL in previous position papers that it is very important for the policy makers and legislators to assess the possible impact on the business of any law with retroactive force. In a secure and predictable business environment, it is critical to ensure that transactions entered into previously (corresponding to regulations in force at the time they are entered into) will not be considered unlawful upon change in the relevant regulatory framework over time.
- 2.1.4. Predictability of legal framework. In connection with the above recommendation, it is also crucial to consider an appropriate transition period and transitional provisions for new regulations, especially, new tax regulation and changes in the existing tax system. It is completely unacceptable if any new tax laws and provisions to be adopted and become applicable just before the new taxation period begins. FICIL acknowledges the fact that the policy makers have considered and determined sufficient transitional periods when adopting the tax reform in 2017. Nevertheless, taxation is just one area, which has direct impact on the business of companies in Latvia. For example, in 2017 FICIL addressed the parliamentary groups regarding intended amendments to the Law on Residential Properties, which was set to change the conditions for dividing the building into residential properties (apartments) and enter into force immediately, thus having an impact on majority of construction projects.
- 2.1.5. Quality of legal acts. Although some improvements may be observed in this regard, FICIL once again reminds about the importance of clear structuring and use of accurate definitions in laws. Clear and understandable laws leave less room for different interpretations and ensures predictability in application thereof. The legal framework of construction laws is often used as an example of poor quality legal act. The comparably lower quality of this act lies within the fact that it is not coordinated with other laws or the real situation (like the term of the lease agreement).
- 2.1.6. Uniform legal structure. FICIL members have encountered the lack of uniform regulatory framework in several legal areas. For instance, there is no uniform regulatory framework with regard to compensation of non-pecuniary losses to an individual. Each area of law, whether it is the civil, criminal or administrative law, has a different regulatory framework and practices when it comes to claiming and determining the amount of losses. This leads to inequality in determining the amount of remuneration, which is paid for the moral suffering of a person. The key principle, which is frequently applied in such cases is that the amount of compensation usually is made dependent on the institution which is obliged to pay the compensation. Such approach, as observed by FICIL leads to unfair results. Instead, objective and comparable criteria should be considered, where the caused harm should serve as basis for

determination of the amount of remuneration.

- 2.1.7. Lack of modern legal framework. FICIL does not support overly detailed or casuistic laws, however there are certain areas where the current legal framework is outdated or non-existent. One of such areas is securitization. The Law on Mortgage Bonds is the only law regulating securitization and was adopted in 1998 (most recent amendments of the law were adopted in 2006). The law is not effective, and securities are not a popular financial instrument in Latvia, partly due to the fact that the legal framework is not clear and modern.
- 2.1.8. Sufficient information on amendments. It is no secret that regulatory acts in Latvia are amended quite often and it is not easy to follow all of the changes. FICIL believes that in order to facilitate and improve implementation of amendments to the law, a legal “mark-up” would be helpful, meaning, a possibility to compare and track changes in the text of the law. This would be helpful not only to professionals and enforcers of law, but to every company, which is interested in legislative changes in their field of business. Similar options are available in Estonia.

2.2. Court System efficiency

In a business environment, it is very important how soon you can have your rights protected by the court, and FICIL has observed progress in comparison with previous years. In accordance with the data of Court Administration, civil cases were usually examined for 9.2 months in 2013, but in 2017 it takes 7.9 months, exceeding the average indicator in the European Union.

Several measures have been implemented for improvement of the court system, including the territorial reform of courts. FICIL is confident that in time it will reduce such problems related to increase in court efficiency as unequal distribution of court duties and different length of court proceedings in cases of the same type.

To continue improving the court system efficiency, FICIL trusts that actions should target at least five aspects: further improving access to courts, organizing more efficient court processes, enabling cooperation with arbitration courts, development of mediation processes and their support and further advancement of the overall work quality of judges. Part of the mentioned recommendations are in the competence of the Court Administration and Council for the Judiciary, and part should be applied by the Ministry of Justice.

Access to courts

- 2.2.1. Further work regarding digitalization of court processes. Significant work has been done in digitalization of court processes and electronic communication; and FICIL believes that the work should be continued by enhancing the use of digital signatures and video conferences in courts to reduce the costs of court processes and to increase efficiency. In addition, although court hearings are planned electronically, and several other steps have been taken to modernize the court proceedings, not all law enforcers comply with the new requirements (for instance, electronic availability of procedural documents to the parties is not provided, etc.). FICIL believes that the mentioned issue may be solved by organizing additional trainings for judges and their staff.

- 2.2.2. Setting the state fee cap. State fees are considered one of the reasons of limiting access to courts. Having state fees reduces the number of unfounded claims, however the policy makers must find a fine balance to make sure that such limitations are not unreasonable. For instance, the fact that the maximum amount of state fee is not set may be considered as unreasonable limitation to access justice, especially in property claims of significant volume. In such cases a maximum cap should be determined. In addition, court fees are often complicated to calculate for persons with no prior experience. State fee calculation mechanics might be simplified.
- 2.2.3. Further improving access to court practice. There have been several significant improvements with regard to structured access to court practice, however further work is required to ensure systematization, classification and more effective searches of court rulings. FICIL supports further development of the court practice systematization and publication work.
- 2.2.4. Publication of procedural rulings. Most of court judgements can be searched and found online, however not the procedural rulings. In order to ensure uniform practices with regard to application of procedural norms, FICIL sees no obvious obstacles to publish procedural rulings arousing legal interest (for instance, decisions regarding ancillary complaints, decisions regarding provisional measures (injunctions), and other matters). To protect the identity of participants, the rulings should be anonymised.
- 2.2.5. Assessment of current efficiency of search and selection of the necessary information in court information systems. Although court rulings are available publicly, the offered search tools could be more efficient in order to simplify the options to find relevant case-law, if necessary. Search tools for case law (and procedural rulings) may be reviewed and improved.

Efficient court processes

- 2.2.6. Specialization of courts. The current specialisation experience in categories of certain cases has been positive, if we take as examples administrative courts, Jelgava court, Vidzeme Suburb Court, or Latgale Suburb Court specialising in examination of particular type of cases. In FICIL's opinion, the possibility should be considered to establish specialised court departments for commercial cases, for example, in commercial chambers at regional courts. FICIL also believes that law enforcers will strengthen their specialisation in commercial cases, which would improve the timing of dispute resolution proceedings, also if they would be reviewed in two instances.
- 2.2.7. Bifurcation of court processes. FICIL recommends to provide a possibility to divide the more complicated processes into two or more parts, thus taking a substantial step towards shorter and more efficient court proceedings. Bifurcation of the process would mean a step by step review of the case. For instance, in the first step, the court determines the existence of the infringement as such. Only if the infringement exists, the court proceeds to the next step to determine the amount of losses. FICIL finds that such approach would be especially effective in complicated cases related to competition law infringements and intellectual property right disputes.

Improving work quality

- 2.2.8. Improving work quality for judiciary professions. Attention must be drawn to recruiting and examination procedures for judges, examination procedures for attorneys, notaries, court bailiffs. Regular further trainings for professionals of the court system are essential in order to improve the work quality. A profound problem in the judicial system which usually goes hand in hand with the work quality is court authority. Poorly reasoned and awkwardly written rulings may raise doubts both about work ethics and authority of courts. Court rulings as well as the overall attitude in the court room and the way the judge manages the process is one of the key elements in forming the society's perception of the court system. In addition, to ensure uniform application of laws, regular discussions and experience sharing in legal theory, legal method, and practical application of laws should be carried out.
- 2.2.9. Form of judgement. FICIL sees that it is necessary to facilitate discussion among judges regarding the key elements of each ruling and quality thereof. It is understandable that overly formalized approach should not be supported, as each case is different, however key problems and best practice guidelines can be clarified during such discussion.
- 2.2.10. Creating and sharing guidelines. Guidelines and handbooks are a great tool to approach uniform application of the legal acts on institutional and municipal level. This also adds to the legal certainty and trust of individuals.

Cooperation with arbitration courts

- 2.2.11. Improving the arbitration framework. FICIL appreciates the work invested in the area of settling the alternative disputes by increasing the supervision of the arbitration courts. However, the court processes, including arbitration processes are becoming more and more complex and the legal framework in this regard might be revised and updated. For instance, only written evidence can be submitted with a Latvian arbitration court, nevertheless, it is clear that witness statements may play a significant role in the court process. Cooperation with state courts to improve the quality of arbitration process and authority of arbitration courts is one of the ways to solve this issue.
- 2.2.12. Cooperation between courts. The current legal framework does not provide for sufficient rights of arbitration courts with regard to securing evidence and it must be improved. The lack of credibility of arbitration court is also based on the fact that state and municipal institutions are prohibited to agree on dispute resolution in arbitration.
- 2.2.13. Application of UNCITRAL Arbitration Rules. Previously proposals have been made regarding application of UNCITRAL Arbitration Rules, but they have not been accepted. These rules can be used to completely replace local laws regulating arbitration process, thus increasing the effectiveness of arbitration and its credibility. UNCITRAL Arbitration Rules are well known by investors all over the world and application thereof can increase comfort and trust in the Latvian arbitration courts system.

2.3. Commercial law matters

Below have been provided specific recommendations in the matters of commercial law, as pointed out by members of FICIL. Recommendations on commercial law development

matters can be structured in three groups considering the type of issue they deal with: (i) lack of legal framework; (ii) insufficient, out of date or otherwise ineffective legal framework, which impedes further development; (iii) legal framework practical implementation of which indicates problems.

Lack of legal framework

- 2.3.1. Introduction of legal framework to facilitate close-out netting. Several financial instruments are not sufficiently regulated. Close-out netting in respect to derivatives is one of such areas. The regulation in the Credit Institutions Law is applicable exclusively to banks; therefore, other legal entities and natural persons have no clear regulation for this financial instrument. What concerns close-out netting, there are several approaches that can solve the occurring problem: supplementing the Financial Instruments Market Law and / or Insolvency Law with the necessary regulation or adopting a special law.

Ineffective legal framework

- 2.3.2. Flexible legal framework covering capital shares of limited liability companies. The FICIL proposes to develop more flexible provisions of Commercial Law applicable to capital shares of limited liability companies (for instance, allowing share categories). The law needs to be improved to create more options to use the limited liability company form towards conduct of holding company activities or special purpose vehicle activities (with respect to project finance or investment).
- 2.3.3. Improving the laws concerning IPO's and other cases of including company securities in stock exchange. Companies in Latvia are reluctant to attract financing through offering their stocks in the public market and only a few companies have achieved it in the last several years. In order to facilitate this trend, FICIL believes it is important to invest further work into current legal framework, to make it clear, understandable and applicable, as well as to promote understanding and to inform the merchants on what is required to complete the procedure to list their stocks in the public market.
- 2.3.4. Improving the legal framework for mortgage bonds. Asset backed bonds are not properly regulated in Latvia. Law on Mortgage Bonds was adopted in 1998. The law must be reviewed and or replaced to be up to date with the current situation and compatible with other relevant laws in the field, for efficient application.

Legal framework causing problems in practice

- 2.3.5. Prohibition to finance purchase of stocks. The Commercial Law prohibits a joint stock company from issuing loans or otherwise directly or indirectly financing a third party to acquire its stocks. This prohibition does not directly apply to limited liability companies, however several courts have interpreted this prohibition and applied it also to limited liability companies. To avoid further confusion, FICIL suggests amending the Commercial Law, expressly stating that this prohibition does not apply to limited liability companies. Such suggestion would be in line with the purpose of the current regulation and EU legal acts. Even more, FICIL is of the opinion that such prohibition should only apply to public joint stock companies, the stocks of which are traded in the regulated market.

2.3.6. Commercial pledges on shares. FICIL would like to draw attention to a problematic situation concerning commercial pledges on shares of joint stock companies. Share pledges are considered quite common in financing of commercial companies. Nevertheless, execution of such pledge, when there are problems with fulfilment of obligations, is difficult due to several reasons. This especially concerns such joint stock companies, stocks of which are not traded publicly, as in this case it is almost impossible to find out who are owners of these shares. FICIL recommends reviewing the legal requirements and improving this situation.

2.4. Competition law recommendations

2.4.1. Amendments to Competition Law. Distortion of competition caused by public persons appears to be a general problem of business environment which disregards the principle of neutrality in competition. Amendments have been prepared to the Competition Law allowing the Competition Council to take action against competition breaches of public persons, but these amendments have not made it past the Cabinet of Ministers due to lengthy discussions and coordination process. The key infringement these amendments aim to tackle is discrimination of private sector companies by providing more favourable conditions to capital companies owned by public persons. The proposed amendments will help strengthening two important principles: fair competition and good governance. In addition, these amendments are in line with the recommendations of OECD as well. Currently the negative effects of activities of public persons in competition are already recognized and regulated in several Member States of the EU, including Sweden, Italy, Finland, Romania, Slovakia, the Czech Republic and Lithuania. FICIL would like to stress the importance of timely adoption of legislative changes. Discussion and summarizing opinions of all interested parties, is, of course, important, however it should not be used as cover to delay the legislative process.

2.5. Construction law recommendations

2.5.1. The draft amendments to the Construction Law must be revised, excluding the liability of the customer (the formal initiator of the construction process) for the mistakes of the construction specialists. FICIL recommends reviewing the prepared draft with respect to the liability of the construction process participants and looking for other ways to improve the regulation. The principle proposed by the Ministry of Economics suggesting that the initiator of the construction process shall be liable towards third persons for mistakes of other construction participants (architects, engineers, construction companies, construction experts etc.) is unacceptable.

2.5.2. The individual liability of the construction process participants shall remain in force. FICIL believes that the existing principle must be retained – everyone must be liable for their own mistakes, otherwise it is clear that the volume of investments in the construction sector in Latvia will decrease significantly. The solution of the problem related to the protection of third persons who have

incurred damage from construction, cannot be found in shifting the whole liability to the construction initiators but in introducing a more efficient process for compensation of losses. This can be achieved either via improvement of the insurance regulation and/or by creating an out-of-court dispute resolution body which could decide on the compensation requests (up to a certain amount) in a more efficient and faster way.

- 2.5.3. Improvements to the regulation on the insurance. FICIL has come across a profound problem in the field of the construction insurance – the lack of a clear legal framework. The insurance regulations must be reviewed and amended in order to be brought up to date with the current situation and market practice and compatible with other relevant laws in the field, so that it could be effectively applied. Insurance coverage (and the allowed exceptions) and liability limits must be precisely defined.