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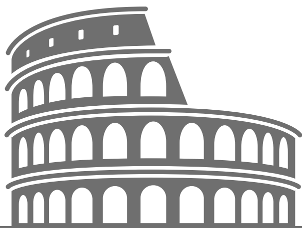

ROMA CONVENTION CENTER-LA NUVOLA

IBA 2018

ROME 7–12 OCTOBER

ANNUAL CONFERENCE OF THE INTERNATIONAL BAR ASSOCIATION

The 2018 IBA Annual Conference will be held in Rome, the Eternal City. Founded nearly 3,000 years ago, the city is renowned for its ancient ruins, classical architecture, renaissance palazzos and baroque fountains. Rome is a vibrant, cosmopolitan city and will provide an elegant backdrop for the IBA Annual Conference.

Modern Rome is a major international business destination. It is the seat of the Italian government and the economy is dominated by services, IT, aerospace, defence and telecommunications companies, research, tourism, construction and banking. The city hosts the head offices of the vast majority of major Italian companies, as well as the headquarters of three of the world's 100 largest companies, Enel, Eni and Telecom Italia.

As the saying goes, 'all roads lead to Rome' and it will indeed bring together delegates from all over the world for the largest and most prestigious event for international lawyers, providing an abundance of business and networking opportunities, not to mention the chance to explore one of the most fascinating cities on Earth.

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- Hear from leading international figures, including officials from the government and multilateral institutions, general counsel and experts from across all practice areas and continents
- Acquire a greater knowledge of the role of law in society
- Be part of the debate on the future of the law

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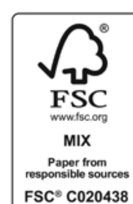

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Welcome to the May issue of the Banking Law Committee newsletter, edited by our Publications Officer, Philippe Dupont, from Arendt & Medernach SA, Luxembourg, supported by Anne Bodley, member of the Banking Law Committee. As usual the newsletter has been published to coincide with the start of the IBA International Financial Law Conference, taking place in Amsterdam from 30 May to 1 June. The conference, now in its 35th year, is jointly organised by the IBA Banking Law and Securities Law Committees.

The conference offers the opportunity to share our experiences of the law as it relates to the functioning of financial institutions and systems, as well as the capital markets. This opportunity has proven exceptionally valuable given the constantly changing situation in the global economy and the consequences of the radical development of new technology. In responding to these changes, financial markets and institutions create new products and new forms of communicating with clients, whereas legislators create new legal frameworks for their functioning and ensured security of client interests.

We lawyers have never lacked subjects for discussion at our annual meetings since the first financial law conference in London in 1984. We have met in various cities throughout Europe, which has allowed us to become acquainted with the specific nature of local financial markets and interesting personalities from the financial world operating there. Irrespective of conference location, we discuss legal issues that are vital to practically the entire financial universe.

The committee held a discussion at the IBA Annual Conference in Sydney last October, entitled 'Cross-border aspects of legal opinions in financial transactions.' This is always a relevant topic, to which we regularly return. At a session entitled 'Project financing of renewable energy' we addressed the topical issue of renewable energy. A panel discussion with the provocative title, 'Banks and financial technology: will banks become back-offices for Fintech companies?', was summed up in the daily conference bulletin as 'Fintech friend not foe.'

The idea of an annual finance law conference has taken firm root in Asia. The 3rd IBA Asia-based International Financial Law Conference took place in Hong Kong on 8–9 March 2018. Some of the articles in this newsletter report on what was a very successful conference.

The programme of the 35th International Financial Law Conference in Amsterdam promises to be very interesting. Sessions sponsored by the Banking Law Committee will be dedicated to: 'Bail-inable bonds and recent experience'; 'Art finance', as well as responses to the question, 'Need to know about insolvency?' The Securities Law Committee will deliberate on: 'Practical aspects of the new EU prospectus regulation'; 'The art of the accelerated book build', and 'Returning cash to shareholders'. Two joint sessions will discuss issues relating to inter-creditor agreements and MIFID 2 and reverse solicitation.

The conference will be preceded by a session for young lawyers entitled, 'Live long and prosper: skills young lawyers need in order to prosper in an age of technology disruption.' We hope that young lawyers will join our committee and bring new ideas for our further activity, while more experienced new members share their knowledge.

Dirk Bliesener from Hengeller Mueller, Frankfurt has been appointed to the newly-created position of Membership Officer. In this position he is able to outline our committee's activities to new members.

The second newly-created position in the committee is Special Projects Officer; Hannes Vallikivi from Derling, Tallinn has been appointed to this position. Work on Special Projects is also now strongly supported (and financed) by the IBA, which should be an additional incentive to the committee to start such projects. We encourage the submission of bold ideas.

The International Financial Law Conference in Amsterdam will, as always, be an excellent venue for networking and the hospitable organising committee will facilitate an attractive social event programme.

We invite you to Amsterdam!

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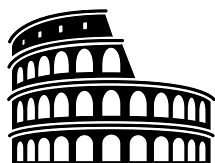

IBA 2018

ROME 7–12 OCTOBER

ANNUAL CONFERENCE OF THE INTERNATIONAL BAR ASSOCIATION

Banking Law Committee's sessions

Monday 1115 – 1230

Industry-funded ombudsman: good business and smart justice?

Presented by the Access to Justice and Legal Aid Committee, the Banking Law Committee, the Communications Law Committee, the Consumer Litigation Committee and the Insurance Committee

This session will examine whether industry-funded ombudsmen can enhance access to justice by dealing with claims against a business that would be inappropriate for traditional dispute resolution methods, while being an efficient way for a business to finalise otherwise costly complaints. What are the safeguards required? Do they suit every jurisdiction?

Tuesday 1615 – 1730

The role of FinTech, lending and international organisations in delivering aid in humanitarian crises

Presented by the Banking Law Committee

Humanitarian institutions are increasingly using finance technology and new funding mechanisms to deliver aid to crisis regions. This requires close cooperation between various stakeholders in the financial markets, including banks, mobile network providers and payment transfer providers as well as innovative credit risk mitigation and funding mechanisms. This session will explore the intersection between the law and practice of finance and humanitarian aid as well as the successes, failures and challenges that projects in this field have had.

Wednesday 1115 – 1230

Corporate governance for African business: the role of lawyers on a continent of small and medium-sized enterprises (SMEs)

Presented by the African Regional Forum, the Banking Law Committee and the Financial Services Section

The African private sector is overwhelmingly made up of small and medium-sized enterprises (SMEs) who often don't seek legal services until it is too late. They too are subject to national, regional and even international corporate governance regulations, which they are often unaware of importance of international regulations – for example, United Kingdom Bribery Act, United States Foreign and Corrupt Practices Act, and their implications for African business, supporting boards and so on will be discussed in this session.

Wednesday 1615 – 1730

Motion picture finance

Presented by the Banking Law Committee

At the crossroads of artistic creation and capital-intensive industry, motion picture is affected by a rapidly evolving environment in production, postproduction and distribution, as well as renewed competition, stakeholders and risks patterns that fastly impact its financing models. The panel will raise the curtain on motion picture funding, with experts from several geographical areas who will share their experience and provide feedback from typical cases.

Thursday 1115 – 1230

Impact of international economic sanctions to the mining sector and how to manage risks

Presented by the Mining Law Committee, the Banking Law Committee, the Criminal Law Committee, the International Trade and Customs Law Committee and the Litigation Committee

Economic sanction regimes, particularly those promulgated from the United Nations, European Union and United States, can have a significant impact on the exploration and production activities of mining firms and related service providers. Depending on the particular sanctions programme, prohibitions may range to a comprehensive embargo on all trade with a country or government, including state-owned enterprises, to more targeted restrictions that penalise dealings with certain persons (ie, individuals, entities or vessels), which could be customers, suppliers, service providers, subcontractors, employees, operators or other business partners. Sanctions can affect offshore conduct, and penalties or other liabilities that may be imposed can contribute to negative financial conditions and reputational damage. This session will review existing sanction programmes of the principal sanctioning authorities (UN, EU and US) and explore how the risks created by those programmes can be most effectively managed.

Continued overleaf

Thursday 1115 – 1230

The good, the bad and the ugly: Who's who in transactions in distressed financial assets? The originator, the investor and the regulator's perspective

Presented by the Banking Law Committee and the Creditors' Rights Subcommittee

The NPL market is booming. Although the positive trend of the global economy is having an undoubted positive effect, divestitures by originators are, at least in some jurisdictions, the primary driver of the decrease of NPL ratio in the originator banks' balance sheet, securitisation being one of the most commonly used tools for such divestitures. New challenges are posed by a number of variables, including the increasing interest of investors in the so-called 'unlikely to pay' distressed assets, the new skills which servicers are requested to deploy in the management of this assets class and in extracting value from NPLs generally, regulatory changes and the introduction of IFRS 9. This session will explore the approach of originators, investors and their servicers, and the regulators approach to such demanding developments.

Thursday 1615 – 1730

Trends and perspectives of international arbitration in disputes involving financial institutions

Presented by the Banking Law Committee and the Arbitration Committee

While the evolution of the financial industry and its relations with counterparties has modified the disputes pattern in recent years, the historical perception in the financial industry that arbitration is unsuitable for disputes involving financial institutions has been challenged.

The session will review the reasons for the change and discuss feedback from experience in key business lines and expert subject matter where arbitration is already used. It will consider the specific procedural needs of the financial industry, the impact of market associations, such as the International Swaps and Derivatives Association (ISDA) and the Loan Market Association (LMA), proposing standard arbitration clauses and the role of specialist arbitration centres. Going further, it will explore the potential for growth through the adaptation of arbitration rules and education of financial institution staff.

Friday 0930 – 1045

Whose second life is it anyway? Personal information and financial services

Presented by the Financial Services Section, the Banking Law Committee, the Capital Markets Forum, the Insurance Committee, the Investment Funds Committee and the Securities Law Committee

The panel will consider the collection of personal information (both mandatory and voluntary) and the use of that personal information by financial institutions across the range of services they provide. This will include the transfer of personal information from traditional financial institutions to FinTech companies.

All programme information is correct at time of print.

To find out more about the conference venue, sessions and social programme, and to register, visit **www.ibanet.org/Conferences/Rome2018.aspx**.

Further information on accommodation and excursions during the conference week can also be found at the above address.

CONFERENCE REPORT

IBA Annual Conference, Sydney, 8–13 October 2017

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Ulrike Naumann *Bowman Gilfillan Inc, Sandton*

Panellists
Russell DaSilva *Hogan Lovells, New York*
Andreas Meyer *Deutsche Bank AG, Frankfurt am Main*
Anastasia Walker *Macquarie Bank, Sydney*
Jaap Willeumier *Stibbe NV, Amsterdam*

Co-Chairs Ulrike Naumann and Benedikt Maurenbrecher introduced the session describing the role that legal opinions play in cross-border finance transactions and the typical structure of a cross-border opinion with the main categories of opinions you typically see in cross-border transactions. They also highlighted appropriate purposes of legal opinions as a means of documenting due diligence, along with issue spotting and legal risk assessment; as opposed to inappropriate uses, for example as a substitute for legal due diligence, as insurance for the opinion-recipient or for the purposes of 'papering over' – a known problem. In an international context, legal opinions also help to close a gap of understanding between different legal regimes. In this context, a lively discussion emerged on the difficulties of reconciling local opinion practices and wordings with the expectations of opinion-recipients in a cross-border setting.

The main part of the session consisted of a case study involving an acquisition financing where counsel to obligors in relevant local jurisdictions were requested to provide enforceability opinions to syndicate banks in relation to a facility agreement. In the discussions, Andreas Meyer from Deutsche Bank AG in Frankfurt and Anastasia Walker from Macquarie Bank in Sydney pointed out the lenders' needs and expectations, while Russel DaSilva from Hogan Lovells in New York and Jaap Willeumier from Stibbe represented the counsel's view, setting out the difficulties of covering all the required legal aspects within the constraints of a transactional context.

The heart of an enforceability opinion on a facility agreement is a statement that the obligations thereunder are the valid and binding obligations of each obligor, enforceable against the obligor in accordance with its terms. As Russel DaSilva explained, the precise meaning of such an opinion is heavily disputed even in a national (US) context. While initially the enforceability opinion was understood to centre on the correct formation of the contract and the enforceability of the obligor's key (payment) obligations, increasingly it has been taken as a confirmation that each and every provision of the contract is legally valid, binding and enforceable as written (which is the understanding prevailing in Europe, the United States and elsewhere). This has triggered not only an increase in the number of assumptions and qualifications contained in the opinion of the law firms, but also misunderstandings and frustrations in the negotiation of legal opinions.

Opinion givers tend to cover themselves against the risk of unenforceability of any provision or wording potentially contained (or rather, given the volume of the current documents, hidden) in the transaction agreements, which may not be enforceable under their local law. In some cases this has led to ever-longer catalogues of so-called 'kitchen-sink' assumptions and qualifications that do not necessarily relate to the transaction or the opinion given. As Jaap Willeumier pointed out, this tendency is also a result of the pressure to issue opinions in an ever-tighter time and budget frame and implies risks both for opinion-givers and opinion-recipients. In certain jurisdictions,

a qualification which does not relate to an actual opinion statement may however, in itself, have the unintended effect of an implied opinion which counsel had not intended to give. For the opinion-recipient, there is a risk of assumptions which effectively assume the actual opinion away or allow the opinion-giver to hide behind broad and unspecified qualifications, the implications of which are not clear to the opinion-recipient. In an extreme situation, long lists of irrelevant assumptions and qualifications could render the recipients' reliance on the opinion letter unreasonable. In the resulting discussion, agreement was reached that the goal for opinion-givers and opinion-recipients cannot be to have 'exception-less' opinions, but rather relevant and intelligent ones, even if this comes at a higher cost.

An even bigger question that was raised is the meaning of an enforceability opinion in the context of a cross-border transaction, as Jaap Willeumier pointed out. If a local counsel in one jurisdiction is supposed to give an enforceability opinion on a facility agreement governed by the law of another jurisdiction, shall that local counsel limit the opinion to a statement on the enforceability of the choice of law and a judgment of the competent courts? Or is the local counsel supposed to confirm that the obligations under the agreement would be enforceable if they were governed by the local laws? While US firms and certain European countries are quite strict in limiting their opinions on matters in their own jurisdiction, opinion-givers in other jurisdictions are much more relaxed and frequently provide 'legal, valid, binding and enforceable' opinions in relation to foreign-law-governed transaction agreements 'as far as enforceability under the laws of their jurisdiction is concerned'.

Naturally, the broader the requested opinion is, the more sweeping the assumptions and qualifications proposed by opinion-givers. For example, many opinions in an international context say that a statement pursuant to which an obligation is enforceable does not mean it is certain that the contract will be enforced in accordance with its terms in every circumstance. In this context, comprehensive reservations are made as to enforceability in bankruptcy, as to violation of equitable principles and in relation to public policy. In a cross-border setting, public policy exceptions are viewed particularly critically by arranger's counsel because of their broad and unspecified nature.

As Anastasia Walker and Andreas Meyer stated, one of the thorniest issues for opinion-recipients is the limitation on disclosure and reliance often included in the opinions they receive. Frequently, opinions in financing transactions may only be relied on by the original syndicate members and other institutions that become lenders within a designated period of time (eg, 90 days) as a result of the primary syndication process, while transfers outside the primary syndication are not covered. Opinion-givers are hesitant to assume liability globally to unknown future transferees with whom they have no relationship and that may include vulture funds or other special investors. Such transferees may acquire their participation in a situation that is long after, and very different from, the situation under which the opinion was issued; and they may be much more inclined to sue the opinion-giver. Moreover, in its conversation with the arrangers, the opinion-giver may have provided additional colour or disclosure in relation to the opinions given, which informally is normally not passed on (and hence capable of being raised as a defence) to a transferee.

As Andreas Meyer pointed out, in the aftermath of the WorldCom decision (*In re WorldCom, Inc Sec Litig*, 346 F Supp 2d 628 (SDNY 2004) and *In re WorldCom, Inc Sec Litig*, No 02 Civ 3288 (DIC), 2005) so-called 'red flags' have become an area of particular concern to opinion-givers and opinion-recipients. A red flag is a sign of a particular problem requiring attention. In an opinion context, the red flag frequently relates to the factual basis of an opinion for example, when the opinion-giver or the opinion-recipient has indications that the assumption as to the facts may be incorrect or inaccurate. In the *WorldCom* case, the US federal court said that the underwriters in a securities offering had reasons to doubt the accuracy of an audit opinion in relation to the financial statements contained in the prospectus. For purposes of an enforceability opinion, red flags could also relate to bona fide assumptions if the parties have indications to the contrary. The panel agreed that red flags should be brought to the client's and the opinion-recipient's attention as they become apparent and in due time so that the recipient can request the appropriate action to fix the problem in time for the proposed transaction to go forward. Accordingly, red flags should not primarily be disclosed (or disclosed for the first time) in opinion letters, because the formal opinion

language bears the risk that the problem does not become sufficiently visible. If there are red flags, the opinion should address the issue in a clear manner. As the 1998 US TriBar Report on Third Party Legal Opinions highlighted, an opinion that the opinion-giver believes to be misleading should not be issued until the issue is properly disclosed.

A matter of great interest in cross-border opinions is the clauses by which an opinion-giver chooses its law to govern the opinion and its courts to resolve any disputes in relation thereto. From the recipient's perspective this raises the question whether such an opinion is still fit for purpose in a cross-border setting, where the opinion-recipient(s) may be sued in a number of jurisdictions. Moreover, it leaves the opinion recipient with the question whether the legal opinion may only be properly understood by readers familiar with the chosen (local) law. However, Jaap Willeumier made a strong point in stressing that a choice of law and forum is required to allow an opinion giver to manage the risk of the opinion-giver. Courts are generally not very familiar with the bespoke structure and wording of legal opinions. If this is combined with a lack of familiarity with the applicable concepts of the laws opined upon, the outcome of a litigation scenario would become highly unpredictable. It was noted that provisions choosing the jurisdiction to resolve disputes arising in relation to a legal opinion are not common in the United States.

During and after the session, a lively discussion with the audience ensued, demonstrating how open the issues relating to cross-border opinions in financing transactions remain, despite significant harmonisation in this area over the past decade.

FEATURES

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Fintech innovation: combating money laundering and the financing of terrorism

Fintech and Regtech

New technologies are increasingly shaking up the financial sector and radically transforming the way people gain access to financial services, as well as offering new opportunities for the banking and financial industries. As a result, investors and consumers have more choice and easier access to new financial services. 'Fintech' refers to the technology-enabled provision of financial services, including by alternative providers who use technology-based systems either to provide financial services directly or to make the financial system more efficient. It also includes 'Regtech', which stands for regulatory technology and is a business model whereby technology enables firms to better comply with regulation. Regtech can enable government bodies to implement, monitor or enforce regulation in a more effective, efficient or user-friendly manner.

Money laundering and terrorist financing

Money laundering and the financing of terrorism are financial crimes with economic effect. These activities can undermine the integrity and stability of financial institutions and systems, discourage foreign investment and distort international capital flows. Money laundering is the process of concealing the illicit origin of proceeds of crimes, while terrorist financing is the collection or provision of funds for terrorist purposes.

In the case of money laundering, the funds are of illicit origin; whereas in the case of terrorist financing, funds may stem from legal or illicit sources.

Strong anti-money-laundering regimes (AML) and combating the financing of terrorism (CFT) enhance financial sector integrity and stability, and technology-based innovations have the potential to be utilised for these purposes.

Links between new technologies and the fight against financial crimes

With AML fundamentals – including customer due diligence, knowing the source and destination of money flows and identifying suspicious activities – technological innovation is an opportunity to bring AML regimes into the 21st century.[1] Regtech can reduce the cost of compliance and improve the efficiency and effectiveness of customer due diligence. These solutions enable big and small players alike to provide financial services safely and transparently, and to support growth and innovation. Regtech could change markets by automating checks on companies, people and identification documents to meet know-your-customer requirements through remote identification, and tackle fraud issues. The European Commission will facilitate the cross-border use of electronic identification and know-your-customer portability based on Regulation No 910/2014 on electronic identification to enable banks to identify customers digitally.[2]

Big Data, artificial intelligence and machine learning could improve the detection of suspicious activities, potential illegal activity and criminal networks. Different technologies may improve cross-border payments, including by offering better and cheaper services and lowering the cost of compliance with AML/CFT regulation.

Fintech, however, is a double-edged sword: it could be used to promote and fund terrorism including through the anonymity of virtual currencies. Nevertheless, it can also be a powerful tool to strengthen our defences against the financing of terrorism.[3] Fintech can identify terrorist financial flows, including in the case of very small transactions. Machine learning and other artificial intelligence tools can help identify patterns of activity that would otherwise be very difficult to detect.

Cyberattacks are a growing threat to all digital infrastructure, including financial systems. The risk of attack on the financial sector is three times higher than that of any other sector. Fintech can also help protect financial systems against cyberterrorism – for example, the distributed ledger technology that underpins virtual currencies and other applications is less vulnerable to a single point of failure and could prove resilient to cyberattacks because the ledger (or record of transactions) exists in multiple copies. In particular, as specified by European Securities and Markets Authority (ESMA), distributed ledgers – sometimes known as blockchains, in the case of virtual currencies – are essentially records of electronic transactions, similar to accounting ledgers. They are maintained by a shared or 'distributed' network of participants (so-called 'nodes') and not by a centralised entity, meaning that there is no central validation system. Another important feature of distributed ledgers is the extensive use of cryptography, that is, computer-based encryption techniques, such as public/private keys and hash functions, to store assets and validate transactions. Distributed ledgers and blockchain are often used interchangeably when discussing the technology; however, blockchain is a particular type of distributed ledger originally designed and used for bitcoins.[4] Blockchain consists of many blocks of encrypted electronic records of bitcoin transactions linked together. Bitcoin was invented by an unknown programmer who used the pseudonym Satoshi Nakamoto and was released as open-source software in 2009 along with a white paper describing the technical aspects of its design. Bitcoin was the first decentralised convertible virtual currency, and the first cryptocurrency. It is still the market leader amongst virtual currencies.

Virtual currencies

A virtual currency is a digital representation of value that can be digitally traded and functions as: (1) a medium of exchange; (2) a unit of account; and/or (3) a store of value, but does not have legal tender status (ie, when tendered to a creditor, is a valid and legal offer of payment) in any jurisdiction. It is not issued or guaranteed by any jurisdiction and fulfils the above functions only by agreement within the community of users of the virtual currency. Virtual currency is distinguished from 'fiat currency' (also known as 'real currency', 'real money', or 'national currency'), which is the coin and paper money of a country that is designated as its

legal tender, circulates, and is customarily used and accepted as a medium of exchange in the issuing country. It is distinct from 'e-money', which is a digital representation of fiat currency used to electronically transfer value denominated in fiat currency. E-money is a digital transfer mechanism for fiat currency, that is, it electronically transfers value that has legal tender status. Digital currency can mean a digital representation of either virtual currency (non-fiat) or e-money (fiat) and thus is often used interchangeably with the term virtual currency.[5]

The nature of virtual currencies is difficult to comprehend, the underlying technology is complicated, their operations are conducted in a decentralised way, and they are almost unregulated.

Virtual currencies have the potential to further illicit AML/CFT activities. In the 'Emerging Terrorist Financing Risks Report' (October 2015), the Financial Action Task Force (FATF), the world AML body, illustrated a case study from the United States that concerns the promotion of virtual currency to fund terrorism. In August 2015, Ali Shukri Amin was sentenced to 11 years in prison after pleading guilty to using Twitter to provide advice and encouragement to ISIS and its supporters. Amin provided instructions on how to use bitcoin to mask the provision of funds to ISIS and facilitate the travel of supporters to Syria to fight with the terrorist group. Amin used Twitter to publicise an article he had written entitled 'Bitcoin and the Charity of Jihad'. The article suggested using Dark Wallet, a new bitcoin wallet that keeps the user of bitcoins anonymous through a combination of electronic techniques, such as anonymisers, which help to hide the source of a bitcoin transaction and information black markets. It included advice on how to set up an anonymous donations system to send money, using bitcoin, to the Mujahedeen.

Crowdfunding

One example of Fintech is crowdfunding, a means of providing financing and an alternative investment solution, albeit from a small base.

In July 2015, ESMA published *Questions and Answers: Investment-based Crowdfunding: Money Laundering/Terrorist Financing*. The risks in relation to terrorist financing and money laundering related to investment-based crowdfunding can be mitigated if platforms apply due diligence checks on the project owner (including the project itself) and on investors, and where other parties involved in the transfer of funds are responsible for AML/CFT controls, even where the platform itself is not.

In its *Emerging Terrorist Financing Risks Report* (October 2015), FATF described a case study from Russia that includes a large-scale crowdfunding scheme with e-wallets. A group organised a scheme to raise funds via social networks and the internet, and registered numerous e-wallets, credit cards and mobile phone numbers. The details were placed on the internet (including on social networks) under the pretext of collecting donations for Syrian refugees, people in need of medical and financial aid, or for the construction of mosques, schools and kindergartens. Investigations showed that the funds were sent to credit card accounts or e-wallets to support terrorists and their families instead. Collected funds were moved through a chain of transfers and were withdrawn in cash to be further transported by couriers, and the payment instruments were managed via the internet using mobile devices.

FATF and the San Jose Principles

Partnership between the Fintech and Regtech sectors is one of the FATF's priorities for 2017-2018 under the Argentinian presidency. Building such a partnership will enable FATF to become more proactive in the development of standards, guidance and best practice, anticipating and participating in these new developments rather than responding to them at a later stage. FATF must continue this important work to anticipate, follow up, and be involved in new financial service developments through cooperation with regulators and collaboration in the development of risk mitigation measures. This dialogue will contribute to the integrity of the international financial system and support innovation and growth in our economies.

In May 2017, FATF released the San Jose Principles as guidance on how the public and private sectors can co-operate to support innovation and manage AML/CFT risks, including:

- fighting terrorism financing and money laundering as a common goal;
- encouraging public and private sector engagement;
- pursuing positive and responsible

innovation;
- setting clear regulatory expectations and smart regulations that address risks, as well as allowing for innovation; and
- fair and consistent regulation.

In July 2017, G20 leaders at its Hamburg summit said: 'The G20 will focus on Fintech, Financial Intelligence Units and Banks in developing new tools and technologies to track terrorist financing. This echoes the efforts that FATF has undertaken over the last year, which resulted in the San Jose Principles, and which will remain an important issue during the Argentinean Presidency of the FATF'.[6] In particular, G20 leaders asked finance ministers and central bank governors to work with FATF, the Financial Stability Board, the financial sector, financial intelligence units, law enforcement and Fintech firms to develop new tools, such as guidance and indicators, to harness new technologies that can better track terrorist finance transactions, and to work together with law enforcement authorities to bridge the intelligence gap and improve the use of financial information in counter-terrorism investigations.

Notes

1 David Lewis, FATF Executive Secretary, XXV International Financial Congress, St Petersburg, 1 July 2016.
2 Regulation EU No 910/2014 of the European Parliament and of the Council of 23 July 2014 on electronic identification and trust services for electronic transactions in the internal market and repealing Directive 1999/93/EC. An inter-operable framework for electronic identification could also help firms develop digital customer relationships.
3 Christine Lagarde, IMF Managing Director, FATF Plenary Meeting, Valencia, 22 June 2017.
4 European Securities and Markets Authority, 'Discussion Paper: The Distributed Ledger Technology Applied to Securities Markets', 2 June 2016.
5 Financial Action Task Force, 'Report: Virtual Currencies Key Definitions and Potential AML/CFT Risks', June 2014.
6 See FATF, G20 Leaders Strengthen their Efforts to Tackle Terrorist Financing Together, 10 July 2017, available at www.fatf-gafi.org/fr/publications/recommandationsgafi/documents/g20-leaders-summit.html?hf=10&b=0&s=desc(fatf_releasedate).

Why resolving Islamic finance disputes through international arbitration makes sense

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Introduction

Islamic finance has been gaining popularity over the past few years as it is deemed to offer a credible and ethical alternative to the conventional banking system and its allegedly rapacious practices, which have been said to have prompted the financial crisis. According to the *ICD/Thomson Reuters Islamic Finance Development Report 2017*, global Islamic finance assets stood at US$2.2tn in 2016 and are expected to grow to US$3.78tn by 2022. A subsection of faith-based finance, which, to some, forms a limb of ethic-based finance, Islamic finance offers financial intermediation through innovative products based or compliant with Islamic law.[1] The unprecedented growth that Islamic finance has seen in the past few years has led to a democratisation[2] and a sophistication of its product offering. The array of innovative tools offered by the Islamic finance industry has largely contributed to its globalisation and expansion beyond the Muslim world. These factors have led to an increase in the number of disputes the subject matter of which relate to Sharia-compliant transactions. This article argues that arbitration constitutes an efficient and effective means[3] of resolving disputes arising out of institutional Islamic finance deals.[4]

Islamic law deems disputes relating to property and of monetary rights to be arbitrable. Arbitration is 'a process by which parties consensually submit a dispute to a non-governmental decision-maker, selected by or for the parties, to render a binding

decision resolving a dispute in accordance with neutral, adjudicatory procedures affording each party an opportunity to present its case'.[5] The values of arbitration, aiming principally at resolving disputes efficiently in the interest of justice and fairness, are enshrined in Islamic law. Islam has long established a dispute resolution framework through several methods,[6] one of which is arbitration. The Islamic conflict resolution mechanism's inclusion of arbitration is a testament to the advantages arbitration has to offer as an alternative dispute resolution tool. The article discusses below some of the reasons for which the author believes arbitration is ideally suited in relation to resolving disputes arising out of Islamic finance transactions.

Confidentiality

One of the major, often-cited advantages of arbitration over litigation is the confidentiality governing, to some extent, the arbitral proceedings. While variations exist from jurisdiction to jurisdiction, and from one set of arbitration institutional rules[7] to another, as to the scope and standards of confidentiality to be upheld in arbitration proceedings, the confidentiality of the arbitration proceedings, and later thereafter the underlying arbitral award, are usually assured under most modern arbitral regimes.[8] Given the subject matter of Islamic finance disputes, and the identities of the parties, one of which is usually a financial institution, the confidentiality of the arbitration proceedings in contrast to the publicity of local proceedings is not to be underestimated. Moreover, this advantage is in line with the Islamic philosophy that encourages the settlement of one's affairs and conflicts in a discrete manner.

Party autonomy

Party autonomy is another noteworthy benefit of arbitration. Through the doctrine of party autonomy, parties to arbitration are given a front seat in setting the framework by which their disputes shall be resolved. The parties' autonomy in arbitration proceedings is principally expressed through the arbitration agreement, the backbone of any arbitration proceedings. Through the arbitration agreement, parties are given the freedom to devise the framework through which they wish to have their disputes governed, including the choice of the forum and the governing law. Such prerogative is crucial in cross-border transactions in which the neutrality of the forum and governing law are decisive elements of comfort to the parties.

Specifically, and in relation to Islamic finance transactions, party autonomy provides flexibility to adhere to the principles of Sharia in addition to national 'secular' laws. This is important since Islamic finance transactions must comply with a two-step regulatory framework. First and foremost, Islamic law should be adhered to before moving to the second, no-less-important consideration of compliance with the financial and banking regulations of the host jurisdiction's national laws. Recent Western court decisions,[9] which have set aside the application of Islamic law in relation to the adjudication of breach of contract and the corresponding liability of the parties and subjected it only to national 'secular' laws, have raised concerns in the Islamic finance community. The choice of arbitration as a dispute resolution mechanism is likely to put such uncertainty at bay as parties can agree to submit their dispute to a governing set of rules, which will safeguard the double layered system.

Furthermore, arbitration offers the parties the option of choosing their 'judge' and ensuring that such a decision-maker is expert in Islamic law and, specifically, Islamic financial arrangements. Such expertise is essential to ensuring the efficient and just outcome of arbitration proceedings, an objective that is aligned with the spirit of Islamic finance and the sophistication of its product offering bolstered by an ever-increasing demand.

Enforceability

One of the oft-cited benefits of international arbitration over litigation is the relative ease through which enforcement of an award may be sought in reliance on the Convention on the Recognition and Enforcement of Foreign Arbitral Awards, commonly known as the New York Convention. The New York Convention provides a legal regime for the recognition and enforcement of foreign arbitral awards within its 157 contracting states' network. The success of the New York Convention stems from the duty laid on its contracting states to recognise and enforce foreign arbitral, awards subject to narrow exceptions. This transnational enforcement passport is of utmost value in disputes arising out of

Islamic finance transactions given their recent globalisation extending beyond the borders of Muslim countries and the attitude of some national courts in resisting and denying the enforcement of foreign judgments issued by certain jurisdictions.

Conclusion

There are undoubtedly several synergies between the essence and spirit of Islamic finance and that of arbitration; the present article has attempted to discuss some of them. As financial institutions in general, and Islamic financial institutions in particular, have so far been somewhat reluctant to submit their disputes to arbitration, there has been a recent shift to this trend, in part due to institutional support[10] and the launch of a dedicated set of arbitration rules.[11] That said, with the anticipated growth of Islamic finance-related arbitrations comes the challenge of educating and training well-rounded experts in these fields and that for the purpose of serving the interests of justice and fairness, which remain the foundation of any sustainable and unswerving legal mechanism.

Notes

1 Islamic law is formed by primary undisputed sources, being the Quran and the prophetic Sunnah – together forming the Sharia – and the secondary sources consisting of the effort and work product of the schools of jurisprudence, which are tasked with a dual mission of interpreting the primary sources and conceiving rulings relating to factual situations, covering both the spiritual and social, including commercial and contractual relationships of a believer, and not dealt with under the primary sources.

2 Islamic finance no longer exclusively caters to clients of the Muslim faith.

3 In some instances, intervention by the local courts may provide further support to the arbitral process through interim measures, such as provisional attachments.

4 By institutional this article specifically refers to mid to large lending and project finance arrangements and not retail Islamic finance arrangements. Based on the author's experience in the Arabian Gulf, and specifically in Dubai, local courts tend to provide a more suitable forum to disputes arising out of retail Islamic finance arrangements, and particularly home financing transactions, as the courts offer in such cases an expedient and cost-effective recourse to the assets backing such straightforward structures.

5 G Born, *International Arbitration: Law and Practice* (2ndedn, Wolters Kluwer 2016), s 1.01 [A].

6 Such methods include Sulh and Musalaha (reconciliation through settlement), Mufawada (negotiation), Wasata (mediation), Hudna (truce) and the subject matter of this article, Tahkeem (arbitration). Islam encourages alternative dispute resolution mechanisms as a guarantee to a peaceful and prosperous society.

7 Arbitration can take two forms: institutional and ad hoc. Institutional arbitration is the prevailing form under which an arbitration centre administers the arbitration proceedings that are also governed procedurally by the centre's rules. There is not an administration of the proceedings by a centre under ad hoc arbitration and the parties must agree and determine all the aspects of the arbitration proceedings.

8 Exceptions to the duty of confidentiality exist. In addition to the commonly accepted permitted disclosures, initiating recognition and enforcement procedures usually breaks the seal of the award's confidentiality.

9 See *Shamil Bank of Bahrain v Beximco Pharmaceuticals Ltd and others* [2003] EWHC Comm 2118, and *Beximco Pharmaceuticals Ltd and others v Shamil Bank of Bahrain* [2004] EWCA Civ 19. The English courts have held that the principles of Sharia referred to in an English law governing clause could not 'trump' the national laws of England.

10 See the International Swaps and Derivatives Association (ISDA) 2013 ISBA Arbitration Guide and specifically in relation to Islamic finance, Section 13 (c) of the ISDA/IIFM Tahawwut (hedging) Master Agreement, which provides for the possibility of resolving disputes through institutional arbitration.

11 See the Rules of the Dubai-based International Islamic Centre for Reconciliation and Arbitration and the i-Arbitration Rules of the Asian International Arbitration Centre (formerly the Kuala Lampur Regional Centre for Arbitration). That said, and while such rules are welcome, 'secular' arbitration rules should not be disregarded as the Sharia-compliance process would be safeguarded given their procedural nature (contra substantive and merits).

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Agility or redundancy: regulatory relevance in the age of distributed ledger technology

'Any sufficiently advanced technology is indistinguishable from magic'

Arthur C Clarke, Profiles of the Future

Introduction

The fourth industrial revolution was not heralded by Hadron colliders or inter-galactic space travel but rather by cryptographic algorithms and smart contracts[1] scripted in seemingly arcane languages such as *solidity*. Economic opportunity has transcended borders. Disruption and innovation are the watchwords across industries.

2017 was an eventful year. Global regulatory and policy response has been myriad, ranging from panic to insight and, at best, divergent. Blockchain[2] dispenses with time-honoured concepts and practices, such as jurisdiction and validation based on trust. The latest evolutions of distributed ledger technology (DLT) in the financial sector challenge the traditional understanding of value by ushering in new theories that do not rely on underlying assets.[3]

This article seeks to explore and make sense of the top compliance and regulatory concerns that have come to the fore in this ever-accelerating era of technology.

Key issues

The end objective for any regulatory authority is certainty; the foundation stone for stability, and in the case of blockchain, scalability and interoperability. As a technology, blockchain itself is unregulated and should remain so. However, its specific deployment and usage are the domains that warrant regulation.

Regulators the world over hail from starkly contrasting compliance cultures, often hampered by an ingrained resistance to change, thereby giving rise to the not entirely misguided notion of being a barrier to business. In this context, the drivers of change in technology are often motivated to defeat the traditional regulatory approaches, which tend to favour complexity. After all, the true defining characteristic of innovation is and always has been simplicity.[4]

Ostensibly, the chief concerns for regulators with the rise of blockchain are money laundering and terror financing muddled together with a host of cyber-security issues. The mercurial growth of virtual currencies and initial coin offerings has served only to magnify the need for regulation in the financial sector where blockchain has seen the greatest traction. The questions that rise to the fore are consumer protection, industry stakeholder collaboration and data ownership. Challenges, as ever, create opportunities. The dual onus of managing inherent risks and ensuring regulatory compliance that comes as part and parcel of adoption of new technology can in fact be addressed by the same technology that is sought to be adopted.[5]

Global regulatory response

From an historical vantage point, resistance to technology initially serves to dispel any perceived pro-innovation bias and thereafter catalyses refinement efforts once flaws have been identified.

With the 2017 global initial coin offering (ICO) market having exceeded US$3bn, this article takes a quick whirl around the world to discern prominent regulatory reactions.

Japan

Of all the regulatory environments around the globe, Japan possibly represents the most measured and sagacious regulatory response despite having weathered the debacle that was

Mt Gox, which, going by current 'valuations', represents a loss of billions of dollars. Not only was a subject-matter relevant statute enacted whereby Bitcoin was classified as an asset and allowed as a method of payment, strong consumer protection measures were also incorporated. Tax reform was also successfully put in place, which opened up its markets to international investors.

The approach adopted by the Japanese Financial Services Agency (FSA) serves as a case study for regulators worldwide. By actively involving all stakeholders across the board, they sought to better understand the technology implications, eliminated barriers, instituted safeguards against manifest concerns and actively consolidated their position as the largest Bitcoin market in the world. However, the recent Coincheck hack has galvanised the FSA to monitor and investigate all crypto exchanges for potential security breaches and may catalyse the implementation of stronger regulatory oversight.

United States

The United States has seen an incoherent regulatory response since 2013, when the Financial Crimes Enforcement Network (FinCen) sought to define virtual currency and regulate the operations of exchanges.[6] The Internal Revenue Service (IRS) classified virtual currency as property in 2014.[7] Thereafter in 2015, the US Commodity Futures Trading Commission (CFTC), in its order settling charges against Coinflip Inc and its Chief Executive Officer Francisco Riordan, defined virtual currency as a commodity under relevant statute.[8] July 2017 saw a flurry of developments starting with the Uniform Regulation of Virtual Currency Business Act being approved by the Uniform Law Commission,[9] amendments to the Delaware Code relating to General Corporation Law thereby allowing the use of distributed ledgers for the creation and maintenance of corporate records, including the corporation's stock ledger[10] and a report from the Securities and Exchange Commission of an investigation of the DAO, 'one example of a Decentralized Autonomous Organization', which found that tokens or virtual coins sold through ICOs are securities under the US Securities and Exchange Act of 1934.[11] What is abundantly clear is that the different interpretations rendered by the regulatory authorities in the US present a non-homogeneous policy stance that deprives industry stakeholders of certainty. On the private circuit speculation is rife, with Protocol Labs and Cooley LLP publishing the Simple Agreement for Future Tokens (SAFT) framework in October 2017.[12] A repartee to SAFT was released in the form of the Cardozo Blockchain Project Report #1.[13]

European Union

The EU financial markets regulatory landscape represents a more mature and harmonised approach to blockchain regulation despite differing Member State classifications for cryptocurrencies, tokens and ICOs. However, the European Securities and Markets Authority has issued public statements to investors and parties involved in ICOs describing risks relating to untested technology, lack of information, price volatility, the absolute vacuum of intrinsic value and that innovative structuring may be used to remain outside the remit of existing regulations. The most recent evolution on the legislative front is the new EU Payment Services Directive (PSD 2), which was implemented on 13 January 2018.[14] PSD 2 seeks to establish fundamental standards to allow payment services providers to roll out secure digital payment services in an environment that provides legal certainty by addressing issues of protection of consumer rights and security. It expands the scope of regulated payment transactions by including payment initiation services, account information services and its providers under the list of regulated business activities, and mandates a dedicated interface[15] in light of the market evinced need for increased interaction with consumers. Previously, banks could monopolise the control of information and exposure to customers. Technical standards are to be developed by the European Banking Authority to ensure customer authentication and secure communication. They should be effective by June 2019.

United Kingdom

In April 2017, the Financial Conduct Authority of the United Kingdom engaged the public in a discussion[16] on the ramifications of DLT and thereafter published a feedback statement in December.[17] The UK Treasury is also contemplating extending the application of anti-money laundering and counter-terrorism financing regulations

to cryptocurrency exchange platforms and custodian wallet providers.[18]

Singapore

As the central bank of Singapore, the Monetary Authority of Singapore (MAS) is the regulatory authority responsible for the oversight of financial services, capital markets intermediaries, banking, insurance and the stock exchange. The MAS determines the relevant licence regime applicable to the deployment of emerging technologies and its protagonists. A keen perspicacity has been demonstrated towards DLT, exemplified by Project Ubin, a collaborative effort by the regulator, an enterprise software firm called R3 and prominent institutions from the financial industry to create a proof of concept for inter-bank payments using DLT. The objective was to evaluate the consequences of having a tokenised form of the Singapore dollar on a distributed ledger so that banks could eliminate intermediaries, processing fees and time lost by bank users during currency exchange. MAS's participation as the regulator during the development cycle allowed it to gauge and assimilate critical risks and gaps associated with credit and liquidity, the requisite standards for testing and contract development, how data must be secured to ensure privacy and to establish selection parameters for the blockchain. The grand scheme is to establish Singapore as a Smart Financial Centre. Relevant to the ever-burgeoning cryptocurrency and ICO market, the MAS has released a 'Consumer Advisory on Investment Schemes involving Digital Tokens' (including virtual currencies),[19] which urges abundant caution and prudence as would be expected of any other ordinary investment.

Canada

In a pioneering effort at collaboration with the industry, the Bank of Canada initiated Project Jasper in partnership with R3, its member banks, Payments Canada and others during the first half of 2016 with the common objective to conceptualise a model for digital currency issued by Bank of Canada, to validate technical and operational propositions and to disseminate findings on the feasibility of Distributed Wholesale Payment Systems. Significant insights were gleaned from Project Jasper ranging from how cost savings may be potentially realised to the requirement of data verification with increased sharing. However, Project Jasper also provided a jarring reality check of sorts, 'One of the main lessons from this experiment is that the versions of distributed ledger currently available may not provide an overall net benefit when compared with existing centralized systems for interbank payments'.[20]

Canada's position on cryptocurrency offerings, including ICOs, is also worthy of note since it does not make the distinction between commodities and securities, when arriving at the broad conclusion that Canadian securities or derivatives laws, as the case may be, would apply if the person or company selling the securities is conducting business from within Canada or if there are Canadian investors.[21]

Thailand

The 'Golden Land of Smiles' benefits from a strong, yet conservative, banking system where the 'passbook' is still very much in vogue in retail banking services. The unintended consequence is that while the greater majority of the population has access to banks, they do not enjoy untrammelled access to the full spectrum of financial products otherwise ordinarily available in other jurisdictions. The incumbent government pins its hopes on the Thailand 4.0 agenda and the associated technology that would be ushered in to transform Thailand into a digital economy. Naturally, the legion of regulatory authorities in Thailand will have to work cohesively to create the climate in which this can be facilitated. In a laudable effort to keep abreast of developments in Fintech, the Payment Systems Act, BE 2560 (2017) was passed in August 2017, duly notified in October, and is slated to become effective in April 2018. Payment systems have been classified as (1) integral payment systems that facilitate high-value transactions and are used for settlement and clearance thereby constituting a crucial financial infrastructure of the Kingdom, (2) regulated payment systems and (3) regulated payment services. Keeping with civil law traditions, the new legislation bestows broad administrative discretion upon the office of the Minister of Finance and the Bank of Thailand to determine applicability and whether licensing or registration would be required of business operators in the payment space.

On the crypto front, Thai regulatory authorities have pivoted from initial

prohibition to tacit clearance with the caveat that it is not legal tender. In 2017, the Thai Securities Exchange Commission (SEC) issued an online notification urging investor caution with regard to ICOs, reiterating that where an ICO constitutes an offering of securities, the issuer will need to comply with applicable regulatory requirements under its purview.[22] Interestingly, the SEC in its public consultation paper published on 27 October 2017 proposed a new type of security called an Investment Participation which could effectively bring ICO's that currently do not fit the existing definition of securities per the Securities and Exchange Act BE 2535, into SEC ambit if the statute is amended to include this new type of security. Public hearings were closed on 22 of January. During the same month it was reported that SEC has 'insisted' that bitcoin futures are regulated.[23] On 31 January 2018, it was reported that should companies listed on the Stock Exchange of Thailand seek to raise capital via an ICO they would be required to inform the SEC before engaging the public.[24]

South Korea

As the third-largest market in the world for cryptocurrencies after Japan and the US, the chief bugbears for the Korean Financial Intelligence Unit and the Financial Supervisory Service are ensuring compliance with anti-money laundering and know-your-customer regulations. The New Year has had a tumultuous start with the Ministry of Justice issuing a statement to the effect that virtual currency exchanges would be shut down,[25] only to have a clarification from the Presidential Office that policy had not yet been inked. It is increasingly clear from the furore that the government does not have consensus within its ranks to articulate a policy. Meanwhile, the Bank of Korea is keen to explore its own virtual currency. Inconsistency appears to be the only certainty.

China

In the face of multiple onslaughts in the form of economic deceleration as a result of interest rate liberation and declining profitability, policy-makers have garnered the somewhat misleading reputation of toeing a hard-line stance, especially in light of media speculation that the People's Bank of China (PBOC) is deliberating on the issue of whether or not Bitcoin mining should be shut down, together with what was perceived as a concerted effort at closing Bitcoin exchanges. This comes close on the heels of its ban on ICOs.[26] However, the Chinese government has spent some time and resources as would be evident in the Ministry of Industry and Information Technology White Paper published in 2016 wherein the finance sector was identified as the industry most suited to benefit with payments being the obvious use case.[27] Other applications included identity management, securities and asset management. The white paper called for global standardisation, crucial for scalability and interoperability, not just for the financial sector, but also for the government itself as far as its regulatory policies are concerned, going so far as to plot a road map for how this could be implemented. The Chinese government has demonstrated significant zeal for the implications of DLT to the extent of including the technology as part of the 13th Five-Year Plan for National Informatisation, albeit with the hiatus induced by the recent prohibitory position with regard to ICOs and crypto-exchanges. The statement issued by the PBOC in response to ICOs was purportedly derived from its reading of its own laws and the laws relating to securities, commercial banking, telecommunications, financing and its related activities, as well as the law of the land, the People's Republic of China. Not surprisingly, the statement also called for self-discipline from industry players in order to maintain market stability, apropos to conduct expected in the approaching era of decentralisation. 2018 is touted as the year when China will roll out its own central bank digital currency (CBDC), a parallel strategy to its Belt and Road initiative.

Australia

In 2016, the International Organization for Standardization appointed Standards Australia as the lead in an international technical committee, ISO/TC 307, slated to build a uniform approach to DLT with an emphasis on public and private permission models, smart contracts and application programming interfaces among other focus areas. The mandate is to create common standards for system interoperability, privacy, security and terminology. To quote Standards Australia CEO Bronwyn Evans, this development puts Australia in a position to influence the direction of international standards to support the deployment of DLT.

The Australian Transactions and Reporting Analysis Centre is the financial intelligence and regulatory body responsible for enforcing the recently amended Anti-Money Laundering and Counter-Terrorism Financing Act, which now regulates cryptocurrency exchanges to ensure compliance, identify terror financing, tax evasion, welfare fraud, money laundering and organised crime, and thereby halt access to funding for criminal activities. The enacted reforms are not intended to sequester or stunt the proliferation of blockchain and cryptocurrency, but rather safeguard from malicious actors.

On the ICO front, the Australian Securities & Investments Commission has adopted a rather comprehensive classification based relevant statutory applicability read with the specific attributes and forms of offerings.[28]

Vietnam

Despite the imposition of stringent foreign exchange controls by way of rigorous reporting requirements on outbound remittances, the World Bank hails Vietnam as among the fastest growing emerging economies in the world. Technology is being absorbed with uncanny rapacity. Blockchain deployment is widely expected to disrupt onerous cross-border remittance fees. On the cryptocurrency front, Vietnam outlawed the issuance and use of cryptocurrencies as a means of payment, a position that was reiterated by the State Bank of Vietnam in October 2017, with dedicated cryptocurrency regulation and tax law amendments expected to be unveiled by early 2018, under the aegis of the Ministry of Justice and the central bank, which, among other developments, has also established a Fintech steering committee in association with the Asian Development Bank.

Indonesia

The 2016 Presidential Decree on e-Commerce Roadmap places small and medium-sized enterprises (SMEs) and startups front and centre of the plan for digital transformation of the country by focusing on fundamental aspects such as funding, taxation, consumer protection, human talent, education, logistics, infrastructure and cyber security. Indonesia is pegged to become a force to be reckoned with in the e-commerce space behind China and India, in line with the government's vision to transform Indonesia into the largest digital economy in South East Asia by 2020. Also in line with its avowed objective to implement the internet of things, the Palapa Ring Project is expected to introduce fibre optic connectivity across Indonesia by 2019. Blockchain technology is witnessing increased acceptance in the Indonesian payments industry.

However, Bank Indonesia has taken a rigid stance against cryptocurrencies urging all parties to desist from trading, owning or selling the same on account of the high risk and inherently speculative nature associated with virtual currencies.[29] The risks identified by the Indonesian central bank are the inherent propensity of virtual currency to form asset bubbles, which thereby lead to inflation, in turn having long-term implications on financial stability. This is close on the heels of its preceding ban on Fintech firms using digital currency on their platforms.

Hong Kong SAR

In 2016, the Fintech Facilitation Office (FFO) of the Hong Kong Monetary Authority (HKMA) commissioned the Hong Kong Applied Science and Technology Research Institute (ASTRI) to conduct a research project on DLT. ASTRI thereafter released a white paper on DLT, which, aside from providing an in-depth primer on the various aspects of the technology from both a macro and micro perspective, its disruptive properties, platforms and deployment, also identified regulatory and legal considerations that could emerge from known and unknown risks as well as including initial analyses of proof of concept work on DLT application in mortgage loan application, trade finance and digital identity management.

Cryptocurrency exchange activity remains unregulated, though a number of exchanges voluntarily register themselves as money service operators especially when transacting with fiat money for foreign exchange and remittance services. While cryptocurrencies are defined as virtual commodities but not legal tender,[30] the Hong Kong Securities and Futures Commission (SFC) has clarified that though a virtual commodity itself is not a security, certain ICOs have terms and features that may mean that they are securities. The SFC has also elaborated on the kinds of ICOs that may be classified under the definition of a security offering.[31] China's shutdown on virtual currency exchanges was widely expected to drive

businesses to Hong Kong among other nearby jurisdictions such as Japan and South Korea. Hong Kong has always been regarded as a favourable regulatory environment, among the many reasons why it has been a global financial capital since the 19th century. In December 2017, a cautionary circular was issued to licensed corporations and registered institutions, if not investors, reiterating the regulatory position under the Securities and Futures Ordinance on bitcoin futures contracts and cryptocurrency related investment products, that only licensed firms are allowed to offer such products.[32]

Message

The message that can be distilled from a collective reading of global regulation is disconcerting – while innovation is welcome, its corollary, disruption, is not. A great many countries are still setting up the basic infrastructure to support the deployment of new technology, let alone develop the sort of legislation that would direct and shape what is to be fulfilled by the technology. The internet itself was in development since the late sixties, but it was not until the passage of a decade before the Internet Protocol Suite was standardised. Even then, the Internet Corporation for Assigned Names and Numbers was only established as late as 1998. In the case of DLT, it is not just the technology that is emerging, but also the rules and best practices.

Insight

Traditional models of regulation have always presumed centralised authority. Governments and corporations alike function today on centralised platforms that derive legitimacy and capitalise on their ability to enable and validate relationships of trust. Blockchain technology represents an antithesis of this concept, verily a paradigm shift from conservative notions of authority and control. If anything, the centralisation of power has created the opportunity for its impending distribution. Then again, perhaps humanity's hopes for emancipation are being unreasonably hinged on this emergent technology among other developments.

DLT also has its known limitations given that it is still in nascence. Interoperability and scalability are the key pain areas that must be overcome before blockchain can emerge from its chrysalis and be accepted as a viable replacement to legacy systems. While regulators are acting to address manifest concerns relating to money laundering, terror financing, data security et al, the glaring lack of consistency in policy articulation stands to relegate them to the ignominious fate of redundancy. Regulatory apathy can present the ideal environment for disruption but in the long term, overbearing and restrictive regulatory environments tend to breed a culture of risk avoidance, which, in turn, severely crimps innovation. A growing trend has emerged in the ICO sector where issuers actively seek to exclude persons hailing from jurisdictions that adopt legal interpretations that are adverse for the offering.

Blockchain is not a technology that will be implemented in isolation but rather in parallel to artificial intelligence, the internet of things and quantum computing. With the advent of fifth generation wireless systems, the pace of change will only quicken exponentially. Regulators cannot afford to let uncertainty determine how these technologies develop, but must instead embrace the change to come as captains steering the course of the future. The other alternative of course is to be eclipsed by nations that inculcate and facilitate the acceptance of technology. History is replete with examples of how ignorance has led to exclusion, which, while staring at an opportunity that is bigger than the world's borders, would be a tragic state of affairs – especially when we really knew better.

> *'If you treat the future as something definite, it makes sense to understand it in advance and to work to shape it. But if you expect an indefinite future ruled by randomness, you'll give up on trying to master it'*
>
> *Peter Thiel and Blake Masters, Zero to One*

Notes

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Initial coin offerings in Switzerland – towards a regulated legal and tax environment

Overview

Start-ups and, lately, more well-established companies have become increasingly interested in the issuance of coins or tokens as a new way of financing their business activities. In an initial coin offering (ICO) – also referred to as token sale or token-generating event (TGE) – the issuing entity raises funds from investors based on a white paper that describes the project to be financed in detail.

In return for the funds, usually paid in Bitcoin or Ethereum (but also in other crypto- or even in fiat currencies), the investor receives specific entitlements or rights in the form of tokens, which are created on a blockchain as internet-based decentralised storage media. Hence, the investor acquires his or her entitlements or rights in the form of tokens and not in the form of an interest in a global note or an intermediated security. The tokens can be electronically transferred to third parties at a later stage.

The entitlements/rights represented by the tokens can be of different kinds. Most of the tokens that the authors have come across so far may be allocated to one of the following categories but there is no legal categorisation:

- tokens that give the token holder the right to a share of the future income of a company ('income-sharing token');
- tokens that give the token holder the right to a share of future royalties generated with a technology ('royalty-sharing token'); and

- tokens enabling the token holder to use a technology yet to be developed by the issuing company ('utility token').

The three token designs described should be distinguished from tokens that are exclusively used to represent ownership in any kind of assets ('asset-backed tokens') and tokens that are a digital currency comparable to Bitcoins ('intrinsic or native tokens'). Intrinsic tokens do not carry an embedded right against an issuing company or a company operating a technology platform or other token holders participating on such a platform. The transfer of legal ownership of assets from one token holder to another token holder would, generally speaking, only be valid under Swiss law provided that a robust (collateral) holding agency is set in place.

Issuance of an income-sharing token

An income-sharing token enables the token holder to participate in income generated by the issuing entity. There are different sub-categories to an income-sharing token. In the traditional form, the token holder receives payments that correspond to a share in the future income according to the profit and loss statement (either before or after tax) of the issuing entity. In other cases, the token holder receives payments if the issuing entity, for example, generates positive earnings before interest and taxes (EBIT) or distributes dividends to its shareholders.

As long as the reference value is not positive there are usually no payments to the token holder. Assume a Swiss start-up company intends to develop a new robot designed for household tasks. In order to finance development of the robot, the company issues a certain amount of tokens to be paid in a digital currency such as bitcoin or Ethereum. The token gives the token holder the right to participate in the future success of the company, as the company is obliged to make payments to the token holder to the extent of 30 per cent of all future positive EBITs.

Legal qualification of the token

The right embedded in the income-sharing tokens is similar to a derivative financial instrument. This has various regulatory consequences as described below.

The issuance of an income-sharing token on the primary market should not be subject to anti-money laundering regulations in Switzerland and, for the time being, should also not be subject to prospectus requirements. Despite this analysis, it clearly reflects good practice to apply certain know-your-customer (KYC) procedures to the acquirers of the tokens at issuance. In most ICOs executed in Switzerland, the KYC did not conform to the standards that would be required under Swiss anti-money laundering regulations.

Under the Swiss Financial Markets Infrastructure Act, a token (if not structured as an intrinsic token that gives no rise to claims on their issuer) qualifies as a security. Acting as market maker of securities or operating an (internet) platform enabling the trading in securities will trigger licensing requirements in Switzerland. The issuing company of the income-sharing token is not subject to these licensing requirements. A Swiss entity acting as issuing company in an ICO should consequently not take the role of market maker of its tokens and not provide for a trading platform of its own tokens.

On 16 February 2017, the Swiss financial regulator FINMA confirmed the analysis above and stated that it will continue to closely review ICOs executed in Switzerland. Generally, it is advisable to obtain a non-action letter from FINMA prior to launching an ICO should the structuring of the ICO and the token give reason for uncertainty of the application of Swiss financial law and anti-money laundering regulations despite the above analysis. As stated, the issuance of an intrinsic token would be subject to Swiss anti-money laundering regulations given that such a token qualifies as a cryptocurrency under Swiss law.

Corporate income tax at the level of the issuing entity

The payment of the token holders to the issuing company is generally treated as income for accounting purposes at the level of the company. This would trigger corporate income taxes as Swiss tax law, as a general rule, follows accounting law. The company should, however, be allowed to record provisions in the same amount as the received funds neutralising the income from issuing the tokens. There are at least two conceivable justifications for such a provision.

First, the provisions are justified in all three model cases as the issuing company is obliged to use the proceeds for the development of the new technology. As the development leads to tax-deductible expenses at the level of the issuing company and is directly linked to the

income from the issuance of the token, the income should be neutralised by a provision for these future expenses.

Secondly, in the case of income-sharing tokens, there is another justification as the issuance of income-sharing and royalty-sharing tokens is not only linked to future expenses for the development of the technology, but also to an expectation of future payments to be made to the token holders depending on the development of a reference value. Therefore, at the time of the issuance of the tokens, the funds generated are linked to these future payments representing tax-deductible expenses at the level of the issuing company.

In conclusion, the recording of a provision in the amount of the collected funds should avoid triggering any corporate income taxes at the level of the issuing company at the time of the issuing event. However, the actual acceptance of the provisions depends on the individual case and requires a detailed analysis of whether provisions in the amount of the funded revenues are justified.

Withholding tax and income tax treatment at investor level

Regarding the qualification of the income from tokens for income and withholding tax purposes, it is first important to note that the tokens can be understood as an evidence for a contractual agreement between the issuing company and the investors, that is, tokens are certainly not corporate rights from a civil law perspective.

Under Swiss income tax law, the payments of the investors at the time of issuance against the issuance of the income-sharing tokens are qualified as tax neutral at the level of the investors. However, it is the current understanding of the Swiss Federal Tax Administration that all future payments made by the issuing company to the token holders be regarded as taxable 'compensation payments' to the investor. This means that not only payments exceeding the invested amount but all future payments to token holders should be subject to income taxation. However, there is not yet published practice available and in individual cases that deviate here solutions could be discussed with the relevant tax authorities.

On the other hand, no withholding tax should be levied on income from tokens issued by entities in Switzerland, even though the token might from a substance-over-form perspective have elements of a share, a bond, a collective investment vehicle and even of a lottery subject to withholding tax.

Conclusion and outlook

In 2017, the financing of start-ups and ideas via ICOs exceeded venture capital financings by far and opened such investments to a large number of non-institutional investors. The authors believe that the new blockchain technology will, despite some initial teething troubles, have an important role in venture capital and probably also in other kinds of corporate financing.

The present article reflects recent developments on the legal and tax treatment of ICOs in Switzerland. It also considers the first indications received from Swiss authorities in this respect. No published practice of any tax authorities is, however, available as yet. Despite the increasing certainty on the qualification of income-sharing tokens in particular, the authors recommend following future developments closely.

Claims arising from the current handling of cum/cum trades by the German tax authority

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Background

To avoid taxes, numerous financial institutions engage in so-called 'cum/cum' trades – a type of trade that allows foreign investors to avoid a German withholding tax on dividends. The resulting tax evasion amounted to approximately €5bn between 2011 and 2016. Recently, the practice has evoked increased criticism due to the alleged social damage.[1]

A cum/cum trade is the trade of a stock where the purchaser is eligible to claim the dividend of the stock. As such, the stock transfer has to take place on or before the date of the general meeting of stockholders (the dividend date). A cum/cum trade aims to avoid the effective taxation of the dividend payment. These trades are of particular interest to companies that do not reside in Germany, so called non-residents.[2]

If either a resident or a non-resident receives a dividend payment from a stock traded in Germany, the dividend tax must be retained. Only the remainder of the dividend is transferred to the stockholder. However, a resident can in principle request reimbursement of the deduction. This means that the resident receives the entire dividend payment; the non-resident receives the dividend only after deduction. The cum/cum trade developed the following solution. First, the non-resident transfers the German stock to a resident before the payment date of the dividends. The resident will consequently claim a dividend payment. If dividend tax is deducted, the resident will request reimbursement. After the dividend date, the resident will transfer the stock back to the non-resident, including – if agreed – the complete dividend. The legal nature of such trade may be a repurchase agreement or an agreement to borrow the stock. The transfer of the stock can also function as security for another transaction between the parties, such as the granting of a loan.[3]

With letters dated 11 November 2016 and 17 July 2017, the German Federal Ministry of Finance interpreted cum/cum trades as a possible violation of section 42 of the German Taxation Act (Abgabenordnung, AO), which provides that it shall not be possible to circumvent tax legislation by abusing legal options for tax planning schemes. A legal consequence of the violation is that the resident has to pay dividend tax and has no right to request reimbursement.[4]

The question is whether the party that acted as a German tax resident can recover the loss from the non-resident that corresponds to the paid tax. The underlying argument is that the tax resident would not have agreed to the cum/cum trade under the agreed price if it had known that it had effectively to bear the dividend tax.

Claims to amend or terminate the contract

The current change in practice by the German tax authority with regard to cum/cum trades may constitute a material change of circumstances and thus provide a right to amend or terminate the contract. Usually the wording of the material change includes circumstances that refer to the party's conduct or its capacity that arise after conclusion of the contract and that would have prevented conclusion of the agreement under the existing conditions. The wording does not usually include circumstances that arise independently of the party's conduct or its capacity. As such, the current change in practice by the German tax authority does not constitute a material change.

However, under German law a court can intervene and determine how in good faith the parties would have agreed on unforeseen circumstances had they considered it.[5]
The conditions are that:

1. the contract has no provision dealing with the existing situation (a gap);

2. the parties would have included a contractual provision for such situation had they known; and
3. the purpose of the contract is endangered without court intervention.[6]

The court may not intervene though when the existing contract would lead to mere unfairness or to unreasonable provisions.[7] If the parties have not agreed on who bears the risk that dividends are taxed, such omission should constitute a gap (condition 1 above). A provision that stipulates other taxation matters may illustrate that the parties considered the taxation risks and sought to resolve them in the contract. This may imply that the parties would have also agreed on the taxation of dividend payments had they been aware of them at the time of entering into the (contract) (condition 2). Such an argument holds true in the case of a security agreement.

A repurchase agreement is concluded on the assumption that the resident receives a higher dividend than the non-resident owing to the tax privilege. Considerations about tax dividends are intrinsic to such agreements. In this regard, the second condition can only be fulfilled if one party argues that the parties were so certain about the tax privilege that they did not consider the illegibility of tax reimbursement. This argument seems weak. Pursuant to section 42 of the German Taxation Act, the parties should have known of the risk that the tax privilege may not apply in their particular case. The court may request the resident to prove that it did not consider the risk at all. Finally, in many cases the contract would lose its purpose if the tax is to be paid (condition 3). For example, in cases where the stock is transferred as the security of a loan the value of the stock including the dividend payment is essential for calculating the interest on the loan. Further, a repurchase agreement does not seem to be advisable when tax is deducted.

Pursuant to section 313 of the German Civil Code (*Bürgerliches Gesetzbuch*, BGB), a party can adapt a contract. The conditions are that:

- material conceptions or circumstances have become the basis of the contract but are not included in it;
- these conceptions or circumstances are found to be incorrect; and
- considering all circumstances of the individual case, in particular the contractual or legal risk distribution, adherence to the unchanged contract cannot reasonably be expected.

Here, the parties may have considered the legal risk corresponding to the tax privilege but relied on the customary evaluation at that time and wrongly calculated the risk to be virtually zero. As argued above, the tax privilege is essential for concluding the agreement under the existing conditions. Further, the misconception was not expressly included in the contract. Accordingly, the Federal Court recognised misconceptions about the obligations to pay taxes in other cases.[8] As illustrated above, the risk corresponding to dividend tax has not usually been distributed to one of the parties. As to the final condition, one may find contractual provisions that may entail one party to bear many or all tax risks. Accordingly, that party may also have to bear the risk to be obligated to pay dividend tax. In the absence of such provision, one may argue that an unchanged contract would be highly disadvantageous to the resident. However, the court may be less inclined to grant the resident the right to amend or terminate the contract under section 313 BGB when both parties intentionally sought to exploit tax privileges.[9]

Undue enrichment

In cases where a court concludes that the contract expressly stipulates that its purpose is to receive the entire dividend payment without tax deduction, the resident may recover the tax paid from the non-resident on the basis of undue enrichment.[10] This claim is not available if both parties knew their contract violated statutory prohibitions or public policy.[11] Until the letter of 11 November 2016, it was common opinion in Germany that cum/cum trades did not constitute an abuse in the meaning of section 42 AO but were merely application of a poorly written law.[12] With contracts concluded before that date the parties could not have known that the trade would constitute a violation of section 42 AO and as such the claim should be available.

Legal damages

A contract may also, depending on its content, oblige each party to inform the other of relevant circumstances when deciding whether or not to conduct the trade.[13] If one party fails to inform the other, the damaged party is entitled to compensation. Such claims have been the subject of an array of cases and in this regard associated with high legal

uncertainty. Generally, the claim is subject to the conditions that:

- the debtor has to know the risk that the tax privilege may make inapplicable;
- by contrast the creditor must not have known of this risk; and
- this information asymmetry is unjust.[14]

In cases where a borrower raises debt finance to save on business taxes, the Federal Court has established that a lending bank in general bears no obligation to inform the other party of a potential tax liability.[15] The underlying assumption seems to be that a link should be drawn between the return from an exploitation of tax privileges and the associated risks. In cases of security agreements, the non-resident borrower does not request debt finance to save taxes. However, the interests of the non-resident borrower are similar. The borrower benefits from the tax privilege because its security has a higher value than when taxed. To link benefit and risk, the borrower should bear the costs corresponding to the tax and inform the lending bank of the risk that the security could be of smaller value than expected. If the borrower did not inform the bank, the bank should be entitled to compensation. Alternatively, the bank may claim to be provided with additional security to compensate for the decreased value of the original stock.[16]

In the case of a repurchase agreement the resident buyer may have a claim of compensation when the purchased stock is regarded to have a deficiency. The Federal Court established that a product has in principle a deficiency when the product lacks a promised feature and a tax privilege could constitute such a feature.[17] As such, the seller may have promised that any purchaser of the offered stock is entitled to tax privileges. If such promise proves to be false, the purchaser may claim compensation. The limitation period is two years and commences when the stock is transferred to the purchaser.[18]

Right of recourse

A provision that stipulates that the non-resident bears all risks associated with claims by the tax authorities is sufficient for a right to recourse. Such provision is rare, however.

When the trade includes an element where the resident is instructed by the non-resident to collect the dividend to the benefit of the non-resident, the resident may recover unforeseen tax obligations from the non-resident on the basis of a claim on compensation of expenses (*Ersatz von Aufwendungen*), section 670 BGB.[19] Such instruction is stipulated in a repurchase agreement, where the resident is instructed to collect and transfer the dividend payment to the non-resident. In a security agreement, the resident is instructed to hold the dividend payment together with the stock as security of a loan. After repayment of the loan, the stock and the dividend are transferred to the non-resident. The obligation to pay the tax is a consequence of performing the assignment.[20]

Owing to the current opinion of the Federal Ministry of Finance, both parties, the resident and the non-resident, are liable to pay the dividend tax to the tax authority. Yet, the tax authority is entitled to the tax only once. Such a relationship is similar to the principle of joint and several liability. As such, if one party pays the entire debt, it has a claim against the party to be compensated proportionately. Accordingly, if one party pays the entire tax, it is entitled to be compensated in part by the other party.[21]

Limitation period

All claims, excluding the claim to compensate for a deficient product, are subject to a limitation period of three years. The period commences at the end of the year in which the claim arose and the creditor obtains knowledge of the circumstances giving rise to the claim and of the identity of the debtor, or would have obtained such knowledge if he had not shown gross negligence.[22] As such, the claim is likely to arise when the tax authorities request tax payment or refuse reimbursement.

Conclusion

As of now, few courts have considered the claims that may arise due to the recent change in practice by the German tax authority. In previous cases, courts were hesitant to assist parties that were merely unable to benefit from tax privileges. This contribution illustrated some possible claims. In this context a claim seems possible when the creditor demonstrates that either (1) the risk associated with the dividend tax should be entirely borne by the other party, (2) the other party is solely to be blamed for the attempted tax evasion or (3) the party has a right of recourse on the basis of the particular legal relationship.

Notes

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2 Letter of the Federal Ministry of Finance dated 17 July 2017 – IV C 1 – S 2252/15/10030 :005, DStR 2017, 1599 Rn 1–2.

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4 Letter of the Federal Ministry of Finance dated 17 July 2017 – IV C 1 – S 2252/15/10030 :005, DStR 2017, 1599; Letter of the Federal Ministry of Finance dated 11 November 2016 – IV C 6 – S 2134/10/10003, DStR 2016, 2709; German Federal Court of Taxation, judgment of 18 August 2015 – I R 88/13, DStR 2016, 168.

5 German Federal Court, judgment of 21 September 1994 – XII ZR 77/93, NJW 1994, 3287.

6 Busche, in *Münchener Kommentar zum BGB* (7th edn, 2015), section 167, para 44.

7 German Federal Court, judgment of 1 June 1979 – V ZR 80/77 –, BGHZ 74, 370, 373 ff.

8 Compare to Finkenauer, in *Münchener Kommentarzum BGB* (7th edn, 2016), section 313, para 283.

9 Also compare to German Federal Court, judgment of 26 October 2004 – XI ZR255/03, DNotI-Report 2005, 22; German Federal Court, judgment of 18 March 2008 – XI ZR 246/06, NJW-RR 2008, 1149, para 15.

10 Section 812 sentence 2, 2nd alternative BGB.

11 Schwab, in *Münchener Kommentar zum BGB* (7th edn, 2017), section 817, para 83.

12 Spilker, '*Rechtsstaatliche Grenzen für die steuerliche und steuerstrafrechtliche Würdigung von Cum/Cum- und Cum/Ex-Transaktionen*', FR 2017, 138 (145); also compare to Higher District Court (OLG) Köln, judgment of 11 December 2014 – I-7 U 23/14 –, juris.

13 Section 280 para 1 in conjunction with 241 para 2 BGB; Bachmann, in *Münchener Kommentar zum BGB* (7th edn, 2016), section 241, para 110.

14 Bachmann, in *Münchener Kommentar zum BGB* (7th edn, 2016), section 241, paras 122–124.

15 German Federal Court, judgment of 26 October 2004 – XI ZR 255/03, DNotI-Report 2005, 22; German Federal Court, judgment of 18 March 2008 – XI ZR 246/06, NJW-RR 2008, 1149, para 15.

16 Section 249 para 1 BGB.

17 German Federal Court, judgment of 19 December 1980 – V ZR 185/79, NJW 1981, 864 (865).

18] Section 438 para 1 No 3, para 2 BGB.

19 Section 670 BGB (in conjunction with s 675 BGB or 662 BGB).

20 Wiese and Schulze, in Schulze, BGB (9th edn, 2017), section 670, para 3; Schäfer, in *Münchener Kommentar zum BGB* (7th edn, 2017), section 670, para 20; also compare to Eckelskemper, in Bengel and Reimann, *Handbuch der Testamentsvollstreckung* (6th edn, 2017), section 10: *Die Vergütung des Testamentsvollstreckers und ihre Besteuerung*, para 118, with regard to the law of succession.

21 Compare to German Federal Court, judgment of 22 October 1992 – IX ZR 244/91, NJW 1993, 585; District Court Berlin, judgment of 28 March 2001 – 23 U 170/99, NZG 2001, 1084; Higher Administrative Court Bautzen, judgment of 11 January 1999 – 2 S 518/98, NVwZ-RR 1999, 788.

22 Section 195, 199 para 1 BGB.

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Russia: a review of new measures aimed at preventing the insolvency of credit organisations

Introduction

Russian Federal Law No 84-FZ of 1 May 2017 'On Amending Certain Legislative Acts of the Russian Federation'[1] (the 'Law') introduced Chapter X.2 'The Management Company of the Fund for the Consolidation of the Banking Sector' into Federal Law No 86-FZ of 10 July 2002 'On the Central Bank of the Russian Federation' (the 'CBR Law') and made respective amendments to Federal Law No 127-FZ of 26 October 2002 'On Insolvency (Bankruptcy)' (the 'Insolvency Law') as the latter establishes the legal framework for the bankruptcy procedure of credit organisations.

It must be noted that the mere fact of introducing the amendments suggests that the Central Bank of Russia (CBR) has

changed its focus from liquidating credit organisations to restructuring them.

This article provides a brief overview of the legislative amendments introduced by the Law and provides examples confirming that the new procedure is being applied in practice.

Management company

The Fund for Consolidation of the Banking Sector (the 'Fund') is a special investment fund created by the CBR in 2017 to support the financial rehabilitation of troubled banks. Although the Fund is not a separate legal entity, its property is isolated from the CBR's assets. The Fund's assets consist of contributions raised in accordance with decisions effected by the CBR's board of directors. The CBR Law is silent about the sources from which the Fund is being financed. The CBR chief auditor is required annually to assess the effectiveness of the Fund.

Following the amendments the CBR is the only owner of the Fund's management company (the 'Management Company'). In accordance with Article 76.10 of the CBR Law the Management Company shall implement measures aimed at the financial rehabilitation of credit organisations. According to publicly available information from the Unified State Register of Legal Entities, the Management Company was established on 12 July 2017 with charter capital of 1.5 billion roubles (approximately US$25.98m).

The Insolvency Law, as amended, also provides that the Management Company, on behalf of the CBR, shall use Fund moneys to rehabilitate and prevent the bankruptcy of Russian credit organisations.

Article 76.10 of the CBR Law sets out that the Management Company has the right, inter alia, on behalf of the Fund to:

- be engaged in the trust management of mutual investment funds (based on a licence), which moneys may be used for preventing the bankruptcy of credit organisations;
- act as a dealer in capital markets; and
- manage securities.

The Management Company, however, cannot advise third parties on investments or related issues.

Pursuant to the provisions of Article 76.10, the Management Company has the right to administer:

- shares (participatory interests) of credit organisations transferred to the Management Company by the CBR;
- mutual investment funds whose sole trustor is the CBR; and
- debt claims arising out of subordinated loans transferred to the Management Company by the CBR.

According to the Insolvency Law, measures aimed at preventing the bankruptcy of credit organisations with the participation of the Management Company should be taken before the CBR revokes the banking licence of a particular bank.

The Management Company may provide financial assistance by contributing to a bank's charter capital at the expense of the Fund.

Cases of Russian Bank rehabilitation by the Management Company

Pursuant to publicly available information, the CBR has applied the newly introduced mechanism several times.

In August 2017, the CBR took over the major Russian bank Otkritie and ruled to increase its charter capital at the expense of the Fund. From 29 November 2017 to 21 December 2017, the Management Company acted as a temporary administrator[2] and contributed to the rehabilitation of Otkritie and to the stabilisation of its finances. As of January 2018, the Management Company is no longer the bank's temporary administrator. With the CBR's and the Management Company's efforts Otkritie is now capable of forming its own corporate governing bodies and continues its banking operations.[3]

In September 2017, the CBR stepped in to rescue B&N Bank, which was undergoing financial difficulty despite being one of the top five privately owned Russian banking groups and among the top ten of all Russian banks.[4] The CBR again used the Fund to invest in B&N Bank contributing to its charter capital with the purpose of stabilising the troubled bank. As of January 2018, the Management Company continues to act as a temporary administrator.[5]

Another major Russian bank – Promsvyazbank[6] – suffered financial complications in December 2017 pursuant to which the CBR announced it would rescue and rehabilitate the institution at the expense of the Fund. In January 2018, it appointed the Management Company as a temporary administrator.[7]

If the CBR designates the Management Company as a temporary administration of a troubled bank, the Management Company usually takes, in particular, the following measures aimed at rehabilitating an ailing bank:

- fully replaces the bank's management and performs its functions;
- examines the bank's financial position;
- defines whether there are any grounds for revoking the banking licence in accordance with Russian legislation;
- develops and employs any measures aimed at rehabilitating the bank;
- ensures the safety of the bank's assets and documents;
- reveals the bank's creditors and defines the amounts of their monetary claims; and
- takes other measures as are prescribed by Russian legislation.

The Otkritie case demonstrates the important role of the Management Company in preventing the insolvency of major credit organisations in Russia. Having received the necessary financial support, Otkritie has recommenced carrying out its banking activities in full.

At the moment it is not clear whether the CBR will continue rehabilitating troubled credit organisations at the expense of the Fund on a regular basis. Regardless, the above examples show that the CBR's policy is no longer exclusively aimed at liquidating credit organisations.

Notes

1 The text in Russian is available at: https://www.rg.ru/2017/05/03/izmeneniya-dok.html
2 See the bank's official website: https://www.open.ru/en/about
3 See an order of the CBR: http://www.cbr.ru/credit/PrBankrot/GetDocument.aspx?DocID=15547
4 See the group's official website: https://eng.binbank.ru/
5 See an order of the CBR: http://www.cbr.ru/credit/PrBankrot/GetDocument.aspx?DocID=15491
6 See an article available at the bank's official website: https://www.psbank.ru/Bank/Press/News/2017/12/15-01
7 See an order of the CBR: http://www.cbr.ru/credit/PrBankrot/GetDocument.aspx?DocID=15492

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Securitisation in India – recent trends and challenges

The Union Budget for 2018–19 lays emphasis on the development and growth of the infrastructure sector and the micro, small and medium enterprises sector. While the Union Budget provides for a specific fund allocation for these sectors, opening new avenues of financing would also aid this sector to a large extent. Securitisation of non-financial receivables (such as toll, tower and rent receivables) may be one such option for the infrastructure sector. While such securitisation transactions are not prohibited in India, there is no specific regulation to this effect and therefore there is no investor base. Few changes in the current regulations, applicable to securitisation of loans, will assist financial institutions to better manage risks associated with a particular sector.

In India, securitisation typically means either of the following transactions:

- direct assignment of standard loans;
- securitisation by way of issuance of a pass through certificate (PTC) of standard loans;
- direct assignment of bad loans; and
- securitisation of bad loans by way of issuance of security receipts (this is akin to PTCs).

This article deals with the direct assignment of standard loans and securitisation through PTC of standard loans.

In the recent past, securitisation volumes (including direct assignment of loans) have touched a record of INR92,7bn (approximately US$14,5bn), which includes securitisation of INR43bn (approximately US$6.72bn) through the PTC route. Overall, the securitisation market has grown by 40 per cent in the financial year 2017.[1]

Some of the primary reasons for increased activity in the securitisation market are:

- the implementation of the Insolvency and Bankruptcy Code, 2016 ('IB Code'), which indirectly boosts the securitisation market. The IB Code provides for greater clarity on the insolvency process of corporates and will therefore provide flexibility as regards legal structuring. The impact of an originator default can be better assessed under the IB Code and in turn will result in an increase in the investor base;
- the Union Budget for 2016 has allowed complete pass through of income tax to securitisation trusts and replaced the

distribution tax with tax deducted at source. The removal of dividend distribution tax on PTCs has been affirmatively received by the marketplace;

- the initiative of the Government of India (GoI) to exempt securitisation deals from attracting taxation requirements under the Central Goods and Services Tax Act 2017; and
- renewed interest from the mutual fund industry in this segment. Prior to 2013, mutual funds were under scrutiny by the income tax department, which stated that investments in PTCs were tantamount to an alleged revenue leakage. This resulted in mutual funds opting to stay away from the securitisation market. The Finance Act 2013 resolved this issue by clarifying that mutual funds were exempted from application of the distribution tax imposed on securitisation special purpose vehicles (SPVs).
- The Reserve Bank of India's (RBI) regulations require priority sector lending for foreign banks (with 20 branches and above) to be at par with scheduled commercial banks. The securitisation market has witnessed substantial advancements in light of regulatory developments to the priority sector lending guidelines.
- Non-banking financial companies have also amplified their investments in PTCs on account of higher yields attached to this instrument. PTCs have also been preferred by market participants over the direct sale route. This is primarily on account of higher regulatory diligence. Conversion of non-banking financial companies into banks has further contributed to the demand for PTCs.
- Public sector banks have also augmented their volume of direct assignment transactions as compared to their private counterparts and this has generated higher credit growth and enhanced the retail portfolios of such banks.

Another structure that is gaining widespread popularity in the Indian market is priority sector lending certificates (PSLCs). In a PSLC structure, banks that have a deficit in priority sector loans can purchase PSLCs from those banks that have surplus priority sector loans through RBI's platform. This has helped banks (in specific foreign banks) to achieve their priority sector lending targets and reap benefits in relation thereto.

Even with the recent upsurge in securitisation transactions in India and despite the RBI, in the aftermath of the 2008 global financial crisis, issuing revised securitisation guidelines in May 2012, the current penetration in India is estimated to be between two and five per cent of the total retail assets. The securitisation market in India is less than one per cent of the market in the United States.[2]

There are several reasons for such slow growth. In the aftermath of the 2008 crisis, the RBI made securitisation guidelines more stringent. Both minimum holding period and minimum retention requirements are to be met by an issuer as against any one of these. RBI has also regulated direct assignment transactions, which were not regulated previously. Furthermore, credit enhancement in direct assignment transactions has been prohibited. Considering that innovative structures in securitisation have already been prohibited, RBI may consider relaxing some of the regulations to expand the market.

In addition, the market lacks transparency in terms of volume, price, parties to the transaction, etc. The ad valorem stamp duty is a deterrent for the securitisation market. While certain states in India have acknowledged the special nature of securitisation transactions and accordingly capped the stamp duty amount payable in relation thereto, in most states the rates of stamp duty levied continue to be relatively high. The GoI may, in consultation with the state governments, consider amending stamp duty laws in line with the laws pertaining to factoring transactions.

Also, the existing set of foreclosure laws are said to increase the risks of mortgage-backed securities by making it difficult to transfer property in cases of default. Additionally, India is plagued by certain stringent tax provisions. For example, income tax laws contemplate the transfer of income without the transfer of assets that are the source of the income. In such a case, the income so transferred is chargeable to income tax as the income of the transfer and is included in the transferor's total income.

Investor awareness and understanding of securitisation is lacking in India. RBI and other key rating agencies should find ways of educating corporate investors as regards the benefits of securitisation transactions (such as improvement of capital returns, diversify portfolio, reduction in credit exposure, etc). Investor trust could also be gained by ensuring the mandatory rating of all structured obligations.

Financial sector entities in India are now required to adopt new accounting standards; however, the changes in accounting, specifically related to de-recognition of securitised assets and their resultant impact in capital requirement for the issuers of securitised papers, will decide how the volumes pan out in the future. If the capital requirements for the originators were to increase, the same would act as a deterrent vis-à-vis the volume of securitisation transactions.

Post the demonetisation drive undertaken by the GoI, the number of mortgage-backed securitisation deals have reduced significantly. While housing finance companies slowed issuances of securitisation deals, banks were engaged in carrying out the herculean task of retreating the de-legalised currency from the Indian economy.

Although the securitisation market in India has witnessed an escalation in the recent past, there is still a prospect to further enhance the number of transactions in this sector. Having in place more cost-effective stamp duty and foreclosure laws, a robust tax regime and increasing awareness among investors is vital and will further boost the number of dealings in this market space.

We strongly recommend clarity on securitisation of general receivables (ie, non-financial receivables). This will provide an additional option to market participants to monetise non-tapped receivables lying with corporates. Presently, corporates hypothecate these assets against their borrowings and such borrowings are an expensive affair as compared to securitisation.

Notes

1 Report by CARE rating agency dated 12th May 2017. www.careratings.com/upload/NewsFiles/SplAnalysis/Securitisation%20market%20touches%20a%20new%20peak%20in%202017.pdf
2 Securitization in India: An Overview. www.yourarticlelibrary.com/accounting/securitization/securitization-in-india-an-overview/72046/

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Italian Court of Cassation solves conflict on supervening usury

Brief notes on usury under Italian law

Usury is a debated issue under Italian law. In broad terms, there are two different types of usury provided for by Italian law:

- objective usury, meaning applying interest exceeding the usury threshold (which is set on a quarterly basis by a ministerial decree, based on interest applied on the market); and
- subjective usury, which applies when both of the following conditions are met: (1) 'disproportion' – the agreement provides for disproportionate interest amount with respect to principal and the average interest rates applied for transactions of the same type (even if the usury threshold is not exceeded); and (2) 'state of difficulty', which does not mean a 'state of need', but rather refers to both economic difficulty, based on a global evaluation of the borrower's assets, and financial difficulty, which is a temporary lack of liquidity.

In practical terms, subjective usury is not frequently applied and, in any case, is difficult to prove.

Under Italian law, sanctions for usurious interest are twofold. First, there are civil sanctions, pursuant to article 1815 of the Italian Civil Code, no interest shall be due and the borrower shall be entitled to claim the reimbursement of all interest amounts already paid to the lender. Second, pursuant to article 644 of the Italian Criminal Code, criminal sanctions shall apply.

This article does not consider the criminal aspects of usury and only deals with objective usury.

Supervening usury

The notion of 'supervening usury' refers to a case where interest is below the usury

threshold at the start of the loan, but exceeds such thresholds at a later stage. This scenario has become progressively common, given the fall of interest rates from 2013 onwards.

In this respect, Law Decree No 394/2000 clearly states that interest is deemed usurious only if it exceeds the maximum threshold provided for by law at the time when the interest is contractually agreed by the parties, regardless of the time of its actual payment.

Notwithstanding such provision, the Italian courts, including the Italian Court of Cassation (the 'Court of Cassation'), have addressed the issue of supervening usury on several occasions and given rise to two different views: (1) according to a number of judgments, Law Decree No 394/2000 only excluded applicability of sanctions in the case of supervening usury, but interest rates should have been lowered from time to time in order to align with the then applicable usury threshold, by way of an automatic replacement of the usurious interest clause; or (2) according to other judgments, Law Decree No 394/2000 should be construed literally as such, compliance with the usury threshold is relevant only at the time of execution of the loan agreement, regardless of the time of payment.

The judgment of the United Sections of the Italian Court of Cassation

In light of conflicting views of the Court of Cassation, the case was deferred to the United Sections (*Sezioni Unite*) of the Court of Cassation (the 'United Sections'), which are called upon to judge where there are conflicting views on major points of law. Thus, although the Italian legal system does not recognise the stare decisis principle, the judgment has a particular relevance.

Namely, by judgment No 24,675 of 19 October 2017, the United Sections endorsed the literal and lender-friendly approach, which excludes relevance of supervening usury at all.

In the United Sections' view, lenders should assess compliance with usury rates only at the time when the loan agreement is established, irrespective of when payments are made: as such, any subsequent change to the reference usury threshold is not relevant. Therefore, a lender will be duly entitled to claim and receive from the borrower payment of the full amount of interest provided for in the loan agreement.

Relevance where non-Italian law applies and non-Italian courts have jurisdiction

In one case only (judgment No 17,349 of 2002) did the Court of Cassation expressly deal with the issue of whether usurious interest might prevent enforcement of a foreign judgment in Italy.

However, usurious interest had not been applied in the context of a loan agreement in that case, but rather as a consequence of a contractual breach under an accounting services agreement, thus it is not clear whether such a judgment is applicable to loan agreements as well.

On the contrary, some authors have expressed the view that application of usurious interest might actually prevent the enforcement of a foreign judgment sentencing a borrower to pay usurious interest, the rationale being that rules on usury are deemed an international public policy principle.

Therefore, in the case where a borrower only has assets in Italy (thus, the foreign judgment would have to be enforced in Italy in case the borrower refuses to pay), it is strongly advisable to comply with Italian rules on usury to ensure enforceability in Italy of the future judgment. In this respect, the judgment of the United Sections is very helpful, as it excludes relevance of supervening usury at all.

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Ukraine: recent developments fostering cross-border lending

Historically, Ukraine has been known for its tight currency controls regime and a complex jurisdiction for cross-border transactions. As the National Bank of Ukraine (NBU) introduced additional temporary measures to support the local currency (UAH) in 2014, currency restrictions became even harsher. Specifically, in relation to foreign currency (FX) cross-border loans extended by foreign lenders, the NBU prohibited local borrowers from making early repayments. Coming on top of existing mandatory NBU loan registration requirements and limitations on payments for the use of loans by reference to the maximum interest rates of the NBU (the MIR limitation), the early repayment prohibition significantly impeded the ability of Ukrainian borrowers to attract new money FX loans from abroad.

Move towards currency control liberalisation

In tandem with signs of recovery in Ukraine's economy and UAH stabilisation during 2016 and 2017, the NBU has been gradually softening currency control restrictions and improving regulations relating to cross-border FX loans.

The NBU has lifted the early repayment prohibition in respect of cross-border FX loans that are:

- refinanced by FX loans with longer maturity;
- provided to Ukrainian banks;
- insured or guaranteed by foreign export credit agencies;
- provided by any foreign bank;
- extended or guaranteed by international financial institutions (eg, EBRD or IFC);
- extended, guaranteed or insured by any foreign state through its respective agencies;
- extended by a foreign lender with a foreign bank, international financial institution or foreign state among its shareholders, etc.

Given the breadth of exceptions from the early repayment prohibition, essentially the ban remains in place for cross-border FX loans between mere corporates, while for many foreign banks willing to lend to borrowers in Ukraine, this prohibition is no longer an obstacle.

In addition, the NBU has made a number of changes to streamline the existing registration procedure for cross-border FX loans. Specifically, it has allowed foreign lenders to initiate registration with the NBU of a change to lenders under cross-border FX loans. Previously, registration of such changes could only be initiated by the local borrower and foreign lenders had to rely on the borrower's cooperation (as a result, loan transfer transactions in default scenarios were quite problematic in the past).

Furthermore, the NBU also revisited the MIR limitation regulations and specifically excluded the premiums of export credit agencies from MIR limitation. This move facilitated ECA-backed financings to Ukrainian borrowers.

The NBU has now totally cancelled the mandatory NBU registration requirement in relation to cross-border loans provided by international financial institutions. Coupled with cancellation of the requirement to obtain an individual licence from the NBU for payments under suretyships relating to such cross-border loans, this development is a very positive step by the regulator and should further boost financing from international financial institutions.

Enhanced security instruments

Ukraine has recently enhanced the position of pledgees under pledges over bank accounts. The law now generally prohibits a pledgor and its servicing bank from terminating or amending the underlying bank account agreement without the pledgee's consent. Additionally, the parties may agree on a minimum account balance, in which case the pledgor as account holder may not initiate transactions resulting in the balance of the secured account falling below the minimum agreed amount. This novelty should make pledges over bank accounts much more reliable security mechanisms in future.

In addition, the concept of escrow accounts has been implemented in Ukraine. Essentially, this helps to balance the rights and interests of all parties, while relying on the services of a trusted bank acting as escrow agent. Similar to how such accounts operate in more developed jurisdictions, in Ukraine these accounts will be helpful in dealing with counterparty risk in all types of M&A and secured lending transactions.

Furthermore, a number of recent changes to Ukraine's energy laws and regulations should boost new money financing into this sector. By way of illustration, Ukraine has now implemented a long-awaited bankable power purchase agreement (PPA) for energy produced from renewables, allowing financiers to take security over receivables under the PPA.

Finally, it is worth mentioning that Ukraine has also reformed its judiciary and currently undergoes major reforms in other areas, which should have a positive impact on the flow of new investments into the country.

Macau payment services updates in 2018: legal implications

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Introduction

The financial system in the former Portuguese territory of Macau – since 1999 the Macau Special Administrative Region – was put in place around a quarter of a century ago when the Financial System Act (RJSF) came into force and remained largely unchanged until 2017 – well after the 1999 transfer of sovereignty over Macau to the People's Republic of China.

Despite several challenges in the past three years – some attributing its causes to instability in the global financial markets and to China's capital controls – the economy of Macau has blossomed in the past decade compared to other economies over the same period. As drivers of any economy, the banking and financial services industry has also played a significant role in the economic expansion of Macau. The industry has been steadily growing since the area's handover. Acting within the legal and financial framework of Macau, the banking and financial services industry has been conventional. However, in late 2016 and throughout 2017 a series of actions taken in relation to payment services reignited debate in the legal/financial framework of Macau.

Unlike some critics who have labelled the functioning legal and financial framework as a legal impediment to financial innovation and change, the authors would suggest that the following actions described could mean innovation in the industry, thanks to Articles 1/b) and 15/d) of the RJSF regarding other credit institutions and to Articles 1/a) and 118 of the RJSF regarding other financial institutions.

Recent actions

In November 2016, the public company limited by shares GPAP Macau, SA was authorised specifically to provide payment services in relation to bank cards (original text *prestação de serviços de pagamento adquirentes de cartões bancários*) under Articles 1/a) and 118 of the RJSF regarding other financial institutions.

More recently, in July 2017, the public company limited by shares Uepay Macau Sociedade Anónima was authorised specifically for the provision of payment services via the internet and by mobile phone (original text *prestação de serviços de pagamento através de internet e telemóvel*) also under Articles 1/a) and 118 of the RJSF regarding other financial institutions.

Legal implications

Under the RJSF, payment services fall into the specific category of financial services that can only be provided by 'those financial

institutions which have been properly constituted and authorised under the terms of this Act or special legislation',[1] meaning that such services can be provided by fully licensed banks and other credit institutions and other financial institutions as specifically authorised for such services.

As the concept of banks has been well established internationally and payment services have long been considered an inherent part of the services that can be provided by any fully licensed bank, no legal operator raises questions as to the legal capability of banks to provide payment services. However, many legal operators were intrigued by the reference to 'other credit institutions' and 'other financial institutions' as they are non-typical categories and reserved for instances where the entity does not fit into other categories such as banks, finance companies, financial leasing companies, investment funds managing companies, etc. In February 2006, a payment services company called Macau Pass, SA was authorised for the issuance and management of electronic purses (original text *emissão e gestão de cartões porta-moedas electrónicos*) under Articles 1/b) and 15/d) of the RJSF regarding other credit institutions. Together with GPAP Macau, SA and Uepay Macau Sociedade Anónima, they are the three representatives of 'other credit institutions' and 'other financial institutions'.

Conclusion

The reasons for the success of the banking and financial services industry are grounded in the stability of the Macau legal and financial framework, in particular:

- the Finance Companies Law (Decree Law No 15/83/M of 26 February);
- the Financial Leasing Companies Law (Decree Law No 51/93/M of 20 September);
- the Investment Fund Law (Decree Law No 83/99/M of 22 November);
- the Offshore Activity Law (Decree Law No 58/99/M of 18 December);
- the money changers rules (Decree Law no 38/97/M of 15 September); and
- the cash remittance companies rules (Decree-Law No 15/97/M of 5 May).

Other credit institutions and financial institutions should be regarded as residual categories that were foreseen by the legislator in 1993 specifically for creative and imaginative financial operators, leaving an unlimited space for the RJSF to be permeable to the ever-changing financial world: stock exchanges, Bitcoin, fintech, etc.

Note

1 Article 2 of the RJSF.

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Is a 'demand for payment' a sine qua non condition under Mauritian banking law?

Mauritius became independent on 12 March 1968 after being a French colony (1715–1810) and then a British colony (1810–1968).

Although the country has had banks since 1838, it was only in 1969 that Mauritius experienced for the first time a law dealing with fixed and floating charges, titled the 'Loans, Charges and Privileges (Authorised Bodies) Act', which specifically catered for the creation of charge instruments termed as either a 'fixed charge' or a 'floating charge'. In 1971, the Act was amended and then repealed in 1983 to pave the way for the provisions of article 2202 of the Code Civil Mauricien (the 'Code') (the part relating to the creation of fixed and floating charges was inserted in the Code in 1983, though the Civil Code has been in existence over the island since 1808).

The charge instrument allowing for fixed and floating charges had, for historic reasons,

adopted a British format. As a result, the regime for taking security lacks coherence in Mauritius and has more or less been amended to fit the legal environment of the local banking sector. Since the coming into operation of the first banks in Mauritius, the British construct of the charge instrument was adopted and has remained more or less unchanged. Even for French banks in Mauritius the language governing fixed and floating charges remains English.

The charge instrument is a document that governs the conditions of the guarantee as opposed to the 'sanction letter' or 'letter of offer' where the bank informs the client that his lending proposal has been approved, setting out the conditions for repayment of the loan facility. The bank first issues the sanction letter or the letter of offer and only if the conditions of the loan are accepted by the client, the charge instrument to secure the loan is then also executed.

Both fixed charges and floating charges are created in favour of the bank or financial institution, duly approved by the Ministry of Finance, to secure repayment of the loan. These are called *institutions agréées* (authorised institutions). The fixed charge concerns security created over particular fixed assets for the repayment of the facilities; whereas the floating charge covers all undertakings, goodwill, movable and immovable properties as well as on all or any part of the properties of any kind and nature whatsoever and wheresoever both present and future (including debts receivable and other claims for moneys past, present and future).

To better approach this subject, the author will answer the following questions:

- what is a demand of payment?;
- when does a demand of payment become necessary?;
- what are the effects of a demand for payment?; and
- is a creditor entitled to take action under the charge instrument against its debtor without making a demand for payment?

What is a demand of payment?

Mauritian law does not define 'a demand for payment'; however, one may have recourse to the standard charge instrument used by all banks in Mauritius, which stipulates as follows:

> 'A demand for payment or any demand or any notice under the charge instrument may be given by any Manager or Officer of the Bank by letter served at the known address of the Company and/or Surety or sent by registered post addressed to the Company and/or Surety at the address given in the security or at the last known place of business of the Company and/or Surety and every demand made by post shall be deemed to have been made on the day the letter was posted.'

The foregoing leads us to infer that a demand for payment must be made in writing by the creditor and served on the guarantor. It is an extrajudicial process where the bank does not need to have recourse to the courts before communicating same. When does the demand of payment become necessary?

Prior to serving a demand of payment, a contractually agreed or legal event of default must have occurred.

What are the effects of a demand for payment?

A demand for payment will accelerate the loan and suspend any further facilities and require the debtor to comply therewith by repaying the indebtedness owed. Should he fail to do so the bank will be entitled to take whatever available remedies that are provided for in the charge document. These remedies may include the following.

The appointment of a receiver/manager

If the debtor is a company, the charge instrument would ordinarily provide for the appointment of a receiver or a receiver/manager in the event of non-payment for insolvency. The receiver/manager shall be the agent of the chargor, unless the instrument expressly provides otherwise. He alone will be liable for its acts and defaults and repayment and shall have the authority and be entitled to exercise the powers set out under the Insolvency Act 2009. The receiver is entitled to do all acts and things that may be necessary for or considered to be incidental or conducive to the carrying on of the business of the company and/or the surety. His powers include raising money with the consent of the creditor either on the security of the assets or without security and generally to take proceedings in the name of the company and/or surety or otherwise as may seem expedient to sell, alienate, dispose, pledge, mortgage, charge, create any real rights in respect of all or any part of the said assets and to make any compromises. A receiver and manager so appointed shall

have all the powers of the company and/or surety, more specially the power to sell all or any of the assets charged even after an effective order for the winding up of the company and/or the surety has been made and shall notwithstanding the appointment of the liquidator effect and complete such sales and effectively, alienate the assets and for that purpose sign all acts and deeds necessary to so sell, dispose or otherwise alienate those assets in whole or in part. The receiver and manager shall have the power to so sell those assets in the name of the company and/or the surety and to complete such sale by the execution of a conveyance even after that the company and/or surety is/are being wound up and a liquidator appointed. The proceeds of such sales shall remain with the receiver and manager notwithstanding the appointment of a liquidator.

Personal guarantee (principe du cautionnement)

This mode of guarantee is found under the provisions of article 2021 and following of the Code. It is a process whereby a guarantor intervenes by his signature and can be called upon to pay the debt if the principal debtor defaults. It is common in Mauritius for loans and other banking facilities granted to individuals, but the banks also make use of it by asking the directors of companies to intervene as guarantors in addition to the creation of fixed and floating charges over assets.

In the charge instrument, the bank usually requests a personal guarantee (whether from a corporate entity or an individual) for the purpose of securing the repayment of any money loaned or advanced, to be loaned, to be advanced, paid or to be paid under the charge instrument by the bank. This method is set out in the Code wherein the guarantor usually intervenes as a joint and several surety (*caution solidaire*). The guarantors usually bind themselves as joint sureties for the company in favour of the bank both for the repayment and discharge on demand of all monies and liabilities now or thereafter due and owing to the bank by the debtor company under the charge instrument in respect of capital, interest, costs and any accessories, and for the due and proper execution of all conditions therein stipulated and governing the facilities and other financial accommodations.

The bank is entitled under the provisions of article 2021 of the Code to request the 'surety' or the 'guarantor' to pay in lieu and stead of the principal debtor as if he was the main debtor.

Seizure and sale of property subject to a fixed charge

The bank is also entitled to seize the immovable property given in guarantee. In this it will have to comply with the provisions of the Sale of Immovable Property Act 1864 to sell the property that has been seized. The bank will have a *titre exécutoire*, which means it does not have to ask for a prior judgment from the court should it decide to seize and sell property given as collateral.

The proceeds of the sale are then shared among preferential creditors before the Master's Bar of the Supreme Court. Preferential creditors include the government, the revenue authorities, certain salaries etc.

Regarding the above available remedies, the question still remains as to whether the creditor may exercise its right against the debtor or guarantor without sending a prior demand for payment. The reply is found below.

Is a creditor entitled to take any action available under the charge instrument against its debtor without making a demand for payment?

This point has never been put to the Mauritius Supreme Court but we may rely on case law from the House of Lords.

The operative principle in banking law is that the relationship between a banker and its customer is that of a creditor and its debtor; but as a term of implied contract the money loaned is not repayable except on demand. In the case of *Lloyds Bank Ltd v Margolis and Others*,[1] Upjohn J held that time began to run from the date of the advances, so that the bank in that case was just within the statutory 12 days. In his judgment he said (at p 649):

> 'where there is the relationship of banker and customer and the banker permits his customer to overdraw on the terms of entering into a legal charge which provides that the money then due or is thereafter to become due is to be paid "on demand," that means what it says. As between the customer and the banker, who are dealing on a running account, it seems to me impossible to assume that the bank were to be entitled to sue on the deed on the very day after it was executed without making a demand and giving the customer a reasonable time to pay. It is indeed a

nearly correlative case to that decided in *Joachimson v Swiss Bank Corporation*[2] where the headnote was this – "where money is standing to the credit of a customer on current account with a banker, in the absence of a special agreement, a demand by the customer is a necessary ingredient in the cause of action against the banker for money lent."'

In this case the agreement has provided quite clearly what is to be done before the bank can sue for non-payment. They must demand the money.

The importance of a proper demand before the exercising of any rights of sale or foreclosure is emphasised by the decision in *Hunter v Hunter and Others*[3] where demand properly made was held by the House of Lords to have been waived by the taking of further security and the resumption for a year of normal working on the account.

The foregoing boils down to the principle that no inscribed creditor is entitled to take action against its debtor without sending a prior demand for payment to its debtor and/or guarantor that is then not satisfied.

Notes

1 (1954) 1 WLR 644.
2 (1921) 3 KB 110.
3 [1936] AC 222.

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Zambia: newly enacted netting legislation permits enforceability of the ISDA master agreement

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Introduction

The netting clause in the International Swaps and Derivatives Association (ISDA) Master Agreement and similar collateral gross settlement arrangements have hitherto not been fully enforceable in Zambia, an issue that has posed a serious risk to entities entering into collateral arrangements with Zambian counterparties. The danger has been that once a Zambian counterparty became insolvent and the process of sequestrating the assets had begun, interested entities would have to queue like other claimants to be paid their claims in accordance with established priority – notwithstanding that the obligations of the interested parties would have become immediately payable to the liquidator of the insolvent Zambian institution. In short, there was no possibility of enforcing the right to net off outstanding obligations and merely settle the net value. Fortunately, this problem and the associated risks will now be eradicated with the Zambian Banking and Financial Services Act No 7 of 2017 and the Corporate Insolvency Act No 9 of 2017.

The Corporate Insolvency Act No 9 of 2017

In 2017, the Zambian parliament passed the Corporate Insolvency Act No 9 of 2017 (the 'Corporate Insolvency Act') into law. The Corporate Insolvency Act provides for:

- corporate receiverships;
- appointment of receivers and the duties and responsibilities of receivers;
- business rescue, appointment, duties and responsibilities of business rescue administrators;
- rights of affected persons during business rescue proceedings and business rescue plans;
- schemes of arrangements or compromise with creditors;
- winding up of companies, appointment of liquidators and the duties and responsibilities of liquidators, committees of inspection, special managers and the Official Receiver;

- insolvency practitioners and the duties and responsibilities of insolvency practitioners; and
- cross-border insolvency and matters connected with, or incidental thereto.

With respect to netting off, once a corporate entity has entered liquidation or similar, section 164 of the Act provides as follows:

> **164.** *An unperformed obligation arising out of an agreement in respect of an asset which has been transferred for purposes of collateral security shall, on sequestrations of the estate, of either party to such agreement, terminate automatically at the date of sequestration and the value of the obligations shall be calculated at market value as at that date and shall be netted off and the net amount shall be paid.*

The import of this provision is that the netting clause in an ISDA Master Agreement and under similar arrangements is now fully enforceable in Zambia. If a party to an ISDA Master Agreement becomes insolvent and legal possession of its assets is taken, a process otherwise known as sequestration, the agreement terminates and the value of the obligations shall be calculated at market value as at that date and netted off, and only the net amount shall be paid. Counterparties to an ISDA Master Agreement and similar arrangements no longer have to wait to be paid in accordance with priority lists in law like other claimants of the insolvent party.

The Banking and Financial Services Act No 7 of 2017

The Banking and Financial Services Act No 7 of 2017 (the 'Banking and Financial Services Act') has also been passed into law. This provides, inter alia, for:

- the licensing of banking and financial businesses and for the provision of financial services;
- the incorporation of standards, principles and concepts of corporate governance in institutional systems and structures of banks and financial institutions;
- sound business practices and consumer protection mechanisms;
- the regulation and supervision of banking and financial services;
- to repeal and replace the Banking and Financial Services Act, 1994; and
- to provide for matters connected with, or incidental thereto.

The previous banking code, the Banking and Financial Services Act Chapter 387 of the Laws of Zambia, did not recognise the legal right to set-off or netting after the appointment of a receiver or the taking of possession of the bank or financial institution by the Bank of Zambia. Netting provisions were thus unenforceable after the insolvency of a financial institution. However, unlike before, provisions of the Banking and Financial Services Act permit the enforceability of the netting clause in the ISDA Master Agreement or similar arrangements after appointment of a receiver or possession of a bank of financial institution by the Bank of Zambia.

Section 76 of the Banking and Financial Services provides as follows:

> **76.** *(1) Where the Bank takes possession of a financial service provider—*
>
> *(a) despite the provisions of any other relevant law relating to extension of time, any term, whether statutory or contractual, on the expiration of which a claim or right of the financial service provider would expire or be extinguished, shall be extended by six months from the date of such expiration;*
>
> *(b) an attachment or lien, except for an attachment or lien existing twelve months prior to the taking possession of the financial service provider, shall be vacated;*
>
> *(c) an attachment or lien shall not attach to assets or property of the financial service provider during the period that the possession continues, except an attachment or lien created—*
>
> *(i) by the Bank in carrying out its role of lender of last resort; or*
>
> *(ii) in favour of a payment system, settlement system or settlement in netting or gross settlement arrangement;*

Further, section 120 of the Act provides as follows:

> **120.** *(1) Despite the Corporate Insolvency Act, 2017, or any other law, an insolvent financial service provider shall not—*
>
> *(a) receive deposits; or*
>
> *(b) enter into any new, or continue to conduct existing, banking or financial service business, except that which is necessary or incidental to the orderly realisation, conservation and preservation of the assets of a financial service provider.*
>
> *(2) A transaction with a depositor or a creditor and a settlement in a netting or gross settlement arrangement in accordance with a system of settlement approved by the Bank, or provided*

for in any other law shall not be treated as prohibited in accordance with subsection (1) by reason only that the insolvency transaction or settlement took place prior to—

(a) a resolution to liquidate the financial service provider; or

(b) the appointment of a receiver or the taking possession of the financial service provider by the Bank

The significance of these provisions is that netting off under an ISDA Master Agreement and similar arrangements is now permitted, even after the central bank as regulator has taken possession of a financial service provider or appointment of a receiver, as such netting off falls within what can be termed as a netting or gross settlement arrangement.

Conclusion

The provisions in the newly enacted Banking and Financial Services and the Corporate Insolvency Act permit netting arrangements even after the insolvency of a Zambian counter-party to an ISDA Master Agreement or under similar arrangements.

The importance of the provisions in the newly enacted legislation is that the netting clauses in the ISDA Master Agreement and in similar arrangements are now fully enforceable in Zambia. If a Zambian counterparty to an ISDA Master Agreement becomes insolvent and legal possession of its assets is taken, a process otherwise known as sequestration, the agreement terminates, and the value of the obligations shall be calculated at market value as at that date and shall be netted off with only the net amount to be paid. Counterparties, foreign or local under an ISDA Master Agreement or under similar arrangements, do not now have to wait to be paid in accordance with the priority list in the law like other claimants of the insolvent party. The ultimate result is reduced risks for investors in the country's financial markets.

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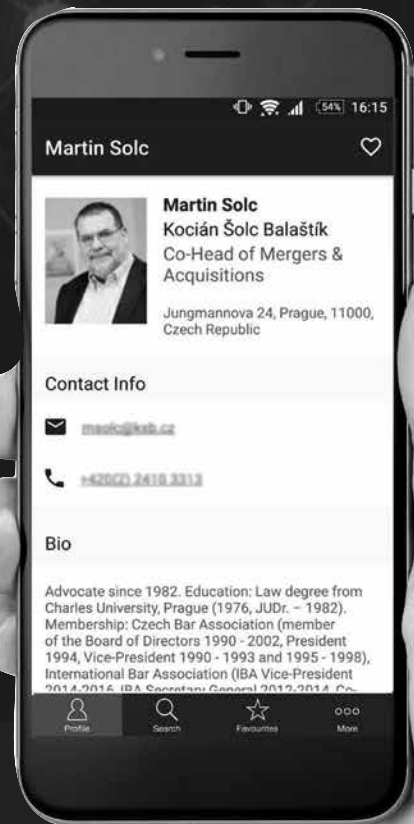

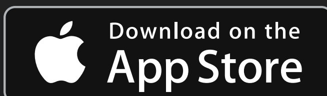

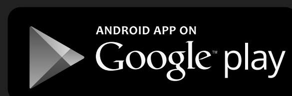

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