



Centre for Banking & Finance Law  
Faculty of Law

## Financial Law Amity Symposium

*A Symposium at the Faculty of Law, National University of Singapore,  
11<sup>th</sup> – 12<sup>th</sup> February 2019*

### Report of Proceedings

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The Centre for Banking & Finance Law (CBFL) at the Faculty of Law, National University of Singapore, focuses broadly on legal and regulatory issues relating to banking and financial services. It aims to produce research and host events of scholarly value to academics as well as of policy relevance to the banking and financial services community. In particular, CBFL seeks to engage local and international bankers, lawyers, regulators and academics in regular exchanges of ideas and knowledge so as to contribute towards the development of law and regulation in this area, as well as to promote a robust and stable financial sector in Singapore, the region and globally.

# ***Report of Proceedings on the Financial Law Amity Symposium***

Emma Leong (ed)

## **I. ABOUT THE SYMPOSIUM**

Post-global financial crisis, the field of banking and finance has evolved rapidly in the face of increasing regulation and swift technological change. International co-operation is necessary to tackle novel issues that push legal and ethical boundaries.

The Centre for Banking & Finance Law (“*CBFL*”) held a Financial Law Amity Symposium at the Faculty of Law, National University of Singapore on 11 – 12 February 2019 (the “*Symposium*”). Fifteen academics from around the world - China, Hong Kong, Israel, Norway, Malaysia, Singapore, South Africa, the United Kingdom and the United States - presented and discussed their research on a variety of topics relating to banking and financial law.

Topics converged around the areas of financial regulation and the adequacy/suitability of recent reforms, the protection of consumers in their dealings with financial institutions, and developments relating to the crypto-economy including initial coin offerings and artificial intelligence. The event facilitated the forging of new academic links and the inspiration of fresh ideas and insights into the law relating to banking and finance.

The Symposium was convened by Sandra Booyesen (Associate Professor, NUS Faculty of Law, and Deputy Director, CBFL) and Christian Hofmann (Assistant Professor, NUS Faculty of Law, and Executive Committee Member, CBFL) on behalf of the Centre.

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***PERSONAL VIEWS***

*The views expressed herein are those of the speakers in their private capacities and do not represent the views of their employers.*

*All reports of presentations are based on each speaker's individual presentation at the Symposium.*

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## A. INTRODUCTION

The Financial Law Amity Symposium organised by the Centre for Banking & Finance Law, National University of Singapore on the 11<sup>th</sup> and 12<sup>th</sup> February 2019 expounded both on recent developments in the field of banking and finance law, and revisited established banking law practices from novel perspectives. The Symposium provided a sweeping overview of past, present and future issues in the banking and finance industry. These issues can be broadly categorised into four themes: (i) customer protection; (ii) regulation; (iii) technological advancement in the banking sector; and (iv) comparative studies on banking practices.

## B. CUSTOMER PROTECTION

### 1. Product Suitability for Consumer Investors – Dora Neo, National University of Singapore, Faculty of Law

The collapse of Lehman Brothers in 2008 resulted in the loss of over S\$500 million by nearly 10,000 investors in Singapore who had invested in Lehman-linked products.<sup>1</sup> Numerous regulatory changes have since taken place to enhance investor protection. For instance, the passing of the Financial Advisers (Amendment) Bill in 2012 (the “*Bill*”) widened the scope of obligations imposed on financial adviser firms when communicating with customers. At the reading of the Bill, it was remarked that the purpose of implementing such regulation was to improve the financial advisory process in a way that would better serve investors and to develop a culture of advice that would benefit retail investors in particular.<sup>2</sup>

The provisions in the Bill enhanced safeguards against potential mis-selling, i.e. where an investor has been sold a financial product that was not suitable for his or her needs. These provisions were eventually adopted. Currently, the material provisions governing mis-

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<sup>1</sup> Melanie Lee, ‘Financial crisis politically awakens Singapore investors’ (*Reuters*, 7 November 2008) <https://www.reuters.com/article/us-financial-singapore-investors/financial-crisis-politically-awakens-singapore-investors-idUSTRE4A61O320081107> accessed 21 February 2019

<sup>2</sup> Statement by Mr Tharman Shanmugaratnam on the purpose of the proposed amendments in the Financial Advisers (Amendment) Bill 2012, Singapore Parliamentary Debates 15 November 2012, vol 89, pg. 39

selling are found at ss.25, 26 and 27 of the Financial Advisers Act (the “Act”). The focus of the paper was s 27, on product suitability, which is reproduced as follows:

*27.—(1) No licensed financial adviser shall make a recommendation with respect to any investment product to a person who may reasonably be expected to rely on the recommendation if the licensee does not have a reasonable basis for making the recommendation to the person.*

The protection accorded to investors under the Act is supplemented by the MAS Notice on Recommendations on Investment Products FAA-N16 (“*FAA-N16*”) and the Financial Advisers Regulations (“*FAR*”). The FAA-N16 sets out the requirements that apply to a financial adviser when it makes recommendations about products to clients, and the due diligence requirements and customer knowledge assessment that advisers need to undertake before selling such products. Likewise, regulation 18B of the FAR imposes product due diligence requirements on financial advisers to assess the suitability of new products for any targeted client. However, such protection does not currently apply where the target client is an accredited investor. With the passing of the Securities and Futures (Classes of Investors) Regulations 2018, from 8 April 2019, a person who meets the criteria to be classified as an accredited investor may be treated as an accredited investor only if he opts for such classification.

An investor who has suffered loss as a result of a recommendation made by a financial advisor without having a reasonable basis for doing so has recourse under s.27(3) of the Act, which entitles the investor to damages in respect of that loss. Under s.87 of the Act, a fine of \$12,500 would be imposed on the financial advisor in contravention.

These statutory provisions have not been tested in the courts in Singapore. But cases brought by investors against banks based on common law causes of action like misrepresentation, breach of contract, tort and breach of fiduciary duty have shown that it is by no means easy to succeed in a mis-selling claim against a bank. For example, in the case of *Deutsche Bank v Chang Tse Wen* [2013] 4 SLR 886 (“*Deutsche Bank v Chang Tse Wen*”), the Singapore Court of Appeal found on the facts that there was no contractual or tortious duty of care owed by the bank to the investor, and that there was no misrepresentation. The investor therefore failed to establish a USD 49 million claim against the bank for his investment losses. The decision of the Court of Appeal in *Soon Kok Tiang v DBS* [2012] 1 SLR 397 (“*Soon*”), indicated that a strictly contractarian approach towards

establishing any alleged mis-selling would be taken in Singapore. The Court stated that “*under the law of contract, a person who signs a contract which is set out in a language he is not familiar with or whose terms he may not understand is nonetheless bound by the terms of that contract. Illiteracy, whether linguistic, financial or general, does not enable a contracting party to avoid a contract whose terms he has expressly agreed to be bound by.*”<sup>3</sup> In *Soon*, the investors’ contracts had contained a non-reliance, non-advisory and own judgment clause. However, the investors did not challenge the validity of these clauses, but sought to set aside another contractual clause for uncertainty.

Any harshness arising from a strictly contractarian approach can potentially be mitigated in two ways. Firstly, by applying the Unfair Contract Terms Act (Cap. 396) (“*UCTA*”). While the argument is commonly made that a non-reliance clause is a “basis clause” which defines the obligations between the parties, and is therefore not caught by *UCTA*, in *Deutsche Bank v Chang Tse Wen*, the Singapore Court of Appeal warned against placing too much emphasis on the form of the clause as compared to its substance. They pointed out that section 13(1) of *UCTA* prevents a party from excluding or restricting liability by reference to a contractual term or non-contractual notice which excludes or restricts the relevant obligation or duty, and were of the view that this seemed to preclude any material distinction being drawn between clauses which exclude liability and those which restrict the scope of the duty or the obligation. It is notable that in the UK case of *First Tower Trustees v CDS (Superstores International) Ltd* [2018] EWCA Civ 1396, it was held that a non-reliance clause was to be subject to the test of reasonableness in the UK equivalent of *UCTA*. Secondly, the Consumer Protection (Fair Trading) Act (Cap. 62A) (“*CPFTA*”) may potentially be applicable to aid the investor. Section 4 of the *CPFTA*, which is applicable to financial products, protects the consumer from unfair practice:

4. — *It is an unfair practice for a supplier, in relation to a consumer transaction —*

- (a) *to do or say anything, or omit to do or say anything, if as a result a consumer might reasonably be deceived or misled;*
- (b) *to make a false claim;*
- (c) *to take advantage of a consumer if the supplier knows or ought reasonably to know that the consumer —*

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<sup>3</sup> *Soon Kok Tiang v DBS* [2012] 1 SLR 397 at [63]



- (i) *is not in a position to protect his own interests; or*
- (ii) *is not reasonably able to understand the character, nature, language or effect of the transaction or any matter related to the transaction; or*
  
- (d) *... to do anything specified in the Second Schedule.*

As per the CPFTA's second schedule, unfair practices may include taking advantage of the consumer by including terms and conditions that are harsh, oppressive or excessively one-sided so as to be unconscionable. However, it remains to be seen as to whether the inclusion of non-reliance, non-advisory or own judgment clauses would constitute an unfair practice under the CPFTA.

While a host of regulatory changes have been effected to ensure product suitability, there has been a dearth of case law testing the protection accorded by these regulations. The judicial attitude reflected in the results of decided Singapore cases tends toward upholding contractual certainty between parties. As long as contractual non-reliance, non-advisory or own judgment clauses remain in agreements between financial advisors and customers, it remains to be seen whether the investor protection that regulators hope to accord by way regulation can be achieved.

## **2. Law and Ethics: The Bank's Fiduciary Duty Towards Retail Customers – Ruth-Plato Shinar, Netanya Academic College, Israel**

Recent scandals that involved the largest global banks show deterioration in the level of ethics of banks. This situation can be answered in part by imposing a wide fiduciary duty on banks towards their retail customers.

The fiduciary duty is the strictest duty that exists in the realm of private law. The fiduciary must act in the best interests of his principal, and prioritise these interests over every other interest - including those of his own. The fiduciary duty imposes a higher standard of conduct than the requirement to act in good faith, which merely requires an individual to act fairly in the course of pursuing his own personal interests. In contrast, the fiduciary duty

is underpinned by a duty of loyalty, and obliges the fiduciary to prefer the interests of his principal over those of his own.<sup>4</sup>

While there is a common understanding of what imposing a fiduciary duty entails, the extent to which it is imposed on banks differs across jurisdictions.<sup>5</sup> In common law jurisdictions, it is a well-established principle that banks are self-interested and the bank-customer relationship is not a fiduciary one. A fiduciary relationship may only be recognised in exceptional circumstances, such as where there is a relationship of special proximity, or where the customer was accustomed to relying on the bank's advice.<sup>6</sup> In contrast, a bank-customer relationship is recognised as a fiduciary relationship in the European civil law tradition. However, this duty is limited in scope and is mainly implemented in the field of investments, and not in core banking transactions.

The broadest fiduciary duty is imposed on banks under Israeli law. The duty applies towards each and every customer, and to the whole spectrum of banking activities. This is especially pertinent given the huge disparity of power between the bank and its customers, and the concern – that has materialised more than once - that the bank may abuse its power to the detriment of the customer.

Imposing a fiduciary duty on banks is a most suitable vehicle for diluting the power of the banks and ensuring that it is not abused to the detriment of customers; for justifying the legitimate expectations of the customers that the bank would act in their best interests; and for instilling norms of ethics in the banking activity. There would be numerous beneficial externalities arising from the imposition of a wide fiduciary duty on the banks. These include ensuring a wide duty of disclosure and explanation towards the customer,<sup>7</sup> facilitating responsible lending, showing flexibility towards customers that encounter financial difficulties, and even the situation where banks would inform customers of possibilities to save fees. The fiduciary duty of banks should not be construed as an

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<sup>4</sup> Ruth Plato-Shinar, "An Angel Named 'The Bank': The Bank's Fiduciary Duty as the Basic Theory in Israeli Banking Law", 36 Common Law World Review 27- 49 (2007)

<sup>5</sup> Ruth Plato-Shinar, Rolf Weber, "Three Models of the Bank's Fiduciary Duty, 2 Law and Financial Markets Review 422-438 (2008)

<sup>6</sup> *Lloyds Bank Ltd v. Bundy* [1975] QB 326 (CA), *Woods v. Martins Bank* [1959] 1 QB 55

<sup>7</sup> Ruth Plato-Shinar, "The Bank's Duty of Disclosure – Towards a New Model", 27 Banking & Finance Law Review 427-444 (2012)

altruistic duty, but rather as a legal instrument designed to ensure a basic level of professional ethics in the activities of the banks.<sup>8</sup>

In sum, imposing such a fiduciary duty would alter bank practice in a very positive manner and would lead to the creation of an appropriate culture of bank ethics.

### **3. Customer-Oriented Corporate Governance – Sung Eun (Summer) Kim, University of California Irvine, School of Law**

This project challenges the conventional view of ownership and control in corporate law scholarship which regards shareholders as principals and managers as their agents. Under the conventional framework, consumers are regarded as one of the objects to be managed by managers in their maximisation of shareholder value. The speaker shows how consumers have taken on new roles in contemporary society that requires an update to the legal status of consumers within firms.

For example, a consumer of a crowdfunded product does not take shares but provides capital and product design advice during the early and critical stages of the product's development. A consumer using a ride sharing application makes significant contributions to building the platform and provides real-time feedback regarding their experience which is used to incentivize desirable behaviour within the platform. A purchaser of a token in an initial coin offering (“ICO”) purchases a medium of exchange that can be used on a particular network, with the value of the token determined by the network's success.

In each of these examples, consumers offer critical input that are connected to the long-term value of the firm. Hence, the speaker illustrates how these consumer characteristics are functional equivalents of the characteristics that legal theories of the firm have long relied upon to justify the law's treatment of shareholders as owners and principals of firms. By bringing attention to the increasingly important role of consumers in corporate governance, the speaker suggests updates to the legal status of consumers that are more commensurate with their contributions. The growing significance of consumer markets has been undeniable. In Q2 of 2018, consumer spending in the US approximated \$14 trillion, and the average American spent over \$60,000 in 2018. Work done by American economists

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<sup>8</sup> "Law and Ethics: The Bank's Fiduciary Duty towards Retail Customers", in *Research Handbook on Ethics in Banking and Finance* (William Blair, Rosa Lastra and Costanza Russo, eds. Edward Elgar, forthcoming in 2019).

have shown that there is correlation between consumer satisfaction and the performance of firms.<sup>9</sup>

Given the rising importance of consumers in contemporary firms, both as a source of funding and in terms of their impact on firm performance, it is arguably beneficial to expand the notion of ownership and to implement a consumer-as-owner framework. This framework would entail the following: firms owing fiduciary duties to consumers, consumers having increased voting rights, and consumers having enhanced participation and consultation rights - these are pre-existing concepts that already exist in other legal relationships. For example, in the USA, shareholders are substituted by creditors in insolvency proceedings. Likewise, consumers should be accorded the same substitution to the extent that they are the residual claimants of firms. The fiduciary duties that bank directors owe depositors in the USA could be similarly extended to firm directors in the context of consumers to the extent consumers are the victims of the market failures that the fiduciary laws aim to remedy.

Critics of the consumer-as-owner framework argue that this would lead to a diffusion of focus resulting from the enlargement of the ownership class. There would also be significant administrative challenges in pinning down the class of owners constituting consumers. Admittedly, these are legitimate concerns, but none of which the speaker views to be insurmountable, particularly with the increasing availability of new technologies in corporate governance.

#### **4. Trusts and Company Charges – Hans Tjio, National University of Singapore, Faculty of Law**

How has the concept of “intermediate rights” developed recently? *Prima facie*, the concept of the proprietary right seems to have been overused. In *Schmidt v Rosewood Trust* [2003] 3 All ER 76, the Privy Council held that a proprietary right was “was neither sufficient nor necessary for the exercise of the court's jurisdiction”.<sup>10</sup> In that instance, it was sufficient

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<sup>9</sup> Nick Bontis, Lorne D. Booker, Alexander Serenko, "The mediating effect of organizational reputation on customer loyalty and service recommendation in the banking industry" (2007) *Management Decision*, Vol. 45 Issue: 9, pp.1426-1445 <<https://doi.org/10.1108/00251740710828681>> accessed 21 February 2019; Thomas S. Gruca, Lopo L. Rego, "Customer Satisfaction, Cash Flow, and Shareholder Value" (2005) *Journal of Marketing*, Vol. 69, No. 3, pp. 1-130. <<https://doi.org/10.1509/jmkg.69.3.1.66358>> accessed 21 February 2019

<sup>10</sup> *Schmidt v Rosewood Trust* [2003] 3 All ER 76 at [50-51], [52], [54], [55], [58], [66-67], [69]

that the beneficiary's right was enforced pursuant to the court's inherent jurisdiction to supervise a trust. Yet, it would be careless to completely dismiss the concept of proprietary rights. The growing use of intermediate rights (i.e. rights that are short of property rights, but more than contractual rights) in legal analysis has proven useful; in particular by allowing for more flexibility to reach pragmatic solutions in adjudicating on cases involving novel lending practices.

Interests may be intermediate where they are ascribed to an indefinite class of singular persons, or a defined class of numerous persons. Such intermediate interests may arise in a trust situation, in secured transactions, leases or bailment. In *Ernest Ferdinand Perez De La Sala v Compañía De Navegación Palomar, SA* [2018] SGCA 16, the concept of beneficial "ownership" was conceptualised as a "right against a right" i.e. a right to constrain or control the way another person exercises his right to deal with a thing, rather than a right against the thing itself.<sup>11</sup> This analysis of having an intermediate right that is short of a "right to a thing" is congruent with the recent approach in the UK. In *Akers and others v Samba Financial Group* [2017] UKSC 6, the Supreme Court held that a wrongful disposition by a trustee of trust assets does not give the beneficiary as against the recipient of trust property the same rights as the beneficiary had under the trust as against the trustee.<sup>12</sup> Instead, the beneficiary only has the right to have the trust assets restored to the original trustee.<sup>13</sup> Hence, the action against a trustee for breach of duties is not proprietary in nature.

The prevalent trend in the Singapore courts towards using the "intermediate interest" analysis has resulted in a divergence between the Singaporean and the English approach towards characterising proprietary interests. In *SCK Serijadi Sdn Bhd v Artison Interior Pte Ltd* [2019] SGCA 05 ("*SCK Serijadi*"), the Court of Appeal held that an equitable charge created upon service of a garnishee order *nisi* does not create a proprietary interest in the sense of an absolute right to have the subject property to be applied for the sole benefit of the rightholder, which may be asserted against all third parties.<sup>14</sup> Rather, the garnishee order creates a "proprietary interest" which essentially is a less extensive right to prevent the owner from exercising his full, unfettered right to deal with the subject property in a

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<sup>11</sup> *Ernest Ferdinand Perez De La Sala v Compañía De Navegación Palomar, SA* [2018] SGCA 16 at [145]

<sup>12</sup> In *Akers and others v Samba Financial Group* [2017] UKSC 6 at [46]

<sup>13</sup> *ibid.*

<sup>14</sup> *SCK Serijadi Sdn Bhd v Artison Interior Pte Ltd* [2019] SGCA 05 at [17]

manner that is inconsistent with the rightholder's interest.<sup>15</sup> This is in contrast to the English approach which deems a garnishee order as creating an equitable charge.<sup>16</sup>

The shift towards the conceptual use of intermediate interests can arguably be said to be a fruit of economic functionalism. In *Diablo Fortune Inc v Duncan, Cameron Lindsay and another* [2018] 2 SLR 129 (“*Diablo*”), the Court of Appeal rejected the argument that a lien over a sub-freight (the “Lien”) created a *sui generis* right for its owners to intercept the sub-freight.<sup>17</sup> Additionally, the Court rejected the argument that the Lien could not have been a floating charge because they do not confer a proprietary right until the Lien is exercised<sup>18</sup> - rather, the Lien was indeed characterised as a floating charge.<sup>19</sup> In doing so, the Court employed nuanced legal analysis akin to the conceptual framework of intermediate rights. On a conceptual level, the Lien, as a floating charge, was an instrument which conferred an immediate security interest.<sup>20</sup> However the chargee would enjoy a proprietary interest in the charged assets only after the event of crystallisation.<sup>21</sup> Arguably, the *Diablo* decision serves to protect 3<sup>rd</sup> parties by rejecting the theory that the Lien gave rise to a conceptual right of interception. In *Diablo*, the Lien, having been unregistered, was void against the charterers' creditors. By diluting the security interest, the Singapore courts are afforded more flexibility to protect third party rights. This flexibility would allow room to accommodate international developments in lending practices while affording adequate protection to third parties.

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<sup>15</sup> *SCK Serijadi Sdn Bhd v Artison Interior Pte Ltd* [2019] SGCA 05 at [18]

<sup>16</sup> *Galbraith v Grimshaw and Baxter* [1910] 1 KB 339 at 343; *Société Eram Shipping Co Ltd v Compagnie Internationale de Navigation and others* [2003] 3 WLR 21

<sup>17</sup> *Diablo Fortune Inc v Duncan, Cameron Lindsay and another* [2018] 2 SLR 129 at [26]

<sup>18</sup> *Diablo Fortune Inc v Duncan, Cameron Lindsay and another* [2018] 2 SLR 129 at [55]

<sup>19</sup> *Diablo Fortune Inc v Duncan, Cameron Lindsay and another* [2018] 2 SLR 129 at [36]

<sup>20</sup> *Diablo Fortune Inc v Duncan, Cameron Lindsay and another* [2018] 2 SLR 129 at [49]

<sup>21</sup> *Ibid.*

### 1. Prudential Regulation and Secured Transactions Law: Is a Sound and Inclusive Credit Environment Achievable? – Giuliano G. Castellano, University of Hong Kong, Faculty of Law & Asian Institute of International Financial Law

Prudential regulation and secured transactions law represents key legal and regulatory components sustaining credit-based economies. Oscillating between the need of expanding credit creation to promote economic growth and the urgency of controlling the excessive accumulation of debt, modern economies depend on private law rules and regulatory provisions that originate in different fora of the international law-making arena.<sup>22</sup> Under the auspices and guidance of international organisations concerned with the alleviation of poverty, a growing number of jurisdictions across the globe have embarked upon substantial legal reforms to facilitate credit expansion and financial inclusion through a credit environment that favours security rights on a wide array of personal property items.

Through international regulatory standards, prudential regulation establishes, *inter alia*, the amount of capital that – relative to the total investments and in proportion to the risks acquired – regulated deposit-taking institutions (for simplicity, banks) must not fund with borrowed money. Broadly speaking, capital regulation reflects the general twofold aim of prudential regulation of promoting the soundness of individual banks and the stability of the financial system as a whole. These two branches of law intersect when banks secure the repayment of loans with collateral. Nonetheless, from a regulatory standpoint, not all security rights are considered to offer sufficient protection against credit risk.

Although it is not surprising that from a prudential perspective not every item of property could mitigate credit risk with the same vigour, an inconsistency surfaces. Core legal devices designed by private law rules to qualify a transaction as “secured” through a proprietary entitlement may be, *de facto* and *de jure*, equated to unsecured credit, under regulatory regimes.

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<sup>22</sup> Castellano, Giuliano G. and Dubovec, Marek, Global Regulatory Standards and Secured Transactions Law Reforms: At the Crossroad between Access to Credit and Financial Stability (March 30, 2018). Fordham International Law Journal, Vol. 41, No. 3, 2018. Available at SSRN: <https://ssrn.com/abstract=3152934>

The dissonance between secured transactions law and capital requirements has knock-on effects on access to credit and financial stability that requires further investigations in order to understand their consequences on the credit supply.<sup>23</sup> More broadly, international standard setters, such as the UN Commission on International Trade Law (“*UNCITRAL*”) and the Basel Committee on Banking Supervision (“*BCBS*”), should aim to enhance coordination between these two branches of the law. This point was advocated at the *UNCITRAL* 50<sup>th</sup> Anniversary Congress in 2017.<sup>24</sup> This resulted in a new mandate for *UNCITRAL* to engage in a process of coordination with the *BCBS*<sup>25</sup> and to consider the regulatory treatment of security rights within a new international soft-law instrument, namely, in Chapter III of the draft Practice Guide to the *UNCITRAL* Model Law on Secured Transactions.<sup>26</sup> Further research and policy coordination, however, remain to be done in order to ensure that law reforms at the domestic level are geared to promote an inclusive *and* prudent access to credit.

## **2. The Regulation of Securities Banking, in the Aftermath of Basel III – Vincenzo Bavoso, University of Manchester, School of Law**

Post-crisis, there has been increasing emphasis on market-based channels of financial intermediation to alleviate burden traditionally borne by banks. In particular, regulation has been increasingly implemented to make capital markets more resilient. One such piece of regulation is the Basel III framework, which aims to build on existing regulatory infrastructure. Basel III is targeted at large financial institutions such as dealer banks or systemically important financial institutions (“*SIFIs*”) to limit any potential build-up of risky exposures. This is mainly done by increasing the cost for large financial institutions to engage in balance sheet expansion. Basel III attempts to build on the three-pillar

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<sup>23</sup> Castellano, Giuliano G. and Dubovec, Marek, Credit Creation: Reconciling Legal and Regulatory Incentives. Law and Contemporary Problems, Vol. 81, No. 1, 2018. Available at SSRN: <https://ssrn.com/abstract=3069594>

<sup>24</sup> Castellano, Giuliano G. and Dubovec, Marek, Coordinating Secured Transactions Law and Capital Requirements (June 20, 2017). Modernising International Trade Law to Support Innovation and Sustainable Development (*UNCITRAL* 50th Anniversary Congress, 4-6 July 2017, Vienna). Available at SSRN: <https://ssrn.com/abstract=3077243>

<sup>25</sup> See United Nations, Report of the United Nations Commission on International Trade Law, Fiftieth session (3-21 July 2017). General Assembly Official Record (Supplement 17); at para 402

<sup>26</sup> Chapter 3 of Practice Guide represents a novelty for a number of reasons. First, *UNCITRAL*, for the first time since its establishment, has been dealing on regulatory matters. Second, Chapter 3 illustrates that, from a prudential policy perspective, the reduction of credit risk is not automatic; certain conditions must be met for security rights to mitigate risk, pursuant to international capital standards. The finalised text will be submitted to the Commission for approval in July 2019 and it will be available here: [https://uncitral.un.org/en/working\\_groups/6/security\\_interests](https://uncitral.un.org/en/working_groups/6/security_interests)



approach present in its predecessor, Basel II. These three pillars constitute a minimum capital requirement, a supervisory review process, and market discipline.

To understand the risks that Basel III is meant to regulate, the nature of the banking industry in pre-crisis years must be examined. Pre-crisis, the business model of large banks progressively shifted more traditional depositor-based models towards wholesale models. Banks' balance sheet expanded exponentially in the pre-crisis years as it incorporated changing models of assets, liabilities and transactions.

*Figure 1: Assets and liabilities of traditional commercial banks*

<b>Mortgages and other secured loans</b>	<b>Deposits</b>
Interbank loans	Borrowing from other banks
Other unsecured loans	Bank capital (equity)
Securities (such as government bonds)	
Reserves and cash items	

*Figure 2: Assets and liabilities of dealer banks*

<b>Asset-backed securities (1 to 3 year maturity)</b>	<b>Repo agreements with money market funds</b>
Derivatives exposures	Long-term debt
Loan-type assets	Deposits
	Bank capital (equity)

Beyond the balance sheet, the practice of securitised banking grew. Securitised banking has been described as the “money market funding of capital market lending”<sup>27</sup> whereby dealer banks repackaged loans on their assets side and sold them in the capital markets. Regarding liabilities, dealer banks chiefly relied on short-term funding from money market funds through repurchase contracts.

<sup>27</sup> Perry Mehrling, “Direct and Indirect Finance” (2015) <<http://www.perrymehrling.com/wp-content/uploads/2015/05/Lec-17-Direct-and-Indirect-Finance.pdf>> accessed 21 February 2019

Figure 3: Shape of dealer banks' (on and off) balance sheet

<b>Repackaged receivables</b>	<b>Short-term funding</b>
Securitised bonds sold to capital markets investors via SPVs	Repurchase agreements
Derivatives exposures with asset managers and other banks	Money market mutual funds

The expansion of banks' balance sheets into market-based segments created regulatory arbitrage opportunities. Capital requirements were completely stultified due to use of securitisation and off-balance sheet finance, and market-based intermediation allowed uncontrolled credit creation and therefore an increase in leverage both at firm and systemic level. Essentially, the growth of a shadow banking system which replicates bank-like functions and forms of maturity transformation, without similar regulatory constraints (such as capital and deposit insurance protection).

The inadequacy of the Basel II framework is rooted in its failure to incorporate banks' activities on capital markets such as securitisation and off-balance sheet exposures. It had an overwhelmingly micro-prudential approach as it neglected the systemic effect of such activities, whereby banks essentially shifted promises around in the financial system. The inherent weakness of Basel II's core pillars, such as the pillar of market discipline, contributed to its inadequacy. The pillar of market discipline incorrectly assumes that leverage and banks' risky practices would be monitored by market participants. However, this is a severely overreaching assumption.

Hence, Basel III attempts to remedy the inadequacies of Basel II, largely by emphasising the improvement of the quality and quantity of bank capital. Under Basel III, Tier 1 capital (i.e. equity and retained earnings) must be at least 4.5% of risk-weighted assets at all times. The sum of Tier 1 and Tier 2 capital (i.e. revaluation reserves, undisclosed reserves, hybrid instruments and subordinated term debt) must be at least 8% of risk-weighted assets at all times. There is also an additional capital conservation buffer of 2.5% that can be triggered in order to reduce pro-cyclicality. These capital requirements are to be applied evenly across jurisdictions.

Admittedly, the reforms on capital, liquidity and leverage add an important layer of safety to the financial system as they make it more expensive for large banks to engage with

wholesale, market-based activities. However, as long as Basel III is built on the same pillars as Basel II with market discipline as a key pillar, regulatory arbitrage will still be likely and banks are able to shift promises around the financial system in order to alter the capital weight. In light of this, the effectiveness of Basel III remains to be seen.

### **3. Contracts, Investor Protection, Prudential Regulation and Systemic Risk – Mads Andenas, University of Oslo, Faculty of Law**

The interplay between private law and regulatory rules on investor protection is a multi-faceted affair. The first facet, which could be coined as ‘self-regulation’, proposes that fiduciary duties should prevail over contract and Lloyd’s rules. This approach was illustrated by Donaldson J in *North and South Trust Co v Berkeley* [1971] 1 WLR (“*North and South Trust*”). *North and South Trust* was concerned with the practice of Lloyd’s insurance brokers acting as agent for both their customers and also, in certain respects, the underwriters in the settling of claims. Donaldson J held that “fully informed consent apart, an agent cannot lawfully place himself in a position in which he owes a duty to another which is inconsistent with his duty to his principal”.<sup>28</sup> If the agent does so, his unlawful act provides him with no defence to a claim by his true principal for compensation for loss resulting from the agent's inability, due to the conflict of duties, fully to discharge his duty to that principal.<sup>29</sup> Thus, fiduciary duties took precedence over standard practice in the insurance industry and served to protect the investor’s interests.

The second facet would be to consider contractual provisions as providing investor protection. In *Equitable Life Assurance Society v Hyman* [2000] UKHL 39 (“*Equitable Life*”), the Society’s directors had calculated the final bonuses to be allocated to policyholders in a manner which was contrary to the policy terms. Notably, the contractual provision conferring the power to declare bonuses contained no express restriction on the power. The House of Lords held that where a life assurance company had issued retirement policies which guaranteed certain returns, the policy holders had a proper and reasonable expectation that those promises would be met.<sup>30</sup> The discretion given to the directors to set the levels of returns must be read to be subject to the prior expectation created, and must

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<sup>28</sup> *North and South Trust Co v Berkeley* [1971] 1 WLR at 484

<sup>29</sup> *North and South Trust Co v Berkeley* [1971] 1 WLR at 485

<sup>30</sup> *Equitable Life Assurance Society v Hyman* [2000] UKHL 39 at 459

be exercised accordingly subject to those expectations.<sup>31</sup> Hence, contractual provisions may serve to protect investors' financial interests.

Thirdly, one could consider whether regulatory rules should strictly constitute the 'safe haven' for investors, replacing protection accorded to investors through private law means. The judicial attitude in *Caparo Industries PLC v Dickman* [1990] UKHL 2 ("*Caparo*") was arguably symptomatic of this approach. In *Caparo*, Lord Jauncey cited Part VII of the Companies Act 1985 concerning the circulation of a company's accounts, and concluded that these statutory accounts were prepared and distributed for a limited purpose which did not include advice to individual shareholders in relation to present or future investment.<sup>32</sup> Consequently, there could not be imposed upon auditors an additional common law duty to individual shareholders who choose to use these accounts for another purpose without the prior knowledge of the auditors.<sup>33</sup> Thus, the rights of individual investors were strictly circumscribed to those accorded to them by way of regulation.

However, on the other side of the coin, regulatory rules according investor protection may in instances be given effect by way of private law. This is the approach taken by the implementation of EU directives by way of national legislation. For example, the 2004 Markets in Financial Instruments Directive and the 2014 revised version ("*MiFID II*") lay down conduct of business rules, which include the duty to provide information to clients about costs and risk of investments; and the duty to tailor advice to characteristics of client.<sup>34</sup> Article 69(2) MiFID II requires EU Member States to provide in national law for an administrative mechanism under which compensation can be paid or other remedial action can be taken in case financial loss or damage is incurred as a result of breach of the MiFID II.

Finally, by way of coming full circle, contract or regulatory rules may in some instance limit fiduciary duties. The extent to which fiduciary duties should be limited by contract or regulatory rules was the subject of the UK Law Commission's consultation paper on Fiduciary Duties and Regulatory Rules.<sup>35</sup> The Law Commission then recommended that legislation could provide that a court must take account of a reasonable regulatory rule in

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<sup>31</sup> *Equitable Life Assurance Society v Hyman* [2000] UKHL 39 at 460

<sup>32</sup> *Caparo Industries PLC v Dickman* [1990] UKHL 2 at [662]

<sup>33</sup> *ibid.*

<sup>34</sup> Article 22(2) and 22(4) MiFID II

<sup>35</sup> Law Commission, *Fiduciary Duties and Regulatory Rules – A Consultation Paper* (Consultation Paper No. 124, 1992) <<http://www.lawcom.gov.uk/app/uploads/2016/08/No.124-Fiduciary-Duties-and-Regulatory-Rules-A-Consultation-Paper.pdf>> Accessed 21 February 2019

determining the content of a fiduciary obligation and whether there has been a breach.<sup>36</sup> The Law Commission took the position that “in view of the uncertainty [of the extent of fiduciary obligations], legislation may ... be desirable”.<sup>37</sup> Thus, protection accorded to investors under the general umbrella of fiduciary duties may be limited by express regulation.

#### **4. Drawing the Line between Monetary Policy and Monetary Financing: The Unresolved Issue in the Law of Central Banking – Christian Hofmann, National University of Singapore, Faculty of Law**

What ambit of discretion should be accorded to central banks? Specifically, where should the line between monetary policy and monetary state financing be drawn? The answers have important ramifications given the vast powers and responsibilities accorded to central banks. Central banks influence the amount of liquidity in financial markets, mainly by trading securities in secondary markets. A central bank may employ a conventional monetary policy which is characterised by low levels of interference with liquidity supply and liquidity management of banks, and even less interference with non-bank financial institutions. Alternatively, an unconventional monetary policy may be used; and this would include the massive distribution of liquidity to intermediaries and markets by way of unlimited lending to banks, or massive intervention in secondary markets for financial instruments.

The practice of central banking is undergirded by several key principles. Firstly, the principle of central bank independence. The decision-making process of a central bank should not be based on any formal directions from any segment of the government. Central banks should have autonomous decision making to ensure sufficient capitalisation, and whether to distribute or retain profits. A more sophisticated method of determining central bank independence would be to evaluate whether the appointment of key central bank officers coincide with the appointment of a new government. Secondly, legal limits to the powers of central banks i.e. the use of legislation to define the tasks and objectives, as well

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<sup>36</sup> Law Commission, *Fiduciary Duties and Regulatory Rules – A Consultation Paper* (Consultation Paper No. 124, 1992) para 6.27 <<http://www.lawcom.gov.uk/app/uploads/2016/08/No.124-Fiduciary-Duties-and-Regulatory-Rules-A-Consultation-Paper.pdf>> Accessed 21 February 2019

<sup>37</sup> *ibid.*

as mandates of central banks. For example, Article 123(1) of the Treaty on the Functioning of the European Union (“*TFEU*”) prohibits monetary state financing.

However, it is less clear whether the legality of singular decisions taken by central banks can be successfully challenged in court. In *Weiss and Others*<sup>38</sup>, several groups of individuals brought constitutional actions regarding the German Central Bank’s implementation of the Public Sector Purchase Programme (“*PSPP*”) before the German Federal Constitution Court. The PSPP is one of four sub-programmes implemented by the European Central Bank in 2015. Also known as quantitative easing, these programmes were targeted at responding to deflation risks in the Eurozone, and to maintain price stability. In turn, the German Federal Constitution Court requested a preliminary ruling from the European Court of Justice (“*CJEU*”).

In determining the legality of the German Central Bank’s implementation of the PSPP, the CJEU firstly applied a proper reasoning test. It held that there exists a wide discretion of the Eurosystem when deciding in matters of monetary policy because it must make choices of a technical nature and base its decisions on complex forecasts.<sup>39</sup> Judicial interference would be appropriate only in instances of manifest errors of assessment, and monetary policy decisions must be reasoned in ways that enable the CJEU to exercise its powers of review, yet need not necessarily go into every relevant point of fact and law. The CJEU ultimately found that all purchases by the German Central Bank under the PSPP were necessary because prior monetary measures failed to achieve the envisaged economic stimulus and the targeted inflation rate of approximately 2% in the Eurozone.

A two-step test of proportionality was also applied by the CJEU, i.e. to determine whether the monetary policy measures were proportionate to pursued objectives. Firstly, the CJEU reviewed the Eurosystem’s economic analysis of which monetary policy measures to apply and to what end. Notably, in doing so the CJEU relied on the Eurosystem’s statements and did not critique its economic analyses. The CJEU then assessed the proportionality of the PSPP for the declared objective of raising inflation, and accepted that the Eurosystem’s statement that measures with less intrusive effects on the sovereign debt markets fail to achieve goal.

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<sup>38</sup> Case C-493/17 *Weiss v Others* ECLI:EU:C:2018:1000

<sup>39</sup> Case C-493/17 *Weiss v Others* ECLI:EU:C:2018:1000 at [24]

The CJEU's ruling shows the court's reluctance in questioning the Eurosystem's economic policy agenda. The CJEU did not address the crux of the complainants' case, that the implementation of the PSPP had already exceeded the European Central Bank's mandate and undermined the German constitutional identity given the volume of purchases made under the PSPP and the prolonged period of its application. Given that the CJEU decided on the legality of the German Central Bank's implementation of the PSPP by reference to the Eurosystem's own policy objectives, it begs the question whether the substantive merits of (European) central banks' decisions (and correspondingly, the exercise of discretion) can be challenged as long as it coheres to Eurosystem monetary policy objectives.

##### **5. The I(l-)egitimacy of the EU Post-Crisis Bailout System - Michael Schillig, King's College London, The Dickson Poon School of Law**

Post-crisis, there is a trifurcated system of bailout regimes at the EU level. Firstly, the Bank Recovery and Resolution Directive ("*BRRD*") as adopted by the Single Resolution Mechanism ("*SRM*") (collectively, the "*BRRD/SRM*"). Secondly, the EU state aid regime that may be channelled through resolution financing arrangements, government financial stabilisation tools or through the European Stability Mechanism. Thirdly, recourse to corporate insolvency laws. While each forming a distinct element of the bailout regime, the trifurcated regime is an interdependent one. The EU post-crisis bailout system can be evaluated through a system analysis approach i.e. to break it down into its constituent parts, to determine the nature and identity of its subsystems, and to explain the relationships among them,<sup>40</sup> and by using the concept of regulatory legitimacy. Regulatory legitimacy can be further broken down into the sub-components of 'input legitimacy' and 'output legitimacy'.

Arguably, the current bailout system facilitates bailout decisions that lack legitimacy, because the system is unable to produce output that meets the bailout system's purpose of limiting bail-outs that are 'pie-increasing' and hence desirable. As with the case with Banca Popolare di Vicenza ("*Banco Popolar*"), the current system leads to extensive bailouts of institutions that are, at best, only able to generate modest bailout benefits. In the Banco Popolar example, the BRRD/SRM resolution framework was applied to allow the write

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<sup>40</sup> Lynn LoPucki, "The Systems Approach to Law" (1997) 82 Cornell L. Rev. 479 at 482-483

down and conversion of capital instruments, in combination with the sale of business tool.<sup>41</sup> The resolution scheme entailed in a first step the write down and conversion of capital instruments: four billion ordinary shares with a par value of EUR 0.50, amounting to a share capital of EUR 2 billion, were written down and cancelled to 100%; various Tier 1 instruments were first converted at par value into newly issued shares resulting in 1.35 billion of EUR 1 par value shares, which were subsequently written down and cancelled to 100%; various Tier 2 instruments were converted at par into newly issued shares resulting in 684 million of EUR 1 par value shares and transferred to Banco Santander for EUR 1.

*Prima facie*, the Banco Popular resolution appears to be an exemplary application of the BRRD/SRM resolution framework with minimal market disruption and without any taxpayer contribution.<sup>42</sup> However, it is pertinent that the preliminary valuation of Banco Popular's net asset value attributed a figure that was almost equal to the aggregate of additional Tier 1 and Tier 2 instruments. This coincidence meant that the potentially more disruptive bail-in of junior or senior bond holders and the injection of resolution fund money could be avoided.<sup>43</sup> Instead, it is likely that Banco Santander received tacit assurances of contingent loss absorption in the form of guarantees or options to put any non-performing loans back to the Spanish government, hence concealing the true nature and cost of the transaction as a partial bailout.<sup>44</sup>

Ultimately, the bailout system could be improved by re-calibrating the interplay between each element. This could be done by transforming the BRRD/SRM resolution framework into the EU's Bank Resolution and Insolvency Code, with national corporate insolvency law and the EU State aid regime resigned to supporting roles within the resolution framework. This would then significantly reduce the complexity of the current EU bailout framework and thereby enhance transparency and legitimacy of future bailout decisions.<sup>45</sup>

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<sup>41</sup> Single Resolution Board "Decision of the Single Resolution Board in its Executive Session of 7 June 2017 concerning the adoption of a resolution scheme in respect of Banco Popular Español, S.A with a Legal Entity Identifier: 80H66LPTVDLM0P28XF25, Addressed to FROB" (7 June 2017) (SRB/EES/2017/08) paras 9-18 <[https://srb.europa.eu/sites/srbsite/files/srb\\_decision\\_srb\\_ees\\_2017\\_08\\_non-confidential\\_scanned.pdf](https://srb.europa.eu/sites/srbsite/files/srb_decision_srb_ees_2017_08_non-confidential_scanned.pdf)> Accessed 21 February 2019

<sup>42</sup> FT View, "Banco Popular process is a model for failing banks" Financial Times (8 June 2017)

<sup>43</sup> Thomas Hale, Robert Smith & Martin Arnold, "Banco Popular's failure leaves questions unanswered", Financial Times (4 July 2017)

<sup>44</sup> Edward J. Kane, "Europe's Zombie Megabanks and the Deferential Regulatory Arrangements that Keep them in Play" (15 September 2017) <<https://ssrn.com/abstract=3038510>> Accessed 21 February 2019

<sup>45</sup> Transparency International EU, "Two Sides Of The Same Coin? Independence And Accountability Of The European Central Bank" (2017) at p.25 <[https://transparency.eu/wp-content/uploads/2017/03/TI-EU\\_ECB\\_Report\\_DIGITAL.pdf](https://transparency.eu/wp-content/uploads/2017/03/TI-EU_ECB_Report_DIGITAL.pdf)> Accessed 21 February 2019



## D. TECHNOLOGICAL ADVANCEMENT IN THE BANKING SECTOR

### 1. Venture Capital in the Rise of the Crypto Economy – Lin Lin, National University of Singapore, Faculty of Law

Blockchain technologies are transforming the landscape of the financial industry. Initial coin offerings (“*ICOs*”) have become a burgeoning method for start-ups to raise financing directly from public retail investors. The rise of the crypto economy brings promises and perils to the venture capital industry, and distributed ledger technologies offer new investment opportunities to venture capitalists (“*VCs*”). Traditional VCs are gradually diversifying their portfolios to invest in crypto-assets and blockchain technology projects, as well as launching crypto-centric funds. The benefits of ICOs are numerous – lower transaction costs and increased efficiency given that it is conducted online with no staged financing; the ability to reach global investors with no geographical constraints; and increased liquidity given that there are more than 40 crypto-exchanges, and crypto-markets trade 24 hours a day.

However, there are also major risks associated with ICOs. Arguably, crypto-assets issued in ICOs are the riskiest non-leveraged asset class that investors may access at the moment. Such risk may arise from the extreme uncertainty surrounding the volatility of crypto-assets, and implementation of the evolving blockchain technology and business ideas; the high agency costs and the significant information asymmetry associated with ICOs; issuers’ (that are often start-ups) lack of substantial tangible assets and operational track records; the lack of intermediaries for pricing and valuation; cybersecurity risk; and a lack of effective and qualified custodian solutions for crypto-assets.

A comprehensive regulatory response may be a way forward to address some of these risks. Regulators may choose to issue guidance on the conduct of ICOs; create regulatory sandboxes to set boundaries on experimentation with such ICOs; enact statutory reforms to address risk or to take enforcement action against the conduct of ICOs. Recently, numerous regulators such as the U.S. Securities and Exchange Commission, the North American Securities Administrators Association and the Monetary Authority of Singapore (“*MAS*”) have issued a large number of statements and warnings on cryptocurrencies. Arguably, the mere issue of statements and warnings is an inadequate response to the numerous risks

associated with ICOs. Instead, a clear regulatory framework should be aimed at increasing investor and consumer protection.

For instance, regulators may opt to impose regulatory standards on crypto-asset managers. Such regulation should be risk-based and the mandatory requirements should address specific concerns in relation to investor protection, while taking into consideration the scale of cryptofocused funds' activities and their impact on investors. Such a regulatory framework should target risks such as the difficulty in valuation of crypto-assets; volatility in secondary markets and small liquidity pools; inconsistent auditing and accounting standards; limited availability of custodian solutions; and missing regulatory standards and increased occurrence of fraud. In Hong Kong, the Securities and Futures Commission ("*SFC*") has recently issued guidance on the regulatory standards expected of virtual asset portfolio managers and fund distributors.<sup>46</sup> The SFC has specified that in addition to the traditional licensing requirements applicable to funds, funds that intend to invest or are already investing in crypto-assets need to be licensed by the SFC and comply with crypto-specific standards.

Moving forward, a heightened regulatory response including licensing, registration, and enforcement actions, would aid in reducing uncertainty and transactional costs associated with a VC firm's involvement in the crypto sector. It is key that in developing a framework, regulators develop the requisite technical knowledge and engage deeply with practitioners in the market. An increased regulatory responses should also be complemented by various market mechanisms such as developing insurance products that would suit the special nature of the crypto sector. This would in turn facilitate a healthy and sustainable venture capital-crypto ecosystem.

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<sup>46</sup> Hong Kong Securities and Futures Commission, "Circular to intermediaries – Distribution of virtual asset funds" (1 November 2018) < <https://www.sfc.hk/edistributionWeb/gateway/EN/circular/openFile?refNo=18EC77>> Accessed 21 February 2019

## 2. The Law and Finance of Initial Coin Offerings – Aurelio Gurrea-Martinez, Singapore Management University, School of Law

The rise of ICOs as a source of funding has thrown the spotlight on the issue of regulation. In 2017, ICOs raised around \$4 billion in the United States<sup>47</sup>, and this figure reached more than \$21 billion in 2018<sup>48</sup>, surpassing venture capital as a fundraising mechanism<sup>49</sup>. ICOs differ from existing fundraising mechanisms in four main aspects. Firstly, the fundraiser does not issue shares, bonds or other existing financial products but issues crypto-assets (also known as tokens). Secondly, the issuer does not receive money but crypto-assets generally accepted by the public such as Bitcoin or Ether. Thirdly, the issuance of tokens is conducted through blockchain technology which is used to create crypto-assets such as Bitcoin and Ether. Finally, the issuance of tokens does not require the preparation and registration of a prospectus unless the tokens are considered securities under a country's securities law.

While the growing size of the ICO market and the risks associated with this fundraising method has caught the attention of securities regulators around the world, the approach taken to deal with ICOs differs across jurisdictions. Firstly, there is the contractual approach. Under this approach, the issuance of tokens is exclusively subject to the law of contract and excluded from securities laws. While the contractual model may reduce regulatory costs associated with an issuance of tokens, this model also has several drawbacks, including lack of effective protection of holders of tokens (“*tokenholders*”), which are particularly subject to the risk of promoters’ opportunism. Likewise, if functionally equivalent products are not subject to similar regulation, this approach would not provide a level playing field.

The second regulatory approach may consist of imposing bans. Namely, the regulator may decide to prohibit the issuance of tokens (total prohibition), or it may prohibit the purchase of tokens to certain actors (e.g. retail investors, consumers, commercial banks) or up to certain quantitative limits (partial prohibitions). Nevertheless, while imposing bans appear

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<sup>47</sup> Frank Chaparro, “ICO funding soars above \$4 billion as US regulators crack down”, *Business Insider* (13 December 2017) <<http://www.businessinsider.com/ico-funding-soars-above-4-billion-as-us-regulators-crack-down-2017-12>> Accessed 21 February 2019

<sup>48</sup> CoinSchedule, “Crypto Token Sales Market Statistics” <<https://www.coinschedule.com/stats/Jan+01%2C+2018+to+Dec+31%2C+2018>> Accessed 21 February 2019

<sup>49</sup> Betsy Verecky, “Is a Cryptocurrency a Security? Depends”, (4 May 2018) MIT Management Sloan School <<http://mitsloan.mit.edu/ideas-made-to-matter/a-cryptocurrency-a-security-depends>> Accessed 21 February 2019

to be a prudent approach, it may reduce firms' access to finance and it does not always protect tokenholders.

The third regulatory approach subjects the issuance of security tokens to pre-existing securities law. For that purpose, it should be emphasised that, from a legal (securities regulation) perspective, tokens can only be classified as security or non-security tokens. If the token is deemed a security, it would be subject to registration and prospectus requirements. While this approach facilitates investor protection and maintains a level playing field, it also has some flaws. Namely, it does not protect the holders of non-security tokens and it makes difficult for regulators to oversee the entire ICO market.

A final regulatory approach may consist of imposing a system of comprehensive token registration. Under this approach, any issuance of tokens, no matter if they are security or non-security tokens, should be approved by the regulator. While this approach would favour investor protection and the supervision of ICO markets, it can generate several costs, including those associated with hiring and training new employees that might not be needed on a daily basis. Moreover, the approval of non-security token might not be necessary to protect consumers.

As a result of the flaws existing in these models, the speaker and his co-author proposed a new regulatory model to deal with ICOs. This new regulatory model is based on four pillars. First, any issuance of tokens, no matter if they are security tokens or non-security token, should be disclosed to the securities regulator or any other regulatory authority. This disclosure should be done through a simple, harmonized electronic form providing some basic information about the token. Then, promoters issuing security tokens would also need to comply with securities regulation. Second, due to the level of risk and the number of scams existing in the ICO industry, pension funds and commercial banks should not be allowed to engage in a pre-sale of tokens. Third, the regulator should invest more resources in education and awareness with the purpose of making sure that consumers and retail investors understand the risks associated with ICOs. Finally, several devices should be implemented to protect non-security tokenholders. These mechanisms may include the use of cooling-off periods, prohibition of certain terms and products, imposing standards of conduct on issuers, and using litigation rules to favour the position of tokenholders in a hypothetical lawsuit against the promoter. This regulatory model would promote financial

innovation and firms' access to finance without harming consumer and investor protection, market integrity and the stability of the financial system.

### **3. Banking and AI - Studying Its Legal and Ethical Implications— Kala Maruthavanar, University of Malaya, Faculty of Law**

The key trend that has emerged in Malaysia's banking sector in 2018 is the increased investment in artificial intelligence ("AI").<sup>50</sup> While the key focus of AI in the Malaysian banking industry has thus far been the use of chat bots, one potential area that AI would provide value for the Malaysian banking sector is the area of fraud prevention.<sup>51</sup> With the continuous and rapid evaluation of large amount of data, AI can enable banks to detect irregular behavioural patterns and alert their customers immediately.<sup>52</sup> Additionally, credit risk is another key area for banks to consider deploying AI. By analysing customer data such as payment patterns, outstanding balances, data from credit agencies and alternative data sources like social media, banks are more accurately able to assess the credit worthiness of its customers.

However, the rise of AI in the banking industry has raised corresponding privacy concerns. Malaysia's central bank, Bank Negara, has recognised the EU's General Data Protection Regulation ("GDPR") as being one such framework which facilitates the increase of consumer control over data use to manage privacy concerns.<sup>53</sup> In order to be on par with such international regulatory regimes, Malaysia will update its data protection laws by mid-2019.<sup>54</sup> Cybersecurity and data integrity may also pose a significant risk in the growing adoption of AI by the Malaysian banking sector. In an AI scenario, there is little if no direct relationship between the data controller (being the AI entity) and the data subject. As such, it would appear that the verification of the subject's identity becomes unreliable and impossible when it covers indirect relationships and situations involving no relationship

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<sup>50</sup> Vincent Fong, "5 Key Trends that have Emerged in Malaysia's Banking Scene in 2018" (*Fintechnews Malaysia*, 14 December 2018) < <https://fintechnews.my/19393/banking/banking-trends-malaysia/>> Accessed 21 February 2019

<sup>51</sup> "AI's Potential in Banking Still Untapped" (*Finews.asia*, 14 December 2018) <<https://www.finews.asia/finance/27935-ai-potential-banking-untapped>> Accessed 21 February 2019

<sup>52</sup> *ibid.*

<sup>53</sup> Punithaa Kylasapathy, Tng Boon Hwa and Ahmad Haris Mohd Zukki, "Unlocking Malaysia's Digital Future: Opportunities, Challenges and Policy Responses" (March 2018) Bank Negara Malaysia, Economics Department, p.7

<sup>54</sup> Yimie Yong, "Gobind: We'll update data protection" (*The Star*, 5 October 2018) <<https://www.thestar.com.my/news/nation/2018/10/05/gobind-well-update-data-protection-local-and-foreign-threats-to-user-information-call-for-stronger-l/>> Accessed 21 February 2019

between the data controller and the subject.<sup>55</sup> In such a situation, the risk of subject access requests disclosing personal data to the wrong individual, either by accident or malice, is high.<sup>56</sup>

The issue of liability is especially pertinent when involving the use of AI. To what extent should AI be treated as moral agents independent from their human designers and operators? A think-tank comprising of global thought leaders in AI and ethics, the IEEE Global Initiative on Ethics of Autonomous and Intelligent Systems, published a report recommending that all AI systems should be designed with transparency and accountability as primary objectives, and that the logic and rules embedded in the system must be available to overseers of systems, if possible.<sup>57</sup> However, if the system's logic or algorithm cannot be made available for inspection, then alternative ways must be available to uphold the values of transparency and such systems should be subject to risk assessment and rigorous testing.<sup>58</sup>

While the advancement of AI brings tremendous opportunities for progress to the Malaysian banking sector, care must be given in the way such advancement is regulated. The following five principles are useful as an over-arching guide: that AI should be developed for the common good and benefit of humanity; AI should operate on the principles of intelligibility and fairness; AI should not be used to diminish data rights or privacy of individuals, families or communities; all citizens have the right to be educated to enable them to flourish mentally, emotionally and economically alongside AI; and the autonomous power to hurt, destroy or deceive human beings should never be vested in AI.<sup>59</sup> Only with proper regulation and ethical principles in place can the potential pitfalls of AI be mitigated.

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<sup>55</sup> Andrew Cormack, "Is the Subject Access Right Now Too Great a Threat to Privacy" (2016) EDPL 1, p.15

<sup>56</sup> *ibid.*

<sup>57</sup> IEEE, "Ethically Aligned Design" (Version 1 For Public Discussion, 13 December 2016) p.91

<sup>58</sup> *ibid.*

<sup>59</sup> House of Lords Select Committee on Artificial Intelligence, *AI in the UK: ready, willing and able?* (2018) HL Paper 100, para 417 <<https://publications.parliament.uk/pa/ld201719/ldselect/ldai/100/100.pdf>> Accessed 21 February 2019

### 1. Prematurity and Incubation: Tradition, Transplantation and Bifurcation of Financial Development and Law in China – Simin Gao, Tsinghua University, School of Law

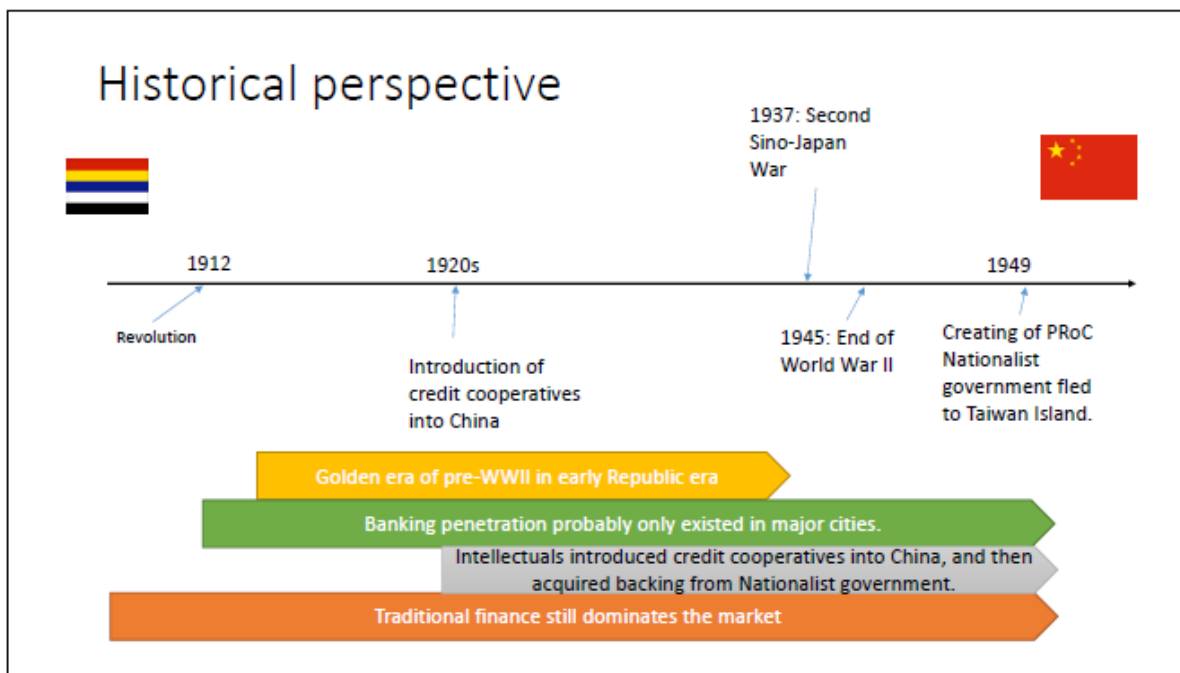
There is physiological evidence to show that the behavior of a large percentage of investors in today's financial market does not differ greatly from investors' behaviour one hundred years ago. From the late 19<sup>th</sup> century, there is evidence that traditional methods of conducting finance in Chinese society ("*traditional finance*") did not disappear from Chinese society, but was merely repressed underground by policymakers who at instances illegitimated such forms of finance. The financial market in China has since become dichotomous with the introduction of modern-finance; modern finance and traditional finance now co-exist in an uneasy equilibrium. This is because the traditional financial market is still utilised by the vast majority of ordinary people, whereas the modern financial market is mostly a market for merchants. Hence, it is beneficial to examine how existing institutions may serve as an "institutional incubator". An institutional incubator would effectively form a springboard to help newly transplanted institutions, such as the modern commercial banks, to be integrated and accepted by Chinese society as a whole.

To understand the characteristics of China's traditional finance, one must understand the Chinese Confucianism values that undergird it. Essentially, Confucianism is a barrier to capital. Confucianism has its own economic function in promoting traditional finance because it promotes the Chinese spirit. Essentially, this economic function is one of social capital development – social groups within the Chinese society provide capital to enhance co-operation. The notion of social capital development is also expounded upon by American political economist, Francis Fukuyama. Fukuyama argues that finance is based on trust, and different financial organisations are based on different trust structures that differs from country to country.<sup>60</sup> In China, it is challenging to develop trust beyond the natural kinship group. This impedes the acceptance of new forms of finance and financial institutions in Chinese society.

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<sup>60</sup> Trust: The Social Virtues and the Creation of Prosperity by Francis Fukuyama, 1996

From a historical perspective, the top-down imposition of modern forms of financial institutions by the government from the late Qing Dynasty has exacerbated the difficulty faced by Chinese society in accepting such institutions. The transplantation of modern financial institutions in large cities such as Shanghai is at odds with the financial landscape of the (majority) rural provinces, which still operated mainly along familial trust relationships in conducting finance. Hence, a pictorial representation of the development of modern finance set against the continuation of traditional finance is as such:



*Figure 1: Historical perspective of the juxtaposition of modern finance against the continued presence of traditional finance in China from 1840 to 1949*



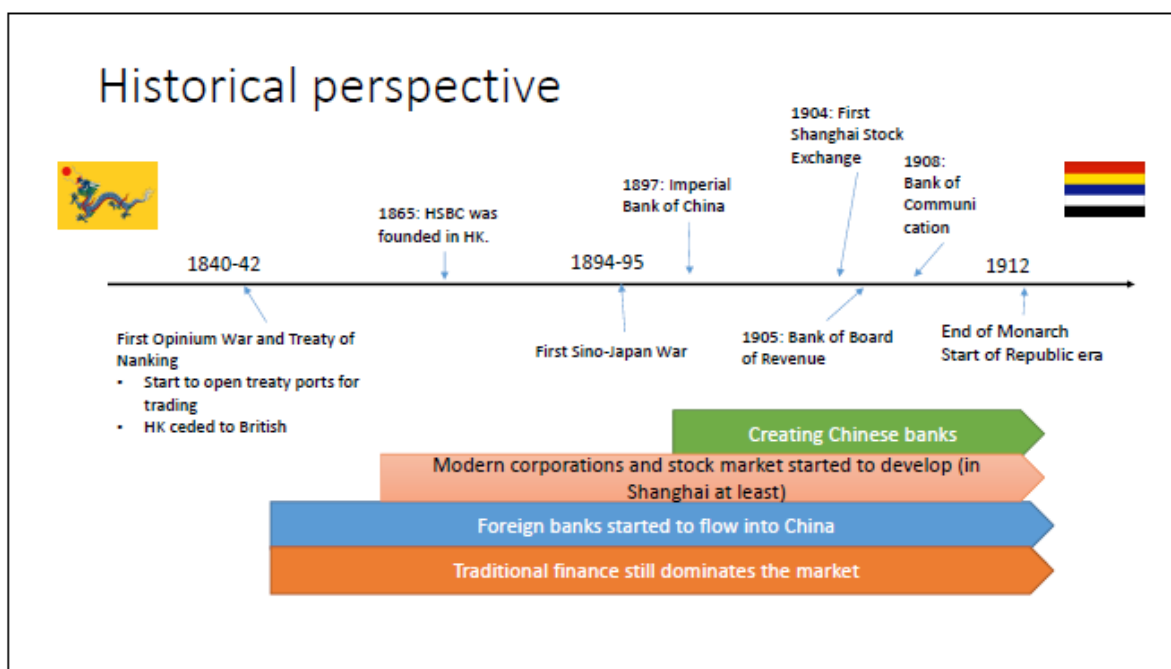


Figure 2: Historical perspective of the juxtaposition of modern finance against the continued presence of traditional finance in China from 1912 to 1949 and beyond

In sum, there is no automatic switch from a family or community-based financial system to a modern financial market. The top-down approach advocated by the Chinese government from the late Qing Dynasty did not connect with a majority of people. Greater recognition should be given to the continued existence of traditional finance, and it would be prudent for regulators to oversee both the modern financial market and traditional finance under one regulatory roof.

## 2. Demand Guarantees in South Africa, the PRC and Singapore – Charl Hugo, University of Johannesburg, Faculty of Law

The interpretation of guarantees as imposing accessory or independent liability on the guarantor has been of growing importance given the increasingly cross-border nature of project financing across the world. In the 2018 China-Africa Forum for Co-operation, China announced that it had set aside \$60 billion to pour into construction projects in Africa.<sup>61</sup> The classification of guarantees as imposing accessory or independent liability

<sup>61</sup> Ruby Orimba, "Here Is How China's \$60 billion pie will be shared among African countries" (*Pulse Live*, 9 May 2018) <<https://www.pulselive.co.ke/gist/politics-here-is-how-chinas-dollar60-billion-pie-will-be-shared-among-african/q4p6e24>> Accessed 21 February 2019

with significant ramifications on managing the risk and robustness of infrastructure projects.

In South Africa, the issue is one of contractual interpretation. The true intentions of parties of whether to accessorise liability is assessed against the background of factual matrix. Where guarantees incorporate the terms of the Uniform Rules for Demand Guarantees (“URDG”) or the ISP98 standard form, the guarantee would be deemed an independent guarantee. However, the issue is more ambiguous where bespoke guarantees are drafted with terms that conflict with the URDG or ISP98. In *Minister of Transport and Public Works, Western Cape v Zanbuild Construction* [2011] ZASCA 10 (“*Zanbuild*”), the South African Supreme Court of Appeal held that naming a bond as “on demand” does not necessarily mean that a bond is in fact one that can be called upon on demand. In *Zanbuild*, the presence of phrases in the bonds that they existed to “*provide security for the compliance of the contractor’s performance of obligations in accordance with the contract*” and the “*due and faithful performance by the contractor*” indicated that the bonds were not on demand bonds but were conditional on the liability of the contractor. This approach of contractual interpretation is also taken in Singapore.<sup>62</sup>

However, a contrasting approach is taken in China. The Independent Guarantee Provisions (“IGP”) state that a guarantee is independent where it meets one of the following three requirements where the guarantee: (i) states that it is payable on demand; (ii) subject to the URDG or other model rules for independent guarantee transactions; (iii) based on the text “...the Issuer’s payment obligation is independent from the underlying transaction relationship or guarantee application relationship, and the Issuer is liable for payment only against a complying presentation.” The Chinese approach leaves more room for ambiguity given the possibility that there are other provisions in the guarantee that may contradict the phrases as cited in the IGP. It is unclear whether such provisions should then be ignored, and whether the elements of the IGP found in the guarantee should take precedence in establishing that it is an independent guarantee.

There is only one well-recognised exception to independence in demand guarantees under South African law, namely where fraud is present, i.e. where a beneficiary makes a call on a guarantee in bad faith, with the knowledge that it is not entitled to payment (see *Guardrisk Insurance Company Ltd and Others v Kentz (Pty) Ltd* [2013] ZASCA 182). However,

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<sup>62</sup> See *China Taiping Insurance* [2012] SGHC 2; *JBE Properties Pte Ltd* [2010] SGCA 46

unconscionability appears to be raising its head in this regard as appears especially from *Sulzer Pumps (South Africa) (Proprietary) Limited v Covec–MC Joint Venture* [2014] ZAGPPHC 695 (2 September 2014).

Although the Supreme Court of Appeal had briefly accepted that the final determination of the dispute in the underlying contract against the beneficiary of the guarantee could also constitute an exception to independence (see *Dormell Properties 282 CC vs Renasa Insurance Company Limited and Others NNO* [2011] (1) SA 70 (SCA)) this was subsequently rejected in *Coface South Africa Insurance Company Limited vs East London Own Haven t/a Own Haven Housing Association* [2013] ZASCA 202. The doctrine of unconscionability is recognised in Singapore, but where parties expressly contract to exclude unconscionability as a ground for restraining a call on a performance bond, the unconscionability exception cannot be relied upon (*CKR Contract Services Pte Ltd v Asplenium Land Pte Ltd* [2015] SGCA 24).

In contrast, the Chinese approach posits much wider exceptions to independence than in South Africa, or Singapore. Article 6 of the IGP states that a guarantee is an independent instrument except in the circumstances set out at Article 12. Article 12 of the IGP contains five broad categories, including situations where a judgment or arbitral award on the underlying transaction has been made in favour of the applicant, or where a beneficiary knowingly abuses its right to demand payment. Given the increasing Chinese investment into South African construction projects, wider exceptions to independent guarantees under Chinese law must be taken into account when issuing independent guarantees to facilitate credit flow in construction projects.

### **3. The Legal Nature of a Bank Deposit: Insights from Roman Law– Sandra Booyesen, National University of Singapore, Faculty of Law<sup>63</sup>**

The legal nature of a bank deposit has long been settled in English law. Monies that are deposited with a bank are a loan by the customer to the bank.<sup>64</sup> Likewise if the account is in debit, the debtor-creditor roles are reversed. The debtor-creditor analysis has a number of implications: firstly, banks are able to use deposits to lend and invest as they deem fit,

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<sup>63</sup> The subject of this paper was inspired by a conversation with Professor Angela Itzikowitz, University of the Witwatersrand, South Africa

<sup>64</sup> *Foley v Hill* [1848] 2 HLC 28 at [44]

subject to regulation. Banks will not be guilty of breach of trust in employing the deposit; and banks are not answerable to the customer if the deposit is put in jeopardy.<sup>65</sup> Secondly, banks may profit from their use of the deposits.<sup>66</sup> Thirdly, banks must repay the numerical value of physical monies are deposited – but are not required to repay the exact coins or notes.<sup>67</sup> An oddity about this analysis is that a deposit is a loan that involves a transfer of ownership. As the English legal historians Pollock and Maitland have said: “to this day Englishmen are without words which neatly mark this distinction. We lend books and half-crowns to borrowers; we hope to see the same books again, but not the same half-crowns; still in either case there is a loan.”<sup>68</sup>

The different treatment of the loan of an object and the loan of money is explicable by the fungible nature of money. Roman law interestingly made a clear distinction between the loan of a distinct thing and the loan of fungible property.<sup>69</sup> Roman law recognised a number of discrete contracts, including the four real contracts of *mutuum*, *depositum*, *pignus* and *commodatum*. Of particular relevance to the bank deposit is *mutuum* and *depositum*. *Mutuum* was a loan for consumption and was used for fungibles, most frequently for loans of money. Historically, *mutuum* was used for loans between family and friends where the object was to benefit the borrower. *Mutuum* had the following legal characteristics:

- i. It was a unilateral contract that came into being on the passing of ownership, because lenders had no obligation to lend unless they had bound themselves to do so by *stipulatio* (i.e. a formal oral contract).
- ii. It was a gratuitous contract and there was no obligation to pay interest unless expressly provided for by *stipulatio*.
- iii. The only obligation was to repay the original sum.
- iv. Risk passed with transfer of ownership and the obligation to repay was not affected by loss or damage to the property.
- v. The repayment obligation arose with the passing of ownership unless expressly agreed by *stipulatio*.

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<sup>65</sup> *Foley v Hill* [1848] 2 HLC 28 at [37]

<sup>66</sup> *Foley v Hill* [1848] 2 HLC 28 at [36]

<sup>67</sup> *Foley v Hill* [1848] 2 HLC 28 at [37]

<sup>68</sup> Sir Federick Pollock and Sir Frederic William Maitland, *The History of English Law before the Time of Edward I*, vol. II (1895)

<sup>69</sup> Roman Law sources consulted: Andrew Borkowski, *Textbook on Roman Law* (1994, Blackstone Press); Reinhard Zimmermann, *The Law of Obligations: Roman Foundations of the Civilian Tradition*, Ch 6 (1996, Oxford Scholarship Online)

- vi. The borrower was confined to any agreed use of the property.

*Mutuum* is similar to the modern bank deposit in that it envisages a transfer of ownership of the loan subject, and the passing of risk with ownership. However, bank deposits are probably not intended by the depositor to benefit the borrower (the bank). The unilateral nature of *mutuum* is similar to the lack of any obligation on bank customers to deposit or on the bank to lend. Further, the repayment obligation of *mutuum* arises on the passing of ownership which is similar to the modern deposit albeit a formal demand must be made for repayment.<sup>70</sup> *Mutuum* also did not give rise to any default interest obligation, similar to modern banking contracts where the terms governing interest generally have to be expressly contracted for.

Roman *depositum* was a contract for the handing over of goods for safe custody without remuneration. There was generally no transfer of ownership involved, and it was a bilateral contract rendering the depositor liable for any expenses of safe-keeping. The depositee would be liable if the item was damaged. A subset of *depositum* was *depositum irregulare* which was for the deposit of fungibles. A *depositum irregulare* would involve a transfer of ownership and the duty to repay the equivalent to the depositor. The object of the contract was for safekeeping and not to benefit the depositee.

Roman law provides useful insights into the legal nature of a bank loan, especially since seminal English banking cases do not explore in the same detail the special features of a bank deposit as a loan of fungibles. Elements of both *mutuum* and *depositum irregulare* are evident in the legal consequences of a bank deposit today. It remains to be investigated whether the English characterisation of a bank deposit was influenced by Roman law, or did great minds think alike?

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<sup>70</sup> *Joachimson v Swiss Bank Corporation* [1921] 3 KB 110