NYSBA

SPRING 2015 | VOL. 28 | NO. 1

International Law Practicum

A publication of the International Section
of the New York State Bar Association

Practicing the Law of the World from New York

Includes Chapter News

PRACTICUM: FORM AND POLICY

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Manuscripts intended for publication in the Spring and Autumn issues must be received by the Editor-in-Chief by the preceding 1 December and 1 June, respectively.

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Transcript: From the Magna Carta to Dodd-Frank: The Rule of Law and International Financial Regulation

[Editor's Note: The following is an edited transcript of the Annual Meeting of the International Section of the NYSBA on 26 January 2015 in New York City.]

I. Welcoming and Introductory Remarks

THOMAS PIEPER: Good morning. I'm Thomas Pieper, Section Chair. The events of the last few weeks have highlighted how important fundamental rights and the rule of law are and how often we just take them for granted. One of the most important milestones, of course, when it comes to the history of fundamental rights, is the Magna Carta. Written in 1215 and signed into law by King John I of England, who was, I think, the great, great uncle of Jonathan Armstrong.

[Laughter]

JONATHAN ARMSTRONG: Yes. I'm waiting for my lance to be restored.

MR. PIEPER: The Magna Carta was basically the first legal document that limited the power of the monarchy and ensured that even kings and queens would be bound by the law. Now 1215 means we also celebrate its eight hundredth birthday this year. There will be tons of events dedicated to this anniversary this year, and we are proud to be among the first ones. On behalf of the International Section of the New York State Bar Association, we welcome you to our annual meeting. We are also proud that we kick off this year's annual meeting. As you have noted, we have changed the date of the meeting to Monday, just to get ahead of the blizzard.

[Laughter]

That's why it's pretty quiet in the hallways. We also have a bigger room. The title of today's session is "From the Magna Carta to Dodd-Frank: The Rule of Law and International Financial Regulation." So that gives you a sense of the approach that we are going to take on this theme. Now I'm sure you have questions. The Magna Carta and The Rule of Law, how does this relate to today's financial markets? The Dodd-Frank Act as a modern day Magna Carta? Really? How have these regulations changed the practice of international law for everyone, anywhere, say in this country, the United States? In Latin America or other civil law jurisdictions? What about Great Britain, Europe? And of course, what about the Middle East, Islamic financing *Shari`ah*? And so on.

Diane O'Connell, our amazing Meeting Chair, has assembled an impressive array of speakers here. And these guys will answer all of these questions and then some. If you do have a specific question about Charlie, one of our speakers is also our Paris Chapter Chair, and I'm sure he'd be happy to share his thoughts. Of course, after this program we'll have our luncheon, where we hand out our awards. In the afternoon we have a meeting of Latin American Council, for those of you who are members. We canceled the Chapter Chair meeting, and instead we will do snow angels outside.

[Laughter]

With that I'll give the floor to Diane. Thank you.

DIANE O'CONNELL: Good morning. One more piece of housekeeping. I was told if you want to connect to wifi, the wifi connection is Meeting Room 4, and the password is nysba2015, all lower case. I wasn't going to give that to you because I didn't want everyone surfing Google and shopping on Amazon while we were doing the panel.

[Laughter]

I'm not going to get into much of an introduction because Thomas did such a phenomenal job. I think he pretty much said it all. So what we are going to do is run through some of the panel speakers. We'll take a coffee break, let you digest some of the information, get a little more coffee to go for the second half, and then we'll bring the rest of the speakers up to conclude the panel and then go to lunch.

To start out, I'll introduce the speakers one at a time. Our first speaker is Curtis Tao. He's currently a Managing Director and Associate General Counsel at CitiGroup. He's advised CitiGroup on bank and bank holding company regulatory matters. He was an Associate General Counsel at Goldman as well as Cleary Gottlieb. So thank you, Curtis.

II. Financial Regulation in Various Parts of the World

A. The Dodd-Frank as International Magna Carta?

CURTIS TAO: Thank you. Good morning to everyone. Let me first start by saying that the comments and thoughts which I will share today are not necessarily those of my company. And let me also be very clear, I don't expect to provide many answers, but I do hope to elicit further thinking and discussion among this group. Because, I think, as many of you know, the answers are less clear than I think at any other time in the realm of financial regulation.

I have the primary responsibility to bring in and tie the topic of Magna Carta to financial regulation. The translation of the Magna Carta is actually "the Great Charter," and in other translations it's been translated as "the Great Charter of Liberties." I think that, if you look at some of the more important and key banking legislations in the United States, many of them can also be viewed as great charters. Or, I often think, like the Magna Carta of a great experiment. If you think of the Magna Carta as being a prelude to the American Declaration of Independence and the American Constitution, it is a great experiment in determining whether a country can self-determine itself through a form of democracy and self-rule. It's aspirational. It is based in part in natural law. I think you can look at the various types of banking regulations in the past in that manner—not necessarily based in natural law—but with key governing, guiding principles as to the public policy objectives they are trying to achieve.

You have this constant struggle and this balancing between liberty and order in the Magna Carta, just like you have in banking regulations: free markets versus regulation. I think there has been over time a recognition by regulators—and I think the public—that that balancing act is a challenging one: you cannot allow a fully free market economy and society to operate, because you will have some dramatic spikes and chasms that will occur over time. I think we as a people and community have determined that that's not acceptable. If you look at those chasms, including The Great Recession and then The Great Depression, we as people have decided that that is not acceptable.

The evolution of some of the great charters in banking law have occurred over time. If you obviously take a look at what's occurred in the past five years, the Dodd-Frank Act is the latest iteration, and we will talk more about what its features are, and then we'll elicit comments and discussion from this group.

Prior to that you have the Gramm-Leach-Bliley Act, which was really about trying to create greater efficiencies in the American financial system, since we had not been using the same model as the universal banking model overseas. Gramm-Leach-Bliley is a recognition that, to be modern in a modern economy, banks—which are the engine of the economy—need to have a wide range of services that they can provide to their customers. So what you had effectively in Gramm-Leach is the ability to affiliate your banking institution to a depository institution and a securities affiliate. Now, these laws obviously did much more than I simply summarized, but I'll try to summarize some of the hot button items that each did.

Riegle-Neal, which was passed in the early 1990s, was really about that same kind of trend—trying to create more efficiencies in the American financial system—and it allowed interstate branching. Again, if you look at how the pendulum moved from the early 1990s and the passage of FDICIA (which is trying to deal with the ills that occurred during the savings and loan crisis), then you would think about modernization. And, of course, modernization ended with the financial crisis, and then we have the pendulum swinging back toward Dodd-Frank.

The Bank Holding Company Act of 1956 was really a loosening—or at least a recognition that Glass-Steagall needed to be updated in the sense that during the Depression the view was there is great risk that occurred in the financial system when you had banks able to engage in what was considered then to be risky securities activity. And then the Bank Holding Company Act recognized that you have a holding company and you have certain affiliates with a depository institution, and there should be greater flexibility in terms of what those entities do, some of which don't necessarily have deposit insurance and don't provide deposit-taking services.

These guiding principles, I think, can be illustrated quite nicely in the opening preamble of the Dodd-Frank Act, which reflects what Congress waited to achieve as the goals of the Dodd-Frank Act: promote financial stability; improve accountability and transparency in the financial system; end too-big-to-fail; protect the American taxpayer by ending bailouts; and protect consumers from abusive financial services practices.

One could very much argue that many of these things are in conflict—such as promoting financial stability and ending too-big-to-fail—and it is in the context of these conflicts that it remains to be seen what the great charter of the Dodd-Frank Act is able to achieve.

Let me just talk a little bit about the different approaches that occurred not only in U.S. banking regulation but also, I think, in some of the legislation of our peers around the globe.

First, approach by firewall. It's really about separating what's risky and what's not risky. Of course that is a very subjective view, which evolves over time. You've seen Glass-Steagall deal with that issue and Gramm-Leach deal with that. The Volcker Rule is also designed to do that, by separating out of the American financial system in bank holding companies what's deemed to be investing. That is, investing your own capital in a trading account as well as investing in covered funds. You also saw that in Dodd-Frank Section 716, which was removing what was purportedly riskier derivatives activities from less risky and more traditional banking activities.

Now this approach by firewall is also being bandied about overseas. For example, in the United Kingdom, the proposal is to remove and to separate your institutional business from your consumer business. We have also seen approach by firewall in existing law. In Mexico you have a corollary to what's called in the United States 23A, which is the limitation of your depository institution to be able to lend to your affiliates. Japan has legal lending limits which are imposed on affiliates. So approach by firewall is nothing new, but it certainly has taken different forms over time.

Second, approach by regulating size and capital. That is, the ability of an institution to have loss-absorbing capacity in the form of equity or debt. These capital standards have evolved, and they have significantly evolved in the Dodd-Frank Act. I think that what you've seen with respect to regulating size is an evolution from the belief that size needs to be limited because of antitrust and market power issues to now regulating size because a bank just poses too great a risk to the financial system.

Third, approach by prudential and conduct regulations. I think what makes the regulation of banks unique is that they are prudentially regulated. There are things that the law can provide. But then there are things that examiners by their authority can impose through the examination process—from letter agreements to informal examination findings to frankly things which effectively provide them the ability to limit the types of activities in which a bank is able to engage.

I think there's a recognition that prudential regulation is key, because you can't legislate all types of conduct. There are some areas of activity that just require an on-site evaluation of the banking activities of the institution and can only be dealt with by an on-site team.

Now conduct regulation has seen a significant expansion, particularly in the Title VII space with respect to derivatives in Dodd-Frank, which we can talk about. But there, too, I think it's a recognition that to really properly manage and to regulate banks correctly you have got to do both: prudential and conduct.

Finally, I'll touch upon cross-border regulation versus mutual recognition. Dodd-Frank has some really historic views toward that typical view in securities law that historically U.S. securities law stops at the water's edge. Well, if you regulate a banking institution and banking system prudentially, things don't end at the water's edge. And I think as lessons have been learned, it's become clearer that financial systems around the globe are intricately connected. So you have CFTC regulations dealing with derivatives that have broad impact across U.S. financial institutions, so that activities that may occur with a non-U.S. person through non-U.S. operations will still be subject to U.S. rules. Then the line to be drawn will of course be one for debate, if it's simply capital along those prudential rules that relate to the institution or transaction level rules that relate to the counterpart. Interestingly, the Volcker Rule also has a broad cross-border application. So if you are any U.S.-based firm, all your global operations are subject to the Volcker Rule. If you are a foreign banking organization that operates in the United States with a branch or a subsidiary, well, potentially your entire global operations can be subject to the Volcker Rule if you have involvement from U.S. personnel.

Finally, another area to which less attention has been paid is that a foreign banking organization with non-U.S. operations occurring, let's say, in Asia, with no U.S. personnel involvement by that institution, can still be impacted by the Volcker Rule, because that foreign bank—when they transact with a U.S. institution—must ensure that the U.S. institution doesn't have any U.S. personnel involved in negotiating or relating to that particular transaction. So the line certainly has moved with respect to the traditional views of the banking regulators to defer to the regulation of the local home country. Rather, U.S. regulators are really beginning to export some of the requirements of U.S. law.

So with that let me open the floor up to any comments or questions for discussion by my fellow panelists or the audience.

MS. O'CONNELL: Curtis, in your experience so far, have you seen the regulations surrounding Dodd-Frank and the Volcker Rule have effect? Or do you think they are doing pretty much similar to the Magna Carta, where there is an unspoken repeal that the regulations have been watered down or compromised based on financial pressure?

MR. TAO: I think of the Volcker Rule as being a culmination of regulatory pressures in the examination level to regulatory trends. Because I think you have to recognize that the Volcker Rule is principally drafted by the banking regulators.

So to the extent that you have a banking organization investing in what's considered a private equity fund or a hedge fund, that's extraordinarily expensive from a capital perspective. So there are great disincentives for banking organizations to do that. Of course the question is, "Have you determined what's a private equity or a hedge fund?"

With respect to proprietary trading—which is the big elephant in the room and which everyone has been focused on from public perception—if you look at the financial crisis, there weren't a lot of losses that related to proprietary trading businesses or desks. However, I think every single institution recognized in the lead up to the actual implementation of the Volcker Rule that it's just not worth it to make a couple of million bucks for a couple of traders to engage in that activity—notwithstanding the fact that the Volcker Rule deals with proprietary trading. So you first have to be trading in a trading account, which is short term, subject to market risk capital rules or in a broker-dealer. It doesn't deal with investing. And many of you can probably recognize that investing is no different than basically investing your own capital, but it just so happens that it's a long-term position rather than a short-term trading position.

Now, I don't think that any of the regulators are prepared to say that investing is inappropriate for banks—because investing is no different from lending. And when you think about the long-term investment in a security, well, I buy an entire issuance of securities from, let's say, an issuer—which might as well be for purposes of funding a portfolio of loans. A security is no different than an IOU, just like a loan is. As for securities, if you look at banks and their balance sheets, banks take in deposits and need to pay a return on the deposits: How do you earn a return on deposits? Well, it's going to lend the money, or it's going to invest in securities, and that's just the nature of banking. So my belief is that the Volcker Rule has been primarily up to this time about work, and it has been a tremendous amount of work and there's a tremendous amount of attention from the governance within the institution, the regulators, Congress and the public. But fundamentally it has not received, and I don't believe it will reshape, the institution, because the institutions in the financial system have already adjusted.

MS. O'CONNELL: Any questions?

MR. TAO: Any questions from the audience? Yes, please.

AUDIENCE MEMBER: What are the likely changes in Dodd-Frank going forward? There has been a lot of talk about different types of regulatory reforms coming into place. What's your outlook on the trending for that law?

MR. TAO: Because of the current political environment, absolutely zero.

Let's just take the example of Dodd-Frank Section 716, which was pushout, which was amended at the end of 2014. I think that was an area where you had a unique combination of things.

One, regulators had publicly indicated that this was one of the areas that really needed to be fixed. Ben Bernanke and Scott Alvarez from the Federal Reserve said the statute just wasn't very well written, and it wasn't well written.

Two, it is an area that actually caused harm to clients. Because I think everyone recognizes that big banks are not necessarily popular today, and so any change in the law in Dodd-Frank that would help big banks is just not going to fly. But there was a real harm to clients and counterparties. Just look at a large U.S. airline that is going to be needing to hedge its long-term debt interest rate exposure and also hedge its credit cost. Right, so you generally want to have one counterparty so that you can net your exposures. But when you need to split it—oh, by the way the traditional counterparty have been banks, particularly interest rates and FX. So if I now have to split my book, and I can no longer hedge with one entity, I've got to hedge with another entity, I can't net those exposures, so it increases my credit costs. So I've got to look at basically fragmenting my trading relationships. So you have harm to consumers and harm to clients.

Third. You had bipartisan support, both in terms of what you saw in terms of the sponsors of the bill in the Senate as well as the passage of the original bill in the House.

Those three factors combined, really. But you don't have a lot of those examples in Dodd-Frank, unfortunately. And by the way, I think things that won't be really emphasized is that the compromise that was achieved was really only because you had Treasury and the White House signing off on it. So you have the regulators saying, "Yeah, we are okay with the deal." And the deal effectively was increased funding for the SEC and the CFTC for this minor modification in Dodd-Frank. The politics, as everyone knows, took over. And I think the politics have been and now continue to be that any changes to Dodd-Frank just are not acceptable. If you look at the fact that the CLO bill has been postponed. And if you look at even the end user relief that was tied with respect to the TRIA bill: it's just a very difficult environment. So I think even the regulators recognize that.

I think that it is what it is for the foreseeable future. And I think any incremental really meritorious discussions on Dodd-Frank will have to be really at the regulatory level rather than the statutory level.

AUDIENCE MEMBER: Just to be absolutely sure we are talking about the same concepts. So you are saying that the Volcker Rule only deals with proprietary trading, so that's essentially only the banks basically investing with their own profits, as opposed to the money that's been deposited or invested with the bank by corporate and individual consumers?

MR. TAO: Yes. I apologize. I think I've been speaking on many of these kind of descriptions as if everyone deals with this every single day.

So the Volcker Rule has two pieces. One is dealing with proprietary trading; and the second one deals with covered funds activities and investments.

On proprietary trading, it basically says that, if you are in a trading account engaged in a covered financial instrument, which could be derivatives, securities, a host of other products, the banking organization—and banking organization must be a U.S. bank holding company or a foreign bank operating in the United States—must only engage in that trading activity for the following purposes: market making; underwriting; risk-mitigating hedging; and a couple other exemptions, including U.S. government securities. What it effectively says is that, if you don't have an exemption and you are engaged in trading, it's prohibited. So the classic proprietary trading desk is as follows. If you had a bunch of men and women who don't face clients, they only face dealers, and they have no customers and they are taking the firm's capital and trading on it and they take the view, "You know what, I think rates are going to move, something is going to happen in this jurisdiction, or I think oil is going to take a plunge, so I'm going to take an out-sized position with the firm's capital." Okay, they are walled off, away from any customers, from any client-facing business; that's the bright line. You know it when you see it. That's prop trading.

There is a difficulty in determining, however, where you are bona fide acting as a market maker and acting as prop trader. For example, I am a market maker, a bona fide market maker: I face clients. As well, I hedge with other dealers in fairly illiquid securities because they are emerging markets. Their credit quality, because of its emerging markets, is like borderline investment grade non-investment grade. They trade with less frequency, but I am constantly buying and selling for clients, but I need to maintain an inventory. You basically say, "Hey, Mr. Bank, can you please let me sell these securities to you, because I've got a liquidity issue." Okay, so I will take them off of you. So I buy them from you, but I'm going to maintain that liquidity or that position until I can sell them again. So that's been one of the most challenging areas of the Volcker Rule. I just want to make sure that I dispel some of the views of the Volcker Rule that it doesn't mean you can't allocate your capital, can't take positions. But the question is for what purpose? If it's not for facilitating customer transactions or market making or hedging or another exemption, it's prohibited.

The cover funds requirements relate to banks which are no longer, or their affiliates are no longer, permitted to invest in hedge funds or private equity funds, nor are you allowed to sponsor a hedge fund or private equity fund.

The big question is what's a hedge fund? What's a private equity fund, right? If it's a non-U.S. UCIT, many UCITs look and feel like a registered investment company. Broad-based investors, is that a foreign public fund, which is exempted, or is that akin to a foreign hedge fund?

AUDIENCE MEMBER: And those are limitations that are imposed on the investing for clients as well as proprietary?

MR. TAO: So, for covered funds?

AUDIENCE MEMBER: Yes.

MR. TAO: For covered funds it gets a little complicated. Certainly I can't invest in my own account, and I can't invest as a seed. If I were engaged in asset management, I'm subject to certain limits, which is three percent of the capital of the particular fund and three percent in the aggregate of my Tier 1. So my options are limited if I'm using my own capital. If I am acting as a market maker in covered funds, I am permitted to hold an inventory position, subject to an aggregate three percent of my Tier 1 capital. But there are certain types of transactions which I think are articulated in the Volcker Rule which are prohibited. There is a catch-all which says that, notwithstanding that you have an exemption, you have to worry about one of the backstops, which is material conflict of interest, or it's unsafe and unsound because of the high risk of trading strategies.

So one of the things, even though I have an exemption, as a market maker I'm not permitted to do is write you a derivative on a hedge fund and hold the hedge fund as a hedge. I think one of the things that the regulators realized is that, if that market goes down because it's illiquid, your device is in default, which leaves me holding the bag and the losses. So there are these exemptions where I invest my own capital but also where I invest on behalf of clients, but they are limited. That was a mouthful.

AUDIENCE MEMBER: How is the Volcker Rule going to affect Citibank's worldwide competitiveness?

MR. TAO: We don't think it will affect our competitiveness. We think that we have already complied and conformed to the Volcker Rule in terms of our operations in our businesses. Our operations are market making, so in terms of business strategy, scope, what we do in the countries where we are, we believe that we have already complied with the Volcker Rule.

The challenge for every single bank is that there are a lot of compliance requirements. First and foremost for the board, and this is the philosophy of the banking regulators. You want adult supervision; get your board involved. So the board must approve your Volcker Compliance Program. It must approve your annual assessment or it could be more than your annual assessment. And your CEO must attest annually that you have policies and procedures which are reasonably designed to ensure compliance with the Volcker Rule. So whenever you get your CEO to sign anything, you're going to have a full cascade of cultural and managerial attention. And I think that was by design—so it is a tremendous amount of work. Much of it is going to be silent to the customers, because we will still be able to transact and act as a market maker. But as an internal legal manager, it's a tremendous amount of work.

MS. O'CONNELL: Any other questions?

AUDIENCE MEMBER: Citi is one of the first banks to get a charter in China. So can you talk a little bit about Citi's outlook in that country?

MR. TAO: If I'm not mistaken, China recently announced a revision to some of its banking laws. The challenge for China has been that a U.S. institution would be limited in the amount of equity it owned in a particular Chinese banking institution. If I'm not mistaken, it's roughly thirty-three percent. Now, there are other things that financial institutions have been able to do to have sufficient kind of—I wouldn't say control but sufficient say. And you can do that through covenants, nomination rights of certain key executives, and supermajority blocking rights on the board of directors.

If you recall, investing in Chinese banks was the super hot thing in the late 1990s, early 2000s. You saw Bank of America and Goldman Sachs invest. We invested. Citi invested—and this is public information, both with respect to subsidiaries where you invested in an actual Chinese bank but as a minority investor, but also with respect to having your own kind of branch. What you also saw later in the 2000s was that many of the U.S. banking institutions sold their interests in Chinese banks.

I think the hope and expectation was that one was going to have an opportunity to enter the massive Chinese market and really find that equity investment was an entry ticket into the country. I think many of the institutions realized that that entry ticket—which may end up being something one can cash in. But just in the foreseeable future there is just no ability to own and actually control and operate a bank in China. So effectively one is just basically an investor. I think many institutions realized that if one's focus is going to be really in the institutional side, there's other ways of accessing that market. In Hong Kong you can certainly have your own branch in China. But the entry into the Chinese consumer market: there were just too many barriers under current law.

I think China continues to be for at least Citi an area of strategic importance for our emerging market business. We continue to have investments there and operations, but I think—and this is public—the Chinese banking laws will continue to make it challenging, I think, for U.S. institutions to be more than an investor.

MS. O'CONNELL: Any other questions? Thank you, Curtis. I am going to shift positions over here.

One last housekeeping matter I actually forgot to say in the beginning. We are going green, and we are trying to mitigate costs, so to keep the pricing down, the course materials are online. If you want to download the materials, there are some good white papers by the speakers, the slides and the outlines, that is the web link to download the materials: It is http://www.nysba.org/intlannualmeetingcourse book2015/.

B. Global Financial Regulations Enforcement

MS. O'CONNELL: So Jonathan Armstrong is a partner at Cordery in the U.K. His practice concentrates on technology and compliance law. He advises multinational companies on matters involving risk, compliance and technology across Europe and has handled legal matters in over sixty countries involving emerging technology, corporate governance, ethics code implementation, reputation, internal investigations, marketing, branding and global privacy policies. In addition to being a lawyer, Jonathan is a Fellow of the Chartered Institute of Marketing.

MR. ARMSTRONG: Thank you so much for that, Diane, and thank you for the kind introduction as well, and the opportunity to speak here on such an important topic.

Many of you will know that I don't spend all of my day doing financial regulation. I certainly don't spend all my day doing financial regulation in the United States. So what I wanted to do was pick up Curtis's last trend in his very erudite opening remarks and look at that global perspective and how I think there is this maelstrom—if you'd like to use maybe an appropriate weather analogy today—of regulators that are colliding and hitting against each other. And what that means for corporations around the world and whether they be in the financial services sector or not.

And the other thing that I would like to thank you for is for talking about Magna Carta still, all of those years since. And if I may just make one political point quickly, it is a shame that our own Lord Chancellor can't see the interest that there is in the Magna Carta here, since he himself is eroding the principles of the Magna Carta back at home. But I believe it was Winston Churchill who said: "When I am abroad I always make it a rule never to criticize or attack the government of my own country. I make up for lost time when I get home." So that's the principle I will be adopting in my remarks this morning.

I think the first thing to say, as Curtis told us already, enforcement is very much now a global game. Any business, whether it be a bank or any other institution, that thinks that their own regulator, own home regulator, is the only regulator will be sadly mistaken. We have a number of countries, like the United States, exerting extraterritorial impacts on what they do. Countries, including the U.K., including Canada, and increasingly including countries that you would not think have an interest in regulation. At the same time we have almost a race when an incident happens between those competing regulators to see who can seize most of the turf most quickly.

Some of us who are outside the United States have observed criticism of the U.S. authorities for trying to seize some of that turf away from other countries. Some might say, for example, that Dodd-Frank itself is an example of that, by incentivizing whistleblowers to bring their complaints to the U.S. Government. I think I'm right in saying that thirty percent of the whistleblowers under the Dodd-Frank program are E.U. nationals. So the U.S. authorities are attracting cases into the United States for them to regulate. Now we might have a view as to whether that's appropriate. In many cases of course it is, because the United States has the resources and willingness to investigate things that are going on around the world.

We also see that there is a connection between things like financial regulation and the War on Terror. It's not something that is most apparent at first, but for example, a key driver of things like knowing your clients and money laundering rules is to stop the international terror and crime syndicates moving money around the world. But at the same time this rise in the extraterritoriality of regulation causes surprises and concerns.

As I said, the United Kingdom is not immune from this extraterritoriality. I looked at just two cases that the Serious Fraud Office of the U.K. had brought last month. In one of them the tag team, if you like, the Wrestling Federation regulators team, included the U.K., Switzerland and Cambodia, and the second case was a dream team of the U.K., Switzerland, Kenya and Ghana. And quite often we are seeing cases where regulating authorities from the U.S., from the U.K., from Canada are bringing the authorities in other countries into that stable, into that team to prosecute wrongdoing around the world.

I did a nonscientific roundup of the recent cases under the FCPA and the U.K. Bribery Act— those cases that are in the public domain that we knew had settled, had gone through court, or were under investigation. And I got more than sixty-one different countries involved in cases that just the United States and the United Kingdom authorities are involved in bringing to justice.

Now as a result, the nature of these investigations has changed exponentially, because they are trying to do them more thoroughly, in more places and involving more countries. And at the same time, we have got more evidence: emails, instant messages, and chat rooms—all of which make these investigations hugely larger than they were in the past. It's no longer possible to go into a bank and take the ledgers off the shelf—as I guess they did in Rockefeller's day—and take those away in a banker's box and for the regulators to go through them and second guess them.

In the foreign exchange investigations alone that the Financial Conduct Authority of the U.K.—the sort of successor to the Financial Services Authority—have done recently, they estimate that they took forty-five man years to look at the documents involved. Forty-five man years! And yet this investigation was concluded in less than twelve months. Obviously they used technology to look at all of these systems, but it cost forty million pounds to bring that one investigation.

We are seeing regulators like the SFO in the U.K. have to do a business case for each investigation. They do each manual investigation, and they go on to the government and ask for specific cash to bring cases. The SFO had twenty-three million pounds granted to bring a specific case to investigation. So as a result the investigators themselves have invested more in this. They have invested more in terms of their time, in terms of money that they have gotten from the government to do this, and in terms of reputation. So as a result we are seeing some regulators make mistakes along the way, because there is almost this race between prosecutors.

For example, in the United Kingdom, the rumor is that the U.S. authorities said that they were going to investigate somebody, a resident in London, a banker, in connection with wrongdoing. And the allegation is that, on the day prior, the U.K. authorities made sure they had gotten around to interviewing him—because they knew the U.S. team was on the plane over. We have all seen this time factor. Why? Because the regulation of financial institutions in particular is a political hot potato. Regulators want to assure their governments they are doing a good job.

Sometimes you might question whether they get the balance right. For example, in the U.K. one licensed individual got on a train repeatedly at an unmanned station without a ticket. He is banned from working in the city of London in financial services for life as a result.

So we might question whether we are actually sometimes having a proportionate response to what we do. But it's true to say that there has been significantly more activity in connection with banks, and, as I say, this extraterritorial reach is something that is very large indeed.

I've looked at FCPA prosecutions recently, the Foreign Corrupt Practices Act. And there is a table of countries of the top ten fines, split up by country. Thomas will be pleased to know that not only have you won the World Cup, but Germany is currently leading as the most heavily fined country for passing bribes. And interestingly, there are only two U.S. corporations in that top ten of a U.S. regulator. So clearly, we are in this environment of regulators regulating sometimes more abroad than they are at home.

At the same time we are seeing some interesting investments in terms of other states getting involved almost after the event. I've been involved in a case relating to a Nigerian politician. The Nigerian politician was under investigation by the U.K. authorities, and the U.K. authorities were prohibited from setting foot on Nigerian soil to investigate him. An order was made by a Nigerian court—some say by a judge appointed by the politician under investigation and some say in fact it was his brother-in-law. Regardless, the judge made an order saying the United Kingdom authorities couldn't set foot on Nigerian soil. The politician was arrested and eventually extradited. He was tried in the United Kingdom, convicted, and he is in a U.K. prison. His assets sit all over the place, including, I think, twenty million dollars in the client account of a U.S. law firm.

Now interestingly, at that stage, post-conviction, the asset collection phase, the Nigerian authorities are all of a sudden very interested indeed and would like a contribution back to the Nigerian state for all of the effort they put into bringing this guy to book.

We are seeing that carbon copy prosecutions—I personally think it's probably the wrong name, but we are seeing these after-the-event prosecutions in a whole host of the states basically trying to collect the money after the U.S. authorities mainly have done all of the good work. Hindsight is now a regular feature of any type of investigation. As I said, hindsight is a wonderful thing, I think, in the financial services sector particularly, because a lot of these activities take place very rapidly in industries that the regulators themselves sometimes don't even understand. And at the same time there is pressure to regulate the whole industry at once.

There is some very interesting material from the FCA about their activities on the 11th of November last year. On that day they announced that results of most of their investigations of foreign exchange occurring in London. Again, I think forty percent of the trades—Curtis will probably correct me if I'm wrong—but roughly forty percent of the forex trades take place in London, and twenty percent in New York, so as a result the regulators have had to cooperate much more than in terms of things like libel.

MR. TAO: And I think it may be even more. I think what you've seen as a result of Dodd-Frank is a lot of the interest rate activity in markets over to London as well—depending on how you measure it—because you've got The London Clearing House, which is the primary clearing house for interest rate trades residing in London as well.

MR. ARMSTRONG: Interesting. Thanks.

As a result, on the 11th of November the FCA looked through the first stage of its investigation. They fined two well-known U.S. banks two hundred twenty-five million and two hundred twenty-two million, respectively. They fined two U.K. banks two hundred seventeen million and two hundred sixteen million, respectively, and a Swiss bank two hundred thirty-three million. So it's interesting that even the U.K.'s announcement in how it has reacted to the forex scandal is to fine two U.K. banks, two U.S. and one Swiss.

As I said, hindsight is a regular feature, but I also worry about regulation as a whole in the fact that we often react to incidents without really getting root and branch to the problem. In the U.K. we tend to call this a dangerous dog, because we have some historically bad legislation that was brought after dogs bit children and has never really had its desired effect.

So to give you just an example in a completely random space, I was interested in the drone attack on the White House this morning. Almost certainly I imagine that about an hour ago some staffer at the Federal Aviation Authority was hauled into his boss's office and told to start drafting new legislation, which undoubtedly we'll hear about in about three days' time, and undoubtedly in six years' time we'll regret as a hastily thought-out piece of legislation that didn't really do the job.

To use that example to make it hopefully more understandable, the U.K. too has looked at things like drone regulation. We tend to concentrate on the micro rather than the principle. Stuff like that is really easy. You don't use agents, whether they be individuals or robots, to attack people. That's really all the regulations and the law need to say. But instead regulators get into saying how big the drone should be, what radio frequency should it operate, what is the permitted circle of operation, and as a result we get very detailed regulation which often undermines the original principle of "don't do harm."

So my esoteric wish is that in the financial services space and in others we get back to a principles-based approach to regulation, looking at the harm and correcting it, rather than this micro- management—which I think Curtis alluded to—which makes it very hard for corporations to operate as well because they are concentrating on the micro elements of the rules rather than the general principle, which is "don't commit fraud on your customers," which I think is something that every regulator globally would buy into.

If I may, Diane, I have just one final remark at this section, which is that we ought not to forget that the challenge of global regulation arose as bad actors themselves globalized. So we know that in many areas of our operations there are state-sponsored actors seeking to undermine what we hold dear in the West and undermine our economic structures as well. So it's right that global regulators respond in a global way, because the threats as well as the regulations are changing by the minute as well.

So there are my opening remarks, and thanks for your time.

MS. O'CONNELL: Any questions for Jonathan?

AUDIENCE MEMBER: Thank you. Very interesting remarks. I think this frankly could be the subject of two days in and of itself. There's so much going on, whether you talk about protection of privilege in an international enforcement context or coordination among extraterritorial enforcements. But I'm going to try to narrow down to a more specific question.

Do you see in your experience evolving jurisprudence in the U.K. Bribery Act? I know this was one of the questions when the law was promulgated, and a lot of comparisons had been drawn to the FPCA— namely, will there be eventual safe harbors that come out of this or affirmative defenses that can be asserted?

Companies like mine, which are U.K.-based but still global and have a significant U.S. presence as well as a lot of operations in emerging markets, are trying to develop what we consider to be best practices. But we are wondering the extent to which an affirmative defense or safe harbor exists in the event that something happens that unfortunately somebody in my position might not find out about until he's asked to clean it up.

MR. ARMSTRONG: That's a great remark. Obviously if the storm comes as predicted, we might have two days isolated to discuss it.

[Laughter]

Basically I think you're right, that there are all sorts of challenges. Privilege, of course, is a huge one, because different regulators have different attitudes to privilege. The E.U., to its shame, does not recognize the privilege of U.S. banks' in-house lawyers and some external counsel, nor of course of E.U. banks' in-house counsel. So you might get cases where the same regulators are discussing the same fact pattern and some regulators are able to get the documents and some are not. And there is at least anecdotal evidence that the regulators between themselves are picking those who have the best case on privilege to be the lead investigator, who then shares documents with the other regulators who ordinarily would not be entitled to such documents because of the privilege laws in that country.

Speaking to the U.K. Bribery Act point specifically, I read another article recently which was, I thought, regrettably laughable: it said that the U.K. Bribery Act had followed the FCPA and co-opted many of its principles. Of course the U.K. Bribery Act comes from legislation in the 1880s, on which the FCPA is in part based. But the principles behind prosecution are not necessarily new. The difficulty we have at the moment is that the United Kingdom generally tends to draft legislation very widely, and it relies on prosecutorial discretion. So there's a wide discretion. And whilst we have got prosecutors who are sensible and not themselves under pressure, then there tends to be a good check and balance. If you're a corporation that's basically a good citizen, and you've found something out that went wrong, then you can go along to the prosecution and talk about it. Ordinarily you would expect leniency as a result.

The difficulty is that the political pressures have increased. We have done things like deferred prosecution agreements under the Bribery Act, which was new in February last year. The result of that is that there is an undermining of the prosecutorial discretion and as a result less leeway in different areas.

The Bribery Act specifically has an "adequate measures" defense, if you like, to some of the offenses, but not all of them. There is a list that the Ministry of Justice has published of measures that should get you either a defense or mitigation against the other hardcore robbery offenses. So it's always wise to invest in procedures like that. You can bench test them against the MOJ's Guidelines; that's a relatively easy thing to do. Or look at things like the OECD Guidelines for Transparency International.

So for many businesses, of course, even in the financial services space, we are seeing that the settlements mandate things that frankly businesses should be doing anyway. Most settlements I see say there must be training program for staff. Well, whoopie doo. That's something that most businesses should be doing from the start. And it's always instructive, I think, to look through some of the settlement hearings to see exactly what is involved. Obviously, under the Bribery Act we are still only six cases in or whatever, so there is not that much material. There are guidelines, and I'm happy to share that afterwards and send you some links. I don't know whether you agree.

MR. TAO: I do agree.

I think one of the challenges of being a financial institution is preventing the next violation of law. If you look at the forex issue, you have a trader, and again depending on the institution, but a trader trading, talking in a chat room using code, and even his manager isn't familiar with the code. So the harm that that individual, who has now been terminated, has caused to the firm, and the numbers, are just going to increase. We are talking about fines in the billions of dollars. And, of course, building in systems to prevent those violations of law are, you know, duh. I think finding individual bad actors really is a tremendous challenge, and we have implemented a host of cultural and ethics training—all those kind of things. But it's the constant worry of our management: "Have we done enough to prevent the next bad actor?" As an institution with two hundred twenty thousand employees, it is what it is. But the vigilance will always, of course, be there, but I think that's the challenge.

AUDIENCE MEMBER: Would you say something about the applicability of the U.K. Bribery Act to lawyers who are involved in these international transactions, lawyers as a class?

MR. ARMSTRONG: Yes, there is obviously an FCPA case involving a U.K. lawyer, who I think is currently staying against his will in Pennsylvania. He may just be about to get out.

I think lawyers particularly are at risk. We know that, for example, some lawyers are used as money mules.

This Nigerian case that we looked at for a client is really an interesting case. The lawyer, if you like, is really the spider in the middle of the web there. The U.K. authorities got the information to unravel this sixty-jurisdiction fraud, because the lawyer had a chimney breast in his office, and he stored the files there. The prosecutors found out the files were there and went up into the chimney breast and took them out. So lawyers as bad actors are I think always likely to be vulnerable and are likely to be regarded as, rightly I think, more culpable sometimes than their clients. Lawyers can also innocently infringe things like the Bribery Act. Those of you know that the U.K. has a much bigger concentration on hospitality, and private-to-private hospitality is under the U.K. legislation. So I think we're seeing U.S. counsel, for example, being much more cautious when they are coming over to the United Kingdom.

For example, I know one attorney who has all of his work come out of the Lloyds markets. In past days, he tells me, he would come over to the United Kingdom maybe three times a year. He felt obliged to sort of put on a show for his clients. It had to be something spectacular, like take them to a skybox at the Formula One racing and so on. Now those elements of hospitality are not likely to really stand up to scrutiny, whether or not you're an attorney.

So we are seeing, if you like, two areas of liability for lawyers. First, lawyers as bad actors are going to be caught. But, secondly, lawyers as businessmen come within the legislation, just as any other corporation does. So in this case I think it's right that the U.K. is having an element of extraterritorial reach with the Bribery Act. It need only be a U.K. registered entity involved, a U.K. national, somebody who is customarily resident in the United Kingdom, or an act takes place on U.K. soil.

As a result whole industries—like oil and gas, like electronics—have almost all come within the Bribery Act, because you need only look at Apple, for example, a U.S. corporation. But from what I understand, a lot of the teams, from the design team down, have U.K. nationals on the team. So as a result the extraterritorial reach is binding on the individuals as well as the corporation as well as the lockers of the country. I think we are going to see more common terms like that throughout proper legislation. I think the CFPOA in Canada follows that model, and I think the Swedish legislation is similar. We are seeing that being adopted as the default model as different prosecutors try to regulate activities involving their nationals within their borders or simply trying to level the playing field for their own domestic corporations.

MR. TAO: I have a question. What are you seeing from the U.K. and other non-U.S. regulators in terms of their willingness to accept an assertion of returning client privilege for internal investigation documents or other types of law firm work product?

MR. ARMSTRONG: I think that's a great question. I think it's definitely under threat. Coupled with that, I am seeing a lot of issues around data protection, data privacy legislation and the way in which evidence was collected in internal investigations.

It is public knowledge that the SFO lost a big case about a year ago, the *Dahdaleh* case, and I am going to try and put this as neutrally as possible. The allegation was that a firm of U.S. attorneys conducted an internal investigation in a way which was accepted in the U.S. but failed the standards that would be expected in the United Kingdom. An individual was charged as a result of his conduct because the fax machine—they still exist—that had the material for part of the transaction was in London. So that's the main point of connection with London.

Prosecution is brought in London. The defense attorneys ask the U.S. lawyers, who led the internal investigation, to come and talk through the witness statements. They refused. The judge takes the case away from the jury, because the prosecution can't meet its burden of proof. So as a result, I think we saw an increasing nervousness from prosecutors in the United Kingdom. And some statements, that may be not neutral this time, I think have been particularly ill advised. So one U.K. prosecutor advised corporations never to instruct—or not to instruct—lawyers in internal investigations: ask people from HR to do the interviews instead, then we won't have any arguments about privilege. I don't think that serves justice. I don't think it serves the company. And I think for a prosecutor that's just lost a case on no proper process to say, "bypass the lawyers and have someone else do it," is a particularly ill-advised comment. So I do see prosecutors trying to undermine privilege. And similarly data privacy as well. I know one leading US prosecutor said basically, "If you raise data privacy arguments, I'm sick and tired of hearing of them, and they are getting in the way of my investigations."

I think that, as a result, there's much more need to plan out an investigation thoroughly. Quite often my experience is that investigations tend to be almost like the corporate equivalent of calling 911. That we know somebody ought to respond. We call 911, and we say, "Quick, there's been an incident!" And the operator asks, "Is it fire or ambulance or police?" And the corporate response seems to be, "I don't know, just send them all." And I think most corporations are going to have to get out of that mindset, and they are going to have to have properly structured investigations, decide what they are looking for, and then have the team ready to do it.

If I could give a quick illustration of that if I've got time, Diane—

MS. O'CONNELL: Yes, very little.

MR. ARMSTRONG: I'm sorry for those of you who have heard this story before. But to illustrate this, my grandfather in the Second World War maintained small arms up the northeast coast of England. They had no food, but they had a quantity of date-expired hand grenades apparently. So they have no food, so how do they get food? They throw the hand grenades into the sea, bomb the fish and get a net and scrape up those on the surface.

So my rude thing to say is why is that familiar to a U.S. audience? Because that's the way most corporations conduct internal investigations. What we have to do instead of that is think of the food that we need, what exactly do we need, bait the hook and fish in the old-fashioned way, to look at the area that we are focused on. I think partly for privilege reasons, partly data parsing, partly because regulators tell us that we are going to have to engineer internal investigations much better. My view is that the lawyer is in the best person to do that, so they are the very last people that should be bypassed when internal investigations are structured.

PATRICK COOK: Briefly to that. In my experience in the United Kingdom, one of the issues always in these things is the tendency within an organization, such as a bank or other big organization, to copy, send it out to other people who don't need to know. And that's what destroys privilege more times than anything else in my view.

MR. ARMSTRONG: Yes, right.

MS. O'CONNELL: Thank you, Jonathan.

Every time I eat fish now I'm going to think about expired hand grenades.

Interestingly, I am an attorney in risk management for the deals line of service at PricewaterhouseCoopers, which is an accounting firm. No legal practice at all because of Sarbanes-Oxley in the United States. But one of the interesting things that I find is that the majority of the questions that I get coming into my office are: Who is your client? How do I comply? They want to do this under attorney-client privilege, how do we do this? And really what I find is that accountants, who will sit there and say, "We're not lawyers," very often will ask the questions, because they find the rules and the guidelines in which they have to operate from an accounting standpoint confusing.

So I bring that up only because of the fact that the level of questions that I get from accountants, who are also professionals in an industry with sophisticated procedures and highly regulated. They come to me and ask questions that most of the time for me seem obvious, but then there are still some times when there needs to be consultation. So from a global standpoint I can see where even though those folks who are trying to comply have issues—it's not always bad actors. Sometimes it's those folks who are really trying to comply; they may know their microcosm of a territory and the rules with which they have to operate there, but may not know what happens elsewhere in the world. So it will be interesting to see how this develops moving forward and things continue to go global and corporations and private equity firms continue to get more complex on knowing who your client is and how to operate in those realms and maintain privilege and what not in a global economy.

C. Islamic Financing and Its Regulation

MS. O'CONNELL: Okay, now we have Michael McMillen, who is a partner at Curtis, Mallet-Prevost, Colt & Mosle. He's internationally recognized for his work in Islamic finance and project and infrastructure finance. He publishes and speaks throughout the world on Islamic finance and project and infrastructure finance. He teaches at the University of Pennsylvania and the Wharton School of Business. In 2014 he was recognized as one of the top ten Global Leaders in Islamic Finance, and the only lawyer recognized on the list. *Euromoney* recognized Michael as one of the eighteen pioneers in Islamic finance. He's twice received the *Euromoney* award for Best Legal Advisor in Islamic Finance. There are many more accolades I can say about him, but for the sake of time, I am going to introduce Michael.

MICHAEL J.T. McMILLEN: Thank you very much.

First, thank you for having me, Diane, Thomas, the Section. Thank you all for being here. I'm a bit of an outlier here in this presentation. There is nothing approaching Dodd-Frank in the Middle East. Let's start with that. Secondly, I live in Pennsylvania.

MS. O'CONNELL: Oh, sorry.

MR. McMILLEN: It's okay. I actually love it.

So this is a little bit of an introduction to issues pertaining to regulation of Islamic banks, which is a relatively new topic. I'm going to look at two sets of issues here. Structural issues pertaining to Islamic banks and Islamic banking. These you can consider in light of particularly Curtis's comments, and secondly *Shari'ah* governance, which is a subset of corporate governance issues.

Context here. There are four divisions of what is known as Islamic finance: banking; finance; investment; and *takaful*, or insurance. We are going to look at banking. Banking, investment and finance activities all use the same contracts and the same structures, so there's overlap. Then Islamic banks sell insurance, *takaful*, rather routinely. Usually it's white labeled, and they put their own name on it.

The structure of Islamic banking is quite different from conventional banking, which is the term I'll use to refer to interest-based banks. Islamic banks operate on a profit-and-loss-sharing model almost exclusively. There are some safeguard concepts, and we will talk about those in a second. Money coming into an Islamic bank is most often at risk, and it's at the risk of the depositor. So there really isn't a deposit concept as you see in conventional banking.

Islamic banking involves *Shari'ah* compliance in every aspect of what you do. I'll use the term *Shari'ah* here as Islamic law. Actually the legal part is a very small part of *Shari'ah*. There's a lot of ethics and moral principles, governmental principles and then a whole body of methodology. So we are going to look at the structure of the bank itself, regulation and governance, the way they obtain money, the way they utilize money and the way they give back money to a customer—and all of those are subject to quite different considerations. Again, they all have to be *Shari'ah* compliant.

Islamic banking began in the 1970s, so this is a very, very young activity. Then it kind of died out. A few of the banks established in the seventies have survived, but not very many. It kind of died out until the mid-1990s, when attention turned to investment activity. So originally in the seventies you were looking at what we will call the deposit side. Money going into a bank. People didn't think too much about the question: "What do you do with the money when you get it?" If you think of Al Rajhi, which is one of the largest Islamic banks in the world, there is no return back to the customer, as you'll see in a minute. Al Rajhi takes the money and invests it for their own account, which is why Al Rajhi is one of the most profitable banks in the world.

The first comprehensive bank regulatory regime was in 1983 in Malaysia. Malaysia is about twenty years ahead of the rest of the world in all aspects of Islamic finance.

Islamic banking is conducted by three types of entities, or two entities in three different ways: (i) full-fledged Islamic banks; (ii) conventional banks that operate a "window" that is *Shari'ah* compliant; and then (iii) conventional banks that engage in *Shari'ah*-compliant transactions. The basic model for regulating an Islamic bank, until very, very recently and probably predominantly still, is the same way you regulate a conventional bank, which as you will see does not work terribly well. The countries that face these issues head on are those in which Islamic banking is being introduced. The United States is not one of those, but the Philippines is—despite being ninety-five percent Catholic, for example. As part of a settlement regarding Mindanao, the Philippines agreed to implement Islamic banking. So they have to implement a whole Islamic banking regime. Or countries like Tanzania: Tanzania includes Zanzibar, which is an island off the coast of Tanzania that is predominantly Muslim. Tanzania mainland is predominantly non-Muslim, various types. So they have to implement Islamic banking. It usually falls to the Central Bank to take that initiative. I've given you just a couple of examples, but it's true all over the world.

The regulatory system is predominantly considered like the United States. The United States has no Islamic banks, and we don't take cognizance of Islamic finance or the *Shari'ah* in any way. That's the basic model. On the other end is Malaysia. Malaysia has a regulatory system that has two entirely different side-by-side systems: one for conventional banking and one for Islamic banking. Then there are some activities in between. So the comments here can't be taken to apply to any specific jurisdiction.

There are a lot of considerations that aren't present in conventional banking. The most important one is that you have to comply with the *Shari'ah*. The primary vehicle for doing that is through what's known as a *Shari'ah* board, a *Shari'ah* supervisory board, which is a group of *Shari'ah* scholars that look at every activity of that bank, and they issue *fatawa*, which are opinions. *Fatwa*, which is what you've probably heard, is the singular of that; *fatawa* is the plural. They issue them on everything, every activity, every document that goes out of an Islamic bank. Virtually everything that happens. So you can see they are very much involved in the corporate governance regime for an Islamic bank. They are a critical institution.

There are some issues with that, because none of the *Shari'ah* scholars—and usually there are three scholars and up to nine, but most often there are three scholars on a *Shari'ah* board—are employees of the bank. They are all outsiders. There are only a few dozen *Shari'ah* scholars in the world that are qualified to do this. We'll come to the conflicts of interest point shortly. But, as you can imagine, no lawyer has a conflict of interest problem like this. This is throughout the Islamic banking industry and throughout the world. *Shari'ah* boards are supplemented by *Shari'ah* review departments, risk management departments, audit departments.

The regulatory issue. The first question that any country faces is how involved does a government, a central bank, let's say, want to be in regulating the substance of the *Shari'ah*? The answer is not easy, which presents some problems. How do you regulate when the substantive points are all going to be definitively determined by somebody you don't control? There are different ways to address that issue.

So what are the models? The principle that most people are aware of is that you can't pay or receive interest under Islam, or anything that smacks of interest, if you will. So depositors can't receive a return on the money they put into a bank unless it's a profit-and-loss-sharing arrangement. And that's kind of the basis of all Islamic finance: profit and loss sharing. There are a few exceptions, but no predetermined returns, no guaranteed market returns, nothing like that. So quite different.

What do you do? You have two types of bodies of accounts: safe-keeping accounts and investment accounts. In safe-keeping accounts—and there are different types—the depositor, if you will, brings the depositor's money in, puts it in an account and gets no return. The depositor gets the principal back in most instances, but no return. In investment accounts, the depositor's money is at risk. The bank takes the money and goes and invests it. If there's a loss, the loss is of the customer's money.

Very few people, by the way, very few Muslims, who go to Islamic banks off the street—I'm not talking about sophisticated investors—are aware of this. It's publicized everywhere, but when you run little studies on the street, people are totally unaware that they might lose their money. They are conditioned the way the conventional world has conditioned them—that there is some deposit guarantee concept. There is none.

The models for investment accounts are of two categories: on the one hand, agency concepts, where the bank acts as an agent; or on the other hand a partnership concept, usually referred to as a *mudaraba*, but a partnership in which the bank provides a service. That is, investing the money of the depositor and the depositor puts in money.

By the way, the *Shari'ah* is a 1400-year-old body of law. It is a very sophisticated body of law. I think its partnership and sales concepts are more sophisticated than here or in any Western country that I've seen. There are more concepts of partnership than you've ever seen in your life. I mean it is very, very sophisticated stuff. One of them is *mudaraba*, and that's what's used predominantly in Islamic banking. The difficulty with the *mudaraba* is that, if there's a loss, only the depositor loses money. In *mudaraba* the banks provide a service, and if there is a loss, they lost their time and effort. That's the theory on which the *Shari'ah* operates. Talmudic concepts are quite similar, by the way.

What does a bank do with the money that it gets? How does it finance, for example, its customers? Well, there are two ways as a basic concept. The bank buys an asset and leases it to its customer or sells it to its customer on a deferred payment basis. So the bank has to acquire the asset first. Well, this is a little bit difficult because most countries prohibit banks from acquiring, for example, real estate expressly, other than your offices and a few limited categories. But that's the bread-and-butter structure for Islamic finance: leasing or selling. Or they form a partnership. So you're the customer, I'm the bank: we form a partnership. I put in essentially the financing amount, and you buy my partnership interest over time at a return rate, a profit rate, and that's how the financing is paid off. Which is called a diminishing *musharakah*.

Well, banks generally in the West don't enter into partnership agreements with every customer that walks into the bank. You can see already the risk profiles are very, very different in Islamic banking. We'll come back to this.

So there is an agency, a *wakala*, model. On the liability side, the customer puts some money in, the bank invests it. If there's a profit, the bank may get a fee. The fee can be variously determined: a flat amount; a percentage; sometimes profit-sharing arrangements. It depends. And then the money goes back to the customer. Simple enough.

Service-capital *mudaraba* structures are quite different. The bank is the *mudaraba* that provides the service or the work. The *rabbul maal*—customer, depositor—provides the cash. Under classical doctrine the bank cannot put any money into that venture. Now in contemporary times they sometimes allow the bank—*Shari'ah* scholars make these determinations—they allow the bank to put some money in, co-invest if you will, with their customers to generate a little bit of risk allocation alignment.

What happens is that you have a *mudaraba* agreement. Every time a customer walks into a bank, the customer signs a *mudaraba* agreement. That says what the *mudarib* can do: restricted, unrestricted, what the bank is going to do with the money. So the customer puts in the customer's capital. The *mudarib* will go out and conduct some business activities—investments of some type—and the return will go back to the *mudarib*: a portion of the profit will go to the customer, and a portion will be retained by the bank, so the bank makes its money.

These business activities are investment activities of various sorts. Often they are in turn buying an asset and leasing it out and taking the return on that lease or that asset sale or another partnership. You can tell that these activities greatly affect the risk profile of an Islamic bank.

Then there is what is called a two-tiered *mudaraba*. This is very, very common around the world, where the *mudarib* that you just saw at the base, and then the bank becomes the *rabbul maal* or the capital supplier in the second *mudaraba* arrangement. This is very, very common as a global matter with a third party who does the investing, so the risk shifts off quite a bit and goes outside the control of the bank in many ways. But it's all investment risk. Now it all passes right through back to the customer.

Important points here. It's like a limited partnership arrangement in many ways. The customer's funds aren't deposits; they are investment funds. The customer's funds are at risk, and the losses all go to the customer. It affects things like reserve calculations. The bank doesn't have any money at risk here. Do you need reserves? What are going to be your capital requirements in situations like this? It's quite a different set of calculations.

So governance. Governance pertains to *Shari'ah* compliance, a whole body of rights, responsibilities, institutions, policies, just like corporate governance. It is a subset. I'll do a few select issues, maybe four or so.

First issue. Operational risk, reputational risk. Regulators care about them a great deal, and a great deal more than in a conventional bank. Why? Failure to comply with the *Shari'ah* is not only a violation of the *Shari'ah* as law, and possibly a violation of secular law, but it's also a religious violation, and runs on banks happen quickly. Where you're violating a religious principle and that word spreads, your exposure on reputational matters can be very great, much higher than a conventional bank. So there's a lot of regulatory consideration that goes into reputational risk. Now the delicate issue there of course is that the regulators don't want to get involved in the substance of the *Shari'ah*, so they focus on mechanisms to try to ensure that the substance is sound.

Now there are four main schools of Islamic jurisprudence. They differ quite greatly in interpretation. Like every religion, there are lots of variations in interpretation within the religion, so reputational risks are accentuated a bit. There are disagreements; you can have reputational risk issues that you never see in a conventional bank.

Second issue. Islamic banks can't obtain funds from lenders of last resort. Why? Because they are interest-based funding arrangements. There are no *Shari'ah*-compliant funding arrangements except in Malaysia and Indonesia. So it's difficult.

What do you do as a regulator? How do you handle liquidity issues as a regulatory matter? And regulators struggle with this, and there are lots of different ways to address it. Some central banks are now implementing *Shari'ah*-compliant liquidity mechanisms. They are not difficult to implement, at least in fairly rudimentary form or forms that are at some risk of criticism but are easy to do and are accepted widely because there are no alternatives.

Third issue. Islamic windows. Think of a conventional bank running a *Shari'ah*-compliant bank within a bank. Different capital requirements. The risk analysis. How is it governed? The board of directors of a conventional bank probably doesn't have a clue about what Islamic banking is all about or how to govern that Islamic window, if you will. Very different. So do you segregate the window? How? Do you segregate all the books? All the funds, et cetera? And the answer is yes, on the whole you do. Regulatory capital segregation, risk weightings; they're entirely different. Risk exposures all over. Separate minimum capital requirements. You treat it as separate bank is the normal result.

Now, you can imagine that this is something of a disaster— that's my opinion personally. But what's happening around the world is that regulators are saying, "Look, I've had enough of this. If you want to do an Islamic window, form a subsidiary and treat it as a separate unit and implement appropriate governance for it, and we will treat it for regulatory purposes as a separate entity." Much cleaner. It doesn't work in a lot of jurisdictions where it is very difficult to set up a subsidiary, and the Middle East includes a lot of those jurisdictions.

Fourth issue. Collective investment schemes. You can see already basically an investment account, a deposit is a collective investment scheme. What's the disclosure to people? What's the investment strategy for that product? Well, the way it works is that mostly depositors sign an unrestricted investment agreement with the bank, and the bank does what it wants, and at present gives very little information to the depositor. Not good as a long-term matter. This needs to be addressed in their institutions, regulatory institutions that are doing that. But basically shouldn't you be making the same disclosure that you make under the securities law?

Now what happens when you suggest that? I advise a lot of central banks, for example, on issues like this. Well, now you have a jurisdictional conflict between two regulators, the bank regulator and the securities regulator—not here, but in other jurisdictions around the world. Nobody wants to move. So these things go, as we say, *shwaya shwaya*, little by little. Very slowly.

Qualifications for bank employees. I should mention this as well. Shouldn't the bank employees be qualified in the same fashion as is required for other collective investment schemes usually regulated by the securities regulator? Well, the banks, the industry, resist this, as you can imagine. It's expensive, reshapes the industry and reshapes the nature of the bank. But these are the banks.

Islamic banks use "smoothing" mechanisms of two different types. Really, two types of reserves: profit equalization reserves and investment risk reserves. Basically what they are doing is taking the excess money from a profitable year that's above market. And the market, how do you determine? By your conventional bank competitor next door? What are they paying? You take the excess and put it in a reserve fund, so that when profits are down and you're below the conventional bank next door, you draw on the reserve to fund in a manner that allows you to compete with the conventional bank next door. The returns are going to end up being basically the same as a matter of competition.

So there's an intergenerational problem here. You're taking money from one group of people and giving it back to a different group of people. This is the solution thus far. But in addition to that there are lots of other issues. Transparency, accountability issues, risk profiles. That money is going to get invested. What do you do with it? It can't be touched as a *Shari'ah* matter by the bank. It can only go back to the so-called depositors. These are the types of issues that regulators address.

Fifth issue. *Shari'ah* governance. The *Shari'ah* scholars themselves, they are not employees of the bank. So many countries have outsourcing restrictions of all different types, and some of them are pretty strict. Well, virtually all the governance is outsourced at the highest level. Think of an Islamic window, an Islamic window within a conventional bank is a pretty small unit usually. Almost one hundred percent of the activities of that window get outsourced, so you're violating the outsourcing regulations for the whole window. So you end up going through and trying to adjust. Then how do you regulate people that are on the outside? Well, extraterritorial reach is not the problem, but they are not familiar with it. It's not there, so you have to design a whole new system to go out there and regulate those people. You can make the people in the bank accountable, but that's not the end of the matter.

Then the confidentiality issues, conflict of interest issues—we won't go through them because they are obvious, but there are tons of them.

By the way, the *Shari'ah* scholars: one scholar may sit on forty or fifty boards. You can imagine those banks are all competing with one another. Now what's interesting is these are people of extraordinary integrity. We have never had a problem since 1996 in this area, but is it going to happen? Of course it's going to happen. It retards the development of the industry in a kind of an interesting way.

I write a lot of first drafts of *fatawa*, for example. I work with a lot of *Shari'ah* boards. I'm working on a structure. I go to the *Shari'ah* board, they say it doesn't work. I say, okay, how can I fix it? They can't tell you because they are on the board of a competitor, and their conservatism is such that they won't tell you how to fix it. So I have to go off and guess how to fix it and go back.

I've been studying *Shari'ah* for nineteen years now; I'm getting better at guessing, but it's a guessing game. It's interesting. It's fascinating, really. Or you start with interpersonal. You watch closely. I know these people really well now. How did the person flinch or look at something. It's that kind of very one-on-one activity.

Qualification as fit and proper. Obviously for all of these people the fit and proper requirements for a bank are great as they stand, but you're going to have to tack on a whole new fit and proper system that deals with *Shari'ah* matters.

Conclusions. This area is expanding at a rate you can't imagine. All over. I mean the Philippines is implementing Islamic banking, as you can imagine. We don't in the United States.

By the way, if you take *sukuks*—*sukuks* I refer to as Islamic bonds, but they are not bonds; they are securitizations. If you take those out of the picture, in my opinion the United States is the second largest Islamic finance jurisdiction in the world. We do just an extraordinary number of deals here, mostly real estate, some private equity. But for example, we own every Cargill office building in Minnetonka and elsewhere in this country; we lease them back. We own Sunrise nursing home. The list goes on. We owned Loehmann's, sold it out in an IPO. Church's Chicken. We own all the Thomson Reuters headquarters in the country and we lease them back. They are sale and leaseback transactions; they are real estate plays. The fact that they are *Shari'ah*-compliant is irrelevant to everybody involved. We own maybe fifty municipal hospitals in the United States. It's big business in the United States, suffice it to say.

It's regulated how? It's not. It's investment activity. It is private investment activity that involves no bank. It is fascinating. You become the second largest jurisdiction in the world, and it's totally unregulated, but that's the U.S. It's like any other investor.

It's happening in Muslim jurisdictions, non-Muslim jurisdictions, everywhere. I personally think it's a great thing. I think people should be able to invest and behave in accordance with their faith, whatever it is, as long as it's not disruptive to the system and harmful to other people.

So what happens? Non-Muslim players come to the point where they don't care; it's just another financial deal. It's leasing. If I showed you a picture of the structures you'd say it was a leveraged lease or possibly a synthetic lease. It looks exactly the same. The risk allocations are pretty much the same. So it's easy to do in the U.S., partly because of our tax system. Economic substance plus our check-the-box regs that allow entities not to be taxed. It's easy to do *Shari'ah*-compliant deals here, and we are a big diverse economy.

So I would encourage you to take a look. To become involved. The industry needs regulatory help. It needs sophistication, and I would hope that people would bring that to bear. I personally believe a great deal in integration, not isolation, of different bodies of people within an economy or a society, and I think this is a great opportunity to do that.

So thank you very much. If you have some questions, I'll take those up.

MS. O'CONNELL: Thank you, Michael. Curtis, do you have a question?

MR. TAO: Yes, I do. Do you believe there are areas where for U.S. banks engaging in Islamic finance on behalf of clients where there is a hole in terms of the authority that's been permitted? For example, a U.S. bank has a number of controls over the currency and interpretative letters over the years that allow it to do *Mudaraba* but not the entire suite of *Shari'ah* transactions. As I recall, there was a forum that was organized by the New York Federal Reserve Bank in 2005, and it was really in response to a concern that the Islamic financing being provided by U.S. institutions since 9/11 had dropped off. It was a terrific forum, bringing together scholars, the industry and the community, but I'm just not sure I've seen that same type of regulatory encouragement since. So are there areas that you think that the regulators should focus on in granting greater authority?

MR. McMILLEN: Well, Tom Baxter has been particularly active and has established a committee that is still operative, but relatively dormant. I mean it comes to life and goes away from time to time, but it's still there.

What we have found in the United States is this: in the early years we were fearful that either somebody would apply for an Islamic banking license, or we wouldn't be able to do *Shari'ah*-compliant finance. We have now found out that within the existing system we can become the second largest jurisdiction in the world. We don't have England's problem with double taxation because of our check-the-box regs, stuff like that. It's not that they have receded so much. It's just that it's not so necessary unless somebody applies for a license.

Now Devon Bank in Chicago, University Bank in Ann Arbor, different banks do a lot of *Shari'ah*-compliant transactions, particularly in home purchase transactions. But increasingly also in other areas. You can do it, Citibank can do it, any bank can do that. Now the difficulties have been tax. I think it was three years ago that New York State issued a tax ruling on the *ijara*, the lease structure. Leasing is the most common and sophisticated transaction, and *murabahah*, which is a cost-plus sale, is the most frequently used and most frequently abused structure in Islamic finance. It's used a lot, and it's accepted because there aren't alternatives for some things. That structure has seen a resurgence since 2008.

The important one though is the *ijara*, the lease, and New York State handled that. They said it's a loan. Well, that relieves enormous pressure. Because where do you do these deals? New York. They are all New York law documents.

The federal Internal Revenue Service has not questioned these. While they haven't issued a ruling, nobody has asked them for a ruling. In almost all transactions in the United States there's a tax matters agreement that says for U.S. tax it has only one substantive point. It lays out every aspect of the transaction: take a lease, and it says this part of the rent payment is principal, this part is interest, and the only reason we did this deal is for *Shari'ah* compliance. This is really a loan for U.S. tax purposes. The only substantive provision of the agreement is that the two entities will file in accordance with that agreement. The IRS has looked at hundreds and hundreds of these. I mean I represent one fund where we did over six hundred *ijara* transactions for that one fund here. Never had a tax problem and that's over a long period of time, now sixteen years. That takes the pressure off.

MR. TAO: Thank you.

AUDIENCE MEMBER: You know, this might be more of a personal question, so if it is, I can talk to you about it later. But the question is how did you get involved in this area, and once you found yourself about to become involved what did you do to prepare?

MR. McMILLEN: Well, if people don't mind, I'll tell this story briefly. I was a project finance lawyer at Debevoise and at White & Case, and I went all over the world. I did the Davo project in India and all kinds of gold mining projects for this and that. And for my sins they sent me to Saudi, because I didn't know the first thing about the Middle East. I did the first project financing in Saudi, which was Saudi Chevron. It was a conventional financing, but one of the lenders—Chase was one of the leads out of London—wanted a mortgage. It's a $2 billion financing, and they wanted a mortgage. You can't get a mortgage in Saudi, and that's because the Al-Sheikh family, which controls the Ministry of Justice, believes that a mortgage secures an interest-bearing obligation, so they won't record mortgages. And the thought was this: "Well, I went through this, I did a U.S. model, a U.K. model; it can't be done. It dawned on me that probably the only country in the world where the *Shari'ah* is the paramount law of the land is Saudi. In other countries it's important, it's near the top, but it's not the paramount law of the land. So I started reading everything in the world in English on the Koran, all *Shari'ah* stuff, and there has to be a mortgage-pledge concept. My partner, a guy named Hassan Mahassni—he's now mid-eighties and probably the most prominent lawyer in the Middle East—got a judge from a *Shari'ah* court to come sit with me from 9:00 to midnight two or three nights a week. Just a blast, actually, and we did this for a long time.

I asked him at one point, you know, if we have a lease, a *Shari'ah*-compliant lease or a *qard hassan*, which is a noninterest-bearing loan, you owe me money under this arrangement as a lessee, can I take your camel as a pledge? He said of course. I spent a year and a half talking to that guy about camels.

[Laughter.]

I know more about camels than you will ever dream. And we talked about date palms. We developed a structure that worked, and the *Shari'ah* scholars approved it. I've worked for nineteen years on the Saudi Mortgage Pledge Law, which was approved last year. It was a big event in my life. After eighteen years, you know, *shwaya shwaya*. I got to tell you, nobody goes more slowly than the Middle East. That's how I got involved.

So the *Shari'ah* scholars started sending me clients, basically. So people would come in and say, "Can you do a *Shari'ah*-compliant equivalent of commercial paper?" Fascinating.

I mean I wrote a book last year on this stuff, but partially from a different vantage. If you're interested in the whole jurisprudential concept of change of law, the evolution of law, most of the time scholars study ancient Rome. That's kind of a main body. But you should study *Shari'ah*. This law has evolved more since 1996 than any body of law in the world and probably in the history of the world, I think. Seriously, I don't think I'm exaggerating this. I spent the last few years just studying this one little topic. It's a fascinating area, even if you have no interest in it as a practical matter, but I bet you will. Virtually every one of you will do a *Shari'ah*-compliant deal at some point. The growth rate is just astronomical.

MS. O'CONNELL: Thank you, Michael. I actually just did one. Any more questions? From everybody's bright and shiny faces I think we could use some coffee. So let's take a break.

III. Impact of Financial Regulation on the Legal Community: How These Regulations Have Changed the Practice of International Law for Everyone Everywhere

MS. O'CONNELL: Thank you for coming back after the break in this storm. Your commitment is very much appreciated. I'm going to introduce Patrick Cook in just a second, but Michael McMillen has one quick story to tell us before I do.

MR. McMILLEN: One of you asked me to tell this story and asked about the *Shari'ah* scholars and whether they had any sense of humor, because it's not always perceived that they do. It's a wonderful group. I was educated by probably five of the top six *Shari'ah* scholars in the world.

By happenstance, I lived in Saudi, and they came through and one of them lives there. I don't know, but in Islam if you convert someone—I'm not Muslim—they go to heaven. These five guys have a pool that if any one of them converts me, they all go.

[Laughter.]

A. The Scope and Effect of Global Financial Regulation

MS. O'CONNELL: Thank you.

Introducing Patrick Cook now, who is going to give us some information from the U.K. perspective as well as from the insolvency perspective. He's currently a partner at Burges Salmon in corporate recovery, an insolvency practice that is now ten partners of a twenty-six-lawyer team. They advise on all aspects of corporate stress and distress, both in the United Kingdom and internationally. Patrick is a specialist in restructuring. He is a corporate insolvency lawyer, with extensive experience in the banking and financial sector. He has over twenty-five years of experience in the industry, and his main clients are banks, financial institutions, public authorities and bodies, pensions, trustees, private equity houses and insolvency practitioners. I can go on: there is more. But his bio is posted online. So for the sake of time, I'll introduce to you Patrick Cook.

MR. COOK: Thank you, Diane.

First of all, thank you very much for letting me come and speak. This is my first ever meeting: I've only just joined the New York State Bar Association, so it's a great honor to be able to do that. And I would like to thank Bill Schrag in particular for organizing that for me.

I'd also like, as an Englishman, to celebrate the linkage with Magna Carta. I have to say as an Englishman that I was ignorant of the effect and esteem that you in the United States have and hold for the Magna Carta. I hadn't appreciated it until I started doing some reading as to quite how important it became.

I am not going to talk to you in any great detail of the nitty-gritty of the U.K. regime. Frankly, it isn't hugely different. It's different in emphasis, different in style. Of course it is; we are English. We don't cooperate as well as we should with our neighbors in Europe, who have a particular way of looking at things. We have a slightly different way of looking at things, and we have a slightly different way of looking at things than you do here. But essentially we have all recognized that the financial markets got into a mess. Things had gone too far and something had to be done about them.

What I would like to do really is just ask you to think a little bit about Magna Carta. I'm sorry to draw you back eight hundred years, but it is quite a celebration: eight hundred years for a piece of legislation. Actually, it wasn't a piece of legislation. It was a treaty, an agreement between a king and some super powerful barons. Now that sort of has some resonance between the state and some powerful financial institutions. There are some other resonances we should be aware of, so we might consider a little bit what the similarities really are.

The first thing that I would like to say in terms of similarities—apart from the state and powerful barons as it were—was that the treaty, the charter and indeed the legislation, whether it be Dodd-Frank or the U.K. equivalent or the European equivalent, are pretty unintelligible to most people. You have to bear in mind that in 1215 very few people could read. In fact, it's likely that most of the barons who imposed the treaty couldn't read. The king was not that good either.

[Laughter.]

They were pretty good at fighting, but that was about it. The king clearly wasn't as good as he should have been. The other thing is that the people that created the charter were a very small body of people who could read and write. They were mostly almost exclusively members of church. So the equivalent is you guys. If you think of yourself as the monks and the nuns of the current laws, because you as lawyers understand the language and the documentation, and indeed, in the case of some, if not most, of you, you are at least financially literate or getting towards it. Perhaps not all of us are as literate as Curtis is, but nevertheless, you are the interpreters of this body of work in a very similar way to perhaps the monks—I think it was the archbishop who actually wrote the Magna Carta for the barons.

The other thing that's worth thinking about is that, although the Magna Carta is only thirty-seven short paragraphs long, as compared to say for example the twenty-three hundred pages of Dodd-Frank—[Laughter.]—it was written by hand. In those days writing, as I say, was something that only a privileged few could do. If you made a mistake you had to start again. You couldn't push the delete button. So actually in its time, in its way, thirty-seven paragraphs of treaty was maybe not quite the equivalent of the twenty-three hundred pages, but it was a big document.

The other thing that I think is worth thinking about in terms of Magna Carta is that it's remembered for and honored for something that it was not ever designed to do. And it's in that regard that I think we might consider where we would be with Dodd-Frank and its equivalent across the jurisdictions in—maybe not eight hundred years, but let's take twenty years' time, because things seem to be moving more quickly now.

I say that because the Magna Carta was imposed upon the state by the barons. Now arguably, Dodd-Frank has been imposed upon the financial institutions by the state, but that's arguable, I suppose. The idea of Magna Carta was that it was to maintain and enshrine the status quo. The idea was that barons wanted to be barons, and they didn't want the king to interfere. They wanted to be allowed to keep their assets. They wanted to be able to do the things that barons do, which is normally pretty nasty: bashing other people over the head with iron bars and so on. If they did and they did it wrong, they were to be tried by their own peers and consummately not to be locked up without having the opportunity for a trial. Because the king was quite adept at nailing people and shutting them up in a castle until they paid him some money.

So the idea of a Magna Carta and what has survived—and I could go on about Scottish and all sorts of exciting things which no longer pertain to any sort of life—but the idea about it was that it preserved the status quo, as far as the barons were concerned. I would raise this question, and it's a question only: Do we really think that Dodd-Frank, that the English Banking Act, the Financial Services Act and the legislation that has come out of the European Union has done anything to alter the status quo in any serious way?

And I would suggest to you there are good arguments saying that it hasn't. What it has done is to enshrine all of the things that the financial services institutions have been doing over the last twenty-five years, let's say. It's found a different way of regulating them, a different way of packaging them, and a different way of thinking about them. But essentially, it has endorsed the behavior and the methodologies that have gone on in the past. What was changed slightly is they said, "Yes, we are going to regulate a bit, we are going to roll back a bit from some of the things that went wrong, but ultimately we are going to tick in the box to say the financial institutions, the financial markets are here to stay, they are a good thing and nothing has changed other than around the periphery."

Now that may not be a bad thing, and I'm not here to argue that we should do away with the financial services market. I'd be a very brave man to come to New York and say that. But I think arguably we have been subject to a collective failure of nerve, faced with a huge potential crisis—a huge actual crisis. Let's not call it potential. It was a huge crisis, and it could have been a lot worse than it was. But I wonder if we have really taken the opportunity—or at least had the opportunity because the crisis was so difficult—to consider whether the way we go about the financial services market genuinely serves us in society.

That sort of begs the question: Well, what do we want from the financial services industry? Clearly, it is essential in the current world, in international trade—we cannot get by without the movement of capital. There are strong social reasons why we need capital movement and capital availability to enable a whole raft of different areas of society to grow and develop. We want people in society to have access to capital so they can improve their lives, perhaps buy a house, take part in society, and that, of course, helps us all. Businesses need provision of capital. I mean I don't need to say some of this, but everyone needs to cover overheads before they got the profits in from trading. So there's got to be a capital provision of liquidity to enable the business world to get by.

Facilitation of international trade is essential. Banking came about because merchants got fed up with having to lug bars of gold around to pay for sheep and whatever else it was they were trading at the time. So somebody thought, "Well, let's just write this down on a piece of paper." And back in the days when trading was relatively simple—from say Holland to England or whatever—somebody in Holland would write a piece of paper saying, "I promise I will pay X bars of gold for your commodities," and that was honored, and somebody would then trade another line on the paper.

Since then, of course, the sophistication of that market has gotten to a pretty extraordinary extent. And we need banks, we need financial institutions to help with risk protection. I mean part of the point of the paper was to protect the risk of the ship going down with the gold in it. Nowadays we have risk protection through things like interest rate hedging, through commodities hedging, all of which makes a lot of sense. It makes business possible. Without it, it wouldn't happen.

Some of the things we wonder about. I mean is it really great to have trades in derivatives? You know, the original derivative maybe you can understand, a hedge and somebody sells that hedge on to someone else and so on and so forth. I wonder whether actually we're right to simply have Dodd-Frank in relation to derivatives and NTC trading, and say, "We are going to enshrine this great idea, we are just going to regulate it a little bit." Are we really going to start that situation that developed and got out of control in the mid-2000s? And I speak of this as an insolvency lawyer who saw how quite absurd, frankly, the situation had got, where you had significant amounts of financial instruments being created on the back of assets which really, frankly, did not deserve them.

For example, CMBS, commercial mortgage backed securitization. I had an occasion where I was asked to try and unravel a situation where 1.2-billion-pound instruments had been created on the back of assets which were care homes. Well, I don't know about in this country, but in United Kingdom the care home industry has been a basket case. And the whole premise was sale and leaseback of care homes and the income generated from them. Well, as soon as the major care homes got into fundamental difficulties themselves and the underlying asset value plummeted, as it was bound to do, those instruments became completely untenable. In this particular case what started out as a 1.2-billion-pound instrument, the rescue value, if we were able to sell all the underlying assets, was somewhat south of five hundred million. So it was a huge, huge write-off. It was created because the underlying asset was never going to be good enough.

So my concern is yes, we have got clearing coming into that market, but might we have gone further? It's a question I don't necessarily have the answer to, but I think that we have enshrined in our legislation that it's okay to do whatever sorts of trading we like in these instruments, and I wonder if that necessarily is going to be for the benefit of everyone in the longer term.

The history of the financial services industry in this country and in the U.K. is of inches being given and miles taken and bankruptcy following. As night follows day that has happened. It will be, frankly, remarkable and a testament to parliamentary drafting, if that's the right word over here, but the drafting of legislation if the effects of the legislation that is coming over here and continues to come in and the legislation in the United Kingdom and in Europe have that effect. I don't know. It might. It might.

But just to come back to the law of unintended consequences in Magna Carta, and to try and bring this together a bit, what happened to the Magna Carta? And why did Magna Carta become what it is and how do we think of it? Bear in mind that only three elements of Magna Carta remain out of the original thirty-seven. The reason it grew to be what it is was because between 1215 and 1278 a word was changed, and the word was "baron," and it was substituted for by the word "freeman." Now "freeman" at that time meant something very specific. There were very, very few freemen in England at that time. There were guildsman, there were a few yeoman farmers, and there were churchmen. The reason that freeman got in was because it was felt that there had to be some recognition to the people of London, who had opened the gates to let the barons in when the king was away, which was the prime bargaining chip as far as the imposition of the Magna Carta was concerned. Of course, the churchman writing the thing wanted to make sure they were included as well. But it was a small change, literally a classic legal one-word change, that led to things becoming different.

There then followed the implosion of the baronial society in the Wars of the Roses, and over a period of one hundred fifty years they actually killed each other out and possibly other bad things. There then followed the rise of, frankly, the middle class, if you'd like to call it that: the merchant class and the lawyers, the secularization. We had the Reformation and the Renaissance. So we had a change of thinking, and the idea of society in the old feudal sense changed.

At that point—and I wish he were my uncle, but he wasn't—Sir Edward Coke, a great Elizabethan jurist, picked up Magna Carta and the word "freeman" and used that in the subsequent arguments against James I, which ultimately led to Charles I having his head cut off. You have to bear in mind that that was an incredible thing. Because in those days people believed that kings ruled by divine right. So to cut the chap's head off was a bit like cutting God's head off.

Sir Edward Coke argued that, on the basis of the fundamental principles that King John had laid down for himself and all of his successors, no man was above the law, and that meant the king wasn't above the law. And that meant that parliament had the right to depose the king and ultimately impeach him for treachery. And it was that small change, and it was because of the word "freeman," because it then applied to all free men. And so it was by then that society had become considerably freer, not completely free, but considerably freer. In England it wasn't until the end of the first world war that women started getting general suffrage, so it's a very long time indeed. But as society changed, that one word made all the difference.

Then, when it came to the birth of your country, people picked up the principles that Sir Edward Coke had picked up back in the 1600s and applied them, because the colonists, as they were at that stage, did not feel that they had to simply do whatever the king said however many thousands of miles back in England. And based on that, through that jurisprudence, the world's greatest democracy was founded.

So if ever there was a law of unintended consequences, if you had said to the Earl of North Hamilton back in 1215, "Do you know what, over there—I know you think you're going to fall off the end of the world because it's flat—but believe me, in a few hundred years' time you're going to start something really big." They would have just not have understood.

So what I think is—and I will put this to you just as a theory—we won't know whether the legislation we have seen enacted over the last few years, and may continue to enact, will have the effect. We don't really know, I think, that we completely understand what effect we intended it to have, but I'm pretty sure that some parts of it will survive.

I'll throw this one out as an interesting thought from Michael's talk. Had the financial institutions and financial markets been run on *Shari'ah* guidelines, we wouldn't have got into the mess we got into in the mid-2000s. One takes the rise of Islam as a fact of life for the moment. Who is to say what's going to happen in the next decades or century in terms of where we are with the way our financial markets are regulated? I think it's an interesting open question. Ladies and gentlemen, thank you very much.

MS. O'CONNELL: Thank you, Patrick. Does anybody have any questions?

MR. TAO: I thought there were some really interesting points raised. So Diane, we can either get into a discussion now or later, it's up to you.

MS. O'CONNELL: Well, let's see.

MR. TAO: I think there's a question from the audience as well.

MS. O'CONNELL: We are doing well on time, so I would say let's go for it.

AUDIENCE MEMBER: How was Mr. Coke able to resurrect the validity of Magna Carta after King John had disavowed it very shortly after signing it?

MR. COOK: Well, King John did, but his son, Henry III, I think, reavowed it, and it was then reavowed again in 1395 by Edward II, I think.

AUDIENCE MEMBER: Thank you.

MR. COOK: Can I just say something. One of the difficulties with that, of course, is that Edward Coke was an amazing guy, but he did collect the law almost as if they were curiosities, and I think subsequent research has shown that some of it may not be accurate.

I'll give you one example. I believe also it says that it is lawful for a man to beat his wife, without exception, provided that the stick is no longer than the tip of your elbow to the tip of your ring finger.

So these days we may not say that that's a firm basis for the law of domestic violence. So I think there needs to be a health warning about some of this. Some of it of course was scientific, but some of it was like almost the old curiosity shop of laws, and the difficulty sometimes has been that we have adopted all of his research en masse thinking that it stacks up historically.

MR. TAO: Let me touch upon a couple of themes and say that the Magna Carta, like financial regulation, must be able to evolve. I think if you look at the more recent incarnations of the Magna Carta, including the United States Constitution, even that document when first drafted and adopted was not perfect. I could cite the three-fifths rule among other things. So I think there were some myths with respect to financial regulation that I think even Congress recognized.

First, derivatives by themselves are not inherently evil. It's how you do those derivatives. So think about the securities that got many of the banks in trouble during the Great Depression. There was great concern about what these things were, and that this wasn't traditional banking. If you look at the evolution of the world financial system, derivatives are really now the next version of securities. Derivatives don't exist simply because banks created them just for the sake of being able to trade them. It's because clients and counterparties require them.

If you think about the trillion dollar—I know it's terrifying—if you think about the trillion-dollar foreign exchange market, okay, but it's because there are massively huge volumes of currencies that exist. If you need to be able to transfer or to hedge or to otherwise fund what you have in terms of a need in Euros and you only have dollars, or let's think about some other jurisdictions that are not developed G20 jurisdictions. Foreign exchange derivatives give you that ability. It's a robust market.

Same thing with interest rates. Interest rates are a trillion-dollar issue—actually even larger than foreign exchange. And it's because virtually every single corporate company in the world needs to issue debt, and that debt has a coupon on it. And you need to be able to hedge your ability to pay that coupon.

There are other kinds of derivatives out there, which I think unfortunately there's a myth about being risky. I'm a lender, I have exposure to you as my borrower, I want to hedge that exposure. I'm going to buy a credit default swap—protection against you defaulting—because it hedges my risk to you, my credit risk exposure. It is in fact right now a fairly liquid and transparent market due to the initiatives of the U.S. regulators.

So the thing that Dodd-Frank tried to do is recognize that derivatives are the new form of securities in the new world, but they tried to fix a couple things: transparency; credit risk (which is by required mandatory clearing); and trade execution and standardization. Now one can argue whether Dodd-Frank achieved those objectives, but I think there is a recognition that our financial market, as much as it had been dominated by securities, is in fact now a derivatives financial market.

The other thing that I think many people don't understand is that everyone thinks of the financial markets as being equity based. Equity comprises a tiny, tiny, tiny portion of the market. It's credit. Credit includes derivatives, it includes bonds, it's about the ability of companies to raise money and raise liquidity.

The second myth I want to mention is risk. Financial markets, the world economy, do not operate unless there is risk. And if clients don't want to bear that entire risk, it has to be by their counterparty. Risk occurs on both sides of every single transaction. Banks must be able to incur risk for the markets to be able to function.

The issue is, how do you manage that risk? I believe fundamentally the financial crisis was caused by a failure to manage risk, to monitor, to identify and then properly to manage risk. That risk can be managed in a couple of different ways. It can be done by making sure you have enough capital. It can also be done by ensuring that you're limited in the type of risk that you incur versus various types of counterparties, that's credit risk or market risk. But I think there just needs to be an understanding that banks do not act as agents. Because if you did, that risk has to be borne by someone, so it will be the counterparties. But the counterparties want to share that risk with the bank, so risk has to occur on both sides.

The last thing I'll mention about risk is that banks are sized today based on their clients. So if you look at a community bank, they are sized appropriately with respect to who their counterparties are: consumers. And if you look at the larger banks, we are sized to who our counterparties are. I posit that Caterpillar, PepsiCo, Delta would not be able to get the services that they require by transacting with a small bank. There are only a couple of banks in the world who can provide the level of services that a U.S. multinational corporation needs to have and their operations in thirty different countries, that span from cash management to being able to issue debt to being able to hedge their risks. And that's why you have banks that are sized the way they are. The question of course is what are those limits and how do you ensure through prudential and conduct regulation that those banks are properly risk-managed?

MS. O'CONNELL: Thank you. Let's go to questions.

AUDIENCE MEMBER: So I have a couple questions. I don't think anybody has anything against hedging. I think we all understand that we need derivatives for hedging. But what do you think about naked credit default swaps? Do you think those are now adequately regulated? That's one. And two, maybe the world isn't well served by world multi-nationals that require huge banks.

[Laughter.]

MR. COOK: Okay. As a rugby player I'd call a pass. But let me make one thing very plain indeed. I come from a family of bankers. My father and my brother both worked for The Bank of England. I'm a banking lawyer, so there must be something in this somewhere. So I'm not in any way knocking the concept of banks as institutions or indeed their size. I think that Curtis is absolutely right: when you look at the current world of international trade, it is impossible—in fact it's inconceivable—to think that you could run the world economy without a number of enormous financial institutions in the banks that we have got. To come back to your question in terms of naked CDSs, that's where I have a question mark personally. I think I said when I was on my feet that I completely understand basic hedging and the reason for it: it's purely risk protection.

Where it becomes slightly less understandable to somebody who is as unsophisticated as I am is trading in effectively bets, beyond the primary hedging and the primary purpose. I suppose that what one has to look at is that of course the institutions that do this make money out of it. And that goes to alleviating the cost of their operation and therefore the cost of credit generally to world trade. So it has a purpose. It's a question whether it's something that we feel is right to allow to happen, and indeed whether it would be right in a free market to try to impose limits on that. And I don't have the answer to that.

But I think that the thing is this. The real issue, as I saw it at least in 2008-09, was yes, there were credit risks that had gone wrong, but the real fundamental issue—and if you look at a securitization or an SIV—the real issue with those was not credit default, but it was liquidity. And none of those instruments had been drafted with liquidity hedging in mind. Indeed, that is not how you would hedge liquidity at that sort of level. Liquidity is based on trust, trust between big organizations, and that broke down in 2007-2008 because banks were not comfortable. If they lent even overnight to another bank, they'd get it back, and that's what caused the thing to grind to a halt.

MR. TAO: If I can just respond and say that's an excellent question. The myth that I don't think unfortunately the press has reported about is that the biggest users of credit default swaps are funds, some corporates, but it is funds. So investors looking to get exposure, okay, full transparency, they want to take risk. They want to invest in the fund or the collective investment vehicle that's looking to take that exposure, but they are either going to buy an actual exposure to the company via bond or security, or they are actually going to do it through a synthetic form, which is the credit default swap, buying and selling. So Congress and I think the regulators have made the decision to allow investors to take the risk they want to take. Once you have determined that investors should be able to take that risk and choose how to put their money to work, at risk or not, banks will now facilitate.

Now, I will tell you right now that, because of Dodd-Frank and the combination of different rules, banks are prohibited to take naked risk in CDSs. We are a market maker and there are various requirements. We have to be limited in the risk to both the counterparty as well as the underlier. And there's a number of things that occurred before Dodd-Frank as well as in Dodd-Frank that says we cannot be naked. So we are really facilitating or hedging our own risks. The people who are naked are the investors. If the public policy decision is that it is a form of risk taken by investors that policymakers don't want investors to take, so be it. But that decision hasn't been made.

MR. COOK: If I could just add one little point to that. The decision about whether investors should be allowed to take risk is a bit like the decisions that are taken on all risks we take. We are not allowed to smoke in public places right now because the risk is too high. It's arguable that one could take a view on that sort of trading. I'm not saying that you should or you must, but it's that kind of thing. It's a development of society and what society wants. And of course, at the moment the loudest voices are probably worthy financial clouters. But eventually the small voice does get heard in these situations.

I'm not sure what the right answer is here, but I just put it out there as a question for thinking about. That is, there are some sorts of financial risk that we ought to think about and decide whether—just as there are some kind of personal risks that we as society don't allow each other to take. We don't allow each other to drive drunk; we don't allow others to do things which ultimately could harm others. Ultimately, if financial markets freeze, that does create a little bit of problems here and there. So it's something for society to decide as a whole I think.

MS. O'CONNELL: Thank you. One more question.

AUDIENCE MEMBER: More of an observation from a different angle. This is very simplistic, and I don't perceive this as a risk management thing. It was a greed management thing, with the sense that the taxpayer will bail out all these bad decisions, so I'm not really taking a lot of risk anyway.

MR. TAO: Who wants to take that one?

[Laughter.]

MR. ARMSTRONG: Can I suggest, if you wish to feed your view on that, there's a really good article about that here. It comes out of The Center for Economic and Policy Research, it's dated July 2009, and it's written by Matthew Sherman. It's a short history of financial deregulation in the United States. It won't improve your blood pressure.

AUDIENCE MEMBER: I'll take the medication before I read it. What was the name of the author again?

MR. ARMSTRONG: Matthew Sherman.

MR. COOK: It is really interesting, a YouTube video that the FCA had put together. In regard to some of the foreign exchange tradings, they have showed the chat room and its messaging communications between groups—and I think it's not all about greed. Some of it is a big game. One group calls themselves The Three Musketeers. They are moving the market in part for profit, but in part on the trade they gave—and I am going to be delicate about the example itself—the gain was about only about ninety thousand sterling, I think. I think it's not necessarily about the profit. Part of it is they are moving the market because they can. They like to think that they are The Three Musketeers.

So it is a more difficult situation than saying take greed out of the market. These are twenty-something guys who are talking about whether someone's going to beat Chelsea in one moment, and then talking about whether they can fix the world financial market and make it do what they want it to do. So to them it's not just a greed thing. That's why, when we train people like this, we have got to go beyond removing the greed, removing the pleasure element, and that then fixes the problem, because it doesn't. We have got to stop them treating trading as video games as well.

MS. O'CONNELL: Which I would say actually brings us back to *Shari'ah* law.

[Laughter.]

B. The Implications of Global Financing and Financial Regulation

MS. O'CONNELL: Any more questions on this? We'll move on to the next speaker.

Last but certainly not least—and thank you for your patience—is François Berbinau. He is a partner at BFPL Avocats in France. His practice focuses on dispute resolution, focusing on corporate, commercial, labor, employment law. His clients include French and international corporations, French public long-term investors, serving the general interests and economic development of the country. He previously practiced litigation arbitration as Cleary Gottlieb in both New York and Paris. So thank you, François.

FRANÇOIS BERBINAU: Thank you, Diane. Three preliminary remarks before I get into the subject of post-global financial crisis regulation.

The first one is the subject of Magna Carta. So what can the French say about Magna Carta?

[Laughter.]

Well, a few things. First of all, I think we're partly responsible for Magna Carta, because at the time, as you know, there was a war going on between the English and the French. And these barons that Patrick mentioned were often going to France to go into battles. At the time, in 1215, they had a tendency to lose their battles on the soil of France—1213-14, Battle of Bouvines. That has not always been the case. I mean we've lost a great deal of battles. There is a subway station in London to remind us every time we go there. We do have some train stations of our own.

But anyway, at the time there was even a story, you know, a rumor that the Magna Carta was actually drafted in France by these barons. I mean now that's been proven completely wrong, but at least there was some relation. And that's about the only relationship we have with Magna Carta. Because as you know from history, we have a different way of dealing with the king's power. It actually took us like five hundred more years, but we ended up chopping his head off. We did, though, pass the Declaration of Human and Citizen Rights a few years before, but nevertheless four years later we finished up the job by chopping off his head. That's pretty much covers the subject of Magna Carta.

My two other remarks are, as you may know this, I'm the only non-English native speaker on the panel, so you'll excuse me if I'm not completely accurate in certain terms. And the other characteristic is I think I'm the only panelist who didn't know anything about this financial crisis, post-financial crisis and markets regulation. I think Jonathan said that he didn't know much about it, but I think he's too humble: he knows a great deal. So I really struggled with the subject, and that was very interesting.

The first issue I have is to whom am I going to talk? Am I going to talk to the New York State Bar Association International Section or the International Section of the New York State Bankers Association? So I figured out, you know, how many of you are going to be very familiar with banking regulations and market regulations? How the markets work or don't work? I figured out there was a little test, and I felt that if I tell you that a CDO is an ABS that is issued by an SPV and can be backed up by high-held corporate bonds, CMBS, REITS and even by RCUs. For those of you for whom that makes perfect sense, I already apologize, because I'm probably going to be overly simplistic in any explanation. For all the others, I'm trying to explain to you what I understood of this whole regulation, what it's all about, and what it's here to address in terms of issues. And to understand that, the first thing I had to do as a French national was understand the following: why did we have this financial crisis in France when the whole thing started with real estate loans in the United States? That was not obvious to me. I mean yes, you read articles, you hear very smart people telling you in very complicated ways why this whole thing went worldwide. And I had to figure that out. First, because the only way to understand what this regulation is all about is to understand what kinds of problems it addresses. Now I've listed a number of reasons, but ultimately—after discussing this with a number of clients who are bankers—I think really what these regulations try to address and correct is a number of behaviors.

If you go back in history to this subprime issue, really what it was—again being probably overly simplistic—was a real estate market that was making plus fifteen percent in Europe at the time in 2001. And at that time there was a policy that everybody had to own their home. I mean you have to loan money to a lot of people so they can become homeowners. The way a certain number of credit institutions went to these potential clients was by saying that, "You can own your home even if you don't have the money for it because I'm going to lend you the money for it. I'm not going to be too worried about your capacity to reimburse me; it doesn't matter, because I'll ask you to start reimbursing me in about two years from now. In two years from now the value of your house, which is my security, my collateral, is going to be much higher than it is now. By the time I'll ask you to reimburse me, I'll make you another loan, a bigger loan, and by that you'll be able to reimburse me and reimburse my interest. It's going to go on like that because your house is going to continue to rise in value over the years, and that is going to go on endlessly like that." Except that obviously in 2006-2007 the real estate market turned. There was a little boost of inflation, and the value of the houses just dropped and that was the end of it.

Now the first behavior that these regulations are trying to address is the behavior toward your client—which is offer products or credits only to clients who can afford it. Know your clients, and don't try to make them lie or invest into a certain number of products that they are not well suited for.

After this failure to properly advise the customer, the second problem behavior was securitization. Again, I had a difficult time to understand the whole concept, so I'll make an example for you. The whole idea of securitizing a claim you have because you've lent money is to make it a product which you're going to be able to sell, an asset you're going to be able to sell.

Imagine for the sake of demonstration that I decide to make a huge loan to Jonathan. I sort of know Jonathan is broke—[Laughter.]—just for the sake of the demonstration. I don't have any insider information on Jonathan's financial wherewithall. But let's say I make this one-billion-dollar loan. Then I'm a little concerned, so instead of keeping that loan to myself—he's given me some assurances, but I don't know really what they are worth—I decide that I'm going to make my claim against Jonathan a product. I'm going to sell it to someone. I'm going to sell it to the gentleman with the bowtie in the first row. I'm going to say I have a fantastic product to sell you. It's going to bring you thirty percent a year in interest. So you're probably not going to ask me the question about whether Jonathan is really solid, but if you do, I'll tell you, "Yes, he's rock solid. He's been invited to the NYSBA as a speaker, and obviously you can trust this. It's a strong thing. Anyhow, what do you care, since you're going to get thirty percent a year?" So you buy it. But then you're going to sell it the next day to the lady behind you, and she's going to do the same to the gentleman behind her. And it's going to go on and on like that. Now you're going to tell me that this is again overly simplistic, because it's easy to spot whether the product is dirty. And you're right, unless—and that's where I come into the picture— it's like French pastry.

Here is an example I got from a trader, who heard it from a former trader. And I think it's very interesting. You all know what a *mille-feuille* is? I think you call it a Napoleon here. What you do with your dirty loan is it's like the bottom lawyer of the *mille-feuille*, you stick it here. The *mille-feuille*, all together, it's a bunch of products, loans. It looks good. It's creamy, and it looks real good. You're going to go to someone at a bank and you're going to say, "Well, you want to buy my *mille-feuille*?" And either they won't even see that the bottom layer doesn't look good, or even if they have some scrutiny and they say, "Well, you know, your bottom layer doesn't look so good." But it doesn't matter, you're going to hire a bunch of mathematicians, some of them coming from France, and you're going to tell them, "You have to find me a way to make this *mille-feuille* really, really great, despite the bottom layer." So they are going to issue you a fifty-page long mathematical formula to explain to you that even if—and it's not the case—but even if one of the layers, say the bottom layer, is a bad layer, it's not going to affect the entire taste of your *mille-feuille*. Why is that? Because it's almost impossible to challenge—and you're going to buy this *mille-feuille*—because it's almost impossible to challenge their explanation. Why? Because mathematically it's almost impossible to challenge and explain and foresee exactly the impact of one loan, whether one loan is likely to end up into the debtor being bankrupt, and another loan in the same *mille-feuille* having the same probability and how these probabilities are going to interact with each other.

So even if you want to make sure that your product is going to be sold, you go to Fitch and they are going to give you a AAA rating. They will say, "Your *mille-feuille* is great! Everybody is going to buy your *mille-feuille*!"

At the time that one discovers that ultimately Jonathan is broke and that the bottom layer is dirty and the whole *mille-feuille* is going to collapse, it will have been sold all over the world. That's how I get it in France. That again is a behavior that the regulations wanted to address.

Now another behavior that these regulations wanted to address is the issue of the lack of transparency that's been talked about, the lack of transparency over-the-counter, of OTCs, especially the credit default swaps product. So credit default swaps: I've heard and agree that they are completely legitimate. It's just that you've made a loan, and you want to obviously hedge your loan, and you want to take some kind of insurance on your loan, and that's fine.

Now again, let me tell you another story to understand what the issue may be. Take a rather mid-size but very solid and very reputable U.S. bank that is making a lot of loans. Now this bank happens to be facing very serious financial issues because of the subprimes, and so they find out they are lacking a lot of liquidity and a lot of money. So they go to a very large bank, much larger than they are, and they ask for a huge loan, like one billion dollars. That bank says, "Yes, no problem, I'll lend you the money."

And they lend the money, but the next day they go to another large bank or an even larger bank, and without telling the first, the smaller bank, they ask the other bank, "Could you sell me these CDSs? Can I buy CDSs from you to cover? Because internally I have to make sure that I'm covered, to cover the loan that I just did to that other bank. And you know that bank, you know it has a very good reputation, so the likelihood that it won't be able to reimburse is very, very low, so you can sell me your CDSs for not too much money." So that bank, that large bank who made this one-billion-dollar loan, either way it makes money. If the smaller bank is able to reimburse the loan, they make money out of the loan and they get their loan reimbursed. Or they fall into a situation where the debtor is not able to reimburse the loan, then it doesn't matter because they have the CDS, and they are going to call for this insurance and say, "Give me the money. I'm sorry, they went bankrupt, they can't reimburse my loan, but I want the money."

Now imagine for a second that this large bank who lent that one billion dollars bought CDSs from not just one bank but from fifty different banks. Then if the smaller bank collapses, then it's not just a matter of a loan of one billion dollars, a coverage of one billion dollars, but fifty times the coverage of one billion dollars and that becomes a huge problem. So that again is a problem, especially so because first of all you don't know about the CDSs at the time. You don't know it because it's over-the-counter, so it's not regulated at all. It's just banks deciding among themselves what kind of security they are going to get, what kind of price they are going to sell it for, and what is the value of the counterpart, the security, they are going to put on it to cover the CDS. So it's not clear and nobody knows exactly what happens, and nothing is regulated.

The second problem is the kind of behavior that I described. I think someone mentioned this is an issue, a very important issue: the matter of trust. It came to a point where banks didn't trust each other, and they wouldn't lend money to each other anymore, or they would only lend it at very high interest rates for a very short limited period of time. So the issue of trust among banks is very important, and probably some of the behavior I described had a bad effect on how people saw the banks and the way they were behaving. So I could get into more explanations, but those are the phenomena that I am trying to address.

Now, there are a number of regulations, and you'll find them in detail in the paper that is on the website. Diane mentioned the website address earlier. I'm not going to go into the details of all of them because there's too many of them. But I'll try to explain to you in general what those regulations at the EU level and at the French level tried to correct in terms of the issues.

So the first thing these regulations tried to do, and I used the metaphor of planes, because really the financial markets are a little bit like the sky we have over our heads, and the banks are like the planes: they fly around in the skies and they interact. As for the sky, you need to have some kind of regulation. In the plane you need to have radar and warning lights to detect problems, and that's what the capital requirement regulations and the CRD, the Capital Requirement Directive at the E.U. level, tried to address. What they did, among the measures, was introduce warning lights like our ratios. You have to respect a certain number of ratios, because these ratios are going to be able to help the bank reimburse their capital funds. There was an issue about liquidity and capital funds, so you have to address it. You have to make sure the banks have sufficient capital funds. In order to do that you have to set up a number of ratios, like liquidity ratios and leverage ratios in order for the banks to be able to, you know, be careful. If you don't respect that ratio, that should act like a warning light and you should correct it.

The other thing is that you have to disclose a certain amount of information. It's one thing to have these ratios, all these ratios, but you have to disclose them to the authorities. So there are a lot of rules about more detailed reports, increased frequency of reports, and how fast you have to pass these reports.

And you also have to improve governance. Among the measures that are involved in trying to improve governance, you have some measures about how you can manage to still incentivize your troops. Because you need this at banks, obviously, the ability to incentivize the troops—but without the troops having a tendency to play against your clients, or take risks that are atrocious simply for the sake of making a bigger bonus. So all of these issues are addressed, and then you also have—I'll get back to that later—the implementation of a single supervisory mechanism in Europe to extend the powers of the European Central Bank and in France the national supervisory body.

The other issue that these regulations wanted to address is to avoid large banks getting too large and too powerful. That's what I call "avoid engine over-heating." There you have two approaches around the world. You have several reports in Europe, and of course in the United States as well. The United States came up with the Volcker Rule, which was talked about earlier.

Basically there are two approaches. One approach is a ban on proprietary trading, and again, that has been addressed before. That's the U.S. approach, and that's the Belgian approach, and that is to an extent an approach that the Europeans share, though not all of them. We are not all there yet and probably will never be, because some countries, like Germany and France, are very much against it. It's more complicated than that obviously, because you can still do some proprietary trading but under certain conditions.

The second approach, which is the French and German approach, is that huge banks have to split off their activities which are retail activities—the activities that are useful to the development of the economy of the country— from those activities that are essentially speculative activities. Under French law that was enacted in French law on July 26, 2013. They went into a lot of detail as to the fact that you have to have like a specific subsidiary that doesn't have the same name as the group to which it belongs that will handle all these proprietary tradings and all these speculative activities, so that they don't risk polluting the rest of the activities of the bank that are considered as very important to the development of the French economy.

Another purpose these regulations serve is the reinforcement of safety measures to protect customers. So you have the *mille-feuille* regulation and the *mille-feuille* directive. The idea of all of these texts, these directives and regulations, is to improve the rules in consumer protection, so that goes to developing the type of information that the documents you distribute will include. You will have some uniform precontractual information, et cetera.

So make sure that your clients are going to be well aware of the type of products that you're selling and what they represent and what kind of risk they represent. And that is something that came out of the analysis of the crisis.

Again getting back briefly to the over-the-counter products and especially the credit default swaps. I think it's Chapter 7 of Dodd-Frank that addresses this issue. In Europe it's called the European Market Infrastructure Regulation, EMIR, and it aims at enhancing transparency of OTC derivative markets, the application of trade repositories. Basically, we have trade repositories into which you're going to transfer the information. They are going to be in charge of collecting and maintaining information and records of these derivatives. At the same time it reduces counterparty risk by clearing obligations, so now you have those centralized clearing houses, which you did not have before.

The whole thing was not regulated. These clearing houses are under the supervision of national and international and E.U. bodies. So the whole idea is it's still important to be able to exchange credit default swaps—but you've got to do it in a way that is secure, and the way to do that is to go through these clearing house entities.

Just a brief word on the issue of cross-border transactions. So now you understand that you have regulations in Europe and you have regulations in the United States and you have regulations in the United Kingdom, and they more or less stem from the same basic analysis and the same objectives. But the U.S. went faster than Europe, and they started with Dodd-Frank, and they started implementing the rules. And then Europe started creating more rules. Now how do these large financial institutions deal with that?

Even if the rules are more or less the same, they are not exactly the same: that would be too easy. Because that was not from the start. At the beginning of the G20 in Pittsburgh, the participating states decided on the main objectives—but they didn't decide that they would move together as one. Unlike in the real skies, where you have flying regulations that are standardized all around the world, here you end up in a sky where the regulations are more or less the same but not completely the same. That is potentially a source of contention and problems for the banks, because they have to find out exactly what regulation they need to respect. Because there are differences in the type of entities that are subject to these new regulations, the scope of the activities that are governed by these regulations.

So to try to address this problem, both the E.U. and the United States have put in place some extraterritoriality principles whereby there is a recognition of comparable regulatory system. So basically the idea is that, if the E.U. is dealing with a bank which is respecting Dodd-Frank Chapter 7 regulations, the E.U. is not going to ask this bank to also respect its own rules in the air.

But that's still purely theoretical. And potentially you have issues. If you want, take two issues. Take the issue of the clearing obligation. The clearing obligation under Article 40 may apply to two counterparties not situated in the E.U. if the contract they conclude have a direct, substantial and perceivable impact in the E.U. Under Dodd-Frank, two parties of a contract not situated in the United States will have Dodd-Frank apply to this contract if one of the parties is considered a U.S. person, a person under U.S. regulation, or their contract has a direct and significant link with activity situated in the United States or activities affecting U.S. commerce. So how do you exactly make these two regulations fit? That's not an easy question. I don't have the answer, and a lot of banks are still considering what to do with that.

Another set of rules that you find throughout the regulations is centralized control towers. So you have bodies throughout different regulations and directives, like the European Central Bank, you have these clearing houses for standardized OTCs, and the European Market Authority, and you have the EAIF. They are all here to try to centralize these warning lights I told you about. There are bodies here to find out like how many planes have such warning lights blinking and whether that may end up having crashes in the skies. So these control towers are something new.

One last thing is emergency measures to anticipate and prevent financial crashes. At the European level the idea is you have a single supervisory mechanism that will supervise, like I just mentioned, when some problems appear in the financial sky. Then if one of these planes, these bad planes, is spotted and is identified as a potentially crashing plane, then we'll intervene. The single resolution mechanism will allow the European Central Bank to report the bank to the Euro zone to a single resolution board, and that resolution board is going to tell the Commission that there is a problem with this bank that should be addressed. And a whole set of rules are going to be put in place to try to save that bank, including a single resolution fund. So instead of having funds at the national levels as now, the idea is to have a fund at the E.U. level in order to be able to address such issues.

It's not easy because laws, like the laws of July 2013 I told you about, the French law—they also have national regulations—where they can eventually intervene in a bank if there is a serious issue. They can intervene, change management, force changes in the organization of the bank: so how this is all going to interact is not completely clear.

One thing I should add about all these regulations is that some of them have set rules that have not been applied yet. They are rules that are meant to be applied in 2016. Other rules were supposed to be applied in 2017, and then they have been pushed back to 2019, so that leaves a long time before all these regulations are going to be put in place.

There is also one thing in France that we are very fond of, and that is taxing. So we tax whatever we can, and if you could tax the air we breathe, we would. But at least in France we tax financial transactions. There is a project about a financial transaction tax at the EU level. It's what we call in France a sea snake. It's talked about, it seemed to be abandoned, and yet the Ministry of Economy was having a meeting like a week ago around breakfast to discuss this. So we don't know whether it's going to end up becoming something real—but for the moment in France it exists, and in the E.U. it doesn't.

I understand that in the original draft that President Obama presented to the Congress there was the idea of a tax on financial transactions? Or am I wrong, and that thing was completely abandoned?

MR. TAO: Well, there are a number of recurring proposals by the Administration called the Financial Crisis Responsibility Tax, and it was just recently also proposed that the tax would charge only banks roughly seven basis points on any funding it raises. So if a bank is going to issue a debt, it will obviously have to pay a certain interest to the investor, and an additional seven basis points to the Government, same thing with a deposit. I think my understanding is that the Republican Congress has not accepted that.

MR. BERBINAU: Just to come to a conclusion, again you have all the details in the paper I've tried to put together on all these EU and French regulations. Ultimately, my understanding of the situation is that all these regulations try to address the behaviors that were considered detrimental to the whole system—but the whole idea is not to completely change the system. The system will remain the same. There are whole economies built on that system. They are trying to make it more visible so that a crisis may be anticipated in a better way. Honestly, I leave it to you to make a conclusion. But I have doubts as to how these regulations are really going to impact the system. Because outside of the behaviors that I have described, and again I'm sorry for putting it in an overly simplistic way, but it's just the way the system functions.

One of the traders I was talking to told me about the solar spots: I don't know if you heard about the solar spots and how they impact the financial markets. Solar spots are the flares on the surface of the sun, and they are like large seas. And they tend, depending on the temperature of the sun, to change in size and suddenly disappear and reappear. Now imagine that you take a TV news presenter or a French TV news presenter, let's say you have Brian Williams, who I understand is a very famous TV and news presenter: imagine Brian Williams comes on TV one night and says that a certain number of solar spots have been observed and they are changing and this changing is going to affect the value of the U.S. dollar in the way that the U.S. dollar in the coming days is going to drop in value. Now you go back home and you say, "That guy, I don't know if he had too much to drink when he went on TV that night. How can he possibly know the solar spots will have any impact on the value of the U.S. dollar?" But the problem is a number of people who will have listened to Brian Williams, and some of them will say, "Well, it's Brian Williams, he said it, so that may well be true, so you know, I should sell my dollars and buy Euros or Yen or whatever." And the others are going to say, "Well, that can't be." And they are also going to see that the problem is that a lot of people are going to believe this guy. So they are going to start selling their dollars, so they believe they should do the same because otherwise.… And that's one problem I see in the markets: you don't want to be right against all the others on the financial markets; you prefer to be wrong with the others than right all alone by yourself. Because ultimately everybody is going to sell their dollars, the dollar is going to drop, and Brian Williams is going to come on TV and say, "I told you." And you're going to say, "Oh, well." Now that's just an example for the sake it's nice to hear now.

Consider this: when President George W. Bush went to Japan several years ago at some point he made a mistake between deflation and devaluation. So he announced that Japan was on the verge of entering a very large, serious devaluation—instead of deflation. That went on TV, and that started people thinking, "Well, I mean this guy knows, he's the President of the United States, he knows something about the Yen being devalued." And the Prime Minister of Japan had to come and make an official statement to explain and correct what George W. Bush had said on TV. So it's a little bit like these solar spots that may affect the markets. I really don't know how you can end up with regulations that can possibly control such behaviors and sensitivity and reaction of people towards the market.

Thank you.

MS. O'CONNELL: Of course, because we are attorneys, we have run over on time. I did leave a buffer of some time, so lunch won't start for about ten, maybe fifteen minutes, I think. So if there are questions for François or the panel in general I welcome those now.

MR. COOK: Diane, quickly before lunch, to make one observation—well, two observations.

First, read François's paper. It is absolutely brilliant. And second, François was modest about the French influence and effect on the Magna Carta. First of all, all the barons were French. They came over with William the Conqueror a hundred years earlier, so they all spoke French, and it had to do with the French war that the king had been losing. But think about this: the three tenets that have survived from Magna Carta are habeas corpus, the fact that no one is above the letter of the law, and trial by jury. That translated in your own constitution in this way: "We hold these truths to be self-evident, that all men are created equal, that they are endowed by their creator certain unalienable rights, among these are life, liberty and the pursuit of happiness."

Now we know Benjamin Franklin spent a lot of time in Paris shortly after that, and guess what comes out in the French constitution: *Liberté*, *egalité*, *fraternité*, completely tied into one.

MR. TAO: If I could also make one comment and say that it's a tremendously fascinating practice, financial regulation. The Dodd-Frank Act is an amazing document, because it really tries to deal with a very complex set of facts and complexities that compound each other, and the governmental officials try to act within the confines of what Congress told them to do: to deal with the contributing factors as well as the causes of the financial crisis. It's incredibly complex, but it's a true exposition of a good-faith attempt to really deal with complex policy matters in a host of different areas. I think the Dodd-Frank Act has become the model which other jurisdictions will now use as the starting point. Not to say that they will follow, but it really represents a comprehensive attempt, and the politics were there at the right time to really try to create solutions for just about any and everything that the policy makers could think of that led to or contributed to the crisis.

MR. ARMSTRONG: I hope we have a panel in nine hundred years' time looking at Dodd-Frank.

MS. O'CONNELL: Just in closing, it sounds like globally so far everybody has been impacted by the financial crisis. We know this. It's been addressed in different ways. We know this. Will it succeed? We'll see you in nine hundred years to determine that. Thank you all for coming. Thank you, Curtis, Patrick, Jonathan, Michael and François for joining the panel. Thank you, audience, for coming out in a blizzard.

Islamic Banking: Some Distinguishing Regulatory Considerations

By Michael J.T. McMillen

I. Introduction

The focus of this article is the regulation of one segment of modern Islamic finance: Islamic banking, whether conducted by stand-alone Islamic banks or "Islamic windows" within conventional interest-based banks. Consideration is given to a select group of illustrative issues that arise in connection with the regulation of Islamic banks. These issues pertain to (i) the structure of Islamic banks and the nature of the activities conducted by Islamic banks with funds provided by the customers of those banks (i.e., the funds that are considered to be "deposits" in conventional banking), and (ii) *Shariʿah* governance, a subset of corporate governance that focuses on ensuring that Islamic banks operate and conduct their activities in accordance with the *Shariʿah*.

Generally considered, Islamic finance is comprised of four categories of activities, each conducted in accordance with the principles and precepts of Islamic *shariʿah* (the "*Shariʿah*").[1] These are (a) banking, (b) finance, (c) investment, and (d) insurance (or *takaful*). There is considerable overlap of the first three of these categories, largely because the same contractual arrangements and transactional structures are used in banking, finance and investment activities. The focus of this article is on Islamic banking.

Modern Islamic finance, in each of these four categories, is a relatively recent phenomenon. Islamic banking began in the 1970s and the first growth spurt occurred during the 1970s and 1980s.[2] *Shariʿah*-compliant finance and investment began in the mid-1990s.[3] Islamic banking may be conducted by (i) financial institutions that are formed and/or regulated as Islamic banks or (ii) financial institutions that are formed and regulated as conventional banks (*i.e.*, interest-based banks) that provide *Shariʿah*-compliant financial products, such as home purchase financings. In the latter case, the conventional banks may operate "Islamic windows" or they may merely use *Shariʿah*-compliant financing structures, including "bifurcated" structures that integrate interest-based financing into a *Shariʿah*-compliant structure.[4]

The regulation of *Shariʿah*-compliant finance and investment activity is, at present, largely pursuant to the same laws and regulations as are applicable to secular, interest-based finance and investment activities. The regulation of Islamic banking presents a significantly different regulatory picture, although the fundamental purposes of prudential supervision and other aspects of bank regulation are essentially the same for both conventional and Islamic banks: to promote and ensure the financial stability of the banking sector and the safety and soundness of the banking system. In some jurisdictions the regulation of Islamic banking and Islamic banking activities is pursuant to the same laws and regulations as are applicable to conventional banking activities. Thus, for example, there are no Islamic banks in the United States, but various banks offer *Shariʿah*-compliant products and are engaged in what can be described as Islamic banking activities.[5] At the other end of the spectrum, Malaysia maintains a dual system of bank regulation: one system being applicable to conventional banks and the other being applicable to Islamic banks.[6] Regulatory regimes exist across the entire spectrum between these two models. As Islamic banking (and other aspects of Islamic finance) expand into jurisdictions throughout the world, regulators are confronted with a perplexing array of policy determinations as to how to regulate Islamic banking and *Shariʿah*-compliant banking (particularly financing) activities ("Islamic banking activities") conducted by conventional banks.

The fundamental nature of Islamic banking is quite different from conventional banking. As a simplistic statement, in conventional banking a customer deposits funds with the bank and obtains a return on those funds at a determinable interest rate. Under the *Shariʿah*, the receipt and payment of interest are prohibited. Thus, customers of an Islamic bank are not able to deposit funds with the bank and obtain an interest-based (or other predetermined) return. Customers of an Islamic bank provide funds to Islamic banks for either safekeeping, in which case they receive no return on their funds, or for investment, in which case the customers are at risk of either losing their funds or obtaining a share of the investment profits. This obviously presents bank regulators with a set of issues that are quite distinct from those arising in the interest-based deposit paradigm, particularly in the case of the investment accounts.

Additionally, all of the activities of an Islamic bank must be conducted in accordance with the *Shariʿah*, which will be considered to be Islamic law for present purposes (although the legal portion of the *Shariʿah* is actually a rather small segment of the entirety of the *Shariʿah*).[7] Manifestly, bank regulators are not qualified to make determinations regarding *Shariʿah* compliance. And, politically, bank regulators are reticent to become involved in making determinations regarding *Shariʿah* compliance.

Various mechanisms have evolved to ensure *Shariʿah* compliance. Often these mechanisms operate outside the bank regulatory regime, at least as regards the substance of the *Shariʿah*. However, the regulatory regime may require that adequate mechanisms are in place to ensure that *Shariʿah* governance requisites (and thus *Shariʿah* compliance) are effected. The basic structural mechanism is the *Shariʿah* supervisory board, a body comprised of *Shariʿah* scholars that (i) makes determinations as to *Shariʿah* compliance, (ii) issues *fatawa* (opinions; *fatwa* is the singular) regarding compliance of contracts, structures and arrangements, and (iii) oversees the entirety of *Shariʿah* compliance for all activities of the Islamic bank. The *Shariʿah* board is supplemented and supported by audit, compliance, review, research and other departments and institutions. The composite of these mechanisms and institutions that address *Shariʿah* compliance is referred to as "*Shariʿah* governance." Obviously, *Shariʿah* governance and related issues are entirely absent from regulatory regimes applicable to conventional banks.

This article focuses on two categories of matters that illustrate some of the issues that arise in connection with the regulation of Islamic banks. The first category pertains to the structure of Islamic banks and the nature of the activities conducted by Islamic banks with funds provided by the customers of those banks (*i.e.*, the funds that are considered to be "deposits" in conventional banking). The second category is *Shariʿah* governance aimed at ensuring *Shariʿah* compliance and the avoidance of reputational and other risks that may be attendant upon noncompliance. Select issues from each of these categories are discussed. The perspective that is taken in this article is to consider these matters from the vantage of a bank regulator in a country with a banking system that does not have an Islamic banking law and does not have any Islamic banks at the time that the first request is made to license a bank as an Islamic bank (*i.e.*, a bank that conducts all of its activities in accordance with the *Shariʿah*).

II. Islamic Banking Models

Categorized by general type of account, there are four main sources of funds for Islamic banks: (i) savings deposits; (ii) current deposits; (iii) term deposits; and (iv) investment deposits. Even this simple statement raises differentiating issues with respect to Islamic banks. The first issues, which are considered later in this section, relate to the "deposit" concept. Are the funds from customers in fact "deposits" as that term is conventionally considered (*e.g.*, in the context of "deposit insurance")? Should these funds be subject to and receive the benefits of deposit insurance laws and regulations? The short answer, for the moment, is that customer funds provided to an Islamic bank may be, but often are not, "deposits" within the deposit insurance regimes that exist around the world. Other issues, also subsequently discussed, pertain to the "investment" concept.

Because of the prohibition on the payment and receipt of interest, among other things, customers of Islamic banks cannot receive an interest-based return on the funds they "deposit" with Islamic banks. As a result, under the *Shariʿah*, the structures of Islamic banks are quite different from those of conventional banks. The most frequently encountered Islamic banking models involve (i) the customer depositing funds with the Islamic bank for safekeeping, and (ii) the customer depositing funds with the Islamic bank for investment purposes. In the latter model, (1) the Islamic bank may act as an agent for the customer in investing the customer's funds (the *wakala* or agency model) or (2) the customer and the Islamic bank may enter into a partnership arrangement in which the Islamic bank invests the customer's funds and the customer and the Islamic bank share in the profits of the investment (the *mudaraba* or service-capital partnership model).[8] Each of these models is summarized in this section. The critical considerations pertaining to each model relate to the respective risks, rights, responsibilities and obligations of the customer and the Islamic bank.

Safekeeping arrangements, while relatively straightforward, are structured in a variety of forms. The common characteristic is that these deposits are not entitled to any return, whether by way of interest, dividend, guaranteed return or other payment. The obligation of the Islamic bank is to return the principal amount of the customer's funds to the customer in accordance with the safekeeping agreement between the customer and the Islamic bank. Thus, for example, in a current account the customer may be entitled to the return of the deposited principal at any time, while that entitlement may arise only at the end of a specific period in a term account.

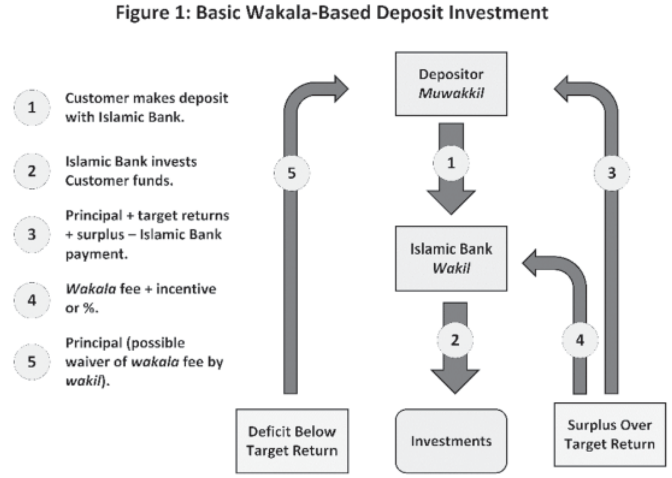
One form of safekeeping account is structured as an interest-free loan (*qard hasan*) from the customer to the Islamic bank.[9] The Islamic bank is a borrower that guarantees the return of the principal amount of customer's funds (with no return), including in cases of negligence involving the Islamic bank or other loss of that principal amount. The Islamic bank is permitted to use the customer's funds in the bank's business and to retain the profits and benefits from use of those funds without obligation to share any of those profits or benefits with the customer who provided the funds.

Another form of safekeeping arrangement, which has variants, is based on safe custody principles (*wadiʿa*),[10] often involving safe custody based upon trust (*wadiʿa yad amanah*) or guaranteed safe custody (*wadiʿa yad dhamanah*).[11] In each form, the agreement between the customer and the Islamic bank will specify whether the Islamic bank is permitted to use the customer's funds and the nature of any such permissible use. It is commonplace for the customer to give permission—often broad permission—to the Islamic bank allowing use of the customer's funds in connection with the Islamic bank's business activities. Any profit or benefit from such use belongs to the Islamic bank and need not be shared with the customer. In the safe custody based upon trust arrangement, the Islamic bank must exercise the same degree of care as it uses with respect to its own funds. This means that the Islamic bank is not liable for losses of the customer's funds unless such losses result from misconduct, fraud, breach, default or negligence of the Islamic bank. In the guaranteed safe custody arrangement, which is the more common form, the Islamic bank will only infrequently be excused from liability for returning the principal amount of the customer's funds.

In practice, although the customer is not entitled to any return (and cannot be promised a return) on its funds, Islamic banks will frequently make periodic "gifts" to customer's that have entered into safekeeping arrangements. To remain competitive with conventional banks in the same market, the amounts of the gifts will often be equal to the interest-based returns provided by conventional banks to their customers with respect to comparable accounts.

The *wakala* or agency model is widely used where investment activities are contemplated. Figure 1 depicts a generic agency-based deposit investment arrangement.

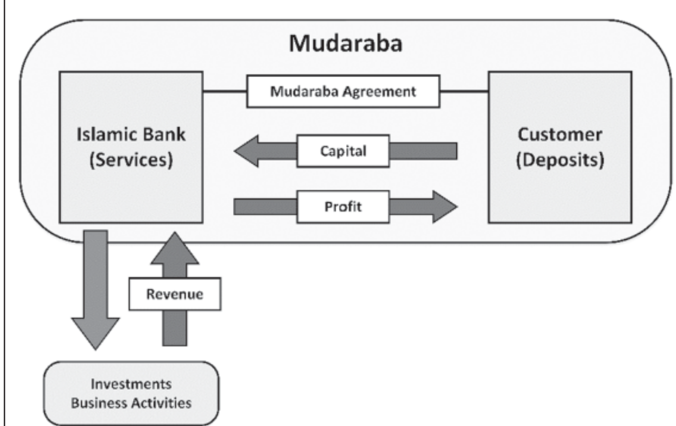
Figure 1: Basic Wakala-Based Deposit Investment



Pursuant to an agency (*wakala*) agreement, the customer appoints the Islamic bank as the customer's agent (*wakil* or *wakeel*) to invest amounts deposited with the Islamic bank.[12] The arrangement may be restricted or unrestricted in terms of the scope of permissible investments to be made by the Islamic bank (although the investments will always have to be compliant with the *Shariʿah*). The Islamic bank is often paid a fee for managing the investments of the customer's funds. The Islamic bank may also receive an incentive fee, which may be structured as a percentage of the profits on the investment of the customer's funds. Investment losses are borne by the customer as the principal, unless resulting from the misconduct, fraud, breach, default or negligence of the Islamic bank. Guarantees of the customer's principal are generally impermissible.

A *mudaraba* arrangement is another common type of investment account. A *mudaraba* is a service-capital partnership (sometimes called a "silent partnership"). The customer (as *rabb ul-maal*) provides funds: the capital of the *mudaraba*. The Islamic bank (as *mudarib*) provides investment services relating to the customer's funds. Usually the *mudarib* is the only partner that is permitted to participate in the management of the affairs of the *mudaraba*. The customer, as *rabb ul-maal*, is a "silent" partner. Profits from successful investment of the customer's funds are shared between the customer and the Islamic bank, usually pursuant to pre-agreed formulae that are specified in the *mudaraba* agreement. Some defining characteristics of a *mudaraba*—which are immutable—are that (i) the losses from investment activities are borne exclusively by the customer (the Islamic bank has lost the services it provided, and suffers no further cash losses) absent misconduct, fraud, breach, default or negligence by the Islamic bank, and (ii) neither the customer's principal nor any return on that principal may be guaranteed or otherwise assured. Figure 2 provides a simplified depiction of a generic banking *mudaraba*.[13]

Figure 2: Banking Mudaraba

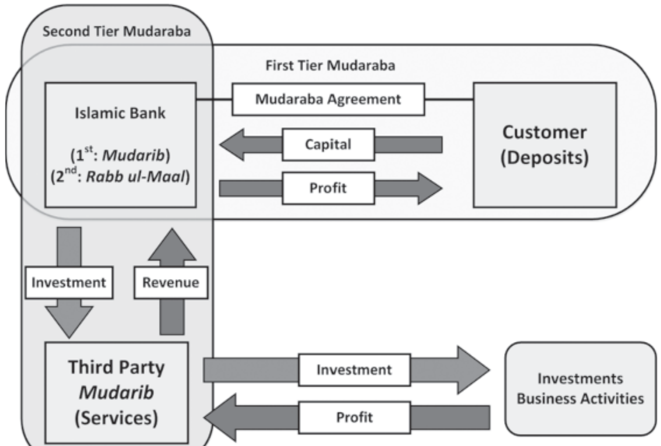


In both the agency (*wakala*) model and the service-capital (*mudaraba*) model the customer's funds are at risk and in neither case is return of those funds guaranteed or otherwise assured. If there are investment losses, the Islamic bank is not obligated to make a payment of any type to the customer (absent misconduct, fraud, breach, default or negligence of the Islamic bank). It is for this reason that these investment accounts are often considered to fall outside the deposit guarantees of deposit insurance laws. More, if the rationale of bank capital requirements and various reserve requirements is that the bank may have financial reimbursement or payment exposures, these capital and reserve requirements are said to be unnecessary in the context of Islamic banking. The

Islamic bank will have no obligation to make reimbursements or payments to its customers in respect of losses on these investment accounts.

A frequently-encountered variation of the *mudaraba* structure illustrates well the balance between the asset and liability sides of an Islamic bank's balance sheet. This variation entails the use of *mudaraba* arrangements on both sides of an Islamic bank's balance sheet. Thus, customer funds are taken into the Islamic bank pursuant to a first tier *mudaraba* in which the customer is the capital contributor and the Islamic bank is the service provider. Customer funds are then deployed by the Islamic bank in a second-tier *mudaraba* in which the Islamic bank is the capital provider (*rabb ul-maal*) and a third party (as *mudarib*) provides investment services. This is referred to as a "two-tier *mudaraba*" and is depicted graphically in Figure 3.

Figure 3: Two-Tier Banking Mudaraba



The first-tier *mudaraba* is identical to that discussed in connection with Figure 2. The second tier *mudaraba* is indicated in Figure 3. The principles applicable to each *mudaraba* are identical. Profits in the second-tier *mudaraba* are split between the Islamic Bank, as *rabb ul-maal* and capital provider, and the third party *Mudarib*, as *mudarib* and service provider. The Islamic Bank, in its capacity as *mudarib* and service provider under the first tier *mudaraba*, will then split amounts received by it with the Customer, as *raab ul-maal* and capital provider under the first tier *mudaraba*. In the event of investment losses at the second tier *mudaraba*, the Islamic Bank, as second tier capital provider, will bear all financial losses and those will subsequently be borne by the Customer as first tier capital provider, without reimbursement or payment of any type by the Islamic Bank.

III. *Shariʿah* Governance

Shariʿah governance in the Islamic banking context encompasses the policies, procedures, practices, mechanisms and institutions that are concerned with ensuring that Islamic banks and their activities are compliant with the *Shariʿah*.[14] It encompasses both procedural compliance and methods of ensuring substantive compliance. It includes the identification and allocation of rights, responsibilities and obligations among different participants within the Islamic bank[15] and the accountability of participants in respect of their responsibilities and obligations.[16] And it includes decision making within the Islamic bank. *Shariʿah* governance is a subset of corporate governance that is focused on *Shariʿah*-related matters.

Shariʿah governance issues are a primary focus of the Islamic Financial Services Board ("IFSB"). The IFSB is a standard-setting organization for the Islamic banking and insurance industry that promulgates voluntary standards relating to the entire range of *Shariʿah* governance matters.[17] An especially important IFSB guidance or standard is the Revised Guidance on Key Elements in the Supervisory Review Process of Institutions Offering Islamic Financial Services (Excluding Islamic Insurance (*Takaful*) Institutions and Islamic Collective Investment Schemes), also known as IFSB-16 (the "IFSB Supervisory Guidance"). The IFSB *Shariʿah* governance standards are something of a "best practices" set of standards for the industry. The standards adopted in any given country will, however, be tailored to the specific country, and the necessity and appropriateness of that tailoring is recognized with the IFSB standards. This results in considerable variation in the regulatory regime and approach from one country to another. Two recent examples are Malaysia and Oman. Malaysia recently adopted a new Islamic Financial Services Act 2013,[18] and previously issued the *Shariʿah* Governance Framework for Islamic Financial Institutions, BNM/RH/GL 012-3, Bank Negara Malaysia (the "Malaysia *Shariʿah* Governance Framework").[19] The Sultanate of Oman introduced Islamic banking in 2012 and thus far regulates Islamic banking under a single regulatory issuance, the Islamic Banking Regulatory Framework of the Central Bank of Oman, Version 2.0, of March 2012 (the "Oman Islamic Banking Regulation").[20]

To provide an indication of the nature of the *Shariʿah* governance issues that are encountered by bank regulators, it is helpful to summarize some provisions of the IFSB Supervisory Guidance. A few provisions of the Malaysian and Omani regulatory standards will be mentioned, but not discussed in detail.[21] It is important to note that Islamic banking is conducted in two regulated circumstances: stand-alone Islamic banks; and conventional banks that operate "Islamic windows" in some manner. The *Shariʿah* governance considerations vary somewhat depending upon which circumstance is being considered: Islamic windows present particularly difficult *Shariʿah* governance issues, a few of which are referenced in this article.

The format of the IFSB Supervisory Guidance is tripartite. The three segments address (i) supervisory and regulatory preconditions, criteria and approaches,[22]

(ii) key elements in the supervisory and regulatory review process (including regulatory capital requirements, internal capital adequacy assessment processes, governance and risk management, related party transactions, securitization risk and related off-balance sheet exposures, transparency and market discipline, consolidated and home-host supervision, and Islamic windows),[23] and (iii) issues specific to Islamic financial institutions, including risk concentrations, assessments of rate of return risks in the banking book, counterparty credit risks, liquidity risk management and supervision, stress testing practices, *Shariʿah*-compliant hedging, valuation practices, and supervisory transparency and accountability.[24]

Among the issues raised in respect of supervisory and regulatory preconditions, criteria and approaches are those pertaining to lender of last resort considerations, Islamic window classification, licensing, and supervisory and regulatory capability matters. Consideration of some select issues will give a feel for the policy determinations, and regulatory adjustments, that confront bank regulators considering the implementation of Islamic banking.

As a *Shariʿah* matter, Islamic banks cannot obtain funds from conventional lender of last resort facilities or discount windows because these arrangements (almost always) involve the payment of interest. The central bank is usually the lender of last resort and makes advances to, for example, solvent but illiquid banks and financial institutions, often at specified interest rates. Often the interest elements are mandatory and no *Shariʿah*-compliant equivalent is as yet available (or permissible). A series of policy decisions must be made with respect to how Islamic banks will address these funding issues. Will they be required to use conventional lender of last resort and discount window arrangements or will alternative arrangements be made? Will there be an additional capital requirement of some sort to reflect these factors?

A second example pertains to an operational risk that may give rise to the central bank imposing additional capital requirements on Islamic banks (at some time and from time to time). This is the operational risk associated with a failure to comply with the *Shariʿah*. Any such failure may have an adverse effect on the reputation of the affected Islamic bank and could lead to a withdrawal of funds from that Islamic bank. This type of reputational risk is greater for Islamic banks than conventional banks due to the fundamental religious elements and nature of *Shariʿah* compliance. Reputational risks of this type are one of the reasons that regulators are particularly concerned about ensuring *Shariʿah* compliance at all times.

The IFSB has addressed this reputational risk in various standards and guidelines, usually in the context of additional capital requirements. In summary, the bank regulator, using both qualitative and quantitative approaches, should specify and provide explanation of the supervisory methodology (*i.e.*, factors forming the basis for any additional capital requirement). Such factors may include: (i) any precedents of material *Shariʿah* non-compliance; (ii) the robustness of the Islamic bank's existing internal *Shariʿah* governance systems; (iii) the presence of internal *Shariʿah* audit and enforcement of relevant *Shariʿah* audit standards; and (iv) the availability of a *Shariʿah* review function.[25]

Another example relates to the supervisory and regulatory processes that are applied to Islamic windows. These vary significantly from jurisdiction to jurisdiction in respect of capital requirements, risk management, funds segregation and other factors. The profit-and-loss nature of Islamic banking, and the attendant risks, are quite different from conventional banking. Early policy determinations and subsequent regulatory adjustments will relate to whether the regulatory capital of the Islamic window will be segregated from the regulatory capital of the parent entity, how the regulatory capital will be calculated for the Islamic window, how risk weightings will be determined for the Islamic window, whether separate minimum capital requirements will be imposed on the Islamic window, whether parent entity guarantees will be required in lieu of separate minimum regulatory capital requirements, whether there will be separate risk requirements for the Islamic window (including in respect of internal systems, procedures and controls), and how each of the policy determinations with respect to these matters will be implemented.

It should also be emphasized that the parent entity of an Islamic window is not an Islamic bank. Islamic windows do not have their own boards of directors and the awareness of Islamic banking at the board of directors level of the conventional bank hosting the Islamic window may be significantly less than at a full-fledged Islamic bank. Reporting should still be to the board of directors. But that governance must be supplemented by robust internal units, departments and mechanisms, and adjustments in respect of how accountability, supervision and management considerations are addressed in these circumstances.

A final illustration of precondition issues confronting the bank regulator pertains to the capabilities of the bank regulator itself. Most bank regulators do not currently have the capacity and skill sets necessary for proper regulation of Islamic banking. There is a need to learn about each of the contracts and structures used by Islamic banks, and the variations in risk exposure that are inherent in or derive from these contracts and structures. The risk exposures and risk profiles of Islamic banking activities are a particularly critical element of the regulatory process. Islamic banks frequently own assets and then lease or sell them to their customers as a means of financing, or they enter into partnerships with their customers to provide financing.[26] These arrangements entail quite different risk exposures than conventional interest-bearing loans. The bank regulator will have to ensure that it has the internal capacity and skill sets to (i) formulate and issue regulations that are specific to Islamic banking, (ii) oversee the practical implementation of *Shariʿah* principles with whatever degree of involvement is chosen as a policy matter, and (iii) supervise and regulate with tools that are appropriate to the relevant country, including both on-site and off-site tools that are responsive to the structures, instruments and risks that are unique to *Shariʿah*-compliant arrangements.

The beginning point in considering *Shariʿah* governance relates to *Shariʿah* boards. It is customary to require each Islamic bank and each Islamic window to establish and maintain a functioning *Shariʿah* board with specific responsibilities, and ultimate responsibility, for *Shariʿah* matters.[27] *Shariʿah* boards are a—if not the—critical determinant of what constitutes the *Shariʿah* in practice. *Shariʿah* boards determine what principles are of relevance (both generally and with respect to each and every matter, structure, transaction, activity, practice, agreement, document and instrument) and how each of those principles is and will be interpreted and applied in every circumstance.[28]

Will there be one or more *Shariʿah* boards within the government, as in Malaysia, which has *Shariʿah* boards within the structure of the central bank and the securities regulator? Will the bank regulator constitute its own *Shariʿah* board in order to harmonize interpretations across the Islamic banking industry? Or will *Shariʿah* boards exist only at the level of each individual Islamic bank, thereby leaving the possibility of diverse interpretations of the *Shariʿah* by individual Islamic banks? Or will a "national" *Shariʿah* board exist? Such a national board might be appointed by an Islamic banking trade association, thereby providing some degree of harmony across the industry by an entity existing outside the government. No matter which of the foregoing is adopted as the structural model, each individual Islamic bank will also have its own independent *Shariʿah* board that will address *Shariʿah* compliance governance for that bank.

Consideration will then turn to variations on corporate governance staples that have distinct ripples in the context of *Shariʿah* governance. The list of such matters is lengthy. For example, will the bank regulator establish qualifications and standards for *Shariʿah* scholars that participate in Islamic banking? If so, will they be general principles or specific requirements, or a combination? Will the bank regulator establish standards and mechanisms to ensure that *Shariʿah* rulings are obtained from the relevant *Shariʿah* boards and thereafter applied? Will the central bank induce harmonization of *Shariʿah* rulings or allow each Islamic bank to arrive at independent (and likely conflicting) interpretations? Will the bank regulator require public dissemination of *Shariʿah* rulings in whole, in part, or not at all? Will the bank regulator promulgate regulations and guidelines pertaining to internal governance and auditing for individual Islamic banks that are particularized as to *Shariʿah* matters? Will the bank regulator take the position that many of the foregoing matters should be addressed by a professional organization or industry association of Islamic banks or of *Shariʿah* scholars? Each of these matters can be addressed in different ways: precise requirements; or broad policies with precise requirements being developed by individual Islamic banks.

It is almost universal practice that the board of directors of an Islamic bank is ultimately responsible for the conduct of its business, as it is with respect to a conventional bank.[29] Many of the considerations in respect of director qualifications, responsibilities, obligations and accountability are identical as between Islamic banks and conventional banks. However, there are additional qualifications pertaining to *Shariʿah* capabilities, some relating to directors and others relating to increasing the scope of the relevant regulations to include critical personnel other than directors.[30] Different jurisdictions address these matters quite differently, including in "fit and proper" regulations. In many models (*e.g.*, Malaysia) these requirements are applicable not only to members of the board of directors but also to members of the *Shariʿah* board, senior management and others in the *Shariʿah* governance framework.[31] Bank regulators have to consider both the degree of application of the fit and proper standards and relevance of additional criteria of relevance to *Shariʿah* matters and Islamic banking.

Similarly, the conflict of interest provisions applicable to members of the boards of directors of banks and financial institutions must be evaluated, from both policy and operational perspectives, to determine whether they should be extended to other individuals involved in the corporate governance—particularly the *Shariʿah* governance—framework and whether the substance of the conflict of interest provisions is adequate in the Islamic banking context. At the level of the *Shariʿah* board, this is a particularly vexing issue. *Shariʿah* scholars are not employees of an institution; they are independent consultants and contractors. *Shariʿah* scholars serve on multiple *Shariʿah* boards, and often on *Shariʿah* boards of institutions that are in direct conflict with one another from any ethics perspective. Given the dearth of qualified *Shariʿah* scholars, the conflict of interest issues are massive, sensitive and difficult to address. Both the Malaysia *Shariʿah* Supervisory Framework and the Oman Islamic Banking Regulation[32] address these matters by limiting the number of *Shariʿah* boards upon which an individual scholar may sit. This is a contentious and delicate issue, and one that is getting an increasing amount of attention.

The fact that many of the customer accounts of Islamic banks are investment accounts presents a number of *Shariʿah* governance and corporate governance issues that are unique to Islamic banking. Examples include the *wakala* (agency) and *mudaraba* (service-capital partnership) accounts previously discussed. The investment account concept is fundamentally different from the deposit account concept in terms of numerous factors, most importantly in terms of customer exposure to investment losses. The investment account concept is analogous to a collective investment scheme in which the Islamic bank is the fund manager and the customer has very limited rights to control the conduct of the fund manager.

The nature of this relationship requires a somewhat different supervisory and regulatory approach than is taken with depositors. Specifically, the investment account holder must be afforded certain of the disclosure rights and protections that are afforded collective investment scheme investors. Many of these rights and protections relate to ensuring that (i) the customer is aware of the risks of loss inherent in this type of arrangement, (ii) the customer is afforded all necessary and appropriate information and mechanisms to enable the customer to make informed decisions regarding the making and monitoring of investments, and (iii) the profit and loss sharing allocations and investment policies are communicated to the customer.[33] Consideration should also be given to the qualifications of the employees of the Islamic bank that are responsible for these investments, and disclosures regarding the investment policies and strategies of the Islamic bank and regarding investment-related procedures and mechanisms (*e.g.*, funds segregation and allocations of profits and losses).

Investment strategies that are—and must be—developed for investments on behalf of Islamic bank investment account holders are likely to have quite different parameters and risk and return expectations than those of Islamic bank shareholders. Investment account holders have lower risk and more stable return thresholds. Commingling of funds from these two sources (investment account holders and shareholders) results in conflicts of interest, and policies and procedures will have to be developed to address these situations.

Distributions to investment account holders are often "smoothed" and not identical to the profitability of the investment accounts due to the use of "profit equalization reserves" or adjustments using "investment risk reserves."[34] These reserves allow Islamic banks to remain competitive in the banking markets in periods when investment returns are diminished. There are transparency and accountability considerations relating to these reserves. These include the adequacy of disclosure regarding (A) reserve calculation mechanisms, (B) risk profiles of the underlying investments, and (C) inter-generational mismatches between the investments that earn the excess profits to fund the reserves and the diminished investments that benefit from the reserves. Each of these disclosure matters is of relevance for the bank regulator, as are the mechanisms used to implement these reserves and their use for the making of payments to the investment account holders.

One solution for some of these disclosure issues is to require detailed disclosure to individual account holders, in the annual report by the Board of Directors of the Islamic bank, on the Islamic bank's web site and in mainstream media.[35]

A final set of considerations that are unique to Islamic banks pertain to audits, outsourcing of functions, and institutional (including departmental) compliance structures. This article discusses the first two of these sets of considerations.

Most bank regulatory regimes require internal audit and control functions. These regulations will be equally applicable to Islamic banks as well as conventional banks. However, there is a need for additional *Shariʿah* auditing for Islamic banks, which is directed at compliance with *Shariʿah* requirements. As a first consideration, there will be a need to establish an internal *Shariʿah* audit function (as well as an internal *Shariʿah* risk function) and to place that function within the Islamic bank. Additionally, there will be a need to establish the qualifications (as well as the responsibilities and obligations) of the *Shariʿah* auditors. In the normal course, the *Shariʿah* audit function is accountable to the *Shariʿah* board, although it must also be created with the necessary degree of independence to ensure that it adequately performs its functions. A recent, as yet minimalist, trend is to require independent external *Shariʿah* audits as well as internal *Shariʿah* audits. Given the small pool of qualified *Shariʿah* auditors, this is a vexing, if philosophically appealing, approach.

It was previously noted that essentially all or a significant portion of *Shariʿah* boards and their functions are "outsourced." Outsourcing is a significant issue in the context of Islamic banking. Smaller Islamic banks outsource a broad range of functions, including *Shariʿah* audit, review, risk and research functions. Islamic windows often outsource virtually all activities relating to Islamic banking functions. These activities are often in conflict with bank regulations that prohibit outsourcing of "strategic" or "non-strategic but material" functions (or, in the latter case, allow outsourcing only with approval of the bank regulator). The relevant outsourcing regulations need to be reconsidered in light of the realities of Islamic banking, and appropriate safeguards need to be implemented to preserve necessary confidentialities, ensure the safety and security of the banking system, and address conflict of interest issues.

IV. Concluding Comments

Islamic banking is being implemented throughout the world in jurisdictions that currently make no provision for, and take no cognizance of, the contracts, structures and arrangements that are used by Islamic banks on either the asset side or the liability side of their balance sheets. As a result of applicable *Shariʿah* principles, including prohibitions on the payment and receipt of interest, the very structure of Islamic banks and their relationships with their customers is notably different from those applicable to conventional banks and their relationships with their customers.

As a general statement, customers of Islamic banks provide funds to Islamic banks for either safekeeping at no return or on an investment basis involving sharing of investment profits, with the customer bearing all financial losses. This is fundamentally different from conventional banking. In the investment account context the Islamic bank has no obligation to make any payments to the customer if losses are experienced on the investments of the customer's funds. Islamic banks invest customer funds and receive fees and percentages of investment profits.

The provision of financing by Islamic banks to its customers frequently entails having the Islamic bank acquire the asset desired by the bank's customer and then leasing or re-selling that asset to the customer with delayed rental or purchase payments. In other circumstances, the Islamic bank forms a partnership with its customer in order to acquire the desired asset into the partnership. Financing is provided by the capital contribution of the Islamic bank to the partnership, which is often equal to the amount that would be loaned to the customer in a conventional loan financing. There is also a related lease (*ijara*) pursuant to which the Islamic bank leases its interest in the asset to the customer for the term of the partnership (which, in turn, is equal to the term of the financing). Repayment is effected by the customer purchasing partnership interests from the Islamic bank over time on a payment schedule that, together with the lease payments under the *ijara*, is equivalent to what a loan amortization schedule would have been had there been a loan.[36]

This article has identified and summarized some of the structural and corporate governance issues, and related considerations, that arise in connection with these Islamic banking arrangements. The issues are many and varied and reflect both the unique structure of Islamic banking and the unique risk profiles of Islamic banks and Islamic banking activities. This article has also identified some of the solutions that have been posited or implemented by standard-setting organizations and different bank regulators. The solutions that have been implemented around the globe are also many and varied, and are directly responsive to the individual systems in which they are implemented. There is no single solution. Given the infancy of the modern Islamic banking industry, the solutions are tentative and evolutionary in nature.

This rapidly growing area of banking and finance cries out for participation by those in the conventional banking industry. It cries out for the expertise that might be brought to bear on these regulatory issues. It cries out for greater rigor and creativity.

The objective is to allow Muslims to conduct banking and finance in accordance with their beliefs and the imperatives of their religion, and to do so in a manner that allows non-Muslims to partake of the alternative that is being constructed on equal footing with conventional alternatives, and to allow for greater competition between and among Islamic and conventional banks on a basis in which neither realizes a benefit not available to the other or suffers a burden not imposed on the other.

Endnotes

1. For a discussion of the *Shariʿah* in the context of modern Islamic commerce and finance, see Michael J.T. McMillen, ISLAMIC FINANCE AND THE *SHARIʿAH*: THE DOW JONES FATWA AND PERMISSIBLE VARIANCE AS STUDIES IN LETHEANISM AND LEGAL CHANGE (2013) ("McMillen, ISLAMIC FINANCE"), at 111-54, which includes a range of sources and bibliographical references with respect to the nature and operation of the *Shariʿah* in modern commerce and finance.
2. The first institutions that can be characterized as Islamic banks were formed in 1963. The oldest continuously surviving Islamic bank (Dubai Islamic Bank) was formed in 1975, the same year in which the Islamic Development Bank was formed. Thereafter, throughout the 1970s and into the 1980s, a wide range of Islamic banks came into existence. Malaysia enacted the Islamic Banking Act 1983 and the first Islamic bank in Malaysia, Bank Islam Malaysia Berhad, was formed in that same year. See McMillen, ISLAMIC FINANCE 59-86; Ibrahim Warde, ISLAMIC FINANCE IN THE GLOBAL ECONOMY 70-92 (2d ed. 2010); Zamir Iqbal and Abbas Mirakhor, AN INTRODUCTION TO ISLAMIC FINANCE: THEORY AND PRACTICE 13-24 (2d ed. 2011); Zamir Iqbal and Abbas Mirakhor, *The Development of Islamic Financial Institutions and Future Challenges*, in Simon Archer and Rifaat Ahmed Abdel Karim, eds., ISLAMIC FINANCE: INNOVATION AND GROWTH 42 (2002)("Archer & Karim, INNOVATION"); Hossein Askari, Zamir Iqbal and Abbas Mirakhor, GLOBALIZATION & ISLAMIC FINANCE: CONVERGENCE, PROSPECTS & CHALLENGES 11-25 (2010); Yusuf Talal DeLorenzo and Michael J.T. McMillen, *Law and Islamic Finance: An Interactive Analysis* ("DeLorenzo & McMillen"), in ISLAMIC FINANCE: THE REGULATORY CHALLENGE 136-150 (2007); Samer Soliman, *The Rise and Decline of the Islamic Banking Model in Egypt*, in Clement M. Henry and Rodney Wilson, eds., THE POLITICS OF ISLAMIC FINANCE 265 (2004), ("Henry & Wilson"); Monzer Kahf, *Islamic Banks: The Rise of a New Power Alliance of Wealth and Shariʿah Scholarship*, in Henry & Wilson, at 17; and Mohammad Nejatullah Siddiqi, *Islamic Banking and Finance*, UCLA International Institute, available at http://www.international.ucla.edu/article.asp?parentid=15056 (2001); Rodney Wilson, *The Evolution of the Islamic Financial System*, in Archer & Karim, INNOVATION, at 29.
3. McMillen, ISLAMIC FINANCE, note 1 *supra*, at 59-86, which also discusses the inception of the Islamic equity markets in 1999 and the Islamic debt or finance markets in 2003.
4. *See* McMillen, ISLAMIC FINANCE, note 1 *supra*, at 189-228.
5. For example, Devon Bank in Chicago, Illinois, and University Bank in Ann Arbor, Michigan, provide a range of *Shariʿah*-compliant financing arrangements, such as for home purchases. *Shariʿah*-compliant home purchase financings are discussed in Michael J.T. McMillen, *Islamic Home Purchase Financing: A Conceptual Overview* (2012) ("McMillen, *Home Financing*"), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2177255, which includes descriptions and graphic depictions of some of the most frequently encountered structures (leases, diminishing partnerships, cost-plus sales, construction arrangements) used in Islamic banking.
6. Conventional banks are regulated under the Financial Services Act 2013 of Malaysia and Islamic banks are regulated under the Islamic Financial Services Act 2013 of Malaysia (the "Malaysia IFSA"). See the descriptions, and links to each of the two financial

services acts, at http://www.bnm.gov.my/index.php?ch=en_legislation&lang=en.

7. *See* McMillen, Islamic Finance, note 1 *supra*, at 113-18, and sources therein cited.

8. Other models are either theoretical or much less common in practice.

9. This arrangement is constructed around principles that are summarized in Sharia Standard No. (19), *Qard* (Loan), issued on 30 Rabii I 1425 (corresponding to 19 May 2004), in *Shariʿah* Standards of the Accounting and Auditing Organization for Islamic Financial Institutions (2010) (the "AAOIFI Standards") of the Accounting and Auditing Organisation for Islamic Financial Institutions ("AAOIFI"). AAOIFI is a standard setting organization for the Islamic banking and finance industry. It issues accounting standards and *Shariʿah* standards. These standards are non-binding unless local law makes them binding (as, for example, for Islamic banking in the Kingdom of Bahrain). However, these standards are often viewed as "best practices" or base practices in the Islamic finance industry.

10. The word "*wadiʿa*" is derived from the Arabic verb "*wadaʿa*," meaning to leave, lodge or deposit.

11. *Wadi a yad dhamanah* is a combination of two contracts: deposit and guarantee.

12. Some of the relevant agency principles are set forth in *Shariʿah* Standard No. 23, *Agency and the Act of an Uncommissioned Agent (Fodooli)*, issued on 23 Rabii I 1426 (corresponding to 2 May 2005), in AAOIFI Standards, note 9 *supra*. A more developed treatment of *Shariʿah*-compliant agency principles, including with discussions of the variations within and among the different schools of Islamic jurisprudence (*madhahib*; *madhhab* is the singular), is Wahbah al-Zuhaylī, 2 Al-Fiqh Al-Islāmī wa-Adillatuh (4th ed.1997), as translated: Mahmoud El-Gamal, translator, Muhammad S. Eissa, revisor, 2 Islamic Jurisprudence and its Proofs, Financial Transactions in Islamic Jurisprudence 631-89 (2002) ("al-Zuhayli").

13. *Mudaraba* are complex partnership structures that are subject to a panoply of other principles and precepts. These principles and precepts are variously interpreted by different *madhahib* and there are interpretive variations within each *madhhab*. For discussions of *mudaraba* principles, see al-Zuhayli, note 12 *supra*, at 483-522 (partnership principles are more broadly considered at 445-82), and *Shariʿah* Standard No. 13, *Mudaraba,* issued on 4 Rabi I 1423H (corresponding to 16 May 2002), in the AAOIFI Standards, note 9 *supra*. An introduction to basic *mudaraba* principles and precepts is Muhammad Taqi Usman, *Mudarabah*, available at http://www.accountancy.com.pk/frameit.asp?link=docs/islam_mudarabah.pdf. For orientation purposes, and as a conceptual conventional equivalent that bears many similarities (but also has numerous differentiating characteristics), one might think of the *mudaraba* as a limited partnership arrangement.

14. The discussion in this part is primarily an abridged summary of an article currently being drafted by the author on *Shariʿah* governance matters; the copyright to that article is held exclusively by Michael J.T. McMillen. Certain language in this part has been taken verbatim from that article.

15. Including any activities that are outsourced.

16. For example, the Malaysia *Shariʿah* Governance Framework, note 19 *infra*, describes *Shariʿah* governance to encompass, for and pertaining to each Islamic bank, the Board of Directors, the *Shariʿah* audit, the *Shariʿah* review, the *Shariʿah* risk management and *Shariʿah* research functions, as well as the *Shariʿah* board itself. See §§ 1.1-1.9, Malaysia *Shariʿah* Governance Framework, note 19 *infra*.

17. The IFSB standards (including guidelines) are available at http://www.ifsb.org. Some of the principal standards are: *Guiding Principles for Governance for Institutions Offering Only Islamic Financial Services (IIFS – Excluding Islamic Insurance/Takaful and Islamic Mutual Funds* (2006), also known as IFSB-3; *Guiding Principles on Corporate Governance for Institutions Offering Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions and Islamic Collective Investment Schemes)* (2006) (the "IFSB Corporate Governance Principles"); *Guiding Principles on Governance for Islamic Collective Investment Schemes* (2008), also known as IFSB-6; *Guiding Principles on Governance of Takaful Institutions* (2009), also known as IFSB-8; *Guiding Principles on Risk Management* (2005), also known as IFSB-1; Islamic Financial Services Board, *Guiding Principles on Shariʿah Governance Systems for Institutions Offering Islamic Financial Services* (December 2009), and *Revised Guidance on Key Elements in the Supervisory Review Process of Institutions Offering Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions and Islamic Collective Investment Schemes)* (2014) also known as IFSB-16 (the "IFSB Supervisory Guidance"). There are others.

18. See note 6 *supra*. The original Islamic Financial Services Act was adopted in 1983.

19. *Shariʿah* Governance Framework for Islamic Financial Institutions, BNM/RH/GL 012-3, Bank Negara Malaysia (the "Malaysia *Shariʿah* Governance Framework"), available at http://www.bnm.gov.my/index.php?ch=en_reference&pg=en_reference_index&ac=584&lang=en#*Shariʿah*.

20. The regulatory issuance is the Islamic Banking Regulatory Framework of the Central Bank of Oman, Version 2.0, of March 2012 (the "Oman Islamic Banking Regulation"), available at http://www.cbo-oman.org/news/IBRF.pdf. For a summary of some of the *Shariʿah* governance provisions of the Oman Islamic Banking Regulation, see Michael J.T. McMillen, *Islamic Banking: Shariʿah Governance* (2012), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2277630.

21. It is recommended that the Malaysia *Shariʿah* Governance Framework, note 19 *supra*, and the Oman Islamic Banking Regulation, note 20 *supra*, be considered on a point-by-point comparison. Each takes a different approach in addressing the issues discussed with respect to the IFSB Supervisory Guidance, note 17 *supra*.

22. IFSB Supervisory Guidance, note 17 *supra*, §§ 28-41.

23. *Id.* §§ 42-198.

24. *Id.* §§ 199-259.

25. See *id.*, and Islamic Financial Services Board Working Paper, *Strengthening the Financial Safety Net: The Role of Shariʿah-Compliant Lender of Last Resort (SLOLR) Facilities as an Emergency Financing Mechanism* (April 2014).

26. *See, e.g.,* McMillen, *Home Financing*, note 5 *supra*, which describes a selection of the contracts and structures used by Islamic banks (in the context of home financings).

27. *See, e.g.*, Malaysia IFSA § 30.1(1), note 6 *supra*, and Malaysia *Shariʿah* Governance Framework §§ 1.3(i), 1.3(ii), 1.6, 1.7, 2.1-2.10, and (with respect to the independence of the *Shariʿah* board) §§ 3.1-3.8, note 19 *supra*.

28. *See* McMillen, Islamic Finance, note 1 *supra*, at 111-54.

29. *See, e.g.,* Malaysia *Shariʿah* Governance Framework, note 19 *supra*, §§ 1.6, 1.7 and 3.2; the structure chart is included in § 1.7. Other *Shariʿah* functions report to the *Shariʿah* board.

30. In addition, many of the regulations pertaining to directors are focused on depositor benefits and interest-based concepts (including experience). These concepts are absent or modified as they pertain to Islamic banks.

31. See Fit and Proper Criteria, BNM/RH/GL 018-5, 28 June 2013, Bank Negara Malaysia, § 36(2), Malaysia IFSA, *supra* note 6, available at http://www.bnm.gov.my/guidelines/01_banking/04_prudential_stds/15_gl_fit_proper_for_key_responsible.pdf, and the Guidelines on Fit and Proper for Key Responsible Persons, BNM/RH/GL 018-3, Bank Negara Malaysia, available at http://www.bnm.gov.my/guidelines/01_

banking/04_prudential_stds/15_gl_fit_proper_for_key_responsible.pdf.

32. Malaysia *Shariʿah* Governance Framework, note 19 *supra*, Appendix 2, Negative List ¶ 2(ii); Bank Negara Malaysia (superseding Guidelines on the Governance of *Shariah* Committee for Islamic Financial Institutions, BNM/RH/GL/012-1, Part D, § 19, particularly 19(b), Bank Negara Malaysia); and Oman Islamic Banking Regulation, note 20 *supra*, § 2.2.3.4, Title 2.

33. *See, e.g.*, IFSB Corporate Governance Principles, note 17 *supra*, §§ 22-33, especially §§ 28-29, §§ 34-44 (with respect to investment strategies), §§ 58-65, and §§ 94-103.

34. *See id*., §§ 34-39 and 94-103, §§ 62-65.

35. *See id*.; the IFSB Supervisory Guidance, note 17 *supra*; and *Disclosures to Promote Transparency and Market Discipline for Institutions Offering Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds (2007)* of the IFSB.

36. Although not discussed in this article, there are significant tax and regulatory considerations that must be addressed in connection with all of these activities. On the tax side, there is frequent double taxation (*e.g.*, on the purchase price of cost-plus sales due to the addition of an additional sale transaction—of the asset from the Islamic bank to the customer) and frequent taxation of the amount of repayments that would have constituted principal had a conventional loan been taken (*e.g.*, the component of lease rentals or partnership interest purchase payments that is, in economic substance, equivalent to repayment of the principal amount of a conventional loan). On the regulatory side, Islamic banks must acquire, directly or indirectly, the assets to be leased or re-sold to customers in order to provide financing for the acquisition of those assets. Consider a home purchase financing. Under the laws of most jurisdictions, banks are prohibited from purchasing real property for these purposes. Islamic banks frequently make use of subsidiaries (in the limited situations in which this is permissible) or special purpose vehicles that are often owned by third parties, including service companies (this latter arrangement itself presenting income tax issues in jurisdictions in which the special purpose vehicle cannot be a disregarded entity for tax purposes).

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Post Global Financial Crisis Regulations: E.U. and French Regulatory Efforts

By François Berbinau

I. Introduction

A. Origins of the Crisis

To understand the profusion of regulations issued since 2008, it is necessary to recall the main factors contributing to the development of the subprime crisis and the importance of the financial crisis that resulted in (i) a failure to properly advise customers on risks that customers could not control; (ii) a lack of transparency in the creation of financial instruments, particularly credit default swaps ("CDS"); (iii) inadequate capitalization of financial institutions, including then-existing regulations that allowed securitized loans to be placed off-balance sheet during the formation of regulatory capital; (iv) a lack of cash in financial institutions to cope with the influx of customer demands who wanted to recover its deposits; and (v) not taking into account the systemic importance of large institutions ("too big to fail") in the context of a crisis, with insufficient capacity of states to intervene in their governance.

B. Regulatory Measures Implemented

Drawing lessons from the crisis, European and French authorities have enacted many regulations aimed at strengthening control and preventing such crises from happening again. The regulations implemented over the last six years meet several objectives of regulators in Europe. Among those are the following.

1. Strengthening the Soundness of Financial Institutions and Providing the European Banking Market with Responsive and Efficient Governance

Regulation by CRR (Capital Requirement Regulation)[1] and the CRD IV Directive (Capital Requirement Directive),[2] adopted 26 June 2013, adapt at the European level the "Basel III" international agreements. These strengthen and harmonize capital requirements and introduce liquidity standards for the banking sector to limit leverage, take full account of the risks associated with securitization instruments or financial instruments such as CDS, and limit the risk of cash shortage during a crisis. The new requirements also introduce a notion of systemic risk, strengthening the requirements for institutions of significant size. In addition, these regulations require that the competence of management and supervisory bodies be strengthened and they allow regulators to intervene in the management of these institutions in case of a crisis, with sanctioning powers and the ability to suspend or release their managers. Finally, these regulations introduce the implementation of a unique supervisory mechanism in Europe (MSU) with the creation of a specific resolution fund.

2. Confining the Proprietary Activities of Banks

In France, the law of 26 July 2013[3] on separation and regulation of banking activities requires banks to establish an ad hoc subsidiary to consolidate all the proprietary activities of the bank in financial markets, thus avoiding risks of contagion to other activities of the bank. It limits its compensation to avoid excessive risk taking. But the Governor of the Banque de France challenged the project of the E.U. Commissioner Michel Barnier, who aimed at imposing more stringent constraints.

3. Developing Transparency on the Derivatives Market (OTC)

EMIR[4] regulations aim for increased transparency in the OTC markets via the creation of trade repositories and counterparty risk reduction through the clearing obligation via central counterparties for certain derivatives.

4. Reinforcing Client Protection

The MIFID 2, MIFIR, UCIT V and AIFM, PRIIPS regulations[5] reinforce the banks' obligations on advice given to clients. Thus there are transparency requirements in all documentation and other media providing information on financial instruments to the general public, reviewing the categories of financial products according to the risks they represent for the client. They also limit and structure the practice of commissions and incentives.

5. Limiting Speculative Transactions

Through the introduction of a tax on financial transactions (FTT) and introducing rules on high-frequency trading, speculative structures are discouraged.

II. CRR/CRD IV—Basel III

A. Context

The CRD IV package, including regulation 575/2013(EU), known as CRR (Capital Requirement Regulation), and directive 2013/36/EU, known as CRD IV (Capital Requirement Directive), was adopted on 26 June 2013. These texts constitute the European deployment of the international accords known as "Basel III," which reinforce and harmonize capital funds requirements and introduce liquidity standards for the banking sector. The CRD IV directive also establishes new governance requirements.

B. Principal Measures

1. Reinforcement of Prudential Requirements, Translation of Basel III

- **Quantitative Reinforcement of Capital Funds:** raising of CET1 (Common Equity Tier 1) and Tier 1 ratios.
- **A more restrictive definition of capital funds:** a "focus" on core capital (CET1).
- **Introduction of new capital buffers:** capital conservation buffers, countercyclical buffers and systemic buffers.
- **Improvement in risk coverage:** counterparty risks in derivatives.
- **New liquidity ratios:** LCR and NSFR.
- **A leverage ratio.**
- **Strengthening disclosure requirements:** all of the above mentioned measures are to be accompanied by reinforced disclosure requirements imposing more detailed reports, increased frequency of reports and shorter deadlines for transmission of reports.

2. Governance

- **Managers:** they must satisfy certain conditions of knowledge, skills, experience and availability.
- **Organization and internal audits:** credit institutions must have governance measures in place, including a clear organizational structure, efficient procedures for holding and monitoring risk, adequate provisions for internal auditing, viable administrative and accounting procedures, and a compensation policy that favors good risk management.
- **Compensation policy and practice:** the compensation structure for risk-takers introduced by the CRD III directive is reinforced with specifically a cap on variable compensation.
- **Specialized committees:** the major credit institutions—depending on their size and their internal organization and the nature, scale and complexity of their activities—must create risk and nomination committees in addition to the compensation committee implemented during the transposition of the CRD III directive.

3. Implementation of a Single Supervisory Mechanism in Europe (SSM)

With an extension of the powers of the European Central Bank and the national supervisory bodies (ACPR), the authority of the national supervisory body for the banking system is transferred from the domestic to the European level, and the ECB becomes the relevant authority for all significant financial institutions. In addition, a single bank resolution fund will be constituted over five years and a single resolution mechanism in Europe will be implemented to enable the European authority to proceed efficiently with the restructuring of an institution in difficulty without an overly significant impact on the taxpayer or the real economy. The first will generate fifty-five billion Euros over five years.

Among other measures are the following.

- The list of parties subject to ACPR control is to be completed with notably mixed holding companies which are, in this respect, subject to a fixed contribution for auditing costs.
- Credit institutions must implement a reporting procedure that specifically enables their employees to report to the ACPR any violation or breach of the regulations defined in the CRD IV package.
- The ACPR may require any subsidiary of any entity for which it is the overseer and any third party to which such entity has outsourced a portion of its activities to produce any document necessary for the accomplishment of its missions.
- In the event of a failure to comply with the regulations established in the CRD IV package, credit institutions will risk financial sanctions for a maximum amount of ten percent of the parent company's annual turnover or twice the gains received due to such failure;
- When the liability of the "effective managers" and officers is established, they risk temporary suspension, resignation from their office or financial sanctions for a maximum amount of five million Euros or twice the gains received due to such violation.

C. Further Information on the Single Resolution Mechanism

The COM (2013) 520 text aims to implement a single resolution mechanism (SRM) in the context of the banking union. This mechanism will supplement the single supervisory mechanism (SSM). Under this mechanism, the European Central Bank (ECB) will be directly responsible for banking supervision in the Euro zone and in the other Member States that elect to join the banking union. In the event that a bank subject to the SSM encounters considerable stress, the single resolution mechanism will enable it to effect resolution efficiently, without overly significant impact on the taxpayer or the real economy. This system aims specifically to avoid the situations encountered in Ireland, Spain or Cyprus, where the intervention of states to recapitalize the banks led to a derailment of public finances.

In the context of the SRM, the ECB, as the supervisory authority, will report if a bank in the Euro zone or established in a Member State participating in the banking union encounters financial difficulties that require it to proceed with resolution. This resolution would be prepared by a Single Resolution Board, constituted of representatives from the ECB, the European Commission and the national authorities concerned.

Based on the recommendations of the Single Resolution Board, or on its own initiative, the Commission will decide whether the bank should undergo a resolution procedure, and when, and will put into place a structure for the implementation of the resolution instruments and the Fund. Under the Single Resolution Board's oversight, the national resolution authorities will be responsible for the implementation of the resolution plan. In the event that a national resolution authority does not comply with the Single Resolution Board's decisions, it may send enforcement orders directly to the banks in difficulty.

A Single Resolution Fund for the banks should also be put into place under the control of the Single Resolution Board in order to guarantee that medium-term financial support is available during the bank's restructuring. It will be funded by contributions from the banking sector. These contributions will replace the domestic resolution funds of the Member States in the Euro zone and the Member States participating in the banking union, as provided in the draft directive on banking recovery and resolution.

The creation of the SRM and the bank resolution funds is the logical extension of the bank union plan, lead notably by France. In the context of a transnational banking market, reinforcement of European oversight constitutes genuine added value and must, in the future, prevent the risk of a banking crisis evolving into a liquidity crisis for the states. The role of the European Commission in the resolution procedure and the conditions for supplying the resolution fund call for debate and in-depth review.

III. Law 2013-672 of 26 July 2013 on Separation and Regulation of Banking Activities

The main purpose of this law is to make sure that activities of certain credit institutions and financial companies which are useful to the financing of the economy will be separated from their speculative activities.

A. Separation of Activities

The objectives of the law are to (i) guarantee financial stability; (ii) reinforce the solvency of banks with regards to depositors; (iii) prevent conflicts of interest with clients; and (iv) support the financing of the economy. The institutions affected are credit institutions, financial companies, and mixed financial and holding companies whose financial instrument trading activities exceed the thresholds established in a decree issued by the *Conseil d'Etat* (French Supreme Court of the Administrative Order).

B. Principle of Separation

The concept is to separate the two types of activities into two branches.

1. Transactions on Own Account with Hedge Funds.

- **Principle:** The law prohibits a credit institution from entering into transactions for its own account with leveraged mutual funds other than through a dedicated subsidiary if certain conditions are not fulfilled.

- **Conditions:** The credit institution must be secured and such security must meet certain requirements, including quantity and quality standards, availability, and oversight by the *Autorité de Contrôle Prudentiel et de Résolution* (the "ACPR" is the French prudential control and resolution authority, an independent administrative authority, which ensures the preservation of the stability of the financial system and the protection of customers, policyholders, subscribers, and beneficiaries of the entities under its control).

- **Scope:** Covered are leveraged mutual funds or other similar investment vehicles meeting characteristics established by a decree of the French minister of the economy, as well as mutual funds that are themselves invested in or exposed, above a threshold set by decree, in leveraged mutual funds.

The credit institution will provide the ACPR with the information on its commitments with these mutual funds.

2. Trading Activities Concerning Financial Instruments Involving a Credit Institution's Own Accounts

- **Principle:** The law prohibits a credit institution from carrying out, other than through the intermediary of a dedicated subsidiary, trading activity for its own account.

- **Exceptions:** There are exceptions from the prohibition for providing investment services for clients, clearing of securities, coverage by the bank of its own risks, market-making (activity useful to the financing of the economy), sound and prudent management of cash, and group investment transactions.

C. Strict Confinement of Dedicated Subsidiaries

The subsidiaries are to be strictly confined and they must use corporate and commercial names that are distinct from those of the group's credit institutions. They are to be approved by the ACPR as an investment institution or credit institution.

When the subsidiaries are approved as credit institutions, they may not receive secured deposits nor provide payment services to clients whose deposits are secured, and the subsidiaries must comply with management standards under the conditions established by decree.

D. Supervision of Direct Market Access and Algorithmic Trading

The law supervises "direct market access" practices for investment firms, and all parties are obligated to declare to the AMF (French Financial Market Authority) the use of data management systems and to maintain traceability of market orders and algorithms used. The purpose here is to embrace the ability of platforms to manage periods of market strain.

IV. EMIR

The E.U. response to the undertakings made at the G20 summit in Pittsburgh in September 2009, concerning the systemic risk associated with the massive use of over the counter (OTC) derivatives, is called EMIR (European Market Infrastructure Regulation), the European equivalent of part of the Dodd-Frank Act provisions in the United States. This regulation appeared in the European Union's Official Journal on 27 July 2012 (EU Regulation 648/2012 of the European Parliament and Council of 4 July 2012).

EMIR focuses mainly on (i) enhancing the transparency of OTC **derivatives markets** via the creation of trade repositories in charge of collecting and maintaining records of these derivatives; and (ii) reducing counterparty risk via clearing obligations so that financial and non-financial counterparties exceeding certain thresholds must centrally clear OTC contracts with an authorized central counterparty.

As an E.U. regulation, it was applicable immediately in all Member States.

A. Context

OTC derivatives, and more specifically Credit Default Swaps (CDS), had been factors of the financial crisis—notably due to the lack of transparency concerning the positions held by the various financial players regarding these instruments, which did not fall under the then-existing disclosure and information E.U. requirements (MIFID).

Structural inadequacies identified concerning the infrastructure for management of systemic risk forced the G20 members to make the commitments set forth in this regulation, which specifically provides for:

- Clearance of standardized OTC derivatives contracts via the intermediary of central counterparties in order to reduce the counterparty risk;
- Implementation of risk management procedures for OTC derivatives that are not cleared;
- Requirement of additional own funds for contracts that have not been cleared;
- Obligation to declare all OTC derivatives contracts to trade repositories: the trade repositories are required to publish the aggregated positions by derivatives category, making it possible for the players to have a clearer view of the derivatives market;
- Reinforcement of the role of the European Securities and Markets Authority (ESMA) in the oversight of trade repositories and the granting or withdrawal of their registration.

B. The Provisions of the Regulation

The regulation concerns primarily the clearing obligation for OTC derivatives transactions and the implementation of risk management procedures for non-cleared contracts. Thus, the eligible derivatives are treated via clearing houses. These clearing houses will limit the counterparty risk, since they act as intermediaries between the buyer and the seller of the derivative. They ensure the solvency of the participants by requiring security deposits (collateral) that are constituted as a function of the evolution of the commodity price (margin calls).

The criteria for eligibility defined by the ESMA to identify the categories of derivatives eligible for the clearing obligation depend specifically on the degree of standardization of the derivatives contracts, the assessment of the reduction of systemic risk on the financial system, the liquidity of the contracts, and the daily availability of information on contract prices. The finalized draft for regulatory technical standards[6] and implementation was issued by the ESMA on 28 September 2012. The definition of the asset categories was established in 2013.

The regulation is applicable to financial and non-financial institutions, with the definition of the rules for exemption concerning coverage transactions and intragroup transactions.[7]

The regulation also includes the obligation to declare that this obligation is applicable to all OTC derivatives transactions, whether or not they are cleared through transmission of details of the transactions to a trade repository. It is to take place no later than the day after the transaction's execution, clearing or modification. The obligation to declare may be delegated by the final investor or a clearing member, its central counterparty or a designated external agent, or even the other counterparty, and it is applicable to all contracts entered into or existing as of 16 August 2012.

V. MIFID2–MIFIR

Draft MIFID II directive of 20 October 2011 repeals the 2004/39/EC framework directive and its implementation measures, namely, 2006/73/EC framework directive and application regulation 1287/2006.

A. Context

The first MIF Directive concerning the Financial Instruments Market was adopted on 21 April 2004 and entered into effect on 1 November 2007. This directive defined the rules for markets and financial intermediaries (e.g., procedure for execution of orders) as well as rules for consumer protection (e.g., client's right-to-know and right-to-information obligation incumbent on the bank, obligation to offer products adapted to its circumstances).

Seven years after its implementation, the results were mixed. Specifically (i) the markets were more fragmented and less transparent (lack of liquidity and misuse of the principle of transparency—dark pools and crossing network); (ii) the post-trade quality of information with regard to investors was not satisfactory; and (iii) there was a lack of coordination among supervisory authorities (in cases of default by counterparties).

In light of these findings, the MIF 2 Directive focuses on the following issues:

– organizing pre-trade and post-trade transparency for securities other than shares and regulating OTC transactions;

– reinforcing investors' protection; and

– strengthening the powers of the European supervisory authorities.

The draft amendment consists of a regulation (MIFIR), which will be directly applicable as such in the Member States, and a Directive (MIFID II), which will need to be transposed in the Member States. Both texts (i.e., Directive and regulation) constitute together the legal framework governing the requirements applicable to investment institutions, regulated markets (RM), and data provision services (Reuters, etc.).

B. Principal Measures of MIFIR and MIFID II

1. MIFIR

The MIFIR contains the following features.

- Expansion of the rules to financial instruments that are similar to shares (certificates of deposit, etc.) and financial instruments other than shares (bonds, structured financial products, etc.).
- Reinforcement of pre-trade and post-trade transparency rules for trading platforms.
- Reinforcement of pre-trade and post-trade transparency rules for investment institutions trading OTC instruments (e.g., obligation to publish firm bid and offer quotes).
- Extension of the scope of application of transactions disclosure by investment institutions, regulated markets, multi-lateral trading facilities (MTF), and Organized Trading Facilities (OTF), including an obligation to keep recordings of transactions (for investment institutions) made on behalf or in the name of a client and recordings of all transaction orders (for platforms) for five years. Post-trade reporting on transactions completed is extended to financial instruments traded in a MTF or OTF, and the level of detailed information that must be transmitted in the trade order (introduction of a Trader ID and a Client ID) is increased.
- Introduction for derivatives of an obligation to trade on electronic platforms (RM, MTF or OTF) and to clear derivatives trades on regulated markets (OTC derivatives must be traded on RMs: this obligation concerns both financial and non-financial counterparties that exceed the clearing threshold set by the EMIR).
- Interoperability: non-discriminatory access for market infrastructure, clearing houses and central securities depositories to the financial instruments trading platform flow of information.

2. MIFID II

The MIFID contains the following concepts.

- The provisions retained preserve the option of linking payment of commissions to the sale of financial instruments.
- The institutions must take reasonable measures in order to ensure that the product is sold to the appropriate category of clients.
- The institutions which market investment products are also required not to compensate their employees, or assess their performance, in any way that might create an interest that is not in the best interests of their clients.
- Investment advisors and salespersons must have an appropriate level of knowledge and understanding of the products they are marketing.
- The list of complex products is dense: certain products considered in the MIF I as simple (such as shares, bonds or funds) may be considered as complex if they include a derivative.
- Keeping a custody account will become an investment service that is provided as a principal service.

VI. AIFM (Alternative Investment Fund Managers): European Directive 2011/61/EC of 8 June 2011

A. Context

The 2011/61/EU Directive of the European Parliament and Council of 8 June 2011 on alternative investment fund managers (the AIFM Directive), was transposed into the Monetary and Financial Code by Decree 2013-676 of 25 July 2013, Decree 2013-687 of 25 July 2013[8] and the decree of 8 August 2013 ratifying the amendments to the general regulations of the Financial Markets Authority.

This Directive provides for increased oversight and regulation of alternative investment funds and their managers. In exchange, it offers new opportunities through a European passport that allows them to provide their management services and distribute their funds in all E.U. Member States.

B. Principal Measures

The main objectives of the AIFM's Directive are the following.

First, the Directive regulates the managers of alternative investment funds that manage and/or market these funds and not the funds themselves, given the extreme variations within this type of funds. All funds not subject to the UCITS Directive are considered as alternative investment funds falling within the scope of the AIFM Directive.

Second, the Directive puts into place a passport for the European managers and for the funds, which took effect as soon as it became effective in 2013, and which would be offered to non-EU managers and funds from 2015.

Third, the Directive mandates a single depositary for each fund managed by a manager, like the UCITS funds.

Finally, the Directive defines a harmonized framework at the European level for the depositary's missions, and establishes the principle of liability of the depositary with regard to the fund it manages in the event of loss of assets in its custody.

VII. UCITS V

The 2014/91/EU Directive amended the 2009/65/EC Directive.

A. Context

On 3 July 2012, the European Commission published a legislative package that sought to improve the protection of consumers in the financial services sector.

B. Principal Measures

This package consists of three legislative proposals:

– A proposal to regulate key information concerning retail investment products (RIP);

– An amendment to the Directive on intermediaries in the insurance sector (IMD); and

– A draft of the Directive amending the UCITS IV Directive integrating the provisions on depositary functions, remuneration policies and sanctions of money market fund managers (UCITS V).

The European Commission, in its draft UCITS V Directive, focused on harmonizing the role, missions and responsibilities of the depositary banks of harmonized funds. In this respect, one will note a number of similarities with the Level 1 of the Alternative Investment Fund Managers Directive (AIFM Directive), such as (i) the description of the depositary's missions (oversight of cash flow, conservation, depository control, custody delegation rule, etc.); and (ii) a liability regime based on restitution in the event of loss of assets under custody.

The initial draft of the UCITS V Directive also contained areas of divergence with the AIFM, certain of which were, however, the subject of draft amendments by the European Council on 4 December 2014, in order to move toward greater harmonization of these two texts.

These differences primarily concerned the following.

– the criteria for eligibility of entities that can offer depositary services;

– the rules on reusing securities in a fund by the depositary;

– the consequences of insolvency of the depositary on the protection of assets; and

– the conditions for delegation to a sub-custodian without the possibility of a transfer of liability to such sub-custodian.

On these points, the European Council, which approved the general approach of the draft UCITS V Directive, suggested amendments in order to improve harmonization of the criteria for eligibility of the depositaries, their missions (monitoring of cash flow, custody, depositary control, delegation of custodial regime) and their liability regimes (reconciliation with the depositary regime introduced in the AIFM Directive).

In addition, the European Council proposed amendments on the regulations for determining compensation for mutual fund managers and harmonization of administrative sanctions imposed by various regulators.

The reform enacted by the 2014/91/EU Directive of 23 July 2014 amends Directive 2009/65/EC (OPCVM IV) on three essential points:

– The depositary function;

– Compensation within the management company; and

– The sanctions regime applicable to trade professionals.

The amendments specifically enable a reconciliation of these subjects, the regime resulting from the mutual funds directive and that from the AIFM Directive (Dir. 2011/61/EU, 8 June 2011: JOEU, 1 July), governing managers and depositaries of alternative investment funds.

The deadline for transposition of the new provisions by Member States is set at 18 March 2016, and it will take effect as of this same date (Dir. 2014/91/EU, art. 2).

VIII. PRIIPS (Packaged Retail Investment and Insurance Products): Draft Regulation 2012 0352 of 3 July 2012

A. Context

The PRIIPS regulation was adopted by the European Parliament on 15 April 2014. Its objective is to ensure uniformity of the pre-contractual information provided to non-professional investors for products whose performance is a function of the underlying assets (structured notes, mutual funds and AIF, structured deposits, unit-linked life insurance contracts, derivatives, convertible bonds, etc.). The regulation is also applicable to titles or shares of special purpose vehicles.

In order to attain this objective, the Regulation requires the initiator/designer of the product to provide a "key information document" (KID), in a clear and concise form, constituted of different sections that enable the retail investor to have access to sufficiently clear basic information in order to be able to understand the products (whether they are financial, bank or insurance products), and to make comparisons between these products. The sectors to be regulated by these draft regulations are bank and capital markets, as well as insurance and asset management for third parties and the products involved are all "retail investment products and insurance-based [investment products]" that fall within the definitions provided by the PRIIPS regulation, namely, the following.

- **Retail Investment Products:** an investment, including instruments described under special purpose vehicles, regardless of their legal form, for which the amount that is repayable to the investor is subject to fluctuations because it depends on reference values or the performance of one or several assets which are not purchased by the investor directly;
- **Insurance-Based Investment Products:** an insurance product that has a maturity or surrender value that is partially or fully exposed, directly or indirectly, to market fluctuations.

Among the products excluded from the scope of the proposed regulation are:

– non-life insurance;

– life-insurance contracts when the services provided under the contract are payable only in the event of death or disability due to an accident, illness or infirmity;

– deposits other than structured deposits defined in Article 4 of the MIF Directive;

– securities described in Article 1 paragraph 2, points b) to g), i) and j), of the 2003/71/EC Directive (Prospectus directive)[9] (This concerns the securities exempted from prospectus with the exception of issuances of securities appearing in an offer when the total amount of the offer is less than 5 million Euros.);

– retirement products, which are considered under domestic law as existing primarily to provide the investor with income when he/she is retired, and which entitle the investor to certain services; professional retirement regimes that are officially recognized and fall within the scope of application of the 2003/41/EC directive or the 2009/138/EC Directive;[10] and

– individual retirement products for which a financial contribution by the employer is required under domestic law and the employer or employee cannot choose the retirement product or provider;

B. Principal Measures

The regulation will regulate the drafting, by the providers of the retail investment products and insurance-based investment products, of key information documents for the products they design and which fall within the scope of application of this regulation. It will also require the provision by the sellers (developer, distributor) to the client concerned about a key information document, prior to the conclusion of a transaction involving a retail investment or insurance product affected by this regulation. Finally, the regulation will require the implementation by the producers of retail investment and insurance-based products of a claims management procedure that is efficient and suitable, in order to respond to claims by investors relating to the key information documents.

IX. Taxes on Financial Transactions

A. Context

France has created a tax on financial transactions (the "FTT"), consequent to the first amended law on finances of 2012 and affecting (at the rate of 0.2 %) the purchase of shares in a company whose registered offices are located in France and for which market capitalization exceeds one billion Euros. The European Commission has proposed a directive aiming to establish a common FTT system, which would be the subject of enhanced cooperation among the eleven Member States (the "Cooperation"), including France.

B. Principal Measures

The European FTT provision under consideration aims to tax all financial transactions, regardless of the market, instrument or institution, if there is any territorial link with the "FTT zone," such link being essentially based on the residence of one of the parties to the transaction or, incidentally, at the site of issue of the financial instruments exchanged.

Even if the tax rates provided are left to the discretion of each State involved, they will be set, according to the provisions, at least 0.1% for shares and bonds and at least 0.01% for derivatives.

The opinion issued by the European Parliament voting in a plenary session on 3 July 2013 recommends, specifically, the application of reduced rates for sovereign bonds and financial instruments issued by pension funds until 2017, as well as exemptions for intra-group transactions and certain market-making activities.

While according to the non-binding opinion published by the European Council's legal experts on 6 September 2013 the drafted European FTT would be legally incompatible with the European treaties, in France, the authors are exploring the relationship between the French FFT and the European FFT.

At the end of the ECOFIN Council meeting of 6 May 2014, ten Member States of the Cooperation (with the exception of Slovenia) signed a joint declaration to implement the FTT progressively, focusing initially on the taxation of shares and certain derivatives (without specifying which). This initial phase was to be implemented no later than 1 January 2016.

Endnotes

1. Capital Requirement Regulation 575/2013 dated 26 June 2013: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013R0575&rid=4.
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4. EMIR Regulation 642/2012 dated 4 July 2012: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32012R0648&rid=6.
5. MIFID 2 Directive 2014/65/EU dated 15 May 2014: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0065&rid=3.

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   AIFM Directive 2011/61/EU dated 8 June 2011: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32011L0061&rid=6.

   PRIIPS Regulation 1286/2014 dated 26 November 2014: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:L:2014:352:FULL&from=FR.
6. That is, risk management procedures, which specify specifically the levels and types of security (collateral), the segregation provisions, and the level of capital required to manage uncollateralized risk.
7. That is, a contract entered into with one financial or non-financial counterparty belonging to the same group, provided that both counterparties are included in the same consolidation.
8. Decree 2013-687 of 25 July 2013: http://www.legifrance.gouv.fr/affichTexte.do?cidTexte=JORFTEXT000027769564&fastPos=1&fastReqId=1148254540&categorieLien=cid&oldAction=rechTexte.
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10. Directive 2003/41/EC dated 3 June 2013: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32003L0041&rid=7; Directive 2009/138/EC dated 25 November 2009: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32009L0138&rid=9.

Commentary: Dodd-Frank, Magna Carta and the New Financial Services Regulatory Regime in the United Kingdom

By Patrick Cook

I. The Implications of the Magna Carta

The Magna Carta, the eight-hundredth anniversary of which is celebrated this year, is a fine example of the law of unintended consequences and should serve as a warning to all legislators and parliamentary draftsmen.

It is not, of course, a piece of legislation at all. At most, it was an agreement or treaty imposed upon a medieval king by a group of barons who did not want to help the king fund a foreign war and who by good luck had seized control of London while the King was away campaigning. As the king needed the revenues generated through the London tradesmen more than he needed to defeat these barons in battle, he had little choice but to capitulate to their demands.

It should not, however, be thought that the barons were pursuing a high-minded cause, such as championing the interests of the common man. All they wanted was to preserve their own wealth, power and traditional rights, to be free from having to meet the king's excessive demands for money, and to ensure that, if they did wrong, they would be tried by their own class (thereby making it more likely that they would get off). There was no thought given to the common man, most of whom were more or less chattels as far as the barons were concerned. There was certainly no intention to deviate in any way from the rigid feudal system that had been imported into the U.K. from France as a consequence of the Norman invasion one-hundred-fifty years earlier.

And yet the Magna Carta has survived, not as a practical piece of law—since all but three of its provisions have long since ceased to apply—but as a concept. There is still no written constitution in the U.K. and no Bill of Rights such as is found in the United States and in much of mainland Europe. Nevertheless, the propositions that no man or woman, including the monarch, is above the law, that nobody can lawfully be imprisoned without a fair trial (habeas corpus), and that when accused everyone has the right to have his or her case heard by a jury of his or her peers, are as entrenched into the British psyche as if these had been included in the Ten Commandments handed down to Moses on Mount Sinai.

That these principles should apply to everyone ("any freeman" according to the Magna Carta) would have horrified the barons. The term "freeman" was substituted for the original term "baron" in subsequent versions of the Magna Carta, probably without most of the barons ever knowing, since many of them would not have been able to read at that time. The change was probably a concession to those very few individuals that made up the merchants, town guildsmen and lower aristocracy, and, of course, churchmen, who were recognized as "freemen" at the time and who had helped deliver London into the hands of the barons.

What no one at the time anticipated was that eventually everyone would be considered to be a "freeman." In England that took many hundreds of years, and came about as a result of the collapse of the feudal system, the self-destruction of the barons during the Wars of the Roses, the Reformation, the influence of the Renaissance from mainland Europe, the Civil War, the execution of Charles the First, and so on. It is indeed less than one hundred years ago that women took the first steps towards equality and became entitled to vote.

The key principles of the Magna Carta were used to justify the removal and eventual execution of the English king, Charles the First, and by the American colonists in their revolt against the British Crown, and found their way into the Declaration of Independence and were enshrined in the Bill of Rights. In this way, what set out as a bit of self-interest on the part of a few medieval barons in a muddy field by the River Thames eight hundred years ago turned into the principal tenets upon which one of the world's largest democracies based its rule of law.

Of course other jurisdictions came to similar concepts in their own way and in their own time, perhaps most notably France with its revolution and the subsequent codification of its laws under Emperor Napoleon. There are, however, clear echoes of the Declaration of Independence ("We hold these truths to be self-evident, that all Men are created equal, that they are endowed by their Creator with certain unalienable Rights, that among these are Life, Liberty and the Pursuit of Happiness") to be found in the French Revolutionary principles of *Liberté, Egalité et Fraternité*. Might this indicate that consciously or unconsciously and directly or indirectly the Magna Carta concepts found their way into the underlying principles not only of common law jurisdictions such as the U.K., Australia and New Zealand but also of those western democracies based on the Code Napoleon or other similar written constitutions?

II. Financial Regulation

Against this background, how do we judge Dodd-Frank and its equivalent in the United Kingdom? For a start, the Magna Carta was very much shorter—thirty-seven operative articles, each no longer than a short paragraph, as compared to twenty-three hundred pages of primary legislation in the case of Dodd-Frank. It should of course be conceded that in 1215 everything had to be written by hand on vellum and relatively few people could read or write, so comparatively speaking it was a significant piece of work. It was also written in Medieval Latin, which possibly was as opaque as some of the language of Dodd-Frank and its equivalent English legislation.

The U.K. Legislation has, in addition to the influence and effect of Dodd-Frank, been influenced and to an extent dictated by European legislation, in particular by the European Market Infrastructure Regulation (EMIR) relating to OTC derivative trading. The terms and effect of U.K. legislation to be found in the Banking Reform Act, which received Royal Assent in December 2013, and the Financial Services Act, which came into force in April 2013, differ from—but have many similarities to—its U.S. and E.U. counterparts.

Thus, common themes are the following:

- The requirement for certain OTC derivatives entered into between authorized counterparties, certain relevant non-financial counterparties and certain non-U.K. entities to be subject to mandatory clearing.
- The introduction of a review process for mandatory clearing of classes of OTC derivative contracts.
- The regulation of derivative dealers and the requirement to register.
- The extraterritorial application of regulations relating to OTC Derivatives.
- The exemptions from clearing for certain products (e.g., FX and covered bonds).
- The acceptance of certain non-U.K. CCPs to provide clearing services for derivatives.
- The exemptions from clearing mandate of certain counterparties (e.g., pension schemes, intra-group transactions, certain non-financial counterparties).
- Reporting requirements.
- Requirement for banks that represent a significant systemic risk if they were to fail to increase the ratio of equity to risk likely well beyond the Basel III requirements.
- The introduction of new regulatory oversight.
- The introduction of measures to protect smaller investors.
- The introduction of new governance requirements.
- The introduction of more robust compensation schemes.

Further legislation will implement the proposals of the Independent Commission on Banking, which among other things will require the separation of retail banking functions from wholesale and investment banking activities (including swaps business).

There are other common themes but also some substantive differences and differences of emphasis between the U.S. and E.U. legislation on the one hand and the U.K. legislation on the other. There are no current plans to impose a Financial Transaction Tax as has been proposed by the E.U. and adopted by a number of European countries. Some of the differences are due to the operations of common law as opposed to codified law. Others are of a more political nature and some reflect perceived national interests. Banking and financial services play a very significant role in the U.K. economy and there is a reluctance to adopt measures that might harm this sector unduly or diminish the importance of London as a financial centre. Indeed there is a fair amount of xenophobic antipathy towards some of the proposals of the E.U. Commission, which are perceived to be aimed at reducing London's position and transferring it to Frankfurt or Paris.

As with the Dodd-Frank legislation and the E.U. regulations and directives, in the U.K. much is still outstanding, to be implemented over a period of years and much relies on secondary legislation that is as yet undrafted. This creates uncertainty which is always unhelpful.

Because of the global nature of financial services and banking, participants in one jurisdiction now have to have regard not only to the legislation and rules applicable in that jurisdiction but also to those which are applicable in others. In some cases this has led to the cessation of certain cross-border trading. The rules are detailed and complex and the cost of complying high. Participation in clearing is necessarily expensive and it is only the larger organizations that can afford to take part. All this inevitably leads to higher costs for the investor.

III. Implications for the Future

It is far too early to be able to tell whether the raft of legislation and secondary legislation will achieve its intended effect. Indeed it is not entirely clear in all cases what the intended effect is. It remains to be seen whether the credit risk of the various financial instruments that are the subject of the new rules is going to be reduced or effectively contained. Where products are effectively bets, it is difficult to see how this will be the case.

One of the real issues that caused the most recent financial crisis was the failure of confidence, which in turn resulted in a freeze on liquidity. The legislation does not appear to address liquidity risk. Financial markets rely on trust and confidence. Value, much as the Emperor's new clothes, is just what people perceive it to be. While vast sums of money are extracted from the system for the benefit of a relatively few individuals, is any real wealth actually created for society as a whole? Cycles of boom and bust have been endemic throughout the twentieth century and into the twenty-first. Will any of this put a stop to such cycles? If not, then at some stage in the future there will be another liquidity freeze—and it is questionable whether this legislation will help a great deal when that happens.

In the meantime, thousands of transactional lawyers have had to become regulatory lawyers and the creative brainpower that went into doing deals is now deployed in avoiding regulatory mantraps.

It is inevitable—and not necessarily a bad thing—that, when something gets as out of control as the financial markets did by the mid-2000s—there is a reaction. Some of that reaction is bound to be of a knee-jerk variety and some vengeful. In the public arena politicians will sometimes insist on doing things simply so as to be seen as having done something. As a result some of what has been enacted will not survive the long term. It may be that a wholly different and more radical approach to banking and financial services will emerge in time.

It took hundreds of years and the novel re-interpretation of it by Sir Edmund Coke in the early seventeenth century before the true merit of the Magna Carta was revealed. Things move more quickly nowadays, but I suspect that it will be a number of years before we know whether Dodd-Frank and its equivalents in mainland Europe and in the U.K. have resulted in the development of new fundamental principles that can form a cornerstone of a free society of the future, let alone whether it will have any effect on the position of the Common Man.

Commentary: Serious Fraud Office Annual Report Shows Progress

By Jonathan P. Armstrong

David Green, the Director of the U.K.'s Serious Fraud Office (SFO), published his Annual Report for 2013-2014 in June 2014. The report gave us the opportunity to reflect on the recent past and to look to the future concerning the SFO's activities.

However, it is relevant to note that, although in its last reporting year the SFO ran prosecutions of eighteen defendants, with a conviction rate of eighty-five percent, the numbers were quite small—eight prosecutions in which eleven defendants were convicted, of whom four pleaded guilty, with seven being found guilty by a jury. The SFO also opened twelve investigations last year and charged thirty-five defendants. Given the scale and complexity of the SFO's work, this can be regarded as a modest success.

Regarding the outlook for the future, the Director states that the SFO is "undertaking fewer but much larger and more complex investigations" and that the SFO has "expanded [its] analytical and intelligence capability, and currently [has] significant pre-investigation projects in development."

What will be of particular interest to watch as a development is the use of Deferred Prosecution Agreements (DPAs), which came into operation earlier in 2014 with regard to the SFO's enforcement of the UK Bribery Act 2010. There have as yet been no public announcements of a DPA going through the system. DPAs are a tool for the SFO (and other government crime authorities) to try to reach a form of plea bargain with corporate offenders and thereby shortcut trials while reducing time and cost. It will probably take some time for DPAs to bed down, so only time will tell whether DPAs are judged a success.

The SFO also appears to have had some regulatory woes of its own on a different front, including a data loss in 2012 that led to an investigation which resulted in a ninety-eight percent recovery of material. The incident was reported to the Information Commissioner's Office (ICO) as personal data that had apparently been inadvertently sent to a third party. The report states that the ICO undertook a site visit at the end of May 2014 and that the SFO has had a further ten instances of data handling issues, although no more details are given. Data losses are an all too frequent occurrence these days, to which even leading regulatory authorities are not immune.

Since the SFO's report was published, we have also seen the SFO's first convictions under the Bribery Act 2010. The SFO obtained those first convictions under the Bribery Act 2010 on 5 December 2014 at Southwark Crown Court. They secured sentences of twenty-eight years in total for three men.

Two of those accused were convicted of offenses under the Bribery Act 2010. The offenses followed an investigation by the SFO into Sustainable AgroEnergy plc ("SAE"). One of the men, Gary Lloyd West, was a former Director and Chief Commercial Officer of SAE, and the second, Stuart John Stone, was a sales agent of unregulated pension and investment products for a separate company. Both men were convicted of various dishonesty offenses, including being found guilty of offenses under the Bribery Act 2010. Gary Lloyd West was convicted of two counts under Section 2 of the Bribery Act 2010, which relates to the offense of being bribed. Mr West was sentenced to a total of thirteen years in respect of all the offenses of which he was convicted on 5 December. The offenses took place between April 2011 and February 2012.

Stuart John Stone was convicted of two counts under Section 1 of the Act, which covers the offense of offering or giving bribes. He was sentenced to a total of six years in prison for all the offenses that he faced.

West was also disqualified from being a director for fifteen years (the maximum permitted) while Mr Stone was disqualified for ten years. The SFO is also seeking compensation and confiscation orders to deny them their ill-gotten gains. The defendants were found to have been involved in a pension investor scam where people were encouraged to invest in a biofuel scheme that was supposed to yield huge returns. The scheme was a total sham and investors were defrauded of around £23 million. Investors were duped into investing in green biofuel tree plantations in Cambodia. Investors were told they were insured against the crops failing.

The case was uncovered after an SFO investigation into suspicious accounting that had come to their attention. False representations were made to investors and false invoices were made. False email addresses, foreign bank accounts and companies were used to hide the tracks of the fraudsters. Mr West received bribes for his role in the false invoices submitted by Mr Stone.

Judge Martin Beddoe said in his sentencing remarks that the fraud was a "thickening quagmire of dishonesty…there were more than 250 victims of relatively modest means, some of whom lost all of their life savings and their homes."

The most striking things about this case are the following:

- The speed with which the case was processed: the men were charged relatively recently, on 14 August 2013.
- The fact that both the bribe payer and the bribe receiver were prosecuted: under the Bribery Act 2010 it is no longer better to give than to receive.
- The fact that the SFO will take on bribery cases with an international element: this case had Swiss bank accounts, foreign companies and misrepresentations about land in Cambodia.
- The fact that this prosecution was successful: bribery and corruption cases have been hitherto notoriously difficult to prosecute in the United Kingdom and abroad.

These are not the first Bribery Act 2010 convictions in the United Kingdom. Previous cases have included a case of the magistrate's court clerk who took a £500 bribe to wipe a speeding conviction from a court record and a Chinese student who tried to bribe his university professor. This is, however, the first real chance that the U.K. courts have had to interpret the Bribery Act 2010 in relation to large-scale bribery. The court in this case did not shy away from handing out strict sentences. This may signal an era of tough sanctions for bribery offenses.

Since the report we have also seen some additional activity in this area:

- Convictions in December 2014 in the Smith & Ouzman case. The case represents the SFO's first convictions for bribery of foreign public officials after a trial. In this case the SFO received co-operation from Kenya, Ghana and Switzerland.
- The settlement of the SFO's long-running civil actions with the Tchenguiz brothers.
- The sentencing of former Alba CEO Bruce Hall for conspiracy to corrupt in relation to contracts for the supply of goods and services to a Bahraini Aluminium company.
- The laying of criminal charges against a U.K. subsidiary of Alstom after a tipoff from the Office of the Attorney General in Switzerland concerning large transport projects in India, Poland and Tunisia.
- The sentencing of four men connected with Innospec in connection with their involvement in a bribery scheme in Indonesia and Iraq. Mr. Green said of the prosecutions, "This successful conclusion to a long-running investigation demonstrates the SFO's ability and determination to bring corporate criminals to justice." The SFO also secured a guilty plea from the company with fines being imposed in the United Kingdom and the United States after co-operation between the SFO and authorities in the United States, Indonesia, Switzerland and Singapore.

It is clear from both the report and the activity of the recent past that those who think the Bribery Act 2010 is dead have spoken too soon. The SFO is right to focus its resources on the most complicated cases, and the Crown Prosecution Service (CPS) has also used bribery legislation to bring less complex cases to court. Complex cases take longer to reach court, especially given the need for co-operation with foreign law enforcement agencies. It is likely that the next few months will see more activity as announcements are made in some of the SFO's ongoing investigations.

Litigating in the Qatar International Court

By Hon. Gerald Lebovits and Delphine Miller

I. The QFC and Its Entities

A. History

In 2009, His Highness Sheikh Hamad bin Khalifa Al-Thani, then the Emir of the State of Qatar, established and personally inaugurated, with a silver gavel now on display beside the courtroom door, the Qatar International Court. His Highness The Emir's goal was to attract to Qatar international business and financial services; to provide a modern, specialist court with international expertise; and to assure that litigants in conflict in Qatar and across the globe would have an independent, transparent, and enforceable judicial mechanism in Qatar to resolve their disputes quickly and fairly in accordance with due process and the best international legal practices.[1] The Qatar International Court and Dispute Resolution Centre (QICDRC), of which the Qatar International Court is now a part, was established in 2012.

The Qatar International Court itself consists of the Qatar Financial Centre (QFC) Regulatory Tribunal and the QFC Civil and Commercial Court. In 2005, a few years before the Qatar International Court was established, the QFC was founded as a financial and business center for international financial services. The QFC serves as an independent, statutory, and regulatory body authorizing and regulating financial-service businesses in and from Qatar.

The QFC has three entities: the QFC Authority, the QFC Regulatory Authority, and the Qatar International Court, which is itself divided between the Regulatory Tribunal and the Civil and Commercial Court. The Regulatory Tribunal hears appeals from decisions by the QFC Authority, which manages the QFC.[2] It also hears appeals from the QFC Regulatory Authority, established to regulate and supervise "banking, financial, and insurance-related businesses carried on in or from the QFC."[3] The QFC Regulatory Tribunal hears appeals from decisions made by other QFC institutions.[4] This article focuses only on the Civil and Commercial Court.

The Civil and Commercial Court was established as a court of the State of Qatar by Article 8 (3) of the QFC Law (Law No. (7) of 2005), as amended by Law No. (2) of 2009.[5] The Court began to hear cases in 2009.[6] The Court's headquarters are in the QFC, in Doha, Qatar's capital city. Whenever necessary, the Court can conduct its proceedings in any other place in the State of Qatar[7] and, in particular, in Qatar's six other baladiyat, or municipalities.

B. The Structure of the Civil and Commercial Court

The Civil and Commercial Court is comprised of two divisions: the First Instance Circuit and the Appellate Division, sometimes called the Appellate Circuit.[8] In each circuit, three Justices—each called My Lord or My Lady—sit on each case.[9] The Court's thirteen Justices come from Qatar, the United Kingdom, Germany, New Zealand, and Singapore.[10] The Justices, currently all part-time Justices, are all eminent practitioners with considerable experience in their home countries, particularly in dealing with financial and commercial matters.[11] Some are retired judges. Two of the Justices are women. (Proposed legislation calls for full-time Justices, with only one Justice presiding in the First Instance Circuit at each trial.)

The Qatar International Court's current President is the Right Honorable the Lord Nicholas A. Phillips of Worth Matravers, who, from 2009 to 2012, was the first President of the Supreme Court of the United Kingdom. Lord Phillips succeeded the former and first President of the Qatar International Court, the Right Honorable the Lord Harry Woolf, who was the Lord Chief Justice of England and Wales from 2000 to 2005.

The Civil and Commercial Court's overriding objective is "to deal with all cases justly."[12] This objective requires the Court to dispose of cases expeditiously and effectively, using no more resources of the Court or the parties than necessary.[13] The objective also requires the Court to handle cases proportionate to their importance, taking into account the complexity of the issues and each party's financial position.[14]

Several key principles on which the QFC Law is based stem from this overriding objective. The Civil and Commercial Court follows adversary common-law principles, as opposed to the inquisitorial system applied in Qatar's other courts. In those other courts, Qatar applies Islamic *Shari'ah* law as the main source of law and specifically to family law, inheritance law, and some criminal cases. Qatar's civil courts apply Roman and Napoleonic civil law and procedure.

On the other hand, the Court's procedures are similar to those found in common-law systems. They are, at bottom, a simplified version of the Civil Procedure Rules used in England and Wales and are modeled on London's Commercial Court, a division of the Queen's Bench Division of the High Court of Justice. But Qatari law controls. The Appellate Division in the *Chedid* case has made it clear that litigants should not base their arguments on English case law when Qatari law applicable to the Court, such as the QFC Regulations, governs an issue.[15] Moreover, the Court in the *Silver Leaf* case explained that the law applicable to the Court is interpreted with "regard to the circumstances in Qatar."[16] The Court found that it is not bound to follow another country's judicial interpretation of legal principles.[17] That interpretation, according to *Silver Leaf*, may be used only as a guide to interpret Qatari legislation.[18]

The Court's decisions are, however, considered persuasive and not binding, like they are in common-law systems.[19] There is no jury before the Civil and Commercial Court. The Court's decisions may not be appealed to Qatar's civil courts or even to Qatar's highest court, the Court of Cassation. Decisions the Court renders are final.[20]

The Court also follows the equality principle, according to which the Court must ensure that the parties are on equal footing.[21] The Court may not discriminate against litigants in any way or favor one side over the other based on race, religion, wealth, nationality, language, or other considerations.

The Court also follows the best international practices to render its decisions.[22] The Court applies due process by providing fair procedures to litigants. Under due process, parties are entitled to sufficient notice and have the right to be heard.

The Civil and Commercial Court is part of the QFC and is located on two floors in QFC office building Tower Two in Doha. The QFC's Board promotes, operates, and runs the QFC.[23] The Board must provide "all infrastructure, personnel, services, and support" needed to ensure that the QFC is "run at all times in accordance with best international standards for financial and business centers of a similar kind."[24] The Board must also maintain the QFC as a "leading financial and business center in the Middle East."[25]

Foreign companies may register with, and be licensed by, the QFC. There are many advantages for companies to do so. The QFC Law protects QFC-registered companies.[26] Notwithstanding any provision to the contrary, QFC-registered companies may not be subject to expropriation or any restriction on private ownership.[27] QFC-registered companies have the freedom to repatriate profits and realize investments.[28] QFC-registered companies may hire the employees of their choice on the terms of their choice, subject to the Regulations and any international treaty obligations into which Qatar enters.[29] QFC-registered companies are not subject to any taxes, except those determined in accordance with the Regulations.[30] QFC-registered companies may be owned up to one hundred percent by any person, company, or entity not a Qatari national or resident.[31] QFC-registered companies may not be prosecuted if they follow the law.[32]

The Qatar International Court, and by extension the Civil and Commercial Court, has a Registrar, currently Christopher Grout, a UK–trained barrister. The Registrar, who heads the Registry Office, is a judicial officer with a legal, judicial, and managerial role in the Court.[33] The Registrar decides which Justice will sit on which panel, based on the availability and on the expertise of each Justice.[34] The Registrar also often presides over case management, Directions Hearings, and cost determinations. The Registrar's decisions can be reviewed by the Justices on an interim appeal.[35]

The Civil and Commercial Court is presided over by a President, also called the Chairman (whom Americans would call the Chief Justice), and "a sufficient number of members,"[36] called the Lord Justices of the Qatar International Court. Upon the proposal of the Minister of Finance, the Council of Ministers—Qatar's supreme executive authority, also called the Advisory Council or, in Arabic, the *Majilis Al Shura* (a group that includes the Prime Minister)—appoints them for five-year renewable terms.[37] The President and Justices must be of good character, at least thirty years old when appointed, and have the requisite legal knowledge and experience.[38]

The President manages the Civil and Commercial Court's administrative and financial affairs.[39] The President and the Justices of the Civil and Commercial Court may not be Board members or employees, members of the board of directors of the Regulatory Authority, or Board members of a QFC institution.[40] If the President or Justices of the Civil and Commercial Court become members or employees of these institutions, they will automatically cease to be President or members of the Civil and Commercial Court.[41]

The President and Justices of the Civil and Commercial Court must by law perform their duties independently and impartially.[42] They may not have any financial interest with the parties to a dispute.[43] The Council of Ministers may remove the President and any Justice of the Civil and Commercial Court who becomes incapable of performing his or her duties due to illness, is declared bankrupt, or is convicted of a crime, or if the Council of Ministers finds the President or Justice guilty of serious misconduct.[44] If the President is unable to perform the functions of office, the other Justices will name one of their own temporarily to perform the President's duties.[45]

The Civil and Commercial Court, its President, and its Justices are not subject to civil liability in relation to acts, omissions, or good-faith negligence while performing their duties.[46] They are not exempt from civil liability relating to any commercial contract to which they are a party.[47] The State of Qatar has no liability for any acts or omissions by the Civil and Commercial Court, its President, or its Justices.[48] All the Justices of the Civil and Commercial Court are public officers under Criminal Law No. 11 of 2004.[49]

Like every American court, the Civil and Commercial Court has the power to set its own internal regulations concerning employee rules, terms, and conditions.[50]

As noted above, the Civil and Commercial Court is divided into two divisions: the First Instance Circuit and the Appellate Division.[51] The Justices are not permanently assigned to one of the divisions. They may sit in either division,[52] although they may not sit on an appellate panel that reviews one of their own First Instance decisions.

In the First Instance Circuit, the parties are called the claimant and the defendant. The claimant is sometimes called the "plaintiff." A party is called an applicant when that party applies for something (Americans call it a "motion"), such as an application for interim relief. A party is called a "respondent" when that party responds to something, such as an application for interim relief. Before the Appellate Division, the parties are called the applicant and the respondent. Claimants (and applicants on appeal) sit to the Justices' right. Defendants (and respondents on appeal) sit to the Justices' left.

Parties may represent themselves before the Court, without a lawyer.[53] A lay person may appear on a company's behalf on some conditions:[54] There must be leave of Court; the company must authorize the lay person to appear on the company's behalf, and the Court must be satisfied that lay representation is in the interests of justice.

Counsel may represent any party, but the Court has the discretion to decide who has the rights of audience.[55] When the Court does not give any direction, any qualified lawyer admitted to a court of superior jurisdiction anywhere in the world has rights of audience.[56] This right of audience is still subject to the Registrar's or the Justices' being satisfied of the lawyer's qualifications, competence, and good standing. If required, the lawyer must send proof of qualifications by email at the earliest possible opportunity, and at least seven days before a hearing date.[57]

When legal counsel represents a party, any communication between that party and the Court must be done through counsel.[58] If a party communicates with the Registrar, that party should copy the other party to the communication.[59]

II. Jurisdiction

There is no minimum or maximum monetary jurisdiction, and the Court hears only civil cases.

The First Instance Circuit has jurisdiction over civil and commercial disputes arising between QFC-registered companies; between a QFC-registered company and the QFC or any of its institutions; between a QFC-registered company and its employees; between a QFC-registered company and a non-QFC body it has contracted with unless the parties agree otherwise; and between a QFC-registered company and a citizen of the State of Qatar.[60] Currently, one hundred eighty companies are registered with the QFC.

The First Instance Circuit also has jurisdiction over civil and commercial disputes arising between parties that consent to the Court's jurisdiction. In accordance with the best international practices, the Court will take into account the parties' express consent that the Court should have jurisdiction.[61] Consent can be expressed in a document, given orally, or inferred from the parties' conduct. The parties' accord is not binding on the Court.

The parties must object to jurisdiction at the earliest practicable opportunity.[62] Doing so is called an objection, but the parties must make an application to contest the Court's jurisdiction. If the Court does not accept jurisdiction, the Court may refer the proceedings to another court in the State[63] on its own initiative or on a party's application.[64] In considering whether to do so, the Court will take into account whether the parties have consented to the Court's jurisdiction.[65]

The Court also exercises discretion whether to accept or decline jurisdiction.[66] The Court will take into account whether the parties expressly agreed that the Court should have jurisdiction and whether the dispute between the parties has a connection with Qatar.[67]

To contest the Civil and Commercial Court's jurisdiction, the contesting party—the defendant/applicant—must notify the Registry and the claimant within fourteen days of being served with the Claim Form,[68] which Americans call a complaint. Then, the contesting party, called the applicant at this phase, must file an Application Notice with the Registry and serve it on the other party within fourteen days of the notification to the Registry.[69]

The Appellate Division has jurisdiction over appeals against decisions of the First Instance Circuit and the Regulatory Tribunal.[70]

III. The Law Applicable to the Civil and Commercial Court

The Civil and Commercial Court applies QFC Law No. (7) of 2005, as amended, and the Procedural Rules and Regulations,[71] often referred to as the Regulations. In addition to the Regulations, sixteen substantive laws are found on the QFC's Web site:[72] Arbitration Regulations; Companies Regulations; Contract Regulations; Data Protection Regulations; Employment Regulations; Financial Services Regulations; Immigration Regulations; Insolvency Regulations; Limited Liability Partnerships Regulations; Partnership Regulations; QFC Authority Regulations; QFC Tax Regulations; Security Regulations; Single Family Office Regulations; Special Company Regulations; and Trust Regulations.

The Regulations apply to all proceedings, including those before the Appellate Division.[73] The Regulations are drafted in both English and Arabic. Both versions are authoritative, but if a conflict arises between the two, the Arabic version—Qatar's official language—will prevail.[74] Although the Court's own procedural and evidentiary rules control, the Court will apply any substantive law the parties explicitly agree to apply.[75] The Court may, however, use its discretion to decline to apply the law to which the parties agree if it finds good reasons making it inappropriate to apply it.[76] For example, the Court will not apply the law the parties agreed to if the other jurisdiction's law conflicts with Qatari public order.[77] Absent the parties' agreement to apply the substantive law of a different jurisdiction, the Court will apply Qatari substantive law.

In any event, the Court will always apply all consumer-protection provisions of the QFC Law and the QFC Regulations.[78] The Court may also take the Practice Guide into account to assess the parties' conduct.[79] The Practice Guide is issued pursuant to the Regulations.[80] It is read in conjunction with the QFC Law and the Regulations but does not have the force of law.[81] The Court may also issue Practice Directions,[82] although it has not yet done so. The Practice Guide and the Practice Directions may be revised by taking into account practical experience.[83]

IV. How Cases Are Heard in the Civil and Commercial Court

A. Filing Forms

The Court charges no filing fees or other costs for anything.

All forms may be obtained from the Registrar or from the Court's Web site,[84] which is currently under partial construction. Claimants can either sign in as a guest or register on the Web site to complete the appropriate form. All forms are expandable to allow the claimants to choose which parts of the form they need, depending on their dispute, and to enable them to explain their position. After the claimants fill out the form's relevant parts, they submit it by pressing the submit button. New hard-copy forms will be available in October 2015.

A party wishing to resolve a dispute before the Court must concisely complete a Claim Form, which the Registry then issues on the Court's behalf.[85] To make things more user-friendly, the Court allows potential claimants to ask the Registrar to intervene before filing a claim. Claimants that choose to do so should summarize the nature of the dispute and notify the other party no later than the day the Registrar is notified.[86]

The issuance of the Claim Form by the Registry marks the commencement of the proceeding.[87] The day the Registry stamps the Claim Form is the date on which a claim issues.[88] The Claim Form must indicate the names and addresses of the parties and their legal representatives, the facts relied on, the legal basis for the claim, the remedy sought, the applicable law and language, and whether any step has been taken to resolve the dispute by ADR.[89]

The statute of limitations for filing a claim is six years from the date on which the cause of action accrued.[90]

The claimant must attach or append to the Claim Form the documents supporting the claim. The claimant should not, however, detail in the Claim Form the evidence on which the claimant intends to rely.[91] All claims arising out of the same matter must be made at the same time.[92] Claimants that do not do so lose their right to sue anew. If two or more claims are filed regarding the same matter, or for different interests in the same dispute, or which involve similar issues, the Court may consolidate the claims or hear them concurrently.[93]

The claimant serves the Claim Form on the respondent (defendant).[94] A Claim Form is valid for service for four months from the date it issues,[95] which is the date the Registry stamps the form.[96]

Unless the Court orders otherwise, defendants must complete a Defence Form (note the U.K. spelling) within twenty-eight days from the date of service of the claim.[97] In the Defence Form, defendants may admit the claim in full or in part and propose how the claim will be satisfied.[98] Defendants may also state a defense to the claim or interpose a counterclaim. The defendant serves the Defence and/or Counterclaim Form on the claimant. A defendant is not required to serve any defense if the defendant intends to contest the Court's jurisdiction.[99] Defendants are required to serve a defense only after the Court has accepted jurisdiction.[100]

Claimants have the option to complete a Reply to Defence and/or Counterclaim Form.[101] This is an optional, brief statement of reply to the matters raised in the defense. If the defendant counterclaims, claimants must tell the Court whether they admit the claim or any part of it or whether they dispute the claim. Claimants serve on the defendant the reply and/or counterclaim to the defense.

All forms must contain a signed statement of truth to promise the Court that the contents of the claim are true.[102] The statement of truth must be signed by the party, by a party's representative, or by the party's legal representative.[103] The promisor does not write the statement of truth under oath or affirmation. But once in Court, the Justices will ask that person whether the statement is true, and then that person will affirm or swear on the Holy Qur'an or on the New Testament (both of which are in the courtroom at the witness's desk).

The statement of truth must take the following form: "I believe [or, where a statement is made by a representative, 'The [claimant or defendant] believes'] that the facts stated in this [claim form, defence, etc.] are true." [104]

B. Filing and Serving Forms

Forms must be filed with the Court's Registry by post (mail), fax, or in-hand deposit of the document at the Registry.[105] A document satisfies the requirement that it be sent to the Court when that document is filed at the Registry.[106] Electronic filing is not permitted as the exclusive way to file, but it may be used in addition to another method of filing.[107] (Proposed legislation, if enacted, will allow e-filing to be the exclusive way to file all papers with the Registry.)

Claimants and defendants must serve the forms on all parties to the claim.[108] The Court does not serve forms. Service is made by personal service, delivery to a party's home or office address, registered mail, fax, or any other method agreed by the parties or by ordered by the Court.[109] Service within Qatar may be done by personal service, delivery to a party's home address, mail, fax, or any method agreed by the parties or directed by the Court. Service outside Qatar does not require the Court's permission, but service must comply with the rules applicable to the country where the form is served.[110] (Proposed legislation, if enacted, will allow service to comply with Qatari law, and not the law of another jurisdiction.) Claimants must notify the Registry when they served the Claim Form and what method of service they used.[111]

For time limits to file and serve, periods calculated in days do not count the day on which the period in question begins. A "working day" does not include a Friday, Saturday, or Qatar public holiday.[112] "Business hours" are from 7:00 a.m. to 2:00 p.m., Doha time,[113] which is seven hours ahead of New York time. A document served by mail or similar method is deemed served or filed on the second working day after it was sent.[114]

When a document is served or filed by fax and is transmitted during business hours, it is deemed transmitted the same day.[115] When the document is transmitted outside business hours, it is deemed transmitted the next working day.[116] The Registrar or the Justice may extend or shorten any time limit set out in the Regulations but may not shorten the time limits the QFC law sets out.[117]

C. Summary Judgment

The Court may grant summary judgment when the issue can be decided on the facts and law without a trial.[118] The Court may grant summary judgment on a claim, a defense, or any issue.[119] A party wanting the Court to rule on summary judgment makes a pretrial motion, called an interim application. All inferences must be resolved in the light most favorable to the nonmoving party. The Court will deny the application if it finds a genuine issue of material fact. The Court will usually resolve the application on the papers, without oral argument.

D. Case Management

If the Court does not decide the dispute on the papers, the case will go through case management. The Registrar and the Justices—but typically only the Registrar—are responsible for case management.[120] They will set out a timetable, and the Court may give directions, taking into account the parties' interests and the best international practice.[121]

The Court gives directions concerning the future management of the case after service of the Claim Form and service of the defense or of any jurisdictional application.[122] A Directions Hearing may take place if the Court so directs.[123] The Directions Hearing may occur in Doha or by telephone or video if the Justices or the parties are not in Doha.[124] During a Directions Hearing, the Court gives directions about the future management of the case. A minimum seven days' notice to the parties is required for a Directions Hearing.[125] The goal of case management is to encourage the parties to act reasonably and ensure efficiency.[126]

The Court may order case-management directions on any party's application or on its own initiative.[127] The Court may make whatever directions it considers appropriate,[128] such as selecting the issues to be heard at trial.[129] Directions are intended to ensure the "just, expeditious and economical determination" of a case.[130] In the interests of justice, the Court may delegate the hearing of any issue to one or more of the three presiding Justices.[131] The remaining Justices may adopt or reject the decision of the one Justice.[132]

If the Registrar, rather than a Justice, renders a case-management or Directions Hearing decision, either party may file an interim appeal to enable a Justice to reverse the Registrar's decision.

The Court may permit the amendment of the Claim Form or any statement of the case.[133] To grant an amendment, the Court will look at whether it would carry any prejudice, whether the other party has known for some time about the facts underlying the proposed amendment (and thus that no surprise results), whether the prejudice—if any—can be cured, and whether the moving party is unrepresented.

If a party fails to comply with the Court's direction and does not have a reasonable excuse for not doing so, the Court may award costs against that party. The Court may also dismiss a claimant or applicant's claim or application in whole or in part or strike out the defendant's defense or the applicant's response in whole or in part.[134] The Court must always give a party notice of any order the Court is making.[135]

A party seeking relief from the Court other than a full trial may complete an Application Notice and serve it on the respondent.[136] The applying party is the applicant, and the party responding is the respondent, regardless whether either is the claimant or the defendant. The party seeking relief must file the Application Notice with the Registry when it completes it or as soon as possible.[137]

The party being served with the application notice must respond within twenty-eight days of service or within the period of time set by the Registrar of the Court.[138] The respondent must attach any important document to the response.[139] All applications and responses to applications must include a statement of truth, such as: "I believe that the facts stated in this [application] [response] are true."[140] A party with an urgent matter may contact the Registry to seek the Court's assistance before the proceedings begin.[141]

E. Disclosure

Litigants before the Civil and Commercial Court have no obligation to disclose (or, as Americans call it, to provide discovery).[142] But the Court may require the parties to disclose documents relevant to the case and to provide further information about the case.[143] The Court may do so at any stage of the proceedings.[144] If the parties disagree about which document should be produced, the Court resolves that dispute by taking into account the best international practices.[145]

The Court may also determine what documents, if any, are privileged.[146] Privileged documents may be "without prejudice" letters,[147] correspondence between the parties on which the sender mentions "without prejudice." A privileged document may also be an attorney-client or other privileged communication.[148] The privilege attached to the "without prejudice" correspondence and attorney-client communications may be disregarded in exceptional circumstances to protect the public interest.[149]

Parties must disclose all documents on which they rely during the proceedings.[150] Parties are entitled to request disclosure of any relevant document from another party.[151] But parties may assert any privilege they may have on any document.[152]

The need for American-style depositions is reduced by the Court's requirement for witness statements on claims, applications, and responses. The parties may still apply for depositions, which might be granted in the Court's discretion in an unusual case.

F. Pretrial

At least fourteen days in advance, the Registrar notifies parties of the date and place of the hearing,[153] also called a trial. The Court may give directions about the venue, language, length, timing, extent of written or oral submissions, or adjournment.[154] The parties must give the Court a summary of their arguments in the case with references to documents, evidence, witnesses, and legal provisions.[155] This skeleton argument should be as concise as possible and not exceed fifty pages.[156] During the pretrial review with the Court, the parties must also draw up a list of trial issues.[157]

The parties must further agree together on what documentary evidence the Court will consider. The parties prepare a binder of consecutively paginated documents, which they submit to the Court before trial. If the Justices find any document inadmissible or without foundation or weight, they are free to ignore it at trial even though it is already in the binder.

G. Trial

During trial, the Court hears both parties' evidence and arguments. Parties are present in the courtroom in Doha or virtually through video or, if permitted, by telephone.[158] If by video, they must consult with the Registrar about videolink arrangements at least seven days before the trial, sometimes called the hearing.[159]

Trials are held in public,[160] unless an extraordinary circumstance requires closure. The language spoken during the proceedings is English,[161] but it can be Arabic if the parties wish so.[162] To avoid delays and misunderstandings,[163] the parties must choose at the earliest possible time the language they would like to use during the proceedings.[164] If the parties wish to conduct the proceedings in Arabic, they must agree upon it "at the outset of the initiation of the claim."[165] Simultaneous oral translations are available. The Court provides interpreters,[166] who use the courtroom's interpreter booth to translate.

The Court may limit the time allowed for the trial.[167] The method of litigation at the Court is adversarial. Proceedings are audio recorded. Videotaped proceedings and overnight typed transcriptions are available on request.

If the claim is defended or there is a counterclaim, the parties must prove their case in Court. The Court plays an active role in determining what evidence it needs to see by issuing directions to the party regarding the documents that may be filed and by strictly controlling oral evidence. The rules applicable before the Court do not provide for a particular burden of proof. In practice, the claimant's burden, to succeed, is to prove its case by a preponderance of the credible evidence or, as it is put in England, "on the balance of probabilities."

The Court admits evidence both as to matters of fact and as to matters of expert opinion on the terms and in the form the Court considers appropriate.[168] Importantly, the Court generally admits all evidence,[169] including evidence an American court would reject, such as hearsay. But the Court will assess the credibility, reliability, and weight of that evidence in light of the arguments.[170]

A witness may choose between taking an oath or affirming.[171] When witnesses take an oath, they do so according to their religious beliefs.[172] A witness unable to attend the hearing in person may offer evidence by video link.[173] To do so, that witness must make arrangements with the Registrar at least seven days before the trial date.[174]

The Court does not call its own witnesses, except in rare circumstances.[175] The Justices may ask witnesses questions to clarify the evidence.[176] The Court may give directions about how any matter at issue must be established.[177] The Court controls the order in which witnesses will testify.[178]

The Court decides whether parties are permitted to call expert witnesses.[179] The Court may give directions about the form and content of any expert's report and the number of experts who may be called.[180] The Court may appoint an expert to offer an opinion based on the evidence adduced at trial.[181] Experts, by whomever called, have a duty to assist the Court on matters within their expertise.[182] The expert's duty overrides any obligation to the person from whom he or she receives instructions or by whom he or she is paid.[183] Experts must give evidence independently.[184]

The parties may offer opening statements, upon the Court's discretion. An opening statement offers a preview of the evidence. Unlike the American courts' default format, the claimant offers an opening statement followed by the claimant's case-in-chief. The defendant makes an opening statement only when the claimant is done. A defendant that wishes to make its opening statement right after the claimant's must ask the Justices for permission.

The parties' attorneys may question the witnesses in successive turn. During the claimant's case-in-chief, the claimant will examine its witnesses (direct examination), and the defendant may cross-examine the claimant's witnesses. That might be followed by the claimant's re-examination, which Americans call "redirect examination." The defendant's case-in-chief consists of examining its witnesses, the claimant then cross-examining each witness, followed by the defendant's possible re-examination. If permitted, there will be a rebuttal case: first by the claimant, then by the defendant, and finally by the claimant again if the claimant interposed a counterclaim.

There are no affirmative defenses in the Civil and Commercial Court; there are defenses only. After the evidence is presented, the parties will deliver their closing arguments. They reiterate, through argument, the important evidence admitted in Court.

The examination of witnesses, after they affirm or are sworn in, begins with a question to the witnesses calling them to swear or affirm that their witness statements—those they submitted with their claims, applications, and responses—are true. Then, the Justices or counsel will ask the witnesses whether they wish to add or supplement their written witness statements with oral testimony. This procedure, quite different from American procedure, is designed to make trials simple and expeditious while still assuring due process through cross-examination. Witnesses will not, generally speaking, be called upon to lay a foundation to introduce evidence, as they would in an American court. Lawyers will simply refer the Court to the evidence already submitted in the binder.

The Court, based on its U.K. traditions, disfavors the American Perry Mason mode of lawyering. Lawyers do not use the word "objection." To object, lawyers merely rise and state their grounds. Lawyers do not finish with a witness by saying "your witness" to their adversary. They conclude their examination by stating that they have "no further questions," or words to that effect. Lawyers do not end their case by saying "claimant rests." Lawyers do not ask for permission to approach a witness. The Justices will likely deny that permission anyway. Instead, lawyers examine and argue from their counsel table.

If a party fails to appear at trial, the Court may adjourn, give directions, or render a default judgment.[185]

H. The Court's Decision

In deciding cases, the Court takes into consideration the parties' documents, evidence, and oral arguments. The Court may make all orders it considers consistent with the Court's overriding objective: to do justice.[186] The decision of the majority of the Justices is the Court's decision.[187] Any Justice may write a dissenting opinion.[188] As noted above, the Court's decisions are treated as persuasive precedents and not binding.[189] Although the Court is a common-law court, it does not follow an essential principle of the common-law: *stare decisis*.

The Court's decisions are published in English and Arabic on the Court's Web site.[190] The Court must issue a decision within ninety days from the date the respondent received official notice of the claim.[191] This ninety-day time limit from start to finish greatly surpasses the best international practices prescribing quick and efficient judgments. The Court must give reasons for its decisions.[192]

The Court may award costs against parties,[193] and generally the unsuccessful party must bear the winning party's costs,[194] including attorney fees. This rule is different from the American Rule, in which each side bears its own fees unless a statute or contract provides that the loser must pay the prevailing party's reasonable legal costs. In deciding how to award costs, the Court may take into account "any reasonable settlement offers made by either party."[195]

The Court may order the parties to try to agree on the amount of the costs.[196] If the parties are unable to agree, the Registrar will determine the costs,[197] subject to an appeal to the Justices.

The Court may award damages,[198] grant injunctions[199] and restitution,[200] and order specific performance,[201] declaratory relief,[202] and disgorgement of profits.[203] The Court may render a judgment that directs a party to do or not do something. The Court may also render a money judgment,[204] grant an accounting,[205] and order the payment of interest.[206] A money judgment must be complied with within fourteen days of the judgment unless the Court sets a specific date.[207]

The Court can communicate the decision to the parties in several ways. At the end of the trial, the Court may announce its decision and the reasons, or it may announce the decision but reserve the written reasons for a later date. The Court may also announce nothing at the end of the trial and, instead, publish the decision later.

A party may file a motion to reargue within fourteen days of the communication of the Court's decision if the party believes that the Court made an "accidental slip or omission" in its decision.[208] The Court may also correct the error on its own.[209]

Civil claims are often settled between the parties before the trial begins or the judgment is rendered. The parties must record their settlements so that the Court can enforce it.

The Court encourages the parties to engage in an alternative-dispute-resolution process whenever appropriate.[210] The Court supports and facilitates arbitration.[211] The Court may even require the parties to attempt to settle their case through an alternative-dispute-resolution mechanism.[212] The Court can stay or adjourn the proceedings to allow the parties to do so.[213] Parties to a dispute are welcome to seek the Court's help to resolve it, regardless of whether they intend to or could commence court proceedings.[214] The Civil and Commercial Court's President has the power to establish a dispute resolution center.[215]

The State of Qatar designed the Court's layout with alternative dispute resolution in mind.[216] The Court features a mediation and arbitration room, and there are ample break-out rooms for the parties,[217] with separate high-tech rooms for claimants and defendants.

I. Enforcement

Decisions rendered by the Qatar International Court are enforced like any other decision rendered by a Court of the State of Qatar.[218] The enforcement Justice, who is primarily responsible for enforcing the Court's decisions, issues execution orders within the QFC.[219] The Civil and Commercial Court's President appoints one of the Justices to be the Court's enforcement judge.[220] Parties contravene a judgment and are subject to the Court's contempt powers if, without excuse, they fail to comply with the Court's orders or decisions.[221]

J. Appeal

A party may appeal the Registrar's procedural directions or orders to a panel of Justices of the First Instance Court.[222] This appeal triggers a *de novo* review before one or more Justices.[223] A party may also appeal decisions of the First Instance Court to the Appellate Division, with permission of either court.

A party seeking permission to appeal must complete an application and a Notice of Appeal.[224] The Notice must set out the grounds for the appeal.[225] The applicant must file with the Registrar both the application and the notice within sixty days after the date of the decision the applicant wishes to appeal.[226] The notice of appeal must be filed before the Appellate Circuit within sixty days from the date of the decision sought to be appealed.[227]

Applicants may seek permission to appeal either from the First Instance Justices who decided their case or from the Appellate Division,[228] but not from both. If either denies permission to appeal, the First Instance Court's decision is final and binding and not subject to further appeal anywhere. [229] The Court will grant permission to appeal if it finds "substantial grounds for considering that a judgment or decision is erroneous and there is a significant risk that the decision will result in serious injustice.[230] This standard is so high that the Appellate Division stated in dictum in the *Babiker* case that "[W]e do however emphasize that the requirement of the permission should not be used to cause a litigant any material injustice. If this Court considers there is an arguable case it will usually readily grant permission to appeal."[231] (Proposed legislation, if enacted, will make it easier to get permission to appeal.)

The parties may appeal the First Instance Court's cost award, even though the Appellate Division found in *Chedid* that the First Instance Court is "much better placed to evaluate what is fair and reasonable than the appellate court."[232]

If the Court grants permission, the appeal is a review, not a rehearing.[233] Generally speaking, the parties may present only those arguments articulated in their application for permission to appeal.

A First Instance Court Justice who originally issued the judgment may not sit on the Appellate Division to review that same judgment.[234] The Appellate Division may rule on the merits of the appeal when it reviews the application for permission to appeal. This is the "rolled-up" technique, which applies only when the party seeks the Appellate Division's permission to appeal. The Appellate Division must issue a decision within ninety days after the date the respondent receives official notice of the appeal.[235] Decisions of the Appellate Division are final.[236]

V. Q-Construct

Qatar is currently developing a fast-track scheme, called Q-Construct, for construction disputes.[237] This scheme was established as a result of an estimated $280 billion infrastructure investment for the 2022 FIFA World Cup, including new soccer stadiums, transportation, hotels, and residential and commercial buildings.[238] This fast-track scheme will allow parties, otherwise bound by contracts with arbitration clauses, to bring their construction-related disputes before one or more adjudicators selected from a panel of specialists registered at the QICDRC.[239]

A QICDRC Justice specialized in construction will oversee the scheme.[240] The adjudicator or adjudicators will render their decision within thirty days from the day the claim was filed. That decision will be enforceable immediately, but the parties remain entitled to go through the arbitration process provided for in their contracts if they choose to do so. Q-Construct will enable parties to obtain a decision quickly to permit the construction project to go forward if the adjudicator(s) decide(s) that it should.

VI. Conclusion

The Qatar International Court, and more specifically the Civil and Commercial Court, is designed to attract international business and to make Qatar a world capital for investment. The Court seeks to achieve this by assuring justice and an expeditious decision-making process while observing the best international practices. The Court, an institution separate from Qatar's *Shari'ah* and civil courts, uses a simplified model of the United Kingdom's evidentiary and procedural rules. Some of the world's most respected judges preside in this Court.

This article was prepared in the hopes that once practitioners become familiar with the Qatar International Court's procedures and Qatari law, they will take advantage of this extraordinary forum, where they will receive a welcoming *as-salamu alaykum* from the Court and its expert staff.

Endnotes

1. Practice Guide B2 (hereinafter "Guide").
2. Law No. (7) of 2005 (as amended) art. 3 (hereinafter "Law No. (7)").
3. *Id.* art. 8.1.
4. *Id.* art. 8.2(c).
5. Guide B1.
6. *Id.* B4.
7. Law No. (7) art. 8.3(b).
8. Regulations and Procedural Rules art. 2.2 (hereinafter "Regulations").
9. *Id.* art. 35.4.
10. *See* Qatar Int'l Ct., http://qicdrc.com.qa/Biographies.aspx (last visited 6 July 2015).
11. Guide B2.
12. Regulations art. 4.1; Guide B5.
13. Regulations arts. 4.3.1 & 28.4; Guide B5.
14. Regulations art. 4.3.3; Guide B5.
15. *Chedid & Assoc. Qatar LLC v. Said Bou Ayash*, 3 May 2015, Case No. 02/2015, ¶18 (Appellate Circ.), *available at* http://www.qfccourt.com/Judgement.html (last visited 6 July 2015).
16. *Qatar Financial Centre Auth. v. Silver Leaf Capital Partners LLC*, 1 June 2009, Case No. 0001/2009, at ¶33 (First Instance Cir.), *available at* http://www.qfccourt.com/Judgement.html (last visited on July 6, 2015).
17. *Id.*
18. *Id.*
19. Guide C12.1.
20. Law No. (7) Sched. 6, art. 14.
21. Regulations art. 4.3.2.
22. Law No. (7) art. 5.4 & Sched. 4, art. 16.3.
23. Law No. (7) Sched. 1, art. 5.3.
24. *Id.*
25. *Id.*
26. *Id.* art. 12.
27. *Id.* art. 12.1.
28. *Id.* art. 12.2.
29. *Id.* art. 12.3.
30. *Id.* art. 12.4.
31. *Id.* art. 12.5.
32. *Id.* art. 18.1.
33. Qatar Int'l Ct., http://qicdrc.com.qa/Executive_Team.aspx (last visited 6 July 2015).
34. Guide B6.
35. Regulations, Art. 15.4.
36. Law No. (7) Sched. 6, art. 1.
37. *Id.* Sched. 6, art. 4.
38. *Id.* Sched. 6, art. 2.
39. *Id.* Sched. 6, art. 18.
40. *Id.* Sched. 6, art. 3.
41. *Id.*
42. *Id.* Sched. 6, art. 5.
43. *Id.* Sched. 6, art. 7.
44. *Id.* Sched. 6, art. 6.
45. Regulations art. 6.2.
46. Law No. (7) art. 16.1.
47. *Id.* art. 16.3.
48. *Id.* art. 19.1.
49. *Id.* art. 19.2.
50. *Id.* art. 18.5.
51. Guide B3.
52. *Id.*
53. *Id.* C6.4.
54. *Id.*
55. Regulations art. 29.1.
56. *Id.*; Guide C6.1.
57. Guide C6.2.
58. *Id.* C6.3.
59. *Id.* C6.5.
60. Law No. (7) art. 8.3(c).
61. Regulations art. 9.2.
62. Guide C1.2.
63. *Id.* C1.3.
64. *Id.*
65. *Id.*
66. *See, e.g.*, *Chedid & Assoc. Qatar LLC v. Ayash*, 25 Sept. 2014 Case No. 02/2013, at 2 (First Instance Circ.), *available at* http://www.qfccourt.com/Judgement.html (last visited on 6 July 2015) (rendering decision on the merits, having accepted jurisdiction).
67. Guide C1.4.
68. Regulations art. 19.1.
69. *Id.* art. 19.2.
70. Law No. (7) art. 8.3(d).
71. *Id.*, Sched. 6, art. 8; Regulations art. 11.1.1; QFC Law and Regulations database, *available at* http://www.complinet.com/qfcra/display/index.html (last visited 6 July 2015).

72. *See* Qatar Int'l Ct., http://www.complinet.com/qfcra/display/display.html?rbid=1557&element_id=3 (last visited 6 July 2015).
73. Regulations art. 2.2.
74. *Id.* art. 3.1.
75. Regulations art. 11.1.2; Guide at C9.1.
76. Regulations art. 11.1.2(a).
77. Law No. (7) Sched. 6, art. 8; Regulations art. 11.1.2(b); Guide C9.1.
78. Regulations art. 11.1.2(c).
79. Guide A1.
80. Regulations art. 37.2.
81. Guide A1.
82. *Id.* A3.
83. *Id.*
84. *See* Qatar Int'l Ct., http://qicdrc.com.qa/Forms.aspx (last visited 6 July 2015).
85. Regulations art. 17.2.
86. Guide C3.1.
87. Regulations art. 17.1; Guide C3.2.
88. Regulations art. 17.2.
89. Regulations art. 17.3; Guide C3.3.
90. Regulations art. 11.2.
91. Guide C3.3.
92. *Id.* C3.4.
93. Regulations art. 30.1.
94. *Id. a*rt. 18.1.
95. *Id.* art. 17.5.
96. *Id.* art. 17.2.
97. *Id.* art. 20.1.
98. Guide C3.5.
99. Regulations art. 20.2.
100. *Id.* art. 20.2.
101. *Id.* art. 21.1.
102. *Id.* art. 16.1.
103. *Id.* art. 16.2.
104. *Id.* art. 16.3.
105. *Id.* art. 8.1.
106. *Id.* art. 8.2.
107. *Id.* arts. 8.2 & 18.3.5.
108. *Id.* art. 18.
109. *Id.* art. 18.3.
110. *Id.* art. 18.2.
111. *Id.* art. 18.5.
112. *Id.* art. 14.2.
113. *Id.*
114. *Id.* art. 14.3.1.
115. *Id.* art. 14.3.3(a).
116. *Id.* art. 14.3.3(b).
117. *Id.* art. 14.6.
118. Guide C12.2.
119. Regulations art. 22.6.
120. *Id.* art. 7.3; Guide C7.1.
121. Regulations art. 15.2.
122. *Id.* art. 22.1.
123. Regulations art. 22.2; Guide C7.2.
124. Guide C7.2.
125. Regulations art. 22.2.
126. Guide C7.5.
127. Regulations art. 15.3.
128. *Id.* arts. 10.2.1 & 22.3.
129. Guide C7.4.
130. Regulations art. 15.2.
131. *Id.* art. 12.5.
132. *Id.* art. 12.5.
133. *Id.* art. 24.1.1.
134. *Id.* arts. 31.1.2–31.1.3.
135. *Id.* art. 31.2.
136. *Id.* art. 23.1.
137. *Id.* art. 23.2.
138. *Id.* art. 23.4.
139. *Id.* art. 23.4.
140. *Id.* art. 23.5.
141. *Id.* art. 23.2.
142. Guide C8.1.
143. Regulations art. 24.1.3; Guide C8.1.
144. Regulations art. 26.1.
145. Guide C8.1.
146. Regulations art. 10.2.5; Guide C11.4.
147. Guide C8.1.
148. *Id.* C8.1.
149. *Id.*
150. Regulations art. 26.2.1.
151. *Id.* art. 26.2.2.
152. *Id.* art. 26.4.
153. *Id.* art. 28.1.
154. *Id.* arts. 28.2.1–28.2.4.
155. McNair Chambers, *The QFC Civil and Commercial Court: the Essentials* 10 (Dec. 2010), *available at* www.mcnairchambers.com (last visited 6 July 2015).
156. *Id.*
157. *Id.*
158. Regulations art. 28.7.
159. Guide C11.2.
160. Regulations art. 28.3; Guide C10.1.
161. Regulations art. 3.2; Guide C5.1.
162. Regulations art. 3.2; Guide C5.2.
163. Guide C5.1.
164. *Id.* C5.3.
165. *Id.* C10.1.
166. *Id.* C5.5.
167. *Id.* at C10.2.
168. Regulations art. 10.2.3.
169. Guide C11.4.

170. *Id.* C11.4.
171. *Id.* C11.1.
172. *Id.*
173. *Id.* C11.2.
174. *Id.*
175. *Id.* C11.3.
176. *Id.*
177. Regulations art. 21.1.1.
178. *Id.* art. 27.1.6.
179. *Id.* art. 27.1.3.
180. *Id.* arts. 21.1.4 & 27.1.5.
181. *Id.* art. 27.2.
182. *Id.* art. 27.4.1.
183. *Id.* art. 27.4.2.
184. *Id.* art. 27.4.3.
185. *Id.* art. 28.5.
186. *Id.* art. 10.3.
187. *Id.* art. 32.2.
188. *Id.* art. 32.3.
189. Guide C12.1.
190. *Id.* C12.3; Qatar Int'l Ct., http://www.qfccourt.com/Judgement.html (last visited 6 July 2015).
191. Law No. (7) Sched. 6, art. 10; Regulations art. 32.1.
192. Regulations art. 32.1.
193. *Id.* at Arts. 10.4.10 & 33.1.
194. Regulations art. 33.1 & 33.2; Guide C2.2.
195. Regulations art. 33.3.
196. *Id.* art. 33.5.
197. *Id.*
198. *Id.* art. 10.4.2.
199. *Id.* art. 10.4.3.
200. *Id.* art. 10.4.6.
201. *Id.* art. 10.4.4.
202. *Id.* art. 10.5.5.
203. *Id.* art. 10.4.7.
204. *Id.* art. 10.4.1.
205. *Id.* art. 10.4.8.
206. *Id.* art. 10.4.9.
207. McNair Chambers, note 155 *supra*, at 11.
208. Regulations art. 32.5.
209. *Id.* art. 32.5.
210. Regulations art. 5.1; Guide C7.6.
211. Guide B7.
212. Regulations art. 10.2.2.
213. *Id.* art. 25.1.
214. Regulations art. 25.2; Guide C15.1.
215. Regulations art. 5.2.
216. Guide C15.1.
217. *Id.*
218. Regulations art. 34.1; Guide C13.1.
219. Law No. (7) Sched. 6, art. 17; Regulations art. 34.5; Guide C13.1.
220. Law No. (7) Sched. 6, art. 17.
221. Regulations art. 34.2.1.
222. *Id.* art. 15.4; Guide C7.1.
223. Law No. (7) art. 8.3 (a); Regulations art. 35.4; Guide C7.1.
224. Regulations art. 35.3.
225. *Id.*
226. *Id.*
227. Law No. (7) Sched. 6, art. 12; Regulations art. 35.3.
228. Guide C14.1.
229. Regulations art. 35.1.
230. *Id. See Chedid & Assoc. Qatar*, note 15 *supra*, at ¶16 (Appellate Circ.), *available at* http://www.qfccourt.com/Judgement.html (last visited on 6 July 2015).
231. *Babiker & Omara v. Al Mal Bank LLC*, 11 Apr. 2011, Case Nos. 04/2010 & 05/2010, at ¶11 (Appellate Circ.), *available at* http://www.qfccourt.com/Judgement.html (last visited 6 July 2015).
232. *Chedid & Assoc. Qatar*, note 15 *supra*, at ¶50 (Appellate Circ.), *available at* http://www.qfccourt.com/Judgement.html (last visited 6 July 2015).
233. Regulations art. 35.6; Guide C14.1.
234. Law No. (7) art. 8.3(d); Regulations art. 35.5.
235. Law No. (7) Sched. 6, art. 13.
236. *Id.* Sched. 6, art. 14.
237. Ravinder Thukral, *Interview of Mr. Christopher Grout, Acting Registrar at the Qatar International Court and Dispute Resolution Center (QICDR)*, 22 May 2013, *available at* http://www.brownrudnick.com/news-resources-detail/2013-05-interview-of-mr-christopher-grout-acting-registrar-at-the-qatar-international-court-and-dispute-resolution-centre-qicdrc (last visited 6 July 2015).
238. *Id.*
239. *Id.*
240. *Id.*

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Notes on the Reform of the Brussels Regulation Regime Regarding Jurisdiction and Enforcement of Judgments within the European Union

By Joseph M. Kosky

I. Introduction

This article summarizes the key revisions to the Brussels Regulation on Jurisdiction and Enforcement of Judgments in relation to civil proceedings in the E.U. and the practical effect they are likely to have.

The new Brussels Regulation, E.U. Regulation 1215/2012, referred to in this article as "the New Regulation," has applied in the courts of Member States since 10 January 2015 and has replaced the old Brussels Regulation, E.U. Regulation 44/2001, referred to in this article as "the Old Regulation."

II. The Main Changes

The main changes implemented by the New Regulation can be summarized as follows

- Revision of the *lis pendens* provisions (which govern the position where there is already a dispute being litigated elsewhere) where there is in a contract a jurisdiction clause or a clause designating a choice of court for resolution of disputes. The purpose of these changes is to remedy problems that have been encountered as a result of the tactical blocking maneuver commonly known as "the Italian Torpedo."
- Revision of the rules relating to agreements as to jurisdiction/choice of court.
- Implementation of new rules relating to issues involving non-E.U. States and non-E.U. defendants, including new provisions introducing a limited *lis pendens* rule relating thereto.
- Introduction of new wording relating to the exclusion of arbitration from the scope of the New Regulation.
- The removal of the requirement to obtain a court order in the court of the enforcing Member State in order to enforce a judgment of another Member State, as well as certain other changes in relation to the recognition and enforcement of judgments given in one Member State in other Member States.

III. What Matters Does the New Regulation Cover and What Matters Are Excluded?

The New Regulation applies to all civil and commercial matters, but not matters relating to revenue, customs or administrative matters or the liability of States for acts and omissions in the exercise of state authority.[1] Other matters excluded from the ambit of the New Regulation, as set out in Article 1(2) are:

– the status or legal capacity of natural persons, rights in property arising out of a matrimonial relationship, or out of a relationship deemed by the law applicable to such relationship to have comparable effects to marriage;

– bankruptcy, proceedings relating to the winding-up of insolvent companies or other legal persons, judicial arrangements, compositions and analogous proceedings;

– social security;

– arbitration (this issue is dealt with below);

– maintenance obligations arising from a family relationship, parentage, marriage or affinity; and

– wills and succession, including maintenance obligations arising by reason of death.

There has been some debate over the bankruptcy exclusion contained in Article 1(2)(b) (this excludes "proceedings relating to the winding up of insolvent companies or other legal persons, judicial arrangements, compositions and analogous proceedings") as to whether disputes relating to companies in Administration were within or outside the scope of the Old Brussels Regulation.

The New Regulation gives no better guidance on this issue than did the Old Regulation, and thus the position remains uncertain.

The New Regulation revises and expands the scope of the exclusion in Article (1)(2)(a) regarding the status or legal capacity of natural persons and property rights arising out of a matrimonial relationships; this exclusion now includes property rights arising out of "relationships deemed by the law applicable to such relationship to have comparable effects to marriage." The New Regulation explicitly excludes "maintenance obligations arising from a family relationship, parentage, marriage or affinity,"[2] and wills and succession, including maintenance obligations arising by reason of death.[3]

Article 1.2(d) of the New Regulation preserves the pre-existing exclusion of arbitration contained in the Old Regulation, and reinforces the arbitration exclusion with a new Recital 12, which upholds the right of the courts of Member States, when seized of an action in a matter in respect of which the parties have entered into an arbitration agreement, to refer the parties to arbitration, to stay or dismiss the proceedings and to examine whether the arbitration agreement is null and void, inoperable or incapable of being performed in accordance with national law.

IV. What Are the Principal Changes Brought about by the New Regulation?

A. What Are the Changes to the "*Lis Pendens*" Rule?

The New Regulation addresses the issue of "the Italian torpedo," which arose as a consequence of the provisions in the Old Regulation. Article 27 of the Old Regulation stated that, where a court is "second seized" of proceedings between the same parties and involving the same cause of action as proceedings already brought before a court of another Member State, then the court second seized must stay the proceedings before it until the court first seized has decided the issue of whether it has jurisdiction to determine the dispute. Somewhat bizarrely, this provision applied even where a party brought proceedings in another court in contravention of a valid contractual jurisdiction/choice of court clause and did so purely to gain a tactical advantage. Such an "Italian torpedo" normally involved issuing proceedings in a jurisdiction where the judicial process is very slow as a blocking maneuver or delaying tactic. In some jurisdictions, the issue of jurisdiction may not be determined preliminarily, but only as part of any final judgment.

Moreover, in various judgments of the European Court of Justice it had been decided that the making of an anti-suit injunction to prevent a party from pursuing proceedings before a court, which court was not the selected forum specified in any contractual jurisdiction/choice of court clause, is contrary to the Brussels Regulation.[4] These tactics often had the effect of preventing progress of a claim in the court designated in the contractual jurisdiction/choice of court clause for a very long time—such as many months or even years. The outcome was a potential delay of the ultimate resolution of the dispute and wasted costs. Under the New Regulation, however, priority is to be given to the court specified in any contractual jurisdiction/choice of court clause.

Thus, Recital 22 to the New Regulation provides as follows:

> It is necessary to provide for an exception to the general *lis pendens* rule in order to deal satisfactorily with the situation where a court not designated in an exclusive choice-of-court agreement has been seised of proceedings and the designated court is seised subsequently of proceedings involving the same cause of action and between the same parties. In such a case, the court first seised should be required to stay its proceedings as soon as the designated court has been seised and until such time as the latter court declares that it has no jurisdiction under the exclusive choice-of-court agreement. This is intended to ensure that, in such a situation, the designated court has the authority to decide on the validity of the agreement and on the extent to which the agreement applies to any dispute pending before it. The designated court should be able to proceed irrespective of whether the non-designated court has already decided on the stay of proceedings.

The provisions relating to the *lis pendens* rule are set out in Articles 29 to 34 of the New Regulation. They empower the contractually selected forum for any dispute to decide the issue of whether any action commenced should progress—even in the event that it is not the court that is first seized of the dispute. In particular, Article 31(2) of the New Regulation requires any other court to stay any proceedings issued before it until such time as the court seized on the basis of a contractual jurisdiction clause declares that it has no jurisdiction under that agreement.

However, it is necessary to start proceedings in the contractually selected forum so as to obtain a stay of any proceedings commenced in another court.[5] Further, there is no requirement for the courts of Member States to stay any proceedings if the contractual jurisdiction clause confers non-exclusive jurisdiction on the court of another Member State rather than exclusive jurisdiction or if the contractual jurisdiction/choice of court clause confers exclusive jurisdiction on the courts of a non-Member State.

In the case of claims relating to a number of subject matters which might fall within different heads of the exclusive jurisdiction rules contained in Article 24 of the New Regulation (which is the same as Article 22 of the Old Regulation), Article 31(1) states that "where actions come within the exclusive jurisdiction of several courts, any court other than the court first seised shall decline jurisdiction in favour of that court."

There is also an exception made for the provisions in Article 31 in relation to specified insurance, consumer and employee matters.[6]

B. Jurisdiction and Jurisdiction Agreements

The applicable rules, which are now contained in Article 25 of the New Regulation, have been reformulated. Article 25(5) states that contractual agreements conferring jurisdiction on a particular court "shall be treated as an agreement independent of the other terms of the contract." The New Regulation also provides that the validity of such agreements is not susceptible of challenge solely on the ground that the contract itself is, in some way, invalid. Further, the New Regulation has broadened the scope of contractual agreements as to jurisdiction/choice of court agreements that fall within its ambit: there is now no longer a requirement (such as that contained in Article 23 of the Old Regulation) that at least one party to such an agreement must be domiciled in a Member State. This will obviate the need for any investigation into the domicile of the parties (as was the case previously), which can be a complicated, time consuming, and expensive exercise.

However, pursuant to Article 25 of the New Regulations, if the courts of a non-Member State are conferred jurisdiction by any contractual term, such a clause falls outside the New Regulation. Nor does the New Regulation cover jurisdiction/choice of law agreements in favor of the courts of non-Member States. Thus, where contractual terms include such an exclusive jurisdiction clause and, in breach thereof, a party issues proceedings in the court of a Member State in accordance with the jurisdiction provisions of the New Regulation (perhaps on the basis of the Defendant's domicile in that Member State), there is no express provision contained in the New Regulation pursuant to which the courts of that Member State may decline to exercise jurisdiction. Thus, there appears to be a significant loophole in the jurisdictional framework and, in certain circumstances, the courts of Member States may find themselves in the rather unattractive position of being obliged to overlook clear and flagrant breaches of contractual terms as to jurisdiction.

Article 25 contains an exclusion as to its scope in the words "unless the agreement is null and void as to its substantive validity under the law of that Member State." Thus the laws of the Member State court which is conferred with jurisdiction by any contractually agreed term shall, apparently, determine questions of substantive validity of such a clause, even if those laws are not the governing law of the contractual agreement.

Unfortunately, the New Regulation does not address the issue of whether "one-way" jurisdiction clauses are permissible and valid. Such clauses are common and confer power on one party to a contract to select jurisdiction and sue in the courts of its choice. However, the French Supreme Court has recently ruled that such clauses are invalid.[7] This is a problem area that remains.

C. What Are the Changes to the Rules Governing Special Jurisdiction?

Some of the most commonly encountered grounds for alternative jurisdiction in the New Regulation remain restricted to those defendants who are domiciled in Member States and have not been expanded to cover non-domiciled parties.

The following alternative jurisdictional grounds have not been extended to cover defendants who are domiciled in third party states.

- Article 5(1) (Article 7(1) of the Old Regulation) provides that, in respect of contractual claims, the courts of the State within which the contract is to be performed is the place of performance and may have jurisdiction.
- Article 5(3) (Article 7(2) of the Old Regulation) provides that tortious claims (civil wrongs) may be brought in the courts of the State within which the event giving rise to the claim occurred or may occur.
- Article 6(1) (Article 8(1) of the Old Regulation) provides that, where a Defendant domiciled in a Member State is one of several Defendants, such Defendant may be sued in the courts of the State within which any one of them is domiciled, in circumstances where the claims are so closely connected that it is expedient to hear and determine them together so as to avoid the risk of conflicting and irreconcilable judgments being obtained in separate proceedings.

Nor in Article 7(1) of the New Regulation (Article 5(1) of the Old Regulation) have the alternative jurisdictional grounds regarding contractual claims been expanded. Further, somewhat unhelpfully, there is no provision in the New Regulation for jurisdiction to be accorded to the courts of the State whose law is the governing law of the contractual agreement (*e.g.* where the agreement contains a choice of law clause but no choice of jurisdiction clause).

On the other hand, the rules have now been extended to cover defendants who are domiciled in non-E.U. States in respect of certain employee, insurance and consumer claims.

D. What Are the Changes to the Rules Governing Exclusive Jurisdiction?

Article 24 of the New Regulation now expressly provides that the exclusive jurisdiction rules include claims "regardless of the domicile of the parties." For example, claims relating to disputes over real property and tenancies are to be resolved in the courts of the Member State where the property is located.

E. What Are the New Rules Regarding Proceedings Pending in Third States?

The New Regulation introduces some entirely new provisions which confer jurisdiction on the courts of Member States to stay any proceedings before them in order to defer those proceedings to any proceedings already pending before the courts of a non-Member State. The courts of Member States may do so after having taken into account all the relevant circumstances, which may include any connections between the facts of the case and the parties thereto and the third State concerned, the stage to which the proceedings in the third State have progressed by the time proceedings are initiated in the court of the Member State and whether the court of the third State can be expected to give judgment in the proceedings before it within a reasonable time.[8]

Recital 24 to the New Regulation specifically states that the assessment to be made by the courts of Member States in this regard may include consideration of the question whether the court of the third State has exclusive jurisdiction in the particular case, in circumstances where a court of a Member State would have exclusive jurisdiction. This provision seems to encompass the situation where there is an exclusive jurisdiction/choice of court clause conferring jurisdiction on such a State.

The requirement is that proceedings must have been initiated first in the third State, and not merely be contemplated. Thus preliminary letters before action in accordance with any litigation protocol would not suffice to give rise to jurisdiction.

Article 34 of the New Regulation empowers the courts of a Member State seized of an action connected with an action in the courts of a third State to stay proceedings where the following facts are found to exist:

– where it is expedient to hear and determine the related actions together to avoid the risk of irreconcilable judgments resulting from separate proceedings;

– where it is expected that the courts of the third State will give a judgment capable of recognition and, where applicable, of enforcement in that Member State;

– where the courts of the Member State are satisfied that a stay is necessary for the proper administration of justice.

Article 34(3) of the New Regulation also empowers the courts of Member States to dismiss any proceedings of which they are seized if the proceedings before the third State have reached a conclusion and have produced a judgment which is capable of being recognized and, where applicable, of being enforced in that Member State. On the other hand, Article 34(2) of the New Regulation empowers the courts of Member States to continue to hear proceedings where there are connected proceedings in a third State where the following facts are found to exist:

– where there is no risk of irreconcilable judgments;

– where the proceedings in the court of the third State have been stayed or discontinued;

– where the proceedings in the court of the third state are unlikely to be concluded within a reasonable time; and

– where the continuation of the proceedings in the court of the Member State is required for the proper administration of justice.

These provisions go some way toward reducing what was generally regarded as the undesirable impact of the decision of the European Court in *Owusu v. Jackson*,[9] and, helpfully, introduce some aspects of the English law concept of *forum non conveniens* into European law with a generally beneficial effect.

In the *Owusu v. Jackson* case, the European Court of Justice considered a reference to it for a preliminary ruling by the English Court of Appeal, seeking interpretation of Article 2 of the Brussels Convention on Jurisdiction and Enforcement of Judgements in Civil and Commercial Matters (the Brussels Convention), now substituted by the current New Regulation—but the relevant provisions are the same. The relevant Article provided that persons domiciled in a Contracting State shall, whatever their nationality, be sued in the courts of that State. In its decision, the European Court of Justice limited the scope of the application of the principle of *forum non conveniens* to cases which fall outside the scope of the Brussels Convention and ruled that the English Court of Appeal could not stay the proceedings on those grounds.

F. The Exclusion of Arbitration from the Scope of the New Regulation

The New Regulation maintains the pre-existing arbitration exclusion from its ambit in Article 1(2)(d), which is further underlined by Recital 12. Further, Article 73(2) of the New Regulation expressly states that it shall not affect the application of the New York Convention.

Recital 12 provides that the New Regulation shall not apply to arbitration, and the Recital states that "nothing in this Regulation should prevent courts of a Member State, when seised of an action in a matter in respect of which the parties have entered into an arbitration agreement, from referring the parties to arbitration, from staying or dismissing the proceedings, or from examining whether the arbitration agreement is null and void, inoperative or incapable of being performed, in accordance with their national law." Thus, in appropriate circumstances, a party may seek an order from the court seized of any proceedings to dismiss those proceedings and directing that the dispute be referred to arbitration. Further, the opposing party may apply to the courts of the seat of any arbitration for an order directing the parties to proceed to arbitration in the event of any dispute between those parties arising which fails to be dealt with under any operative arbitration agreement.

Recital 12 also excludes certain judgments on arbitration agreements from the scope of the New Regulation and states that a ruling given by a court of a Member State as to whether an arbitration agreement is null and void, inoperative, or incapable of being performed should not be subject to the rules as to recognition and enforcement of judgments contained in the New Regulation. This is so regardless of whether the court has decided this as a principal ruling or as a preliminary ruling of an ancillary issue.

In addition, Recital 12 clarifies matters which are outside the scope of the New Regulation by stating that the New Regulation should not apply to any action or ancillary proceedings relating to, in particular, the establishment of the arbitral tribunal, the powers of an arbitrator, the conduct of the arbitration procedures or any other aspects of such procedures, nor to any action or judgment concerning the annulment, review, appeal, recognition or enforcement of an arbitral award. It also states that where the courts of a Member State decide that the arbitration agreement is null and void, inoperative, or incapable of being performed, this (i) should not preclude that court's judgment on the substance of the matter from being recognized or, as the case may be, enforced, in accordance with the New Regulation; and (ii) should be without prejudice to the competence of the courts of the Member States to decide on recognition and enforcement of arbitral awards under the New York Convention, in that the New York Convention takes precedence over the Regulation.

The changes in the New Regulation relating to arbitration uphold the concept of arbitration and reduce the scope for tactical litigation designed to interfere with the processes of arbitration and the proper implementation of arbitration agreements.

The unwelcome effects of the *West Tankers* case appear to have been remedied by the New Regulation. This case concerned proceedings in an E.U. jurisdiction which were brought in breach of an agreement to refer all disputes to arbitration in England. The background facts were that Erg Petroli SpA ("Erg") chartered a vessel from West Tankers Inc ("West Tankers"). The charter party was governed by English law and contained an agreement to arbitrate, with London as the seat of the arbitration. The vessel collided with a pier (which was owned by Erg) in Syracuse in Italy in 2000. Erg claimed on its insurance policy, but then commenced an arbitration against West Tankers in London to recover the uninsured portion of its loss. In the meantime, Erg's insurers exercised their subrogation rights against West Tankers and brought a claim against West Tankers in the court of Syracuse to recover the sum paid out by them.

West Tankers sought, and obtained, an anti-suit injunction from the English court to prevent the insurers from pursuing the proceedings in Italy, in breach of the arbitration clause, and a declaration that disputes were subject to arbitration. However, a leapfrog appeal by the insurers went to the House of Lords (now the English Supreme Court) and was then referred by it onto the European Court of Justice on the issue of whether an anti-suit injunction could be granted to restrain proceedings in another E.U. Member State or whether such an order was precluded by the E.U. jurisdictional rules set out in the Old Regulation.

The arbitration continued (with the insurers joined to the proceedings as co-claimants) and in May 2008 the tribunal declared West Tankers was not liable to Erg. Other issues that had been referred to the tribunal were adjourned until the European Court of Justice decision was made. This decision stated that an anti-suit injunction was not available. The outcome was that West Tankers had the benefit of an English arbitral award which exonerated it from any liability, but nonetheless was embroiled in court proceedings in Italy which could not be stopped.

The New Regulation does not, it appears, go so far as to empower the courts of a Member State to grant anti-suit injunctions in relation to proceedings in the courts of another Member State brought in breach of an arbitration agreement: the requirement of mutual trust as between Member States, which has been the basis of the bar to such orders, remains. There remains, therefore, scope for issues to continue to arise in respect of the interface between arbitration and the New Regulation. This might arise, where, perhaps, if the court of one Member State were to rule that an arbitration clause is ineffective and deliver judgment on the substance of the matter, but the court of another Member State or an arbitral tribunal find differently on the issue of validity.

G. The Lugano Convention

The Lugano Convention States which are not Member States of the E.U. are Switzerland, Iceland and Norway. These States are unaffected, since the New Regulation does not affect the Lugano Convention.[10] It is to be noted that the Lugano Convention contains similar "*lis pendens*" provisions to those found in the Old Regulation. Thus it appears that the inherent problems in the Lugano Convention and the Old Regulation remain, because it will still be possible to launch an Italian torpedo against the jurisdiction of the courts of any non-E.U. Lugano Convention State.

The other Lugano State, Denmark (which is also an E.U. State), will give effect to the New Regulation.

H. The Enforcement of E.U. Judgments throughout E.U. Member States

Under the regime set out in the Old Regulation, in order to enforce a civil judgment made by the courts of one Member State in another Member State, a judgment creditor was required to obtain a declaration of enforceability from the courts of the enforcing Member State. Depending on the particular enforcing State, this process might take several months. The New Regulation streamlines the procedure and provides that a judgement of the court of a Member State judgment will be immediately enforceable in another Member State court without any further declaration of enforceability being required.

The courts of Member States will proceed on the basis of mutual trust in one another's rulings. Safeguards have been put in place, but it is only in exceptional cases that recognition and enforcement of the judgments of the courts of one Member State by those of another will be refused, such as where a judgment is regarded as being contrary to the public policy of the enforcing Member State.

While Article 36 of the New Regulation provides for automatic recognition, pursuant to Article 36.2, any interested party may request a decision stating that no grounds for refusal of recognition under Article 45 exist. Further, if the outcome of proceedings in a court of a Member State depends on the determination of an incidental question of refusal of recognition, that court shall have jurisdiction over that question.[11]

The declaration of enforceability of a judgment that was previously granted by the court of the Member State where enforcement was sought, is now issued from the court of the Member State making the judgment to be enforced in the form of a certificate.[12]

Further, pursuant to Article 40 of the New Regulation, an enforceable judgment carries with it, by operation of law, the power to proceed to award any protective measures which exist under the law of the enforcing Member State.

Article 41 of the New Regulation states that, as a general rule, the procedure for enforcement of judgments given in another Member State shall be governed by the law of the enforcing Member State. Similarly, the procedure for refusal of enforcement is governed by the law of the enforcing Member State insofar as it is not covered by the New Regulation.[13]

Grounds for refusal of enforcement are set out in Article 45 of the New Regulation:

– judgment is contrary to public policy;

– judgment was given in default and the defendant was not given sufficient time to file a defense or apply to set aside judgment;

– judgment is irreconcilable with another judgment between the same parties in the enforcing Member State or with an earlier judgment in another Member State or in a third State involving the same cause of action and between the same parties, provided that judgment fulfils the requirements for recognition in the enforcing Member State.

Article 54 of the New Regulation provides that, if a judgment contains a measure or an order which is not known under the law of the enforcing Member State, that measure or order shall, to the extent possible, be adapted to a measure or an order known under the law of that Member State which has equivalent effects attached to it and which pursues similar aims and interests.

However, the New Regulation is not very clear as to how to implement such adaptation, and it remains to be seen how this provision will be implemented in practice.

Endnotes

1. E.U. Regulation 1215/2012 (hereinafter "New Regulation") Article 1(1).
2. *Id.*, Art. 1(2)(e).
3. *Id.*, Art. 1(2)(f).
4. *See, e.g.*, *Gasser GmbH v. MISAT srl (Case C-116/02)*, [2003] ECR I-14693; *Turner v. Grovit (Case C-159/02)*, [2004] ECR I-3565.
5. New Regulation Art. 31(2).
6. *Id.*, Art. 31 (4).
7. *See X v. Rothschild*, French Supreme Court, First Civil Chamber, 26 September 2012, No. 11-26.022.
8. New Regulation Recital 24.
9. Case C-281/02, [2005] ECR I-383.
10. New Regulation Art. 73(1).
11. *Id.*, Art. 36.3.
12. *Id.*, Art. 53.
13. *Id.*, Art. 47.2.

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Conference Report: What's New in International Arbitration and International Litigation: View from the Bench and International Lawyers

The 2015 edition of Global Law Week dazzled members of the NYSBA International Section with an exceptional CLE program entitled "What's New in International Arbitration and International Litigation: View from the Bench and International Lawyers," held at Locke Lord LLP on 14 May 2015. An outstanding panel, featuring distinguished judges and seasoned practitioners, discussed new international arbitration developments in New York and the impact of recent federal jurisprudence on issues frequently arising in international litigation.

The panelists included moderator Jay G. Safer, a partner at Locke Lord LLP; Judge Sidney H. Stein of the United States District Court in the Southern District of New York; Justice Charles E. Ramos of the Commercial Division of New York County Supreme Court; Alexandra Dosman, Executive Director of the New York International Arbitration Center; and Jack G. Lerner, Vice President-Corporate Counsel at Prudential Financial, Inc.

The program began with a discussion highlighting the benefits of international arbitration *vis-à-vis* litigation as a method to resolve international disputes. Judge Stein observed that generally parties do not want to be subject to the jurisdiction of the other party's court system. In that regard, international arbitration provides a neutral forum where the parties have control over the selection of the tribunal and its procedures, thus eliminating a party's "home court advantage." Arbitration is also attractive because parties can select arbitrators with an expertise in the subject matter of the dispute. By contrast, courts of general jurisdiction rarely employ judges who are specialized in a particular industry. Also, parties to arbitration have the ability to keep the procedure, documents presented, and the resulting award confidential, while the advent of digital recording systems and electronic filing has further increased the transparency of litigation in the courts. In addition, there is typically less discovery in arbitration and no appeals. As a result, the average time to reach a resolution is generally shorter in arbitration as compared to full-scale litigation.

Judge Stein remarked that he sees no competition between the judiciary and arbitration. "Arbitration frees up resources for the other cases in the courts," he stated. Moreover, the two systems can be complementary. At the end of an arbitration, the tribunal issues a binding decision that can be enforced internationally under the New York Convention, a widely recognized treaty on recognition and enforcement of foreign arbitral awards. The parties then petition a court for confirmation of the award in order to convert it into a judgment. "This process should be fairly quick and should not pose substantial hurdles," said Judge Stein. He also suggested that countries that want to attract more foreign business should have a strong public policy in favor of arbitration.

The panel then examined two innovative initiatives poised to bolster the resources of New York as a forum for international dispute resolution: (i) the creation of the International Arbitration Part in New York Supreme Court, a specialized part that handles all international arbitration related matters filed in state court; and (ii) the establishment of the New York International Arbitration Center (NYIAC) in Midtown Manhattan.

Justice Ramos, who has been designated to hear all applications related to international arbitration brought under NY Civil Practice Law and Rules (CPLR) Article 75 or the Federal Arbitration Act in the New York Supreme Court, New York County, remarked on the importance of providing litigants with a venue to resolve these matters efficiently and expeditiously. Justice Ramos explained that the court's practices and procedures for submitting applications involving international arbitration are set forth in the "International Arbitration Part Rules" of Part 53, available at http://www.nycourts.gov/courts/comdiv. In addition, lawyers need to properly designate the application as one concerning international arbitration on the Request for Judicial Intervention, as indicated in the "Administrative Order Relating to International Arbitration" (also available on the Commercial Division's website), so that the matter will promptly be assigned to the specialized Part.

Justice Ramos noted that the matters brought before him since the creation of the Part in September 2013 cover a wide range of litigation ancillary to international arbitration, and include applications to compel or stay arbitration, for interim relief, and to confirm or vacate awards. He explained that, under the Federal Arbitration Act, parties have a right to be heard in federal court. To avoid removal of the proceeding to a federal court, Justice Ramos suggested that the arbitration agreement should provide for the exclusive jurisdiction of the Supreme Court of the State of New York in matters related to enforcement.

Turning to NYIAC, Alexandra Dosman explained that the state-of-the-art hearing center was founded in 2013 to promote and enhance New York as a leading venue for international arbitration. A nonprofit organization, NYIAC was formed under the leadership of Former Chief Judge Judith S. Kaye, who rallied thirty-seven New York law firms, which in turn provided financial support for the Center. By contrast, Ms. Dosman noted that similar centers in other financial hubs around the world are supported by public money. Ms. Dosman emphasized that NYIAC does not administer arbitrations, but provides hearing rooms, breakout rooms, audio/video conferencing, and a translation booth for simultaneous interpretation for the conduct of international arbitrations, either *ad hoc* or under any institutional rules. She stated that the Center reported thirty-nine bookings through December 2014, and has been booked for another fifteen cases so far this year.

In addition to hosting arbitral proceedings, Ms. Dosman explained that NYIAC's mission includes developing and promoting programs on topics of interest to the international arbitration community in New York. She added that NYIAC's programming and outreach are also geared to attract the young minds, i.e., the numerous foreign students pursuing an LL.M. degree in New York every year, so that they will be more inclined to designate New York as the arbitral seat once they return to practice law in their home jurisdictions.

Next, the discussion turned to recent developments in international litigation. Jack G. Lerner addressed the timely topic of extraterritorial application of U.S. antitrust law. Mr. Lerner focused on *Motorola Mobility LLC v. AU Optronics Corp.*, 775 F.3d 816 (7th Cir. 2015), which dismissed a price fixing claim by Motorola and its ten foreign subsidiaries against foreign manufacturers of liquid-crystal display (LCD) panels used in Motorola's cellphones. The court held that two prongs of the Foreign Trade Antitrust Improvements Act (FTAIA) must be satisfied when applying U.S. antitrust laws (here, the Sherman Act) to conduct occurring wholly or partially in other countries: "There must be a direct, substantial and reasonably foreseeable effect on U.S. domestic commerce—the American domestic economy, in other words—and the effect must give rise to a federal antitrust claim. The first requirement, if proved, establishes that there is an antitrust violation; the second determines who may bring a suit based on it." (775 F.3d at 818.)

In *Motorola*, the immediate victims of the price fixing were only the foreign subsidiaries, since ninety-nine percent of the cartelized components were bought and paid for by, and delivered to, the foreign subsidiaries, which incorporated the components into cellphones, and later sold and shipped the phones to Motorola in the United States. Since the foreign subsidiaries were separate legal entities from Motorola, the court concluded that the allegations failed to meet the domestic effects exception to the FTAIA, which requires that the effect on United States commerce "give rise" to a plaintiff's antitrust claim.

Mr. Lerner drew a distinction between the *Motorola* case and *United States v. Hui Hsiung*, 778 F.3d 738 (9th Cir. 2015), which upheld the defendants' convictions for participating in the liquid-crystal display (LCD) price-fixing conspiracy, on the ground that the defendants had imported some of the price-fixed panels into the United States. Thus their conduct fell outside the FTAIA's extra layer of protection against Sherman Act claims implicating foreign activity. Based on these cases, Mr. Lerner cautioned lawyers that the ability for a large business to seek private redress through litigation may be limited for multinational cartel activity, even if the U.S. government power is not.

Finally, the panel addressed the evolving concept of personal jurisdiction in the United States. Jay G. Safer discussed the decision in *Daimler AG v. Bauman*, 134 S.Ct. 746 (2014), where the U.S. Supreme Court dismissed a case against a German corporation for lack of personal jurisdiction. In *Daimler*, Argentinian residents sued Daimler, a German parent company, seeking to recover for injury suffered as an alleged consequence of activities undertaken by a Daimler subsidiary in Argentina. The jurisdictional issue was whether the California contacts of Daimler's U.S. subsidiary could be attributed to the German parent and, if so, whether those contacts were sufficient to establish general personal jurisdiction. The Court explained that an entity's continuous and very extensive contacts with the forum, including those of its U.S. subsidiary, are not enough to establish general jurisdiction. Rather, general jurisdiction can be found only where a corporation's affiliations with the state are so continuous and systematic as to render it essentially at home in the forum state.

Mr. Safer remarked that *Daimler* has changed the concept of general jurisdiction based on the "doing business" test from the pronouncement of the Court in the landmark case of *International Shoe*. He explained that *Daimler* now makes it harder to sue a large corporate entity on the basis of general jurisdiction in a state other than the corporation's principal place of business or place of incorporation, or other state where the corporation is "at home."

The event concluded with a breakfast reception. The program, attended by attorneys who practice law in different jurisdictions all over the globe, provided an excellent educational update and networking opportunity to American and foreign lawyers who engage in international litigation and arbitration worldwide.

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Law Report: The Reform of French Civil Law

The basics of French contract and tort law are contained in the Code Civil, most of which has not been modified since its creation in 1804. Over the past fifteen years, there have been attempts to modernize it, the most noteworthy being the project Catala in 2008. However, none of these attempts have been successful.

The current reform was initiated in February 2015, and at this stage takes the form of an *ordonnance* (the "Ordonnance"). In addition to reforming French contract law, the Ordonnance proposes to largely reorganize tort law by dividing it in three parts: the sources of obligations; general dispositions on obligations; and evidence.[1]

As a general comment, the innovations developed within the Ordonnance can be described as twofold: (i) improving the efficiency of the law; and (ii) increasing the protection afforded to the weaker party.[2] That being said, the project also takes the opportunity to reaffirm key notions of French civil law.

I. Improving the Efficiency of the Law

A. The Removal of the Notion of Cause of the Contract

The new project is innovative, since it will remove the notion of cause as a condition of validity to the contract under French law. This notion of cause is difficult to apprehend, but it is close to the English notion of consideration in contracts.

New Article 1127 sets out three conditions for a contract to be valid, instead of the current four in Article 1108 of the Code. The three conditions are the following: the parties consent to the contract; are lawfully able to contract; and the content of the contract is lawful and certain.[3] This last condition replaces the notion of cause of the contract, which is the reason for which the contract was created.

Although the notion of cause of contract will disappear, two of its effects will be preserved. First, Article 1167 provides that, if consideration is insufficient, the contract is void. However, consideration need not be adequate, unless the law provides otherwise, as stipulated by Article 1177. Second, Article 1168 stipulates that any clause that renders the core duty of the debtor illusory is void. The reasoning behind this is that the parties themselves cannot dismiss the very reasons for which they contracted. However, as commentators have indicated, the meaning of "core" is not defined.[4]

B. Offer

The central notions of offer and acceptance will finally be added to the Code in Article 1113.[5] The current French Civil Code does not contain any articles codifying these notions, although French case law has incorporated these mechanisms.

The proposed Article 1114 establishes the difference between an offer and an invitation to treat, the latter being non-binding.

The text differentiates retraction from revocation of the offer.[6] Retraction means that the offeree has not yet received the offer, whereas the revocation of the offer can only happen after the offeree has received the offer. Although it is not said so explicitly, an offer can be retracted at any time, since it only takes effect when received by the offeree.

The offeror cannot revoke the offer before a certain time period has lapsed, as stipulated by Article 1116. This time period can be defined by what is expressly agreed upon by the parties or what is reasonable. As Article 1124 provides, revocation of the offer before the time period has lapsed is not valid.

As for the nullity of the offer, Article 1118 provides several possibilities: the expiration of the time period set by the offeror or the death or incapacity of the offeror. The current state of the law on this matter is that, at the death of the offeror, the offer passes down to the offeror's heirs, but the wording of the article is clear: where the offeror dies, the offeror's offer ceases to be valid.

C. Acceptance

Article 1119 defines acceptance as the intention of the offeree to be legally bound by the terms of the offer. The acceptance must be clear and straightforward. If it modifies the terms of the offer, such as the price, then it is a counteroffer.

The Ordonnance also provides for the conditions of acceptance. Article 1121 confirms that silence itself does not constitute acceptance. An offer can only be accepted by oral or written conduct.

Article 1122, which changes the current state of the law, stipulates that the offeree has to have received the acceptance in order for the contract to be valid. The contract is concluded at the location where the acceptance was received.

D. Unilateral Contracts

Article 1124 defines a unilateral contract as one where the offeree is free to accept the offer of the offeror within a set time period. The contract is formed as soon as the offeree does so.

As for the situation of the offeror, although it is not clearly addressed, the implication is that the offeror is legally bound by the terms of its offer and cannot withdraw it, which is at odds with the current state of the law.

E. Right of Pre-emption to Contract with the Offeror

Proposed Article 1125 defines the right of pre-emption as a promise from the grantor to contract with the beneficiary of the right, were the beneficiary to choose to contract.

The rules on this matter differ from the current state of the law in two respects. First, if the offeror contracts with a third party, the beneficiary can choose to either have the contract declared void, or take the place of the third party in the contract. Second, the proof that the third party knew of the existence of the promise is enough to establish its bad faith and for the beneficiary to have the contract with the third party declared void.

F. Remedy in Kind to the Non-Execution of the Contract

Where the debtor does not fulfill its obligations under the contract, pursuant to Article 1221, the creditor can force the debtor to do so in kind. This power is limited if a remedy in kind is impossible or if the cost of the remedy is disproportionately high. This second qualification is new and its application would be left to the discretion of the judge.[7]

II. Increasing the Protection Afforded to the Weaker Party

A. Protection Against Unfair Terms

The first major innovation in the Ordonnance is the introduction of a rule in Article 1169 that protects the parties against any unfair contractual terms generally.[8] Any clause that creates a significant imbalance of power between the parties can be struck down by the judge at the request of the party to whom it is detrimental. This innovation will apply to most, if not all, contracts.

B. Protection Against Economic Duress

The second major innovation in the Ordonnance is the addition of an article on the protection of the weaker party from abuse, which essentially protects the weaker party from economic duress. Proposed Article 1142 stipulates that, if one of the parties takes advantage of the vulnerability or situation of dependency of the other, to force that party to enter into a contract that it otherwise would not have done had it not been in that situation, the contract is void.[9]

C. Termination of the Contract in the Event of an Unpredictable Occurrence

Article 1196 presents another innovation. If an unpredictable event occurs after the finalization of the contract, the contract can be renegotiated if the other party agrees to it and then terminated by a judge if the renegotiation fails. This is, however, conditional on the event being unpredictable at the time of the contract, and that, as a result, it would be too expensive for one of the parties to fulfill its obligations under the contract. In addition, the party must not have waived its right to such a remedy by assuming such a risk. The party who makes the request to renegotiate must keep fulfillling its contractual obligations during the renegotiations.

This innovation would allow a party who has suddenly found itself in a disadvantageous position through no fault of its own to get out of the contract, if deemed appropriate by the judge.

However in practice most common contracts, such as leases, contain a clause that allows the weaker party to unilaterally terminate the contract if reasonable notice is given.

III. Reaffirming Key Notions

A. The Freedom to Contract

Article 1102 reaffirms this fundamental principle and adds an already existing qualification: the freedom to contract cannot harm the rights and liberties as between private persons or the public order.

B. The Duty to Contract in Good Faith

Proposed Article 1103, by stipulating that all contracts must be formed and executed in good faith, simply codifies a principle that is already well established.

Article 1129 adds to this duty. Where one of the parties has or ought to have information of interest to the other party, which could affect the other party's decision to enter into the contract, it must communicate that information to the other party. This duty is triggered where the other party imparts confidence on the first party or the other party did not have the information. If one of the parties deliberately withholds relevant information from the other, it is not contracting in good faith. Failure to fulfill this duty will expose the party to liability in tort.

This duty is introduced in the Code Civil for the first time and is also a corollary of the principle of freedom to contract. If the parties are not in possession of all relevant information when contracting, it cannot be said that they are free to contract.[10]

C. The Binding Effect of the Contract

Proposed Article 1194 of the project replaces the current Article 1134 of the Code and reaffirms the principle that the parties to a contract are bound by it. The contract can only be modified or revoked through the common intention of the parties.[11]

D. The Effect of the Contract, Transferring Property

In Article 1197, where the subject matter of the contract is the concession of property, such property is transferred immediately after the contract is signed: no additional formalities are required. However, the immediate transfer is qualified in the second paragraph, which establishes that the parties can decide to have the property transferred at a later date, as is the case in most contracts, especially where real property is concerned. The risks attached to the property are also transferred with it.

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Endnotes

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2. Mazeaud, *Droit des contrats:* réforme à l›horizon! [*Imminent reform of the law of contracts*], 2014 Dalloz Rev. 291.
3. Ministère de la Justice, *Projet d'ordonnance du 25 février 2015 portant réforme du droit des contrats, du régime général et de la preuve des obligations* [*Ordinance Project dated 25 February 2015 on the reform of French civil law*].
4. Dupichot, note 1 *supra*; O. Tournafond, *Le projet de la Chancellerie de réforme du droit des contrats, commentaire raisonné et critique* [*Commentary and criticism of the project of reform of the law of contracts*], 2014 Droit et Patrimoine 241.
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10. Mazeaud, note 2 *supra*.
11. Morelon, note 9 *supra*.

Law Report: Modern Slavery Act and Consultation

I. What Is This All About?

The United Kingdom now has new legislation aimed at combatting slavery and human trafficking in the form of the Modern Slavery Act 2015 ("the Act"), which received Royal Assent on 26 March 2015.

The Act consolidates and expands upon existing legislation, setting up a systematic approach to combatting modern slavery. The Act also imposes transparency compliance requirements in supply chains on businesses on which the U.K. Government is currently consulting.

II. What Does the Act Consist of?

The key aspects of the Act include the following.

- **Main Offenses**. The key offences are slavery, servitude and forced or compulsory labor, and human trafficking. These offenses are closely related but not legally identical. Slavery is where ownership is exercised over a person. Servitude involves the obligation to provide services imposed by coercion. Forced or compulsory labor involves work or service exacted from any person under the threat of a penalty and for which the person has not offered himself or herself voluntarily. Human trafficking concerns arranging or facilitating the travel of another person with a view to exploiting them.
- **Penalties and Enforcement**. For the main offenses the penalties are (i) maximum life imprisonment (conviction on indictment) or twelve years' imprisonment or a fine or both (summary conviction); (ii) confiscation of assets; (iii) slavery and trafficking reparation orders (compensation to the victims); (iv) slavery and trafficking preventative orders (where there is a risk of future offenses); and (iv) foreign travel bans.
- **Anti-Slavery Enforcer**. The new position of an independent Anti-Slavery Commissioner has been established. The Commissioner is tasked with a number of functions, including encouragement of practices in the prevention, detection, investigation and prosecution of slavery and human trafficking.
- **Protection for Victims**. Victims of slavery, including child victims, will be better protected and supported. For example, slavery or trafficking victims will be able to claim a defense against certain offenses that they were coerced into committing the offense in question and, therefore, it is attributable to their slavery or exploitation situation.
- **Business Transparency and Disclosure**. Businesses of a certain size will have to annually disclose in a so-called "slavery and human trafficking statement" the steps that they've taken to ensure that there is no slavery or human trafficking in their business or supply chains. (See below for more on this.)
- **Jurisdiction**. The Act and the business transparency requirements are not restricted to U.K. entities, since they will apply to any business wherever formed which falls under the scope of the Act.

III. Which Businesses Does Transparency Apply to and What Must They Do?

Article 54 of the Act sets out in its entirety the transparency in supply chains requirements. The two main issues here are businesses concerning turnover and the "Slavery and Human Trafficking Statement."

A. Turnover

Transparency applies widely in that it concerns any "commercial organization" supplying goods or services and which has a certain turnover, carrying on a business, or part of a business, in any part of the United Kingdom. Transparency therefore has extra-territorial scope.

The turnover threshold will be prescribed in further (secondary) legislation and the Home Office (the Government department responsible for this legislation) is currently in consultation about the turnover size threshold.

The consultation document gives an indication of the estimated number of businesses that might be required to comply under a range of proposed thresholds as set out below:

Turnover thresholds	Estimated total number of U.K. active companies whose turnovers exceed the threshold**
£36 million*	12,259
£250 million	2,554
£500 million	1,409
£1 billion	724

These numbers are approximate since they do not include businesses registered in other countries and operating directly in the United Kingdom, without a U.K. registered subsidiary.

*£36 million is one of the thresholds which determines the size of a large company for the purposes of the (U.K.) Companies Act 2006.

** Where more than one company within a group exceeds the thresholds, this number includes all such companies.

It should be stressed that these figures have only been provided in the consultation document as a frame of reference and are not intended to limit feedback in the consultation to what interested parties think the final turnover threshold should eventually be.

However, the consultation document does make it clear that total turnover will be the total net turnover of the "commercial organization," *i.e.*, the total amount of revenue derived from all sources, after deduction of discounts, VAT and any other taxes based on the amounts so derived.

This is in effect the same definition as the one used in the (U.K.) Companies Act 2006 for businesses to determine their size for the purpose of complying with that particular legislation.

The turnover threshold of a company carrying on all or part of its business in the United Kingdom will be assessed as including the turnover of all of its subsidiaries.

B. Slavery and Human Trafficking Statement

Businesses with a certain turnover will also be required to publish an annual "Slavery and Human Trafficking Statement," which must disclose the steps that businesses have taken to ensure that their business and supply chains are slavery-free, or the business must provide a statement that no such steps have been taken. The latter course of action carries an obvious reputational risk.

The Home Office is also currently in consultation on future statutory guidance that the U.K. Government will provide on the content of "Slavery and Human Trafficking Statement." A number of issues could eventually come out of this: for example, whether the board itself will have to sign off.

These statements must be meaningful and the Act states that the statement may include the following:

– The organization's structure, its business, and its supply chains;

– The organization's policies in relation to slavery and human trafficking;

– The organization's due diligence processes in relation to slavery and human trafficking in its business and supply chains;

– The parts of the organization's business and supply chains where there is a risk of slavery and human trafficking taking place, and the steps the organization has taken to assess and manage that risk;

– The organization's effectiveness in ensuring that slavery and human trafficking is not taking place in its business or supply chains, measured against such performance indicators as the organization considers appropriate; and

– The training about slavery and human trafficking available to the organization's staff.

If the business has a website, it must publish the "Slavery and Human Trafficking Statement" on that website, and include a link to the statement in a prominent place on the website's homepage. If the organization doesn't have a website, it must provide a copy of the statement to anyone who makes a written request for it within thirty days.

IV. What's Next?

The U.K. Government consultation consists of eighteen brief questions, which focus on determining the disclosure turnover threshold and the disclosure activities content and good practice of "slavery and human trafficking statements," along with requests to provide information about those submitting responses in order to be able to assess the consistency of views submitted.

The consultation closed on 7 May 2015. A response to the consultation will be published: it is not clear at this stage if there will be some kind of hearing concerning the consultation. The supply chains transparency obligation is provisionally planned to come into force in October 2015.

Input into the Act highlighted the vulnerability of U.K. supply chains to slavery infiltration. Businesses should set up a compliance program to deal with this. As of the time of writing this article, businesses will only have six months to prepare before the transparency in supply chains requirements fully apply, which is not much time and especially so because the turnover threshold and full content extent of the "Slavery and Human Trafficking Statement" are still unknown.

V. What Can Be Done?

For those businesses that are likely to be affected by the supply chain requirements of the Act, we suggest that they consider the following as compliance priorities.

- Undertake a supply chain audit in order to hold the supply chain to account, and identify jurisdictions and types of vendors who present the most risk: ensure that the board and shareholders support all of this.
- Develop a "Slavery and Human Trafficking Statement" template, and a communication strategy for delivering the annual statement: it is not only the U.K. Government which will need convincing but maybe also potential pressure group activists targeting the business.
- Train employees and the supply chain: people are the weakest link, and they need to buy in to the compliance program, so adopt an appropriate approach, such as an ethical one that emphasizes the respect for human dignity.
- Update and integrate modern slavery compliance into the businesses' other practices, procedures (including procurement), policies and documentation, including the requirements (since 2013) for quoted companies to report in their annual strategic report on human rights "where this is relevant for an understanding of the business."
- Work with or create alliances to try to deliver improvement across the board and which is not limited to the businesses' own activities, and to create leadership: combined efforts can better bring about change and improve transparency.

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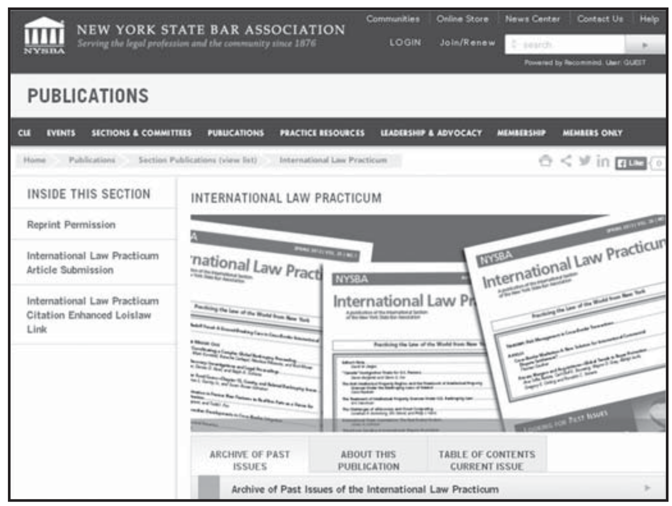

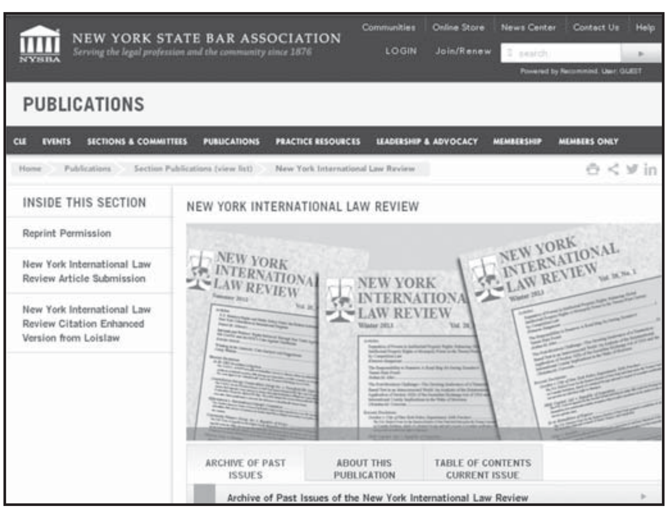

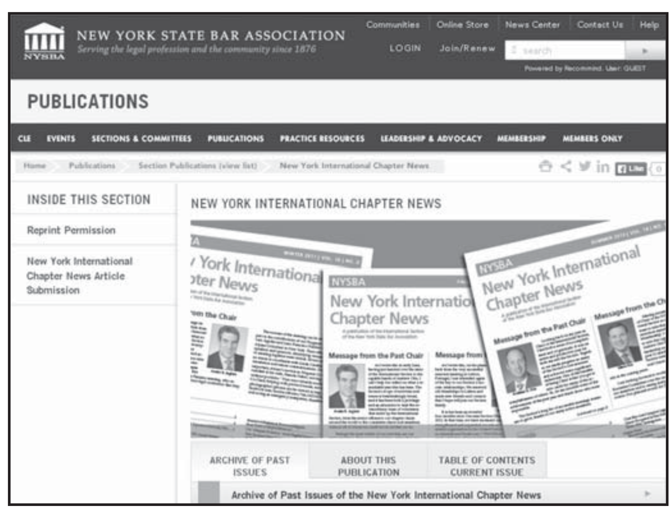

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The New York State Bar Association wishes to acknowledge the generous contribution of Mead Data Central, Inc. in donating access to the LEXIS®/ NEXIS® service for our use in the preparation of this publication.

ISSN 1041-3405 (print) ISSN 1933-8392 (online)