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A TRIANNUAL PUBLICATION OF THE ABA/SECTION OF INTERNATIONAL LAW
THE INTERNATIONAL LAWYER

THE INTERNATIONAL LAWYER (ISSN 0020-7810) is the triannual publication of the American Bar Association's Section of International Law (ABA/SIL) in cooperation with SMU Dedman School of Law. It has a worldwide circulation. Prior to 2013, it was a quarterly publication that included a special Year in Review issue, which is now a separate annual publication known as THE YEAR IN REVIEW.

Publication policy: The objectives of THE INTERNATIONAL LAWYER are to publish high quality articles on international subjects and to foster and record the activities of the ABA/SIL and its committees. The Journal focuses on practical issues facing lawyers engaged in international practice. Thus, the editors are interested primarily in topics concerning trade, licensing, direct investment, finance, taxation, litigation, and dispute resolution. They will, however, also consider public international law topics.

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All articles must be sent in an electronic Word format. Submit to eic-til@mail.smu.edu or send a hard copy with an electronic Word-formatted copy to Editor-in-Chief, THE INTERNATIONAL LAWYER, SMU Dedman School of Law, P.O. Box 750116, Dallas, TX 75275-0116 [phone: 214-768-2061; fax: 214-768-1633]. Manuscripts undergo peer review, which usually takes three to four weeks. Publication is normally four to eight months after a manuscript is accepted. The editors of THE INTERNATIONAL LAWYER reserve the right to move an accepted manuscript from the committed issue to a later issue.

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PUBLISHED IN COOPERATION WITH
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Fifty Years of Excellence

MARC I. STEINBERG*

This Issue marks the commencement of the 50th anniversary of The International Lawyer, the periodical that is widely perceived as the preeminent international journal in the world. Whether one is in New York, Los Angeles, Dallas, London, Paris, Rome, Moscow, Tokyo, Shanghai, Bangkok, Sydney, Auckland, Johannesburg, Cairo, Tel Aviv or other significant locale, The International Lawyer is a steady presence promoting global understanding and the rule of law.

As the Editor-in-Chief of this excellent journal, I have the pleasure of working with the members of the Journal’s internal and external advisory boards. The Journal’s relationship with SMU has proved beneficial both to the Journal and the Law School. In this regard, I wish to thank certain former and current members of the SMU law faculty who have been instrumental to the Journal’s success. In particular, I thank Professor Joseph J. Norton who served as an outstanding Editor-in-Chief of the Journal for many years, Professor Werner Ebke and Mr. Robert Rendell for their influential role in bringing the Journal to SMU, former Dean John B. Attanasio who served superbly as Co-Editor-in-Chief for well over a decade, Professor Peter Winship for his excellent service for several years as Editor-in-Chief, current Dean Jennifer Collins for her strong support of the Journal, and Dr. Beverly Caro Duréus and Ms. Patricia S. Heard who greatly contribute on a daily basis to the Journal’s efficient operation.

Publishing significant and timely articles from both comparative and international law perspectives, the Journal serves as an important resource for both practicing lawyers and academicians. Through the decades, esteemed judges, attorneys, and professors have contributed insightful articles covering a broad spectrum of subject matters. In addition to these contributions, The Year in Review serves as a valuable survey of key global developments that impact dozens of diverse legal specialty areas.1

With some frequency, the Journal also publishes Symposium Issues that focus on critical topics impacting global relations. For example, in the aftermath of September 11th, the Journal published a Symposium addressing

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* Rupert and Lillian Radford Professor of Law, SMU Dedman School of Law; Editor-in-Chief, The International Lawyer.
1. See, e.g., International Legal Developments Year in Review: 2014, 49 Int’l L. Rev. (Spring 2015), which contained over three dozen articles covering such legal topics as: International Antitrust; International M&A; Privacy, E-Commerce and Data Security; International Arbitration; Corporate Social Responsibility; International Intellectual Property; Immigration; and Anti-Corruption.

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“Terrorism’s Burdens on Globalization.” This Issue featured twelve articles analyzing significant and timely matters relating to globalized terrorism. Another Symposium Issue of the Journal examined “International Company and Securities Law.” That Symposium contained fourteen articles from leading scholars and practitioners covering key corporate governance issues. As a third example, with contributions from eminent jurists and attorneys, the Journal enjoyed the distinction of publishing “The Rule of Law Papers.” These Papers represent an impressive collection.

In the Preface to “The Rule of Law Papers,” Lord Hacking acknowledged the vital role that The International Lawyer and the ABA Section of International Law have in enhancing this paramount objective. As Lord Hacking recognized:

The International Lawyer is a particularly appropriate home for the publication of these distinguished papers on the rule of law. It is the flagship publication of the American Bar Association Section of International Law. Rule of law is a core competence of the Section . . . .

With distinction, The International Lawyer over the past 50 years has played an instrumental role in the global understanding of important concepts, principles, and developments impacting comparative and international law. Being preeminent, the Journal continues to have influence and earn admiration among judges, practicing attorneys, and academicians. In the quest for maximizing economic development in a peaceful manner with respect for human dignity, The International Lawyer is a continual force promoting these goals.

I am honored to have served as the Journal’s Editor-in-Chief since the beginning of this century. I am proud of the meaningful contributions that this superb law school, the SMU Dedman School of Law, has made to this Journal. I thank my colleagues here at SMU as well as the Section’s and Journal’s leaders through the decades who have been essential to the success of The International Lawyer. I am confident that the Journal will remain as a premier influential resource enhancing global understanding and the rule of law.

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2. 36 Int’l Law. No. 1 (Spring 2002).
Fifty Years Young: A Personal Note of Congratulations and of Appreciation

JOSEPH J. NORTON*

My heartiest congratulations to the Leadership of the American Bar Association’s (“ABA”) Section of International Law (the “Section”) on the 50th Anniversary of its flagship publication, The International Lawyer (“TIL”). Also, my most sincere appreciation to the Section for maintaining its confidence in my law school, the SMU Dedman School of Law in Dallas, and its international law faculty and law student body by having TIL’s editorial home based at SMU for the past thirty years.

It is undisputed that TIL has established itself as one of the premier international law journals in the English-speaking world, being one of the most widely-cited international law journals and having the largest regular readership touching over ninety countries. TIL has become a key disseminator of the Section’s tagline of “Your Gateway to International Practice,” to the Section’s strong commitment to the global embrace of the “Rule of Law,” and to the Section’s ongoing promotion of inclusion and diversity in its expanding membership base and in its leadership structure.2

Thirty years ago, I had the privilege, along with my then faculty colleague, Professor Dr. Werner Ebke (now a member of the Heidelberg Law Faculty), to interview with the late Mont Hoyt and other Section Leaders, for SMU to take the editorial baton of TIL from the most capable hands of the prior Editor-in-Chief (“EIC”), Professor Bob Lutz.3 Robert Rendell, who was the Section President in 1986, strongly encouraged Werner and me to make this

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* James L. Walsh Distinguished Faculty Fellow and Professor of Financial Law, SMU Dedman School of Law.

1. TIL’s lineage can be traced back to the establishment of the ABA’s International Law Committee in 1878: this Committee was one of the original seven Standing Committees of the ABA. In 1933, this Committee became the Section of International and Comparative Law under the great legal scholar, Professor John Henry Wigmore as its Chair. In 1981, the Section was renamed the Section of International Law and Practice and in 2004 the Section was given its present name of the Section of International Law. See, inter alia, Victor Folsom’s historical discussions of the Section in 16 Int’l. Law. 1, 119 (1982) and in 28 Int’l. Law. 3, 587 (1994). See also Lutz and Schildhaus, infra note 2.

2. For information on the ABA Section of International Law, see generally Section of International Law, American Bar Association, available at http://www.americanbar.org/groups/international_law.html.

3. Bob was to become President of the Section in 2001, and earlier in 2016 the Section awarded him its 2016 Lifetime Achievement Award. Bob, along with another former President of the Section, Aaron Schildhaus, have edited a most impressive volume, The ABA Section of International Law, Leading the World’s International Lawyers since 1878 (ABA 2008).
presentation, and Robert continued to support SMU in promoting international law programs over the years. Our proposal was successful, and I became EIC, with Werner as Associate EIC.

I was fortunate to hold the EIC position and to be a member of the Section’s Council for 11 years. During that time, I had the opportunity to get to know some of the most committed and civic-minded Section Leaders, each of whom made significant contributions to the advancement of the Section. By way of example, Homer Moyer expended endless hours developing the special Central and Eastern European Law Institute (“CEELI”) founded in 1990 after the collapse of the Berlin Wall in 1989. CEELI evolved into the ABA’s comprehensive Rule of Law Initiative in 2007. In speaking of the promotion of the Rule of Law, special commendation needs to be given to Jim Silkenat who was relentless and tireless over the past two plus decades in advancing the Rule of Law through the Section and the broader ABA. TIL has always been receptive to publishing Rule of Law-related articles and reports, including publishing a major Rule of Law Symposium in 2009.

In terms of TIL’s contribution to the SMU School of Law, I wish to briefly note four matters: (1) the founding of the SMU International Law Review Association (“ILRA”), (2) the establishment of the Law and Business Review of the Americas (“LBRA”), (3) the facilitation of several major international conferences at SMU, and (4) the evolvement from TIL proper of a separate Section annual publication, The Year In Review (“YIR”). With the support of my then Dean Jeswald Salacuse and his successors, Dean Kenneth Penegar, Dean C. Paul Rogers, Acting Dean Harvey Wingo, Dean John Attanasio, Acting Dean Julie Forrester, and now Dean Jennifer Collins,

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4. Robert was an Adjunct Professor of International Business Law at SMU for a number of years.
6. In particular, I wish to note the substantial contributions of Arthur Rovine, Robert Rendell (an SMU Adjunct Professor of Law), the late Joe Griffin, Steve Nelson, Homer Moyer, Jim Silkenat, Gerald Libby, the late Prof. Louis Sohn, James Carter, Jay Vogelson (also an Adjunct Professor of Law at SMU), Lucinda Low and her husband Dan Magraw, the late Rona Mears (an SMU graduate), Pof. Don Wallace, Bob Lutz, Tim Dickinson, Edison Dick, Ken Reisenfeld, Edison Dick (director of ILEX), Don De Amecis, Charlene Barshefsky (former USTR) and Judith Bello. Also I would like to give special recognition to Cynthia Price, the amazingly talented, energetic and perceptive Executive Director of the Section for many years.

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my SMU EIC successors (Peter Winship and Marc Steinberg)\textsuperscript{10} and I were able to structure, establish, and maintain the ILRA.\textsuperscript{11}

Over three decades, the ILRA has become a high-quality law review of sixty top law students for assisting in the editing of TIL (and, subsequently, also of LBRA and the new YIR), while still maintaining TIL’s status as the Section’s flagship, professional, refereed publication.\textsuperscript{12} In talking about the success of the ILRA with respect to TIL, I would be remiss not to recognize the great contributions made in the past by Janet Balch and former Senior Associate Dean Christine Szaj and now being made by my colleagues, Beverly Durěús and Patricia Heard. As to this “partnership” between TIL and SMU, our students have been given a special opportunity to have a genuine law review experience that exposes them to a broad range of cutting-edge international and comparative legal issues, that aids in their future job search, and that helps our law school’s external international profile.\textsuperscript{13}

As to the establishment of the LBRA journal in 1994, various Section Committees (e.g., the International Trade, Mexico and Canadian Committees) and members had been active in the launch of the NAFTA initiative. TIL assisted in publishing key articles on cutting-edge issues and developments and in co-sponsoring one of the first major national conferences on NAFTA in conjunction with the Section and SMU. Related to all this, the Section was a co-sponsor, from 1994-2000, with SMU and Kluwer Law International of the first interdisciplinary law journal on NAFTA, the \textit{NAFTA: Law and Business Review of the Americas} (name changed in 2000 to LBRA and continued to be edited by the SMU ILRA). LBRA expanded the SMU external international profile (particularly as to Latin America) and has further enriched the international exposure of our ILRA law students.

In addition to the seminal NAFTA conference referenced above, SMU-TIL collaborated with the Section with respect to several other major international conferences (e.g., the \textit{Rule of Law}, the \textit{New International Financial Architecture}, and the \textit{Arab Spring}). Each conference brought to SMU-Dallas leading experts in the particular conference subject-matter areas and led to significant publications in TIL. Further, SMU-Dallas hosted one of the Section’s Winter Meetings. On a separate note, the SMU-TIL-Section relationship was further solidified by the Section

\textsuperscript{10} Peter served as EIC from 1996-1999. Marc is the current and longest serving EIC, serving as such since 2002. From 2002 to 2014, our then Dean John Attanasio served as a Co-EIC.

\textsuperscript{11} For more information on ILRA, see generally International Law Review Association, SMU Dedman School of Law, available at https://people.smu.edu/ilra/.

\textsuperscript{12} For more information on the ABA and TIL, see generally The International Lawyer, American Bar Association, available at http://www.americanbar.org/groups/international_law/publications/the_international_lawyer.html.

awarding my colleague, Peter Winship, the prestigious Theberge Award for Private International Law in 2007.

The final point I wish to make concerns the institution of TIL’s annual 600 page Year in Review publication. The genesis of this goes back to the mid-1990s, with the Section trying to expand and to energize its Committee structure. The gist was for the Chair of each of its Committees to produce an annual report of “recent legal developments” within the Committees’ coverage areas. These reports were to be assembled and initially reviewed by a designated Section member (e.g., Bob Lutz, John Murphy and Peter Winship), and then turned over to the ILRA. The actual ILRA editorial/publication process initially was under the oversight of our then Senior Associate Dean Christine Szaj, and subsequently under the supervision of two of our Senior Lecturers, Bev Duréus and Patricia Heard. Trying to “ride heard” over this ever-expanding project as the Section increased its Committees to over 40:14 they also had to inter-relate with each Committee Chair, the Section Publication Committee Chair and other Section Leaders, the ABA Chicago Office, the ILRA students dedicated to this project, the publisher, and to the YIR EIC, Marc Steinberg. I cannot emphasize how well Bev, Pat and Marc have done in annually orchestrating this mammoth and complicated process and “in keeping the publication train on track and on time.” Without question, The Year In Review will become a “must have” by anyone interested in the international-comparative law arena.

I am so proud to have been associated with the Section, TIL, the ILRA and my wonderful involved colleagues. For most, “50 years” is the beginning of middle-age, but with the energized and expanding Section and the continuing support of my Law School, I am confident TIL is still in its early life, with many more years ahead in contributing to the global propagation of international and comparative law and of the Rule of Law. Happy Anniversary and a personal note of appreciation for enriching my academic career.

Tribute to The International Lawyer

SARA P. SANDFORD*

As the Chair of the Section of International Law for the 2016-17 ABA year, it is indeed my honor to serve our members, but it is also my honor to serve as Chair in this year, in particular, when The International Lawyer turns fifty. What a privilege it is to have a chance to speak on behalf of all of the Section’s members about the value that The International Lawyer has represented in our collective lives as lawyers. Many of the other tributes included in this edition are from academics and editorial board members who, thankfully, have contributed to the publication and its quality. I, on the other hand, have merely been one of the thousands of beneficiaries of The International Lawyer and its content.

I am in my thirty-second year of practice and from my first year as a lawyer, I regularly looked forward to receiving my copy of The International Lawyer to learn about the latest academic thinking on a variety of international legal topics. Many topics were quite relevant to my practice; some were merely informative on topics that did not directly affect my clients on a day-to-day basis. Some addressed topics of public international law, which at least indirectly affect us all. Virtually all informed me, regardless of whether I agreed or had my own views on the topic at hand.

When I describe the Section’s publications to members and prospective members, I explain that we have several avenues for writers and scholars to publish – many of which are designed to share information among practitioners, academics, in-house counsel, students, non-governmental organizations and government lawyers. I explain, however, that they should look for an opportunity to publish in The International Lawyer if they are looking to present truly scholarly material. The International Lawyer seeks to publish content that is intended not just to report or analyze, but to present new ideas and arguments for others who share our interest in international law. In other words, The International Lawyer is the best publication for those who wish to influence what international law should be.

In many traditions, fifty years may seem minor, but in a nation that is a little over 200 years old, a publication of fifty years is truly remarkable, especially when we can recognize it by its quality and influence in addition to its longevity. The Section’s thirty-year collaboration with Southern Methodist University’s Dedman School of Law to bring The International Lawyer to press has been invaluable in sustaining the quality of the publication, and for that we should all be grateful.

* Chair of the ABA Section of International Law.

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I am eager to see how the profession will change over the next fifty years and, with the evolution/revolution in the publishing world, as well, I have no doubt that The International Lawyer will change too. Whatever happens, I find it difficult to imagine practicing law without some version of The International Lawyer on my bookshelf (whether virtual or real) and without waiting for the next edition to arrive, in whatever form it will take. Over the past several decades, I have grown to rely on its quality and constancy and thank all those contributors who have made the last fifty years of The International Lawyer possible. You certainly have enriched my professional life, and on behalf of all our Section’s members, I sincerely thank you for your contribution to the international legal profession.
A Tribute to *The International Lawyer*

Lisa J. Savitt*

It is a distinct honor to provide a few thoughts to the fiftieth year celebration issue of *The International Lawyer*.

I have been the proud recipient of *The International Lawyer* for over a decade and I watch for each issue with anticipation. I am a litigator, and I am amazed at the breadth of articles on dispute-related topics. However, *The International Lawyer* offers so much more that is of interest to its readers. It is a resource for practice specific topics, and a guiding light for issues relating to human rights and the rule of law.

The Section of International Law has been a proud partner with the faculty and students of SMU Dedman School of Law. SMU’s devotion year after year to producing a high quality resource for the international legal community is truly phenomenal and the appreciation of the ABA Section of International Law knows no bounds. The professional caliber of the staff is unparalleled. Thank you also to the many Section members who have edited *The International Lawyer* over the years.

*The International Lawyer* will face challenges going forward as readers move to digital resources. Knowing how vital international law issues will continue to be in the coming years, I am sure that *The International Lawyer* will remain a relevant and indispensable resource for practitioners.

Thank you and congratulations on the fiftieth anniversary!

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* Partner, The Axelrod Firm, P.C., Immediate Past Chair of the ABA Section of International Law.

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A Tribute to The International Lawyer

ROGER S. CLARK*

It is a delight to contribute a few words to this celebratory issue of The International Lawyer, marking the fiftieth year of its life. For about two decades of that time, I have been proud to be a member of its External Advisory Board. I am particularly appreciative of the sterling labor that the faculty and students of SMU Dedman School of Law have devoted to its production during that time, in collaboration with the ABA Section of International Law. As the most widely-circulated journal in the world on international law, it is important that the journal maintain the highest standards of professionalism. This it has done.

I cannot claim to have read every issue from cover to cover. But I can claim to have dipped into its pages since the very first volume appeared in 1966-67. In the fall of 1967 I came from my native New Zealand to New York to engage in graduate study at Columbia Law School. I remember browsing Volume 1 of The International Lawyer in the Columbia Law Library. That first volume set the basic format for what has always been an eclectic collection of material on what might broadly be categorized as public and private international law and on comparative law. At the same time, that first issue captured many of the burning issues of the day, and some historical ones as well (such as an account of Louis XVI’s lawyers). There were, for example, articles on the (then new) Convention on the Settlement of Investment Disputes between States and Nationals of Other States, the Foreign Claims Commission and the Cuban Claims Program, the early drafting of what became the Principles of International Law Concerning Friendly Relations and Cooperation Among States, a series of items on the recognition of Mexican divorces in selected countries (including one by an Assistant Professor at Rutgers Law School named Ruth B. Ginsburg on Sweden and other Nordic Countries, and another by my Columbia Professor John Hazard on their recognition in the Soviet Union), as well as a thoughtful article on Post-Stalin Soviet Jurisprudence by Gray L. Dorsey and some thoughts on the re-emerging discussions on the law of the sea. There was a note on the recently-concluded Covenants on Human Rights. There was a book review by the Editor-in-Chief, Clifford J. Hynning, of the three-volume collective work edited by Richard Falk and Saul Mendlovitz entitled The Strategy of World Order, a review that could

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charitably be described as nasty.1 Thurman Arnold waxed eloquent about the Law among Nations and explained the Vietnam War as an endeavor to enforce international law, not a position I found sympathy with. To the contrary I thought the war both immoral and illegal.

But it was the human rights discussions in the volume that most captured my imagination. This was one of my main areas of interest in coming to the United States. The previous year, a colleague at Victoria University of Wellington and I had done a program on New Zealand radio about the International Court of Justice’s controversial decision in the South West Africa Cases. (That colleague, later known as Sir Kenneth Keith, recently completed a nine-year term as a Judge at the International Court.) The unfortunate result in denying jurisdiction in that case cast a pall over the reputation of the Court that took some years to dispel. I noted that Volume 1 contained both a symposium on the case which took place at the Annual Meeting of the ABA Section of International and Comparative Law (as it was then known) in August 1966, and vigorous comments in subsequent pages from counsel for both sides. Coming from a country where relations with South Africa and lack of sympathy with apartheid were an important issue in domestic politics, I was disconcerted to realize that the overall editorial approach to the topic seemed rather more sympathetic to South Africa’s position than I expected.

South Africa was not all there was of controversy on the human rights front. The question of obtaining the Senate’s advice and consent to the Supplementary Convention of 1956 on the Abolition of Slavery, the Slave Trade, and Institutions and Practices Similar to Slavery; the ILO Convention of 1957 Concerning the Abolition of Forced Labour; and the Convention of 1953 on the Political Rights of Women were matters of hot debate within the ABA and the Senate.2 I was totally bemused to read in Volume 1 the Report of the ABA’s “Standing Committee on Peace and Law through the United Nations,” chaired by Eberhard P. Deutsch, on these treaties. “Aha,” I thought, “a Committee devoted to United States ratification of human right treaties.” Wrong call!3 The punch line in the Resolution accompanying the Report said it all:

BE IT FURTHER RESOLVED that the Supplementary Slavery Convention, the Convention on the Abolition of Forced Labor and the Convention on the Political Rights of Women, now pending in the Senate of the United States for advice and consent to accession or

1. I must confess that I always enjoyed reading the book reviews and even contributed an occasional one, but that feature was discontinued a few years back.


3. Someone with a sense of irony must have chosen the title of the Committee. I confess I was reminded at the time of the title of the South African legislation that established the Pass Laws in all their infamous glory. It was called the “Natives Abolition of Passes and Consolidation of Documents Act 1952.”

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ratification, being concerned with matters essentially within the domestic jurisdiction of the United States, except for the provision of the Supplementary Slavery Convention that “any slave who takes refuge on board and vessel of a State Party to this Convention should ipso facto be free” and the American Bar Association opposes advice and consent to accession and/or ratification of said treaties.

A strong dissent to the Report, by long-time United Nations supporter Bruno V. Bitker, argued forcefully for the constitutionality of ratifying these three treaties and made some gratuitous comments in favor of ratifying the Genocide, then also languishing in the Senate Foreign Relations Committee. Accompanying the Report were three other Statements made to the ABA supporting ratification, one by Edward D. Re, one by Richard N. Gardner, and a joint one by Benjamin Busch, Walter E. Craig, Donald K. Duvall, Harry A. Inman, Robert Layton, Leonard C. Meeker, Charles Norberg and John R. Stevenson.

Richard Gardner’s piece, The Three Human Rights Treaties: Good Law and Good Policy, was, I think, the first writing I had seen by him. He would become the chair of my doctoral committee at Columbia.

I have, of course, gone back and re-read Volume 1 in order to pen this tribute. The afterglow I still get from the editorial approach of the volume is one of somewhat strident anti-communism, indeed of American exceptionalism. It was a different time, a different ABA and a different-toned journal. However, while people like Hynning and Deutsch were strident in their own anti-internationalist way, the pages were open to other views, pro-UN and pro its human rights program, like those of Bruno Bitker, John Carey, Richard Gardner and Edward Re. Then, as now, the journal reflected considerable intellectual ferment in the bar organization.
The International Lawyer: A Truly Global Law Review

WERNER F. EBKE*

The International Lawyer – these three words stand for an outstanding, truly global law review. The International Lawyer is the official publication of the American Bar Association’s Section of International Law. Prior to 2013, it was a quarterly publication that included a special Year in Review issue, which is now a separate annual publication known as The Year in Review. The ABA published the inaugural issue of The International Lawyer in 1966. In 1986, Professor Joseph Jude Norton brought The International Lawyer to the campus of the Southern Methodist University School of Law in Dallas, Texas. Joe and I had worked out the presentation for the ABA International Law Section and made our case at an annual meeting of the ABA Section of International Law in Washington, D.C. Our growth-oriented, international concept, it seems, convinced the ABA International Law Section. SMU became the proud home of The International Lawyer and has been ever since. Joe became the Editor-in-Chief in the forming years and asked me to serve as Associate Editor, a great honor for me as a young SMU assistant law professor which I accepted with great pleasure.

Since then, The International Lawyer has grown to become the most widely distributed U.S. international law review in the world, enjoying subscriptions of approximately 22,000 readers in more than 90 countries. The global success of The International Lawyer is closely affiliated with the process of globalization, the functioning of which is aptly illustrated by the American author John Naisbitt in his book Megatrends (1982) and the scholarly foundations of which were laid down by the German immigrant and former professor at the Harvard Business School Theodore Levitt in his famous article The Globalization of Markets in the 1983 Harvard Business Review. Globalization has affected almost all aspects of the cross-border exchange of goods and services, capital transfers, current international payments, international activities of (“transnational”) corporations and, last but not least, the employment market and the market for public goods. As a result, national legislatures, supranational economic and political unions (e.g., European Union) or associations (e.g., NAFTA), and international

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organizations (e.g., UN, IMF, World Bank, WTO, GATT, GATS, OECD, IAO, FAO, UNEP) are in search of possible policy, institutional, and regulatory responses to the globalization of markets to overcome deficiencies of national legal systems and create a framework within which global trade and industry can prosper without losing too much control over the market participants and their activities. Needless to say, the increasing role of international economic law adds complexity to the comprehension, structuring, and solution of cross-border cases.

The International Lawyer provides necessary information and supports lawyers worldwide in their endeavor to cope with the challenges of globalization. The International Lawyer focuses on practical as well as theoretical issues of international law, including trade, licensing, direct investment, finance, taxation, litigation, and dispute resolution. Due to the broad range of topics covered and its excellent international reputation, The International Lawyer attracts the finest authors from around the world who view The International Lawyer as a global forum for the exchange of knowledge, ideas, and thoughts. Lawyers, economists, and decision-makers resort to The International Lawyer to find answers to their questions arising out of or in connection with international business transactions.

The professional editorial board of The International Lawyer, which is chaired by Editor-in-Chief Professor Marc I. Steinberg, Rupert and Lillian Radford Professor of Law at SMU Dedman School of Law, is supported by a student editorial board consisting of SMU law students who help produce the issues of The International Lawyer. Personally, I am particularly grateful to Janet P. Balch, a long-time Executive Editor of The International Lawyer, for her assistance during my tenure as Associate Editor of The International Lawyer.

I wish The International Lawyer another fifty successful years as the leading international law review. While the future may be uncertain, The International Lawyer will certainly not run out of interesting, challenging, future-oriented, and controversial topics and issues that need to be addressed and analyzed.
Treasuring What is Golden: *The International Lawyer* at Fifty

ROBERT E. LUTZ*

For fifty years *The International Lawyer* (“TIL”), the flagship publication of the American Bar Association’s Section of International Law (“SIL”), has served to keep its membership apprised of developments, trends, and academic analyses of international legal concerns. And it has served those purposes well. Starting from a newsletter format in 1966 to inform the Section’s members of Section activities and events, the journal grew to a full-content law journal, much in the image of academic law school reviews (and, incidentally, *The Business Lawyer* of the ABA Section of Business Law), but representing concerns of the practicing international lawyer. This focus is reflected best by much of its content over the fifty years, but most recently by the very successful annual publication of *The Year in Review* from 1997 to 2015 as one or more of the Journal’s four annual issues.

For Volumes 18, 19 and 20 (1984-1986), I had the pleasure of being the Editor-in-Chief of *The International Lawyer*. During my editorship, TIL marked its twentieth year of publication and celebrated it in true fashion—by publishing a “Happy Twentieth Anniversary” issue of 450 pages. During that phase, a typical issue contained a rich mix of practical articles for practitioners and some coverage and analysis of major current legal developments, symposia on relevant legal subjects, major reports on international subjects usually authored by ABA Committees, case notes and comments, selected topical or general bibliographies, and book reviews.

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1. Now unofficially the circulation of the each issue of *The International Lawyer* is approximately 24,000 readers, the number of ABA SIL members.


3. *The Year in Review* is an annual compilation of reports and analyses by the 50+ substantive law Section Committees about major legal developments of the past year in the Committee’s field of law.

4. During much of my editorship (from Vol. 18, No. 4 to Vol. 20, No. 4), I also had the good fortune to be assisted by my good friend, Dan Magraw, as Associate Editor, and by a small number of dedicated and very able Southwestern Law student research assistants.

5. 20 INT’L LAW. No. 1 (Spring 1986). My editorship was responsible for 3 volumes (12 issues) of TIL, amounting to 4055 printed pages.

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The purpose, noted in my first issue,\(^6\) was to provide the U.S. international legal practitioner with up-to-date information and analyses which would benefit his/her area of international practice. It was my feeling at the time—and it became my mission as Editor-in-Chief—to generate, aggressively solicit, and carefully prepare, edit and publish materials that would be useful and interesting to the international legal practitioner. The emphasis was (and still should be) on benefitting the practitioner, both private and public lawyers, but did not foreclose the inclusion of academic analyses as well.\(^7\)

After a decade respite from the TIL editorship, I was asked by the Section leadership in 1996 to figure out how to create and publish an International Law Section “Year in Review.” In the year that followed, I developed a Section structure, created a journal format, and edited the first edition of *The International Lawyer*’s Year in Review (“YIR”), which was published as Volume 31, Issue 2. Even though efforts in the past were made by the journal to publish reports of current international legal developments affecting U.S. international lawyers, analyses of such issues were not regular and lacked a broad scope. I calculated that such a publication could generate SIL Committee activity,\(^8\) energize the membership and create a documented annual history of international law developments having impacts on U.S. international law practice. For almost twenty years (1997 to 2015), the annual publication took place as an issue or more of TIL, and I can report all of those objectives were met and more. The YIR became a Section institution and an additional member benefit, today deserving of separate publication by the Section.\(^9\)

Now, *The International Lawyer* faces the future, perhaps even another half century. One must reflect on how the information and digital revolutions impact the form and substance of future law journals. Since the mid-

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\(^7\) Articles about Public International Law subjects were regularly published by noted academic authors, even though the journal primarily focused on articles that would benefit the practicing international lawyer.

\(^8\) In creating the project, I relied on the Section’s committee structure of about 50 substantive law committees to prepare reports of developments in the substantive legal area during the past year according to a formulated outline. The response was impressive, with almost all committees responding. The first issue was 500 pages, with additional analyses by committees in the regional and country law division being published in a later issue. See Robert E. Lutz, *Editor’s Preface and Introduction*, 31 Int’l. Law. 231-34 (1997).

\(^9\) One cannot write about TIL’s fifty years without acknowledging with much gratitude the contributions of the educational institutions that supported the solicitation and editorial work of many academics who served as editors of the journal and/or the YIR. Southwestern Law School, University of Colorado at Boulder, SMU Law School and John Marshall Law School standout in this regard. And the following Editors-in-Chief and Associate Editors deserve special recognition: Joseph Norton, Werner Elke, Peter Winship, Marc Steinberg, John Attanasio, Dan Magraw, this author and, of course, Co-Executive Editors at SMU, Patricia Heard and Beverly Caro Duréus.
nineteenth century, law journals have evolved from being reporters written and edited by local bars and academics from the first law schools to serving educational functions of law schools by being student-edited and produced.¹⁰ In more recent years, specialty law journals have appeared from law schools and the practicing bar, some of which appear exclusively online, though many are still published in hardcopy.¹¹ The methods of communicating legal developments, opinions, and analyses in this technological era to some extent have been taken over by other forms such as blogs, online discussion forums, self-publication, open access services, commercial specialty reporters, bar magazines and more.¹² In this myriad of publication possibilities and taking into account the dramatic impacts of technology and globalization on the international legal profession,¹³ The International Lawyer still occupies an important role—to provide practitioners of transnational public and private law regular publication of important analyses and reports affecting them. But the publication must also adapt to the changing nature of law journal usage in the profession. How do courts, practitioners, academics, students, inter-disciplinarians use law journals? The fast-moving communication world and increasing complexities of transnational and international legal practice provide many, but not insurmountable, challenges. To fashion a new role and continue TIL as the flagship publication of SIL will require continued enlightened leadership from the Section of International Law and from the editors (student and faculty) that have served their functions so well in the past.

HAPPY GOLDEN ANNIVERSARY INTERNATIONAL LAWYER—may you continue to serve our membership and be a major representative of the United States’ transnational and international legal profession in the fifty years ahead!


The International Lawyer Turns Fifty

JOHN E. NOYES

It has been my privilege to serve on the External Advisory Board of *The International Lawyer* for the past twenty years, occasionally reviewing articles being considered for publication, contributing to the Year in Review survey, and acting as a sounding board. Before being named to the Advisory Board, I came to know *The International Lawyer* as a reader, as Chair of the Publications Committee of the ABA Section of International Law, and as a member of the Section's Council. I congratulate the editors of the journal — among them Marc Steinberg, who currently serves as Editor-in-Chief — for producing consistently excellent issues over the years. Both the SMU Dedman School of Law, home to *The International Lawyer* for most of the past fifty years, and the ABA Section of International Law deserve thanks for supporting the journal.

As we mark the 50th anniversary of *The International Lawyer*, let me highlight four of its notable features. First is the high quality of its articles and comments about specific substantive issues. These articles have appeared either as parts of symposia — on topics as varied as NAFTA (Vol. 27, Issue 3 (1993)), terrorism’s burdens on globalization (Vol. 36, Issue 1 (2002)), and international company and securities law (Vol. 37, Issue 1 (2003)) — or as stand-alone pieces. Some decades-old articles published in *The International Lawyer* still provide insightful introductions to complex areas of international law (e.g., Jonathan Charney, “The Marine Environment and the 1982 United Nations Convention on the Law of the Sea” (Vol. 28, pg. 879 (1994)). Scores of other international law journals of course also publish articles about substantive issues, and virtually all of those articles can now be searched in electronic databases. But *The International Lawyer*’s focus on succinct, expert analyses of subjects useful for the practitioner helps this journal stand apart.

Second are occasional articles that “step back” from particular substantive topics and reflect on the nature of international legal practice or international professional responsibility. I note as examples M.W. Janis, “The Lawyer’s Responsibility for Foreign Law and Foreign Lawyers” (Vol. 16, pg. 695 (1982)), and John Gergacz, “In-House Counsel and Corporate Communications” (Vol. 45, pg. 817 (2011)). Such pieces are valuable both for practicing international lawyers and for law students eager to learn about the dimensions of a career in international law, and I have used them in some of my classes. Other perspective pieces examine issues that, although

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not directly related to the day-to-day concerns of practicing attorneys, provide insights into the art form, values, and systems that comprise or influence the enterprise of international lawyering. Examples include F.S. Ruddy, “International Law and the Enlightenment: Vattel and the 18th Century” (Vol. 3, pg. 839 (1968)), Bernhard Grossfeld & Jack Hiller, “Music and Law” (Vol. 42, pg. 1147 (2008)), and symposia on the rule of law (Vol. 43, Issue 1 (2008)) and legal scholarship (Vol. 46, Issue 2 (2012)).

A third notable feature of The International Lawyer has been the attention paid, in many issues of the journal, to policy initiatives of the Section of International Law. Beginning with Volume 1, Issue 3, the journal published many Section recommendations and reports to the ABA House of Delegates. Although The International Lawyer no longer routinely reproduces these recommendations and reports – the most recent to appear concerned proposed amendments to the Foreign Sovereign Immunities Act (Vol. 36, pg. 1261 (2002)) – I found their publication useful, as a way to bring to a wide audience the Section’s efforts to promote the rule of law and to further the progressive development of international law.1

Fourth, the journal has long published overviews of recent developments in international law. Volume 1, Issue 1 provided updates on activities at the United Nations, decisions of international tribunals, and international law decisions in U.S. courts. The journal soon included occasional surveys of developments in substantive fields of international and comparative law. In the days before the internet, these overviews helped the practitioner keep abreast of new trends. Although the contributions of the ABA Section of International Law on this front were not unique; the expert summary analyses of regulatory, legislative, judicial, and arbitral developments in The International Lawyer provided a great service to the profession. In the early 1980s, a valuable set of commentaries on the Restatement (Third) of the Foreign Relations Law of the United States also introduced and critically evaluated that influential work (see Vol. 22, Issue 1 (1988); Vol. 23, Issues 1 and 3 (1989); Vol. 24, Issues 1, 2, and 4 (1990); Vol. 25, Issue 2 (1991); Vol. 26, Issue 1 (1992)).

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2. For example, from 1977 to 1995, the American Branch of the International Law Association also published regular updates of international law developments in the International Practitioner’s Notebook (IPN). (Since 1996, the ILSA Journal of International and Comparative Law has published an IPN issue devoted to papers presented at the American Branch’s annual International Law Weekend, which the ABA Section of International Law cosponsors.)

Since use of web searches and electronic databases has become commonplace, some of the reasons for *The International Lawyer* to summarize international law developments have changed. The internet facilitates searches for information when the user knows a key word, and international practitioners arrange for web searches on topics of interest. But internet searches of key words do not introduce new topics that may – sometimes in unexpected ways – relate to matters of concern. Since 1996, *The International Lawyer*’s Year in Review survey has helped busy lawyers and academics learn about new developments related to their specialties, as well as about areas they do not follow closely. No other print or electronic source regularly surveys the vast array of international legal developments. The mammoth undertaking of writing, editing, and compiling this annual survey, now published separately as *The Year in Review*, has provided a uniquely valuable service to the profession.

I wish *The International Lawyer* many more decades of success and service.
The Eurozone Debt Crisis and the European Banking Union: “Hard Choices,” “Intolerable Dilemmas,” and the Question of Sovereignty

EMILIOS AVGOULEAS* AND DOUGLAS W. ARNER**

I. Introduction***

The 2008 global financial crisis spread to most of the developed economies, including those of the European Union. Unfortunately, despite decades of effort to build a Single Financial Market, almost all EU jurisdictions lacked proper crisis resolution mechanisms, especially with respect to the cross-border dimensions of a global crisis.1 This led to a threat of widespread bank failures in EU countries and near collapse of their financial systems. Today, in the wake of the Eurozone financial crisis and the recent Brexit vote, the EU is at a critical crossroads. It has to decide whether the road to recovery runs through closer integration of financial policies to follow recent centralization of bank supervision and resolution in the European Banking Union (EBU) or whether to take the path of fragmentation with a gradual return to controlled forms of protectionism in the pursuit of narrow national interest, although the latter is bound to endanger the single market. Therefore, the policy dilemmas facing the EU and contemporary institution building within the Eurozone provide a key window into the future of both global and regional financial integration.

The complexity of the financial integration process and its significance means that it is impossible to understand contemporary developments within the EU leading up to the EBU without a discussion of the different forms of financial integration initially presented in Emilios Avgouleas & Douglas Arner, The Broken Glass of European Integration: Origins and Remedies of the Eurozone Crisis and Implications for Global Markets, in INTERNATIONAL ECONOMIC LAW AFTER THE GLOBAL CRISIS: A TALE OF FRAGMENTED DISCIPLINES 72-106 (C. L. Lim & Bryan Mercurio eds., 2015) and Emilios Avgouleas & Douglas Arner, Ch. 10 Regional financial arrangements: lessons from the Eurozone crisis for East Asia, in GLOBAL SHOCK, RISKS, AND ASIAN FINANCIAL REFORM 377 (Iwan J. Aziz & Song Shin eds., 2014). Though those earlier publications covered different ground we draw here on some (limited) text and references from this published work. The authors gratefully acknowledge the financial support provided by the Hong Kong Research Grants Council Project: Enhancing Hong Kong’s Future as a Leading International Financial Center.


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*** This article builds on the authors’ earlier framework of analysis on modalities and risks of financial integration initially presented in Emilios Avgouleas & Douglas Arner, The Broken Glass of European Integration: Origins and Remedies of the Eurozone Crisis and Implications for Global Markets, in INTERNATIONAL ECONOMIC LAW AFTER THE GLOBAL CRISIS: A TALE OF FRAGMENTED DISCIPLINES 72-106 (C. L. Lim & Bryan Mercurio eds., 2015) and Emilios Avgouleas & Douglas Arner, Ch. 10 Regional financial arrangements: lessons from the Eurozone crisis for East Asia, in GLOBAL SHOCK, RISKS, AND ASIAN FINANCIAL REFORM 377 (Iwan J. Aziz & Song Shin eds., 2014). Though those earlier publications covered different ground we draw here on some (limited) text and references from this published work. The authors gratefully acknowledge the financial support provided by the Hong Kong Research Grants Council Project: Enhancing Hong Kong’s Future as a Leading International Financial Center.

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integration and the history of financial integration in Europe. It is important to draw a distinction between economic, monetary, and political forms of integration before looking at the specific properties of EU financial integration. Economic integration normally refers to integration of national commercial and economic policies and elimination of trade barriers and obstacles to foreign direct investment (FDI). Monetary integration refers to formal currency alignments and interest rate cooperation between states supported through a variety of institutional mechanisms. It could take a stronger or a weaker form, depending on the nature of arrangements. The stronger form refers to an unequivocal decision between more than one jurisdiction to share a common currency and a single monetary and foreign exchange policy, as a result of a bilateral or multilateral agreement between interested states. It entails the establishment of a common central bank and shared responsibility for joint monetary policymaking. The weaker form of monetary integration essentially refers to exchange rate alignments, like the Bretton Woods system of fixed exchange rates, or even adoption of another country’s currency policy by means of currency board arrangements. In terms of sovereignty concessions the stronger form means abolition of the

2. For Röpke the free and reciprocal flow of trade between the various national economics is what defines economic integration. See Wilhelm Röpke, International Order and Economic Integration 72 (Gwen E. Trinks et al. trans. 1959) available at https://mises.org/system/tdf/International%20Order%20and%20Economic%20Integration.pdf?file=1&type=1 document. Wilhelm Röpke was a “proponent of the Austrian School.” Shawn Ritenour, Biography of Wilhelm Röpke (1899-1966): Humane Economist, MISES INST. (Aug. 1, 2007), https://mises.org/library/biography-wilhelm-r%C3%B6pke-1899-1966-humane-economist. Thus, he was suspicious of other forms of integration such as political integration and attendant consolidation of political power. Id. He was one of the first economists to highlight “the connection between culture and economic systems,” and, uncharacteristically for an “Austrian,” he “explored the ethical foundations of a market-based social order.” Id. His ideas had significant influence over West German post-war economic development. See id.

3. “Monetary arrangements that supplement trad[e] relationships have existed for centuries.” Ellen E. Meade, Monetary Integration, HARVARD INT’L REV. (Mar. 21, 2009), http://hir.harvard.edu/rethinking-financemonetary-integration/. In the Eastern Roman Empire, “for example, the solidus coin—a money whose metallic content was stable—circulated widely” for more than seven hundred years. Id. Its predecessor, the denarius, was undermined by emperor Diocletian’s (284 – 305 AD) debasing of the metal content of the coin to cover the penury of the Roman treasury at the time due to continuous defensive wars. See Martin A. Armstrong, Diocletian – 284-305 AD, ARMSTRONG ECON., https://www.armstrongeconomics.com/research/monetary-history-of-the-world/roman-empire/chronology_-_by_-_emperor/tetrarchy/diocletian-284-305-ad/ (last visited Oct. 24, 2016). “This type of monetary arrangement was not a true monetary union but rather a common-currency-standard area, because each country’s monetary policy was separately rooted in a commodity—such as gold or silver—and the union did not establish a common monetary authority or currency.” Meade, supra note 3. Thus, they can hardly compare with the EMU. See id.


national currency and of member states' ability to set interest rates. Yet weaker forms like currency boards also entail—in exchange of currency and economic credibility—loss of sovereignty over exchange rate setting and inflation targeting since the currency board country essentially imports the low or high inflation policies of the country of the reference currency.

On the other hand, financial sector integration refers to the elimination of restrictions to cross-border capital flows that may involve transactions concerning loans, debt, and equity securities, and of barriers to cross-border market access and operation by financial intermediaries. It could extend to rights of establishment for foreign firms. The market for a given set of financial instruments and/or services is fully integrated if all potential market participants with the same relevant characteristics deal with a single set of rules, when they transact in financial instruments and/or provide financial services within a certain geographic area or region. Moreover, firms and consumers must have non-discriminatory access to such financial instruments and/or services. Regulatory oversight arrangements within integrated markets are non-discriminatory. Finally, political integration is equally important. It involves the voluntary sharing/pooling of sovereignty, whether in commercial and financial affairs, trade-policy cooperation/coordination, or in relation to justice and national security. Thus, given the sovereignty concessions, integrated markets require a lack of political integration that can hinder the flow of benefits emanating from monetary and financial integration.

A central idea of this article is that the design of institutions underpinning international financial integration has to be a step-by-step process. In the EU market integration took several decades, starting with the European Coal and Steel Community and the European Economic Community (EEC) and from there to the EU and ultimately to the European Economic and Monetary Union (EMU) and the introduction of the single currency.
A key lesson EU financial integration offers is that problems inevitably arise when a supra-national market exhibits a high degree of integration but the development of cross-border regulatory mechanisms lags significantly behind. This was the case in the Eurozone before the advent of the European Banking Union (EBU). Namely, the end-point of any financial integration process is the establishment of common institutions to deal with financial sector supervision and crisis management. This, in turn, means the pooling of sovereignty. The United Kingdom’s decisions, first not to join the euro and second to exit the EU, reflect the likely unwillingness of nations to relinquish sovereignty to the extent necessary to achieve a fully integrated financial system.

This article is in five parts. Following the present introduction, Part II provides an analytical overview of economic and institutional developments relating to the EU single market for financial services in the pre-crisis period. Part III discusses the evolution of the EU Single Financial Market and the causes of the Eurozone crisis. Part IV reviews the main tenets of the European Banking Union and considers how this new set of EU institutions will affect EU economic and political integration, particularly in light of Brexit. It offers a critique of the process so far and discusses remaining gaps. Part V concludes with a discussion of potential implications of EU experiences for the future of international financial integration.

II. Building Blocks of the EU Single Financial Market

The EU constitutes the most advanced global laboratory for regional economic, legal, and political integration. At the same time, the advent of a banking crisis and a sovereign debt crisis—the two normally have a causal relationship—provides a key ground to test again the fundamentals of financial integration in the dual context of cost-benefit analysis and institution building. The establishment of pan-European banks has, of course, been the most potent integrative factor, in an environment marked, at least in the earlier stages, by absence of regulatory cohesion. At the same time, it was inevitable that the concurrent presence of pan-European banks and of incoherent regulatory structures would lead to financial instability across the single market and especially across the single currency area in the event of serious market turbulence.

A. Challenges of European Financial Integration

The establishment of a single currency area (the Eurozone) and the pan-European presence of a number of large banks with large cross-border
operations lent urgency to questions about long-term protection of EU-wide financial stability in the absence of appropriate institutional arrangements.\textsuperscript{11} The so-called financial stability trilemma,\textsuperscript{12} which states that the three objectives of financial stability, financial integration, and national financial policies cannot be combined at the same time, has precisely described the acute policy tradeoff which holds that one of these objectives has to give in to safeguard the other two.\textsuperscript{13} In spite of assertions to the contrary,\textsuperscript{14} the Eurozone debt crisis has proven beyond doubt that a common currency area is not viable without building, at the same time, transnational supervisory structures in the fields of fiscal monitoring and responsibility and bank supervision and resolution. The loss of sovereignty essential in building a fully integrated economy can of course be intolerable and the recent Brexit plebiscite in the United Kingdom highlights the difficulty facing national polities to accept such loss of sovereignty in a multitude of fronts including the financial sector.

Arguably, an essential pre-requisite of financial market integration is imposition of a harmonized set of core rules, which gradually gravitate towards uniformity\textsuperscript{15} and are binding on all jurisdictions comprising the single market. The absence of such uniformity can, in theory, seriously hinder market integration as it can give rise to regulatory arbitrage and hidden protectionism. On the other hand, while protectionism harms efficient group approaches to capital allocation and risk management within

\textsuperscript{11} For example, in 2005, Schoenmaker and Oosterloo conducted a statistical study spanning a four-year period (2000-2003) on the potential emergence of pan-European banking groups. See generally Dirk Schoenmaker & Sander Oosterloo, \textit{Financial Supervision in an Integrating Europe: Measuring Cross-Border Externalities}, 8 INT’L FIN. 1 (2005), \url{http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.584.2073&rep=rep1&type=pdf}. To this effect, they gathered “[a] new data set on cross-border penetration (as a proxy for cross-border externalities) of thirty large EU banking groups.” \textit{Id.} They found a home country bias, but “the data indicate[d] that the number of groups that have the potential to pose significant cross-border externalities within the EU context” was not only substantial, but also increasing. \textit{Id.} Policymakers, therefore, had to “face the challenge of designing European structures for financial supervision and stability to deal effectively with these emerging European banking groups.” \textit{Id.} at 1-2.


\textsuperscript{13} See Schoenmaker, supra note 12, at 57. Compare Lasta and Louis who (perhaps more accurately) describe the same trade-off as an “‘inconsistent quartet’ of policy objectives: free trade, full capital mobility, pegged (or fixed) exchange rates, and independent national monetary policies.” Rosa M. Lastra & Jean-Victor Louis, \textit{European Economic and Monetary Union: History, Trends and Prospects}, 32 Y.B. OF EUR. L. 57, 143 (2013), \url{http://yel.oxfordjournals.org/content/32/1/57.full.pdf}.

\textsuperscript{14} See Tommaso Padoa-Schioppa, \textit{The Road to Monetary Union in Europe: The Emperor, the Kings, and the Genies} (2000).

\textsuperscript{15} See Jacques de Larosière, \textit{The High-Level Group on Financial Supervision in the EU} Report 27 (Feb. 25, 2009), available at \url{http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf}. Uniformity in this context only means the need to have coherence and compatible rules and regulations across jurisdictions. \textit{See id.}
cross-border banks, regulatory arbitrage may have the opposite effect. So, the key rationale behind maximum harmonization is not allocative efficiency in an integrated market but building trust between the players. Certainty that all players are being bound by the same detailed rules—even more so when application is uniform (by means of centralized supervision structures)—offers comfort to market competitors and supervisors that the risk of rule-gaming and racing to the bottom—that would essentially amount to free riding—becomes negligible.

There is no area where divergence of national rules and regulations is more important than cross-border bank failures. Thus, protection of financial stability in an integrated financial market characterized by cross-border financial institutions becomes a very challenging task, especially when there are incongruent policy measures between national preferences and regional integration requirements. While, at the later stages of single market development the EU has moved very close to maximum harmonization in the field of financial market regulation, the overall European regulatory edifice lacked strong uniformity/consistency both in terms of rule construction and rule enforcement in this area. In addition, there was a marked absence of institutions that could provide binding guidance, in the event of difference of opinion between national regulators, as regards the application and enforcement of financial regulation, or could resolve eventual conflicts of national regulatory actions.

B. EARLY STAGES OF EUROPEAN FINANCIAL INTEGRATION

Financial integration in Europe began much earlier than the late twentieth century, at least for the leading European markets. There is convincing evidence, which shows that by the mid-eighteenth century European equity markets were well integrated. This was, in general, a period characterized by a transition from autarky to integrated world capital markets, and, thus, for many it constitutes the first era of globalization. The term “financial integration,” however, was not used in this sense before the mid-1950s. German neoliberals during the 1950s advocated international integration through removal of trade barriers and the introduction of free convertibility. Machlup associated financial integration with capital mobility. Röpke stated that multilateral trade and free convertibility were only “a different expression” for international integration just as bilateralism.

16. See id.
17. See id. For the benefits of regulatory competition, refer to Roberta Romano. See, e.g., Roberta Romano, Yale L. Sch., https://www.law.yale.edu/roberta-romano (last visited Oct. 24, 2016).
and capital controls are another name for international disintegration of the economy. As this argument goes, the greater the degree of regional integration by means of multilateralism and currency convertibility, the larger the advantages of economic cooperation.20 Yet evidence of the existence of a direct causal relationship between financial integration and economic growth remains inconclusive,21 as any economic growth benefits deriving from financial integration depend upon a number of preconditions necessary to facilitate the integration process.22

When the six-state European Economic Community (EEC) was established, in 1957 (by the Treaty of Rome), furthering Member States' growth was the apparent but not sole objective of the founders. Political integration was a stronger long-term objective. Namely, building a single market was seen as an essential prerequisite to political integration and not a self-standing goal. The fact that political integration in the EU is still nowhere close to what was envisaged by the founding fathers can easily explain the lack of adequate institutions supervising the single financial market and securing financial stability. For example, one of the EU fundamental freedoms for building an internal market, the free movement of capital, became effective only after the signing of the Maastricht Treaty in 1992, a full thirty-five years after the Treaty of Rome, and then because it was essential in building a European monetary union and national restrictions in the free flow of capital could no longer be retained.

C. AN EVER CLOSER UNION?

1. The Political Economy of Market Integration in the EU

The European economic integration process and the establishment of the Euro as the common currency of (as of today) nineteen EU Member States has been incremental with periods of strong progress alternating with interludes of painfully slow growth. It has, also, been the product of political expediencies as much as economic efficiency rationales. Thus, it has witnessed major crises and setbacks.23


22. Such integration prerequisites include domestic institutional reforms, the maintenance of adequate and enforceable property rights, and adequate controls on money supply. See generally Economic Reform in China, supra note 20, at 121.

Continental European economies have shown in the post-war era a marked preference for exchange rate stability. When the first set of European arrangements aiming at exchange rate stability failed, following the collapse of the requisite Bretton Woods arrangements, and the post-war world entered the era of floating exchange rates, EEC members created the European Monetary System (EMS) in 1979, in order to manage and control currency fluctuations among EMS members. EMS was viewed as the first step towards permanent exchange rate alignment and paved the way towards the establishment of EMU. Eventually, EMU Member States irrevocably pegged the exchange rates of member country currencies, which were replaced by single European currency.

At this point, the establishment of the single currency was itself a matter of politics as much as economic necessity. Of course, through a currency union, EU members could answer the classic monetary trilemma, which is built on the Mundell-Fleming model of an open economy under capital mobility. The monetary trilemma famously states that a fixed exchange rate, capital mobility, and national monetary policy cannot be achieved at the same time; one policy objective has to give. Therefore, under capital mobility and national monetary policy, fixed exchange rates will invariably break down. But, as the euro-area has been very far from being an optimal currency area under the Mundell model and there was no fiscal integration or debt mutualization, it was only a matter of time before differences in the competitiveness of national economies gave rise to some serious strains. Arguably, the founders of the EMU just hoped that a single currency would pave the way for a fiscal and political union, something that has not yet happened. At the same time, the political element of the EMU, as well as a divergent economic and housing market cycle that had no realistic chance of converging with continental economies was central to the United Kingdom’s decision not to participate in EMU.

Nonetheless, the desire for a political union might not have been the whole story behind EU financial integration. From a political economy viewpoint, European financial and monetary integration was not just an inter-governmental goal, or merely dictated by the conditions of increasing market integration and capital mobility in the EU. The interests of professional intermediaries may have also been a strong force behind the

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push for further integration. For example, the Eurobond and the Eurocurrency interbank markets emerged as a result of national, legal, and regulatory impediments to capital flows. Given an excess supply of petrodollars in offshore markets, their scale began to rival national markets in banking and securities in the 1970s. This led to protracted negotiations in the early 1990s between industry representatives and regulators that brought offshore activity back into national markets, while subsuming the many disparate local practices. In fact, the early Eurobond market might have played the role of an imperfect substitute to financial integration, given that capital mobility was only a secondary EU goal until the 1990s. Conversely, the 1966 Ségre report was both very cognizant of the growth potential attached to financial integration and the potential for this objective to be confounded by commercial interests. In this way, the United Kingdom—as the leading center of the Eurobond and Eurocurrency markets—had a keen interest in participating in the process of financial market integration, while at the same time—from a political standpoint—maintaining its own economic and political sovereignty. This was a balance that has eventually proven impossible to hold.

2. EMU Membership Criteria and Realities

The path to monetary integration that was adopted by the Maastricht Treaty was based on a three-stage process and the fulfilment of convergence criteria. Only countries that met the appropriate criteria could gain Eurozone membership. The transitional framework under the treaty provided some flexibility in terms of the time required for the weaker candidate economies to converge with the strongest, especially as regards their macroeconomic outlooks and policies. But, such convergence proved in many cases no more than drawing board plans. The Maastricht Treaty’s convergence criteria included two basic conditions for euro membership: firstly, a 3 percent limit on general government annual deficit and a 6 percent limit on general government

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gross debt limit. It also included three other important criteria, which were inflation, long-term interest rates, and exchange rate fluctuations. Inflation was to be kept within 1.5 percent margin over that of any of the three EU countries having the lowest inflation rate. Long-term interest rates were to stay within a 2 percent margin over that of the three states with the lowest borrowing rates in the European Union.

As regards exchange-rate fluctuations, there was a requirement of participation for two years in the Exchange Rate Mechanism II (ERM II), which provided for a narrow band of exchange-rate fluctuations. The reality was, however, in glaring contrast with the spirit of the Treaty, due to political pressures and the actual condition of the European economies, which even in the 1990s were mildly to grossly indebted states with considerable budget deficits. The Treaty itself had exceptions to provide political leverage in extending membership to certain countries while restricting it to others. Italy, the third largest economy in continental Europe was running general government gross debt in 1998 at 114.9 percent of GDP (as against 60 percent required by the Treaty). Belgium’s gross government debt (home to the EU capital, Brussels) was at 117.4 percent of GDP, and formation of a euro block was implausible without having both of these countries in the Eurozone. This makes visible a huge difference in the conditions of the European economies upon joining the Eurozone. In practice, these differences meant a much lesser degree of economic integration than had been envisaged in the earlier Werner (1970) and Delors reports (1989) respectively. Moreover, the difference in the macroeconomic “initial conditions” of the founding Member States made it 

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32. Article 104c of the Maastricht Treaty stated that countries could exceed the 3 percent deficit target if “the ratio has declined substantially and continuously and reached a level that comes close to the reference value” or “excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value.” See Treaty on European Union, supra note 31, at 27. Provisions Amending the Treaty Establishing the European Economic Community with a View to Establishing the European Community, art. 104c(2)(a). Euro area countries could similarly exceed the 60 percent gross debt target provided that “the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.” See id. art. 104c(2)(b).

33. As a result of sluggish growth and loss of competitiveness due to inability to depreciate Italian national debt stands today at 142 percent, one of the highest in the developed world. National Debt of Italy, NATIONALDETCLOCKS.ORG, http://www.nationaldebtclocks.org/debt clock/Italy (last visited Dec. 1, 2016).

politically difficult to enforce the strict fiscal criteria laid down for EMU membership.


Completion of the legal and regulatory framework has always been regarded as an essential prerequisite in the EU financial integration process. The first step towards this direction was to develop a harmonized set of minimum regulatory standards based on consensus. This seemed more aligned with the overall objective of achieving a single market without having to endure excessive concessions on idiosyncratic national policy designs and preferences, which might make the harmonization process politically untenable. This was a process in which the United Kingdom was a very active, even leading, participant as well as beneficiary.

1. Harmonization Principles

The Delors Commission’s 1985 White Paper preceded the enactment of the first amendment to the Treaty of Rome in thirty years, the so-called “Single European Act.” The White Paper outlined the reforms required in the pre-existing EEC legal framework in order to build a truly single market in the EEC (as it then was) and pave the way to monetary integration. The White Paper noted at the same time that: “the legislation adopted by the Council and the European Parliament is either too detailed, or insufficiently adapted to local conditions and experience; often in stark contrast to the original proposals.” But, maximum harmonization proved impossible for many areas of activity in the single market and the European Commission adopted instead the principles of mutual recognition, minimum harmonization, and home country control—a system with minimal political integration but maximum market integration—the balance always preferred by the United Kingdom. The three principles were subsequently enshrined in harmonization legislation in a number of areas, including financial services. The internal market was to be based on minimum harmonization

35. This has been defined by one of the authors as the First EU financial services consensus. See Emelios E. Avgouleas, The New EU Financial Markets Legislation and the Emerging Regime for Capital Markets, 23 Y.B. of E.U.R. L. 321 (Apr. 2005).
of national regulatory systems and mutual recognition through which Member States would recognize each other’s laws, regulations, and authorities. Use of minimum regional requirements was intended to limit competitive deregulation by state actors and regulatory arbitrage by commercial parties. It was also a reflection of how political collaboration can encourage adoption of sound market principles and practices.

The EU framework for financial services provided minimum standards for the establishment and operation of banks and other financial intermediaries, conduct of public offers on a national and pan-European basis, and extended to accounting, company law, and regulation of institutional investors, in the form of collective investments schemes. It also provided access to the single market unfettered by national borders or restrictions on activity, the so-called single passport facility. Essentially, the purpose of the passport facility was to allow intermediaries to deliver products or services into any part of the internal market and promote cross-border competition. As a result, the “passport directives” in financial services defined the kind of financial intermediary to which they applied, its activities and the market segment, the conditions for initial and continuing authorizations, the division of regulatory responsibility between the home (domicile) state and the host state, and aspects of the regulatory treatment of Non-EU Member States. Authorized financial intermediaries that came within the ambit of one of the “passport directives” could, on the basis of the home country license, offer banking and investment services on a cross-border basis without maintaining a permanent presence in the target market or through a foreign branch. The home state would generally be responsible for the licensing and supervision of financial intermediaries, for their foreign branches, and for the fitness and propriety of managers and major shareholders. The host state would be responsible for conduct within their jurisdiction or in the course of offering services cross-border to clients residing within their jurisdiction.

40. Id.
41. See Benn Steil et al., The European Equity Markets: The State of the Union and an Agenda for the Millennium (Benn Steil ed., Feb. 1, 1996).
44. EU financial services directives addressed issues relating to regulation of banks and banking markets, investment services firms, collective investment schemes, life and non-life insurance, and pension funds. See generally The Single Market and The Law of Banking (Ross Cranston ed., 2d ed. 1995); European Securities Markets: The Investment Services Directive and Beyond (Guido Ferrarini ed., 1998).
45. See The Single Market and The Law of Banking, supra note 44; European Securities Markets, supra note 44.
46. Id.
47. For a good discussion of the ambit of provisions for investment firms, see Niamh Moloney, EC Sec. Regulation 379–460 (2d ed. 2008).
The Maastricht Treaty, which established the European Union as a successor to the EEC, provided an impetus for states to implement key financial services directives and led to members other than Ireland and the United Kingdom adopting legislation that was often foreign to their traditional market practices. One important influence in the success of the harmonization mechanisms adopted at this stage of EU integration process was the role played by the rulings of the European Court of Justice (ECJ, now the Court of Justice of the European Union (CJEU)). Being part of the EU obligated its Member States to adopt and implement EU legislation, as national governments could be held liable in damages for failing to comply with EU-level decisions.48

2. The Gradual Shift To “Maximum” Harmonization

The “passport directives” clearly enhanced financial integration in the EU, although areas of marked divergence, such as retail financial services, remained prior to 2008 and continue to remain today.49 But minimum harmonization left the EU with an incomplete regulatory framework, because, in many cases, it merely augmented rather than replaced pre-existing national laws.50 Thus, the drive towards harmonization intensified in the early 2000s, following the introduction of the Euro and the publication of the Commission’s Financial Services Action Plan (FSAP) in 1999.51 Arguably, the most important integrative instrument of that era (which can be viewed as the second EU financial services consensus)52 was the Directive on Markets in Financial Instruments (MiFID), which established a detailed pan-European regime with respect to conditions of establishment and operation of financial markets and investment intermediaries and the conduct of cross-border financial activities.53


National implementation of MiFID from 2007 onwards represented the third stage of single market development.\(^{54}\)

To answer a number of challenges pertaining mostly to enactment and consistent implementation of financial services legislation, the EU adopted the so-called Lamfalussy process in 2001. It consisted of four levels that started with the adoption of the framework legislation (Level One) and more detailed implementing measures (Level Two). For the technical preparation of the implementing measures, the Commission was to be advised by the committees made up of representatives of national supervisory bodies from three sectors: banking, insurance and occupational pensions, and the securities markets. These committees were CEBS,\(^{55}\) CEIOPS,\(^{56}\) and CESR.\(^{57}\) The Level Three committees contributed to the consistent implementation of Community directives in the Member States, ensuring effective cooperation between the supervisory authorities and convergence of their practices (Level Three) and finally, the Commission was to enforce timely and correct transposition of EU legislation into national laws (Level Four).\(^{58}\)

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In the aftermath of the 2008 global financial crisis, the EU has introduced a number of pan-European bodies with regulatory and supervisory competence and developed a common rulebook. The new institutions that the EU has built since 2009 are discussed in the ensuing sections.

III. The Global Financial Crisis and the Eurozone Debt Crisis

As mentioned earlier, it was not until the 2008 crisis and in earnest after the outbreak of the Eurozone debt crisis in 2010 that the vexed issue of preservation of financial stability in an integrated market came to the forefront of EU policy-makers’ attention. Both crises have emphasized the need to revisit existing models of financial market integration with a view of enriching them with institutions and structures that underpin financial stability as well as economic growth. It should be noted here that the Maastricht Treaty (1992) did not include “financial stability” as a key objective of the ECB, although, article 127(5) of TFEU underscores “financial stability” as a classic central banking good. Thus, financial stability was not designed as one of the four basic tasks to be carried through the European System of Central Banks (article 127(2) of TFEU) and rather was clustered with prudential supervision under the “non-binding tasks” of the ECB. This is, of course, in marked contrast to all post-2009 EU financial services legislation, which has financial stability either as core or chief auxiliary objective.

A. BACKGROUND

Until the onset of the Global Financial Crisis (GFC) in 2008, the common passport facility was at the heart of the EU market integration effort. The EU legislative framework based on harmonized standards for financial markets sought equivalence among disparate national regulatory and legal systems, so that regional initiatives could recognize the idiosyncrasies of national legal and regulatory regimes. But a multi-level governance system involves far more complexity than a regime based on minimum harmonization can foresee. These mainly arise out of the conflicting and sometimes misunderstood national implementation and enforcement priorities and interpretation of harmonization legislation.

But where the EU moved faster to offer direct regulation and or maximum harmonization of national standards this move was not welcomed by the polities of several member states, due to so-called “democratic deficit,” giving rise to what was subsequently dubbed “Euroscepticism.” In


60. See STEIL ET AL., supra note 41, at 113.

61. This broadly meant that the EU Commission officials that produced the core of European regulations were not elected. In a way this was a rhetoric scheme, especially, from the viewpoint of democratic legitimacy formalities (though, perhaps, accurate, in terms of substance), since most EU legislation was co-produced with the Council which comprises

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fact, the European Union was viewed even prior to 2008 as “too intrusive” and “remote” an institution in need of a more coherent set of policies within existing treaties.62 As this view gathered pace across the EU but especially in the United Kingdom it eventually culminated the in “leave” outcome (so-called Brexit) of the British 2016 EU Referendum.

Political considerations also undermined the credibility of rule-based frameworks for coordination of national fiscal policies in the Eurozone.63 For example, the Stability and Growth Pact (SGP) was originally designed to safeguard sound public finances and to thwart individual Eurozone members from adopting fiscal policies leading to unsustainable debt levels by enforcing budgetary discipline. Nonetheless, France and Germany, faced with a breach of the 3 percent deficit limit in 2002-04, pushed through a watering down of the SGP rules by March 2005. Arguably, the Maastricht Treaty itself allowed sufficient flexibility to the interpretation and enforcement as to allow it to become part of the political bargaining process in the EU at the expense of objective economic criteria.64

In the first decade of its life, the EMU was premised on a weak institutional framework that was more suitable to a “fair weather currency,”65 rather than a monetary union with asymmetrical member economies, which were about to experience massive macro-economic shocks. During the period that the debt crisis was building up, the Eurozone was deeply marked by economic and financial imbalances and the Union itself lacked a central fiscal authority, which would have afforded it a credible mechanism to enforce budget discipline. In addition, trade imbalances due to accelerating competitiveness imbalances and lack of exchange rate flexibility meant that there were no realistic prospects for fiscal convergence.66 Yet, preserving, in the long-term, any currency union, including the EMU, requires a sufficient level of economic convergence, together with a properly functioning internal market, and an effective system for economic and budgetary policy surveillance and coordination. In addition, it seems unlikely that a strong form Monetary Union can survive without balanced trade flows and some
form of fiscal burden sharing. But the EMU—which presents neither of those two characteristics—has confounded expectations so far.

When the GFC broke out with force, European financial stability was hampered by a number of pre-existing problems that had simply been ignored for far too long. These included colossal pre-crisis public and private debt loads, a flawed macroeconomic framework, and absence of institutions capable of handling effectively a cross-border banking crisis. The incomplete institutional design was the true mark of an imbalanced and disjointed monetary union, which, as explained above, also lacked an effective fiscal convergence mechanism. Essentially, it was assumed that any macroeconomic or banking system stability shocks could be dealt with at the national level without requiring any transfers from the strongest to the weaker members of the Eurozone, based on the no bailout clause in the EMU Treaty. Consequently, the outbreak of the sovereign debt crisis in the Eurozone in 2010 meant that the EU had to enter into the most transformative phase of its history. This phase would, in the end, bind euro-area members closer together at the expense of further alienation of reluctant members of the club like the United Kingdom.

While the 2008 crisis intensified reform efforts to a great extent, the true catalyst for the emergence of pan-European supervisory and bank resolution structures has been the ensuing Eurozone debt crisis, which has shaken to its foundations the banking system of the Eurozone. The EU had to devise mechanisms, in the midst of crisis, firstly, to prevent an immediate meltdown of its banking sector and ensuing chain of sovereign bankruptcies and, secondly, to reform its flawed institutions, in order to prevent the Eurozone architecture from collapsing. Namely, Eurozone members had to build both a crisis-fighting capacity and support bailout funding mechanisms. This has led to the establishment of a European Financial Stability Facility (EFSF), superseded by the European Stability Mechanism (ESM). At the same time, serious steps have been taken to build a European Banking Union based on structures safeguarding centralization of bank supervision and uniform deposit insurance arrangements, as well as centralization of crisis-resolution.

B. Problems of Integration – Cross-border Banking

The premise of home-country control and the principle of minimum harmonization were bound, at some point, to undermine the stability of the EU banking system. The integration process had continued apace in an increasingly de-regulated market following the intensification of liberalization efforts in the last quarter of the twentieth century, but the regulatory standards and supervisory principles were not adjusted to new realities. The Eurozone crisis brought home with devastating force the potential risks of financial market integration reflecting the main findings of

the aforementioned financial stability trilemma. Financial integration had led financial institutions operating in the single market to develop very tight links of interconnectedness, allowing thus shocks appearing in one part of the market to be transmitted widely and quickly across all other parts. Examples of such rapid transmission of shocks included the failure of Icelandic banks, the botched rescue of Fortis bank,68 the threat of collapse of the financial systems of Ireland and Spain, and the possibility of a sovereign default (e.g., Greece), or of a chain of sovereign defaults. Each of those crises brought serious tremors to European markets and exposed their fragility and the dearth of policy options available to Eurozone decision-makers.

In contrast, in the United States, following the initial shock from the collapse of Lehman Brothers, the response to the crisis was rapid and came in the form of state purchases of distressed bank assets so-called Troubled Asset Relief Program (TARP), innovative intervention schemes by the Federal Reserve, and (complex) re-regulation of the financial sector. In the EU, however, the diversity of Member State economies and issues arising out of inherent contradictions between national policy priorities meant a much lower degree of responsiveness to the crisis. This became evident as soon as some of the EMU states, which experienced a more severe crisis than other members, had to adopt policies based on their own national needs and interests—which may not necessarily have been in conformity with single market policies. For example, lack of common deposit insurance in a well-integrated banking market at a time of cross-border crisis led to several conflicting policy choices and responses in an effort by the states to protect their own citizens.69

C. The Eurozone Debt Crisis

In Europe, the global banking and liquidity crisis soon transformed into a complex and multilayered regional crisis. As soon as a series of public bailouts took the issue of the continuing solvency of banks in the United Kingdom, United States, and Western Europe out of the limelight, the state of Irish and Spanish banks and the possibility of a Greek default brought the lurking woes of the Eurozone into sharp focus. Ireland and Greece triggered the second and more lethal wave of the crisis of confidence that hit most of Europe since 2010—although Italy and Spain might in the end prove much bigger threats to the Eurozone’s survival than Greece, Portugal and Ireland, which represent only a very small faction of Eurozone GDP.

The Eurozone crisis should be seen as a sequence of four interlocking crises resulting from imbalanced monetary integration. This sequence resulted in a competitiveness crisis that transformed into a marked loss of fiscal revenues and widening fiscal deficits which led to debt accumulations

68. BASEL COMMITTEE ON BANKING SUPERVISION, REPORT AND RECOMMENDATIONS OF THE CROSS-BORDER BANK RESOLUTION GROUP 10-12 (Mar. 2010).
69. Id.
(particularly in Greece, Italy, Portugal, and Spain) that were financed by the surpluses of the northern countries, reflecting, in turn, to massive payment imbalances within the Eurozone (in particular, Germany, the Netherlands, and Finland vis-à-vis the European South). As said surpluses had to be re-invested they led to accumulation of unsustainable levels of public or private debt or both. Essentially, surpluses found their way to the public and private debt markets of deficit countries (Greece, Italy) or to the banking systems of the Eurozone periphery (Ireland, Spain) and financed gigantic real estate bubbles in Ireland and Spain.\(^{70}\)

The Eurozone crisis has signaled a fundamental shift in the political dynamics underpinning the EU. While the exact remedies of the crisis: austerity, more integration, mutualization of Eurozone members’ debt and other measures remain the topic of heated discussion, one remedy is viewed as uncontroversial. Namely, it is quite beyond dispute that the Eurozone crisis would have been much less severe, if EU members could find a way to break up the link between bank debt and sovereign indebtedness, which, of course, created a vicious circle of ever more bank bailouts and ever-higher levels of national debt. The fact that many EU banks had invested in EU Member State bonds and were also adversely affected by the continuous recession ravaging the periphery of the Eurozone only made things worse. As mentioned above, the EMU, although it had interest rate setting competence through the ECB, had until recently been devoid of any binding mechanism to effectively enforce fiscal and banking stability. Both are areas of serious national interest where pooling of sovereignty was regarded, until recently, as intolerable. Moreover, since its establishment, the EMU lacked these crucial supporting institutions that could have helped it to restore financial stability during times of acute uncertainty and market volatility.\(^{71}\)

In the beginning it was thought that EMU Member States could break the vicious circle between bank bailouts and levels of sovereign indebtedness, by means of establishing a funding facility the ESM, which, subject to a strict conditionality, could be employed to directly recapitalize Eurozone banks. Fears of burden sharing between the richer and the weaker Eurozone members through the ESM, which enjoys the guarantee of all Eurozone members, and the need to tighten the framework for bank regulation, supervision, and resolution have meant that the countries in the core of the Eurozone have put a stop to direct (through the ESM) bank recapitalizations and just promoted the centralization of bank supervision and resolution functions in the EMU. Said centralization has given birth to a new set of bank authorization, supervision, and resolution arrangements, which together comprise the so-called European Banking Union. As the United Kingdom did not participate in the EMU and was not part of the Banking Union, its exit from the EU could provide further glue to Banking Union.

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\(^{71}\) Bergsten & Kirkegaard, supra note 63, at 2.
arrangements but for German opposition to any kind of burden sharing for cross-border bank failures, including its continuous opposition to a single deposit guarantee scheme for Europe (discussed in section III.C below).

IV. EU Financial Regulation Infrastructure in the post-2009 period: Phase I – From the Lamfalussy Process to the ESFS

A. The Larosiere Reforms

In November 2008, the Commission appointed a High Level Group (chaired by Jacques de Larosiere) to study the Lamfalussy framework in light of the GFC and the threats to cross-border banking and the internal market that the GFC uncovered, and to make recommendations for a new EU regulatory set up. The proposals advanced by the de Larosiere report were instrumental to subsequent developments. In order to implement the recommendations of the de Larosiere committee, the EU established (through a series of Regulations, normally referred to as the ESAs founding Regulations) an integrated European System of Financial Supervision (ESFS), which came into effect in December 2010. It comprises the European Systemic Risk Board (ESRB) and a decentralized network comprising existing national supervisors (who would continue to carry out day-to-day supervision) and three new European Supervisory Authorities (ESAs): the European Banking Authority (EBA), the European Insurance and Occupational Pension Authority (EIOPA), and the European Securities Markets Authority (ESMA), which respectively replaced the corresponding Lamfalussy Level Three Committees: CEBS, CEIOPS and CESR. Furthermore, colleges of supervisors were to be put in place for all major

74. The European Systemic Risk Board (ESRB) was established on December 16, 2010, in response to the ongoing financial crisis. Regulation No. 1092/2010 of the European Parliament and of the Council of 24 Nov. 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board, 2010 O.J. (L 331) 1. It has been tasked with the macro-prudential oversight of the financial system of the financial system within the EU in order to contribute to the prevention or mitigation of systemic risks to financial stability in the EU. See id.
75. The Committee of European Banking Supervisors (CEBS) as an independent advisory group on banking supervision in the EU was establish by the European Commission in 2004. Commission Decision of 5 Nov. 2003 establishing the Committee of European Banking Supervisors, 2004 O.J. (L 3) 28. On January 1, 2011, this committee was succeeded by the European Banking Authority (EBA), which took over all existing and ongoing tasks and responsibilities of the CEBS. See Regulation No. 1092/2010, supra note 74.
76. The Colleges of Supervisors are mechanisms for the exchange of information between home and host authorities and for the planning and performance of key supervisory tasks in a coordinated or joint manner, including all aspects of ongoing supervision. See generally Comm. of Eur. Banking Supervisors document on CEBS’ Guidelines for the Operational Functioning of
cross-border institutions because supervision of strategic decisions at the consolidated level requires a college of supervisors to understand the global effects and externalities of those decisions.77 Last but not least, a Joint Committee was formed by the European Supervisory Authorities to coordinate their actions on cross-sectoral rule-making and supervisory matters.78

ESAs work with the ESRB to ensure financial stability and to strengthen and enhance the EU supervisory framework. Apart from issuing guidance and recommendations to national supervisors,79 ESAs also seek to formulate a single EU rulebook and harmonize technical standards on the basis of powers conferred by the EU commission,80 which subsequently will be adopted by the European Commission to become formal/binding EU law.81 In order to safeguard consistent application of harmonized legislation, if the ESAs find a national supervisory authority failing to apply EU law, they have the power to investigate infractions, with the relevant Authority having the power to directly issue recommendations to national supervisors to remedy potential infractions, followed by a formal opinion from the Commission (if the recommendation is not acted upon). If the supervisor does not comply with the Commission’s formal opinion, the ESA may then take decisions directly binding on firms or market participants concerned to ensure that they comply with EU law.

In adverse situations, ESAs have wider-ranging powers.82 In a crisis, they will provide EU-wide coordination.83
may make decisions that are binding on national supervisors and on firms, and will mediate in certain situations where national supervisory authorities disagree. If necessary, they will be able to resolve disputes by making a decision that is binding on both of the parties to ensure compliance with EU law. They have a role in EU supervisory colleges to ensure that they function efficiently and that consistent approaches and practices are followed. ESAs conduct regular peer reviews of national supervisory authorities across the EU, and they can collect information from national supervisors to allow them to fulfill their role. This information is used for analyzing market developments, coordinating EU-wide stress tests, and for the macroprudential analysis undertaken by the ESRB. They also have the competence to consider consumer protection issues.

The ESFS did not remedy the “mismatch” between the geographic scope of European bank activities and the regulatory remit of the authorities supervising them. Therefore, even after the implementation of the de Larosiere reforms, cross-border supervision and bank resolution at the EU level remained decentralized and, in want of further clarification as to how ESAs would be able to control and manage their complicated tasks when parties involved, would include non-EU countries. And then, if any major European bank or financial institution failed, it would certainly have repercussions outside the EU, though no provision was made for formalized cooperation structures with third country regulators beyond those provided in the (informal) context of the G20 and the Financial Stability Board.

A binding mediation mechanism would be required, in any case, to deal with cross-border supervisory problems. Without such an effective and binding mechanism, some Member States might, in the future, try to limit the branching activities of any firm regulated only by a home supervisor, who is judged to have failed to meet the required standards of supervisory

84. Id. arts. 19-21, at 28, 29.
85. Id. arts. 27, 29, at 31.
86. Id. art. 30, at 32.
87. Id., art. 36, at 34.
90. E.g., Jamie Dimon has raised a very pertinent question with respect to the effectiveness of regulatory reforms: “has anyone bothered to study the cumulative effect of these regulatory and market fixes?” on June 7, 2011. Ben Bernanke, the Fed Chairman issued a statement, as reproduced by Barth, “the central bank doesn’t have the quantitative tools to study the net impact of all the regulatory and market changes over the last three years. . . It’s too complicated” to study the new regulations’ effect. Moreover, James Barth contends that not everyone is convinced of the new regulations in place (in case of the U.S., the Dodd-Frank Act) have solved the too-big-to-fail problem, yet the biggest banks have not been downsized despite the presence of a general consensus from various stake-holders. See James R. Barth and Apanard Prabha, Breaking (Banks) Up is Hard to Do: New Perspective on Too Big To Fail, MILKEN INST. (Dec. 3, 2012), http://fic.wharton.upenn.edu/fic/papers/12/12-16.pdf.
practice. Such fragmentation would represent a major step backwards for the single market.92

In some ways, this structure was a necessity of the United Kingdom’s refusal to participate in EMU and to countenance the necessary pooling of sovereignty to make it work in the aftermath of the crisis. Given London’s position as the predominant financial center within the EU, this was a major stumbling bloc.

B. PHASE II: FROM THE ESFS TO THE EUROPEAN BANKING UNION

The nature of the regulatory architecture itself may not be an important cause of a financial crisis. Yet, the institutional design can be very important for the prevention and resolution of a major financial crisis. A framework of systemic risk controls and robust micro-prudential regulations deals with prevention. Crisis management and resolution, on the other hand, require established supervisory and resolution structures, which, in an integrated market, must have a cross-border remit in order to override or subsume the principle of home country control.93 For a very long time and until the different pillars of the European Banking Union come into place, the regulatory structures of the EU have been characterized by three principles: decentralization, lack of coordination and segmentation. A careful look at the developmental phase of European institution-building reveals this has been a process of experimentation rather than design.94 The preceding analysis of the crisis and of the responses to it has shown that the inadequacies of the EU financial and institutional framework have played an important role in undermining the stability of the Eurozone financial sector during the crisis.

The EU Treaties did not establish clear institutional borders as a prerequisite for the efficient functioning of multilevel European governance. This flaw was most evident in the Eurozone sovereign debt crisis. European responses to this crisis highlighted the current role of and power balance among EU institutions and Member States where the Union continues only to react to, and very rarely foresees, urgent needs and international developments which call for a speedy reaction. “Who does what” in Europe has been occupying policy-makers for many years.95 A “competence catalogue” was included in the Lisbon Treaty, which has been in force since

December, 1, 2009. This distinguishes between EU and the Member State powers/competences on the basis of the principle of conferral and recognition. Essentially, for the first time in the EU’s history, it has been explicitly enshrined in the treaties that are not conferred upon the Union and, instead, remains with the Member States.

Since 2011, the EU as a whole has embarked on a number of initiatives to build an integrated surveillance framework with respect to (1) the implementation of fiscal policies under the Stability and Growth Pact to strengthen economic governance and to ensure budgetary discipline, and (2) the implementation of structural reforms. As a first step, Eurozone heads of state adopted the intergovernmental Euro Plus Pact, to strengthen the economic pillar of EMU and achieve a new quality of economic policy coordination, with the objective of improving competitiveness and thereby leading to a higher degree of convergence. As this remains outside the existing institutional framework, a constitutional amendment to the EMU will be required to implement it. In addition, the European Parliament and the Council adopted a “six-pack” set of legislative acts, aimed at strengthening the Eurozone’s economic governance by reduction of deficits through tighter control of national finances. The reforms represented the most comprehensive reinforcement of economic governance in the EU and the euro area since the launch of the EMU almost twenty years ago. This legislative package aims to employ concrete and decisive steps towards ensuring fiscal discipline in order to stabilize the EU economy and to avert new crisis in future.

But the most important development has been the implementation of the Banking Union. Also, the implementation of mandatory bail-ins aims at containing the impact of the banking crisis on the sovereign by making bailouts nearly impossible, a measure that has not inspired universal enthusiasm.

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Breaking up the vicious circle of bank debt piling up on sovereign debt is a matter of utmost importance for the survival of the Eurozone. EU members need to complete the adjustment of internal and external imbalances to repair financial sectors and to achieve sustainable public finances. The economic and financial crisis has exacerbated pressure on the public finances of EU Member States where twenty-three out of the twenty-seven Member States fall in the so-called “excessive deficit procedure” (EDP). EDP is a mechanism established by the EU Treaties obliging countries to keep their budget deficits below 3 percent of GDP and government debts below 60 percent of GDP. Accordingly, the Member States running any excess deficit must comply with the recommendations and deadlines as decided by the EU Council to correct their excessive deficit. Piling up debt in their effort to bail out Europe’s ailing banks only makes things worse. In addition, it raises the cost of borrowing for Eurozone members to unsustainable levels, necessitating continuous bailouts by wealthier members of the Eurozone in an effort to keep the EMU from breaking up. But such sovereign bailouts are not only very expensive; they are also highly unpopular with the citizens of lender countries.

The Liikanen report has proposed solutions to separate deposit-taking banking from riskier banking activities. But a comprehensive EU mandate on structural reform of the EU banking sector may take some time as the EU faces so many existential problems on numerous fronts.

Perhaps as important in stabilizing euro-markets, but impossible to be long-lived, has been ECB activism through its Quantitative Easing program and the still unused so-called Outright Monetary Transactions have stabilized market conditions in sovereign debt markets. Like the establishment and operation of the ESM, these measures just passed the test of legality under the TFEU Treaty and, arguably, the CJEU was very accommodative of the need to adopt practical measures to avert a Eurozone meltdown.

103. There is however, mounting criticism of the conditionality of deficit reduction by pursuing austerity measures and tighter control of national expenses, especially on the Member States facing financial stresses. See, e.g., Riccardo Bellofiore, “Two or Three Things I Know About Her”: Europe in the Global Crisis and Heterodox Economics, 37 CAMBRIDGE J. ECON. 497 (2013) (who perceives a way out of crisis requires not only monetary reforms and expansionary coordinated fiscal measures, but also a wholesale change of economic model built upon a new “engine” of demand and growth that requires monetary financing of “good” deficits).
106. Thomas Pringle v Gov’t of Ireland, Ireland and The Attorney General, Nov. 27, 2012, CJEU Case C-370/12.
Finally, irrespective of the progress already achieved on the policy side, the experience of the past eight years reflects that reversal of sentiment in financial markets and the widening of interest rate spreads can happen very rapidly if the implementation of radical measures falters or the measures do not seem radical enough to meet the requisite challenges. This is a very important qualification as the high levels of bank non-performing loans (NPLs) in the periphery of the Eurozone are a very important time-bomb, not only as regards the financial health of member states’ banks, but also vis-à-vis resolution of the looming debt overhang, supply of new loans, and negative impact on GDP growth. Arguably, the slow level of NPL resolution (e.g., Italy, Greece, Cyprus and Portugal) and of bank recapitalization (e.g., Deutsche Bank) raises questions about the wisdom of not using the ESM as a possible Eurozone bad bank of last resort.

V. The European Banking Union

The EBU has, in principle, three pillars: a unified supervision mechanism (the SSM), operated by the ECB, a single resolution mechanism with no fiscal backstops (the SRM), and a future pan-European deposit guarantee scheme (DGS).

A. The Single Supervisory Mechanism (SSM)

1. Overview

As mentioned earlier, the EU’s reliance on national supervisory structures for the single market proved to be flawed. The failure of the rudimentary crisis management coordination mechanisms that were in place, through the Lamfalussy level-three committees, lacked both the competence and the resources to cope with a cross-border banking crisis that endangered taxpayers’ money. Lack of appropriate coordination structures was most evident regarding bank recovery and resolution. Similarly, the complete absence of a centralized EU structure dealing with systemic risk monitoring was incomprehensible. The most important of those gaps in the Eurozone institutional edifice is about to be remedied through the establishment of the first and most significant pillar of the proposed European Banking Union, the SSM.


On September 12, 2012, the Commission proposed a single supervisory mechanism for Eurozone banks, run by the ECB, in order to strengthen the EMU. The SSM is the first step towards an integrated “banking union,” which includes further components such as a single rulebook, common deposit protection and single bank resolution mechanisms.

The desirable ambit of the ECB’s supervisory powers has been the subject of considerable debate. Several Member States have wanted the SSM to be restricted to “systemically important” banks. For example, there is a controversy about whether German savings and cooperative banks should come under the remit of the SSM, as these banks consider themselves as local regional banks with passive assets and low risk exposures, and hence, subject to different policy regime from commercial banks. But small or medium-sized banks can also endanger the stability of the EU financial system as well, e.g., the failures of banks like Northern Rock or the Spanish Caixas. Thus, a single supervisory mechanism is probably a more effective option. Furthermore, the existence of two supervisory mechanisms for banks, operating in the same market, would inevitably create conflicts of jurisdiction and competence (turf wars) undermining the banking union. Eventually, the ECB would focus its direct supervision only on those banks, which can generate significant prudential risks through their size or risk profile.

There is a legitimate concern that adding supervision—a politically charged task—to the ECB’s responsibilities may compromise its impartiality and independence. Therefore, the supervisory function needs to be kept discrete and independent from the rest of the ECB structures to preserve its institutional autonomy. This is a very important distinction because banking and monetary policy, though inter-linked, are not identical. But there are contrasting views with regards to the extent and form of separation between the two functions.110 This concern is less theoretical than it sounds and in many corners of the euro-area banking sector voices are raised about the deleterious effect that QE and very low interest rates have on bank profitability and overall financial health.111

2. The Scope of SSM Powers

Under the SSM Regulation of October 2013, the ECB is vested with the necessary investigatory and supervisory powers to perform its tasks and will carry out the following functions:

- Licensing/authorization of EMU based financial institutions (in cooperation with the National Competent Authorities (NCAs) (Arts 4 &14 of the SSM Regulation);

111. David Folkerts-Landau, The ECB must change course, DEUTSCHE BANK RESEARCH, June 8, 2016.
Monitoring compliance with capital, leverage and liquidity requirements (Arts 4 & 16 of the SSM Regulation);

Conducting supervision of financial conglomerates (Art. 4(1)(h) and Rec. 26);

Early intervention measures (Prompt Corrective Action) when a bank breaches or risks breaching regulatory capital requirements by requiring banks to take remedial action (Art. 4(1)(i) and Rec. 27).112

The ECB is directly responsible only for the authorization and supervision of “significant” institutions, a term that encompasses individual entities, significant groups, and holding companies. The SSM Regulation and the SSM Framework Regulation contain several criteria according to which credit institutions are classified as either significant or less significant. Accordingly, significance is assessed based on the following criteria: “(a) size; (b) importance for the economy of the Union or of any participating Member State; (c) significance of cross-border activities.”113 A credit institution, financial holding company, or mixed financial holding company shall not be considered less significant, unless justified by particular circumstances, if any of the following conditions are met:

(a) the total value of its assets exceeds EUR 30 billion;

(b) the ratio of its total assets over the GDP of the participating Member State of establishment exceeds 20 [percent], unless the total value of its assets is below EUR 5 billion;

(c) the total value of its assets exceeds €5 billion and the ratio of its cross-border assets/liabilities in more than one other participating Member State to its total assets/liabilities is above 20 [percent].

(d) it is one of the three most significant credit institutions established in a Member State;

(e) it is a recipient of direct assistance from the European Stability Mechanism.114

Following a notification by a national competent authority that it considers such an institution of significant relevance with regard to the domestic economy, the ECB makes a decision confirming such significance following a comprehensive assessment, including a balance-sheet assessment of that credit institution. Notwithstanding the fulfillment of the above criteria, the ECB may also, on its own initiative, consider an institution to be of significant relevance where it has established banking subsidiaries in more than one participating Member State and its cross-border assets or liabilities

113. Id. art. 6, at 75.
114. Id.
represent a significant part of its total assets or liabilities subject to the conditions laid down in the methodology.\textsuperscript{115}

Determination of whether or not a credit institution is significant is made on an on-going basis and the SSM conducts a regular review: all credit institutions authorized within the participating Member States are assessed to determine whether they fulfill the criteria for significance. If a group or a credit institution that is considered less significant meets any of the relevant criteria for the first time, it is declared significant and the NCA hands over responsibility for its direct supervision to the ECB. Conversely, a credit institution may no longer be significant, in which case, the supervisory responsibility for it returns to the relevant NCA(s). In both cases, the ECB and the NCA(s) involved carefully review and discuss the issue and, unless particular circumstances exist, plan and implement the transfer of supervisory responsibilities so as to allow for a continued and effective supervision.\textsuperscript{116}

The ECB has exclusive competence to grant and withdraw the authorization of any credit institution,\textsuperscript{117} acting as the home regulator for firms from the Eurozone who use the EU passport to carry out cross-border business or establish a branch in a non-Eurozone Member State,\textsuperscript{118} and to assess the acquisition of holdings in credit institutions in the euro area.\textsuperscript{119} The ECB’s Authorization Division carries out these tasks.\textsuperscript{120} Notwithstanding the ECB’s exclusive competence in carrying out these tasks the ECB acts jointly with the National Competent Authorities (NCAs).

Both the ECB and the NCAs of participating Member States, where an institution is established, have the right to propose the withdrawal of a banking license. NCAs can propose a withdrawal upon the request of the credit institution concerned or, in other cases, on its own initiative in accordance with national legislation.\textsuperscript{121} The ECB can initiate a withdrawal in cases set out in the relevant EU laws.\textsuperscript{122} Either way, the final decision rests with the ECB.\textsuperscript{123} The institution concerned has the right to be heard under Article 31 of the SSM Framework Regulation. The \textit{ECB Guide to Banking Supervision} provides that the ECB and the relevant NCAs consult on any proposals for the withdrawal of a license.\textsuperscript{124}

Critically, given the fact that such withdrawal, if not voluntary, will inevitably relate to a bank entering resolution due to failing to meet the

\begin{footnotesize}
115. Id.
116. Id. at 75, 77.
118. Id. at 74.
121. Id. art. 80, at 37.
122. Id. art. 82, at 38.
123. Id. arts. 81,83.
124. Id. at 29 n.121.
\end{footnotesize}
capital and liquidity thresholds provided in the CRD IV, these consultations, according to the ECB Guide, are also used to lawfully buy time, as they “are intended to ensure that, before a decision is taken, the relevant bodies (i.e. NCAs, national resolution authorities and the ECB) have sufficient time to analyze and comment on the proposal, raise potential objections and take the necessary steps and decisions to preserve the going concern or resolve the institution, if deemed appropriate.”

B. THE NEW EU RESOLUTION FRAMEWORK

By providing common mechanisms to resolve banks, the Eurozone has established, by means of Regulation (EU) No 806/2014 (SRM Regulation), a single resolution mechanism (SRM), which would govern the resolution of banks in the Eurozone and coordinate the application of resolution tools to banks. The resolution mechanism is aimed at safeguarding the continuity of essential banking operations, to protect depositors, client assets, and public funds, and to minimize risks to financial stability. This mechanism would be more efficient than a network of national resolution authorities particularly in the case of cross-border failures, given the need for speed and credibility in addressing the issues in the midst of a crisis. The core body within the SRM is the Single Resolution Board (SRB), which is the resolution authority within the Banking Union. Together, with the National Resolution Authorities (NRAs), it forms the SRM. The Single Resolution Board (SRB) has been operational as an independent European Union (EU) Agency since January 2015. The mission of the SRB is to ensure an orderly resolution of failing banks with minimum impact on the real economy and the public finances of the participating Member States of the Banking Union.

The decisions have to be taken in line with the principles of resolution as set out in the single resolution rulebook comprising the EU Bank Recovery and Resolution Directive (BRRD) and associated legislation. The main resolution tools, as detailed in the BRRD (Art. 37) are the following:

(1) the sale of business tool whereby the authorities would sell all or part of the failing bank to another bank, without the consent of shareholders (Art. 38-38 BRRD);

(2) the bridge bank tool, which consists of identifying the good assets or essential functions of the bank and separates them into a new bank (bridge bank) (Art. 40-41 BRRD). The bridge bank will later be sold to another entity, in order to preserve these essential banking functions or facilitate the continuous access to deposits. The old bank with the bad or non-essential functions would then be liquidated under normal insolvency proceedings;

125. Id.
(3) the asset separation tool, whereby the bad assets of the bank are put into an asset management vehicle (Arts 37(3), 42 BRRD). This tool relieves the balance sheet of a bank from bad or ‘toxic’ assets. In order to prevent this tool from being used solely as a state aid measure, the framework prescribes that it may be used only in conjunction with another tool (bridge bank, sale of business or write-down). This ensures that while the bank receives support, it also undergoes restructuring; and,

(4) the bail-in tool, whereby the bank would be recapitalized with shareholders wiped out or diluted, and creditors would have their claims reduced or converted to shares (Section 5 BRRD). Therefore, an institution for which a private buyer cannot be found, or which cannot split up without destroying franchise value and other intra-firm synergies, could thus continue to provide essential services without the need for a bail-out by public funds, and authorities would have time to reorganize it or wind down parts of its business in an orderly manner. To this end, banks would be required to have a minimum percentage of their total liabilities eligible for bail-in Art. 48 BRRD). If triggered, they would be written down in a pre-defined order in terms of seniority of claims in order for the institution to regain viability (Art. 46 BRRD). The choice of tools will depend on the specific circumstances of each case and build on options laid out in the resolution plan prepared for the bank.

A bank would become subject to resolution when: (a) the institution is failing or is likely to fail having breached objective capital and liquidity indicators, (b) having regard to timing and other relevant circumstances, there is no reasonable prospect that any alternative private sector measures, or supervisory action, including early intervention measures or the write-

127. Id. art. 37.
128. Id. art. 48.
129. Id. art. 46.
130. Id. art. 32.
131. "[A]n institution shall be deemed to be failing or likely to fail in one or more of the following circumstances: (a) the institution infringes or there are objective elements to support a determination that the institution will, in the near future, infringe the requirements for continuing authorisation in a way that would justify the withdrawal of the authorisation by the competent authority including but not limited to because the institution has incurred or is likely to incur losses that will deplete all or a significant amount of its own funds; (b) the assets of the institution are or there are objective elements to support a determination that the assets of the institution will, in the near future, be less than its liabilities; (c) the institution is or there are objective elements to support a determination that the institution will, in the near future, be unable to pay its debts or other liabilities as they fall due; (d) extraordinary public financial support is required except when, in order to remedy a serious disturbance in the economy of a Member State and preserve financial stability, the extraordinary public financial support takes any of the following forms: (i) a State guarantee to bank liquidity facilities provided by central banks according to the central banks’ conditions; (ii) a State guarantee of newly issued liabilities; or (iii) an injection of own funds or purchase of capital instruments at prices and on terms that do not confer an advantage upon the institution." Id.
down or conversion of relevant capital instruments would prevent the failure of the institution within a reasonable timeframe, (c) a resolution action is necessary in the public interest and to achieve the resolution objectives of financial stability, protection of public money and depositors’ money and continuous provision of critical services. As explained above, it is deemed that entry into resolution will always occur at a point close to insolvency.

C. THE NEW DEPOSIT GUARANTEE SCHEME

The European Union started the process of harmonization of DGSs in 1994 with the EU Directive on Deposit Guarantee Schemes. According to the Commission, the minimum harmonization approach of the 1994 Directive resulted in significant differences among DGSs as to the level of coverage, the scope of covered depositors, and products and the payout delay. Prior to Autumn 2008, when the financial crisis hit, the mechanics of the financing of schemes was left entirely to Member States. This turned out to be disruptive for financial stability and the proper functioning of the internal market. The DGS Directive was significantly amended following the failure of Lehman Brothers, and in 2010, the Commission proposed a comprehensive reform of DGS in the European Union. The harmonization process was primarily guided by the principle of creating a level playing field with a focus on coverage limits and preference for ex ante funding. It was rightly thought that without common rules and consistent protection for consumers, the single market for deposits cannot operate effectively. The Eurozone banking and sovereign debt crisis subsequently became the catalyst, as countries which seemed to be in trouble—especially Greece, but also Italy and Spain—experienced a deposit drain. Accordingly, a pan-European deposit guarantee scheme implemented via a redrawn DGS directive was mooted as the third pillar of the European Banking Union. Yet, it has been the pillar that Member States have found the most difficult to agree on, as doing so would essentially lead to mutualization of bank debt in the Eurozone.

134. Directive 2009/14/EC of the European Parliament and of the Council of 11 Mar. 2009 amending Directive 94/19/EC as regards the coverage level and the payout delay, 2009 O.J. (L 68) 3. The Directive of March 2009 required Member States to increase coverage of their DGS—first, to at least 50,000, and then, to a uniform level of 100,000 by the end of 2010.
136. European Commission Memoranda, MEMO/12/656, Towards a Banking Union (Sept. 10, 2012). “This would be the first step towards a pan-EU deposit guarantee scheme.” Id.
The widespread consultation culminated in the 2014 EU DGS Directive, which had a very short implementation period up to July 2015. Proposals for a pan-European deposit insurance scheme were not adopted, but the Commission has pushed for them and German opposition continues. Thus, deposit protection continues to be provided by national DGSs, which extend coverage nationally to both financial institutions and their EU-based foreign branches. For example, under the 2015 Treasury Regulation, the United Kingdom’s Financial Services Compensation Scheme (FSCS) covers both United Kingdom regulated banks, building societies, and credit unions and their branches in other Member States.

Harmonization of coverage levels under the 2014 DGS Directive is limited to statutory DGSs. Outside the scope of the Directive are Member State protection schemes in Member States (e.g., on a voluntary or contractual basis) that offer additional deposit protection (except for some requirements on the information that needs to be given to depositors about the actual protection offered to them under the alternative scheme). The protection limit for deposits remains at €100,000 or its local currency equivalent. The Directive imposes a standard of a seven (working) day pay-out following a transition period, and has a generous implementation lead-time of nine years. Under the 2014 Directive, deposit protection is now extended to trade transactions, as it covers “temporary high balances.” For consumers, this means they will have some additional protection for exceptional and short-lived deposits resulting from major life events, like the sale of a home. The Directive extends DGS to all businesses and not just SMEs, as was previously the case.

The 2014 Directive imposes a minimum target funding level of 0.8 percent of covered deposits; Member States, however, can set a higher target level for their DGS. Currently, schemes in about half of Member States...
have already reached the above target level or are relatively close to it. In one-third of Member States, DGS funds are above 1 percent of covered deposits, and in a few of them, they are even beyond 2 percent or 3 percent. Nonetheless, the Directive stipulates that Member States, upon approval of the Commission, may set a target level lower than the above, but not lower than 0.5 percent of covered deposits.

In principle, the composition of funds available to the DGS should include cash, deposits, and low-risk assets, which can be liquidated within a short period of time. But, DGS funds may also consist of so-called "payment commitments." Payment commitments are commitments of a bank towards a DGS, which are fully collateralized, provided that the collateral consists of low risk assets, and the collateral is unencumbered by third party rights. The total share of payment commitments shall not exceed 30 percent of the total amount of available financial means of the DGS. In order to ensure consistent application of the Directive in Member States, the European Banking Authority will issue guidelines on the irrevocable payment commitments. Moreover, in order to fulfill their obligations of reaching the required target funding level, Member States may regard bank levies as equivalent to ex ante funds. The available financial means of DGS must be invested in a low-risk and sufficiently diversified manner.

Funding arrangements will also change under the new scheme. For example, levies on the industry to fund deposit protection will be "risk-based," meaning that firms’ liability to meet levies will no longer be based solely on their share of deposits, but will take account of the risk they pose to the deposit insurer. The risk-based approach has been adopted in order to counter moral hazard; namely, in order to provide banks incentives to operate "under a less risky business model." Risk will be measured on the basis of a mix of obligatory indicators developed by the European Banking Authority (75 percent weight) and other indicators developed by the DGS and the national authorities (25 percent weight). In addition, appropriateness of the percentage set, taking into account the failure of EU banks in the past.

Id. Rec. 23.


150. Id. art. 2(1), (12).

151. Id. art. 10(3).

152. Id. art. 2(1), (13), (14).

153. Id. art. 10(3).

154. Id. art. 10(1).


156. Id. rec. 36.

contributions will have a counter-cyclical element. This provision makes very good sense, as it adjusts bank contributions to the macroeconomic cycle and requisite fluctuations of bank profitability.

Finally, the 2014 Directive allows national DGSs to voluntarily borrow funds from each other in the event that they face a shortfall, provided that the total amount lent does not exceed 0.5 percent of covered deposits of the borrowing DGS. But the borrowing DGS must repay the loan within five years, and the contributions levied by the borrowing DGS must be sufficient to reimburse the amount borrowed and to reestablish the target level as soon as possible.

D. EVALUATION OF EU REGULATORY REFORMS

Centralization of bank supervision and resolution within a single currency zone is an essential condition for a functional monetary union, but it is no panacea. The continuing NPL crisis in the Eurozone periphery as well as concerns about the financial health of Deutsche Bank are a very strong argument in favor of this view. The EU crisis management and resolution framework does not contain a fiscal backstop, as the ESM was not, as originally envisaged, as it turned into a direct bank recapitalization tool. On the contrary, the job of breaking up of the doom loop has been entrusted to the creation of a minimum requirement of own funds and eligible liabilities to be bailed-in and the mandatory use of creditor bail-ins up to an 8 percent minimum of total liabilities and own funds to cover bank losses. At the heart of these loopholes is the Treaty prohibition of fiscal transfers in the Eurozone and fears that a fiscal union in the Eurozone will undermine fiscal discipline.

A number of coordination challenges remain within the SSM. The ECB, together with the Central Banks of the EU Member States (NCBs), comprises the European System of Central Banks (ESCB). Because of the dual roles the NCBs play, this configuration produces significant structural complexity. The NCBs, on the one hand, are national agencies that perform non-ESCB functions; and on the other, the NCBs constitute an important part of the ESCB helping to shape the conduct of EMU monetary policy. Moreover, this functional complexity is rooted deeper still in their
The reform of the EU integration mechanisms in the aftermath of the GFC and in the context of the Eurozone debt crisis marks an important milestone in the integration process and regionalism drive, especially because it has exposed the failure of various institutional mechanisms supposed to ensure financial market stability. The EU crisis response bears significant implications in the development and functioning of single market operations and has emphasized the need to improve international and regional coordination on fiscal, monetary and financial policies affecting other states.

Over a period of several decades, the progressive development of an integrated, single financial market in the EU, combined with a single currency among most of its members, led to the imbalances that became

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visible when the GFC erupted in 2008.\textsuperscript{165} Unfortunately, despite the vast amount of effort expended in developing both the EU single financial market and EMU, important design features necessary to support financial stability had not been put in place or were not sufficiently robust, particularly in relation to resolution of cross-border financial institutions, deposit guarantee arrangements, regulation and supervision and fiscal arrangements and affairs.

Arguably, the financial stability risks are magnified within integrated cross-border markets, especially contagion risks. Thus, it is not controversial, even though it does challenge orthodox thinking, to argue that financial integration is not always beneficial. Despite the increased importance of enhanced regionalism and integration, policy formulation must take a balanced view. The European crisis provides a deep insight to the risks of integration and identifies mistakes not to be repeated in the adoption of integration plans elsewhere, chiefly in the context of East Asia.

This balanced view of integration offers further perspectives. First, the soundness and credibility of domestic policies are not substitutes for regional commitments, even though, at times when domestic policies are “stuck,” regional commitments can help to “tie hands” and exert external pressure. Second, rather than imposition of strict benchmarks and milestones to meet the idiosyncrasies of individual economies, the integration framework should facilitate and encourage the growth of regional economies while allowing the market to work freely. Third, it does not matter how much integration or liberalization has been achieved in the region. What matters is that regional approaches and small steps of cooperation result in increased integration which can bring more growth, development and stability, while lowering associated contagion-driven risks.

Risks flowing from cross-border financial crises tend to intensify within integrated markets. The more integrated a regional market, the higher the propensity for cross-border contagion. The cascading effects of the ongoing Eurozone crisis are a vivid reminder of the contagion risk in a highly integrated system.\textsuperscript{166} The EU crisis is a powerful reassertion of the same reality that reflects on the vulnerability of economically integrated markets in times of crisis when national responses prove insufficient to deal with the common issues in an economically integrated area.

The Eurozone debt crisis has clearly exposed the weaknesses of regulatory structures divided along national lines when these have to deal with integrated cross-border financial markets. It has also highlighted the limited range of policy choices available from within the EU/EMU system as it existed prior to 2008. As a result, the EU faces a number of hard choices extending to the intractable trade-offs between national sovereignty and


collective financial stability. The establishment of a European banking union within the boundaries of the Eurozone, which includes a single supervisor, a single resolution authority and, in the future, a pan-European deposit guarantee scheme, have clearly tilted the balance towards further centralization and pooling of sovereignty. This development, however, highlights the level of sovereignty concessions that are necessary to support an effective single market, and even more so when the single market is underpinned by currency arrangements. In that case, a fiscal union to smooth out trade imbalances and to contain shocks in the financial sector seems inevitable.\footnote{AGNÈS BENASSY-QUÉRÉ ET AL., \textit{Which Fiscal Union for the Euro Area?} (Bruegel Policy Contribution ed., 2016), http://bruegel.org/2016/02/which-fiscal-union-for-the-euro-area/.} This level of sacrifice, though, is beyond the capacity of most national polities. This has been clearly demonstrated by Brexit, highlighting the very probable sui generis situation of Continental Western Europe in the process of full economic, monetary, and financial integration.

From the EU regulatory reforms discussed above, three initiatives stand out. First, centralization of supervision for Eurozone banks through the SSM means that the ECB is now the prudential supervisor of the Eurozone banking sector.\footnote{It should also be noted that the ECB had never had a 'treaty-based' mandate to act as shock-absorber in the Euro area sovereign debt markets. Absence of this mandate will continue to represent a missing link in the EU reform process. Emiliou Avgouleas & Douglas Arner, \textit{The Eurozone Debt Crisis and the European Banking Union} 45, n.140 (University of Edinburgh, Oct. 2013), http://www.research.ed.ac.uk/portal/en/publications/the-eurozone-debt-crisis-and-the-european-banking-union(26638640-17eb-4a02-99f6-dcecf125f49e).html.} Second, EU plans for the harmonization of Member State resolution laws and introduction of integrated resolution structures are in the process of implementation. Third, the development of common EU rulebooks for the single market by the European Supervisory Authorities is proceeding rapidly. Another area of particular importance is the adoption by the EU, through the European Banking Union and the common resolution framework, of measures, which aim at breaking the link between bank rescues and public money/indebtedness.

EU Member States have set up, in the course of the last sixty years, institutions in order to manage the challenges of a multi-faceted integration process and provide acceptable structures for political and democratic accountability. EU institutions have also been used by the Union in order to accumulate knowledge and expertise that may be useful in responding to new challenges. But we should be careful in arguing that the EU institution-building experience, or for that matter the EU integration process, given the specific characteristics of internal market, can be used as the only reform template, although they can indeed provide model lessons to the rest of the world.

In past decades, the importance of institutions dealing with financial markets has mostly been ignored, probably because economists thought of them as an unnecessary cost imposed on efficient and self-correcting markets. So, the EU experience is invaluable in supplying policy-makers...
with irrefutable evidence about the axiom that, although financial markets may be established anywhere (provided that certain property rights are recognized by local law), in the absence of restrictions on cross-border flows, their stability may only be guaranteed through appropriate institutions, and not by reliance on market forces’ rationality and coordination. Therefore, arrangements to safeguard the stability of the cross-border market cannot be delayed until formal integration efforts reach a peak, whether in the form of establishment of a single currency area, or otherwise.

The complexities involved in harmonizing common practices, standards and specifically the legal rules for such diverse economies, mean that European Banking Union-type institutions are not feasible in the foreseeable future. Yet, this does not mean that the leadership of those countries should not think about the challenges to financial stability created by increasing market integration and financial interconnectedness in the region. It only means that, for the time being, other less strong integrative measures, such as subsidiarization, are probably more suitable and effective in other contexts than the EU’s plans for centralization of cross-border bank supervision and resolution. In addition, while establishment of a single regulator with power to intervene and discipline banks is probably not feasible in other regions, building a macro-supervisory umbrella is essential. In such a case, the function of macro-prudential oversight ought to be discharged by an independent body in order to secure credibility and authority, even if it is a soft law body.

Arguably, in an increasingly globalized world, formal international cooperation in the field of financial stability and cross-border bank supervision and resolution, might in the long run come to be seen as a necessary ingredient of national prosperity in an environment where national financial markets are closely integrated. This would especially be the case if on-going national and regional reforms prove to be less successful than expected. Building multilevel financial governance in a region as economically and politically integrated as the EU is infinitely less complicated than a similar attempt at the global scale. The same might apply to replication of EU plans in other regions. Of course, these may in the end serve more as challenges to be overcome rather than insurmountable stumbling blocks. Either way, policy-makers should not assume that they have ample time to deliberate before another major crisis breaks out. They should urgently start with the business of augmenting global and regional financial stability mechanisms in order to safeguard future economic prosperity.

169. For an example of such a model for the governance of global financial markets, see EMILIOS AVGOULEAS, GOVERNANCE OF GLOBAL FINANCIAL MARKETS: THE LAW, THE ECONOMICS, THE POLITICS, 213-58, 429-59 (Cambridge Univ. Press 2012).
The Hong Kong Basic Law and the Limits of Democratization Under “One Country Two Systems”

ALBERT H.Y. CHEN*

I. Introduction

My last contribution to this Journal, published in 1999, was about the first constitutional crisis experienced by the Hong Kong Special Administrative Region (HKSAR) after it was established in 1997.1 Since then, the drama of “One Country Two Systems” has continued to unfold. On July 1, 2003, there was a march of an estimated half-million people in Hong Kong against the proposed national security bill to implement Article 23 of the Hong Kong Basic Law. In fall 2014, an “Occupy Central” or “Umbrella” movement was launched to struggle for democratization in this Special Administrative Region (SAR) of the People’s Republic of China (PRC). The occupation of key business and government districts in Hong Kong continued for more than two months, during which Hong Kong was in the limelight of the global media. The participants in this movement claimed that their demands were no more than the realization of what was promised to the people of Hong Kong by the Basic Law, the “mini-constitution” of the HKSAR, enacted by the National People’s Congress of the PRC in 1990. What does the Basic Law actually say about Hong Kong’s democratization? How has Hong Kong’s political system evolved before and after the making of the Basic Law? In the aftermath of the Occupy movement, what are the prospects of democratization in the HKSAR? It is the purpose of this article to explore these questions.

II. The Development of Hong Kong’s Political System: From Colony to Special Administrative Region

The British colony of Hong Kong was created and subsequently expanded by three treaties between the Qing Empire in China and the British Empire

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in the nineteenth century.² The last of the three treaties provided for a ninety-nine-year lease by the Qing Dynasty to Britain of the “New Territories” (north of Kowloon Peninsula and Hong Kong Island, which were ceded to Britain by virtue of the first two treaties) in the midst of the foreign powers’ “scramble for concessions in China” in 1898.³ As the lease would expire in 1997, British Prime Minister Margaret Thatcher raised the question of Hong Kong’s post-1997 constitutional status before PRC leaders when she visited Beijing in 1982. In September 1984, following almost two years of arduous negotiations between the British and Chinese governments, the Sino-British Joint Declaration on the Question of Hong Kong was concluded, and it provided for the return of the Hong Kong colony to China on July 1, 1997.⁴

The PRC’s plan for the governance of Hong Kong after 1997 was based on the concept of “One Country Two Systems” (OCTS). The OCTS concept was developed by senior statesman Deng Xiaoping in the late 1970s, originally for the purpose of achieving peaceful reunification with Taiwan.⁵ In the early 1980s, the PRC decided to apply this concept to the recovery of the British colony of Hong Kong and the Portuguese colony of Macau. In the Sino-British Joint Declaration of 1984, the PRC made various undertakings with regard to how Hong Kong would be governed as a Special Administrative Region (SAR) of the PRC after 1997. The HKSAR would enjoy a high degree of autonomy, with “Hong Kong people ruling Hong Kong.”⁶ Hong Kong would be allowed to retain its existing social and economic systems. The existing laws of Hong Kong would remain basically unchanged; civil liberties, human rights and private property rights would continue to be respected and protected.

The Joint Declaration also provided that the PRC’s policies towards the HKSAR as stated in the Joint Declaration would be stipulated in a Basic Law of the HKSAR and would remain unchanged for fifty years. The National People’s Congress of the PRC enacted such a Basic Law in 1990.⁷ It came into force on July 1, 1997, when the colony finally achieved reunification with China and the HKSAR was formally established. The Basic Law is sometimes called Hong Kong’s “mini-constitution”: it is a constitutional

². On Hong Kong’s history, see G.B. ENDACOTT, A HISTORY OF HONG KONG (2d ed. 1964); STEVE TSANG, A MODERN HISTORY OF HONG KONG (2004); FRANK WELSH, A HISTORY OF HONG KONG (1993).
⁴. See generally STEVE TSANG, HONG KONG: AN APPOINTMENT WITH CHINA (1997).
⁶. Id.
instrument providing for what legal, political, economic and social systems
the HKSAR should practice under the framework of OCTS. 8

Although the British had transplanted to colonial Hong Kong its common
law and its tradition of the Rule of Law, the British style of parliamentary
democracy or the “Westminster-style” government was never exported to
the colony of Hong Kong, which was governed by Governors appointed
directly by London until 1997. 9 Before democratization began in the mid-
1980s, the political system of Hong Kong had been described as an
“administrative no-party state,” 10 a “bureaucratic polity,” 11 or a benign and
enlightened authoritarianism. 12 Power was concentrated in the hands of the
Governor (appointed directly by the British Crown) and senior expatriate
officials of the colonial government of Hong Kong, who were appointed by
the Governor. This formed the top tier of a civil service bureaucracy, which
at its lower levels, was recruited largely from the local Chinese populace.
The legislature—known as the Legislative Council—consisted of senior
government officials and “unofficial members” chosen and appointed by the
Governor from local British and Hong Kong Chinese business and
professional elites. 13 The system was described as “administrative absorption
of politics.” 14

After the Sino-British Joint Declaration was signed in 1984, the British
began efforts to introduce a “representative government” in Hong Kong. 15
Mainly, this was accomplished by introducing elected seats in the colonial
legislature—the Legislative Council. 16 The Joint Declaration had only
briefly provided for the political system of the future SAR, while the Basic
Law provides the details. One of the main areas of controversy during the
drafting of the Basic Law was the extent to which the political system of the
HKSAR should be democratic, given that the colonial political system at the
time the Joint Declaration was signed in 1984 was hardly democratic in that
neither the executive nor the legislature were elected by the people of Hong
Kong. 17 The Joint Declaration did contemplate some degree of

8. See The Basic Law and Hong Kong’s Future (Peter Wesley-Smith & Albert Chen
eds., 1988).
Univ. Press, 4th ed. 1986) (explaining the political system of colonial Hong Kong).
12. Lau Siu-kai & Kuan Hsin-chi, The Ethos of the Hong Kong Chinese 28
(Chinese Univ. Press, 1988).
13. See generally Kathleen Cheek-Milby, A Legislature Comes of Age: Hong Kong’s
Search for Influence and Identity (Oxford Univ. Press, 1995).
14. Ambrose Y.C. King, Administrative Absorption of Politics in Hong Kong: Emphasis on the
Grassroots Level, in Social Life and Development in Hong Kong 127, ch. 7 (A.Y.C. King
15. See generally Lo Shu-king, The Politics of Democratization in Hong Kong
(1997); Alvin Y. So, Hong Kong’s Embattled Democracy: A Societal Analysis (1999).
16. See generally Kathleen Cheek-Milby, A Legislature Comes of Age: Hong Kong’s
17. See generally The Basic Law and Hong Kong’s Future, supra note 8.
democratization of this colonial political system. On the mode of selection of the Chief Executive of the HKSAR, the person who would replace the colonial Governor as the head of the Hong Kong government, the Joint Declaration provided that the Chief Executive “shall be selected by election or through consultations held locally and be appointed by the Central People’s Government.” 18 And regarding the legislature, which was an entirely appointed body at the time of the Joint Declaration, the Joint Declaration provided that the HKSAR legislature “shall be constituted by elections,” but did not elaborate further on the precise mode of election.19 Furthermore, concerning the relationship between the executive and the legislature, the Joint Declaration provided that the executive “shall be accountable to the legislature.”20

The provisions of the Basic Law on the political system of the HKSAR may be summarized as follows. The Basic Law declares that the “ultimate aim”21 of the political evolution of the HKSAR is the election of both the Chief Executive (CE) and all members of the Legislative Council (LegCo) by universal suffrage.22 But it is also provided that such political evolution depends on “the actual situation in the [HKSAR]” and should be “in accordance with the principle of gradual and orderly progress.”23 The Basic Law provides for a progressive increase in the number of directly elected members (i.e. members elected by universal suffrage in geographical constituencies in different parts of Hong Kong, as distinguished from members elected by the “functional constituencies” discussed below) of LegCo from twenty (out of a total membership of sixty) in the first-term LegCo of the HKSAR to twenty-four in the second LegCo, and then to thirty in the third LegCo.24 With respect to the selection of the CE, it is provided that the first CE would be chosen by a Selection Committee of 400 members, and the second and third CEs would be elected by an Election Committee of 800 members, largely elected from four sectors of Hong Kong’s society.25 Then, the Central People’s Government would appoint the elected candidate as CE.26

19. Id.
20. Id.
21. XIANGGANG JIBEN FA (Hong Kong Basic Law) arts. 45, 68 (H.K.).
22. It is noteworthy in this regard that in the Basic Law of the Macao Special Administrative Region which is in most respects almost identical to the Hong Kong Basic Law, there is no mention whatsoever of the direction of political evolution or any eventual destination of universal suffrage for the election of the Chief Executive and all members of the legislature. This testifies to the relative strength of the democracy movement in Hong Kong in the 1980s.
23. XIANGGANG JIBEN FA arts. 45, 68 (H.K.).
24. See XIANGGANG JIBEN FA annex II (H.K.). In the first and second LegCos, ten and six members respectively were to be elected by an election committee. In the first, second and third LegCos, thirty members were to be elected by functional constituencies.
25. XIANGGANG JIBEN FA instrument 12 (H.K.).
26. Id.
Given the ultimate aim mentioned above of achieving universal suffrage, the question of when this would be achieved naturally arises. The Basic Law does not provide any timetable for the eventual realization of universal suffrage. But Annexes I and II to the Basic Law expressly provide that the methods for electing the CE and LegCo may change after 2007. They also expressly provide for the procedure for such constitutional change, which involves the support of a two-thirds majority in LegCo, the CE’s consent, and the approval of (in the case of a change in the electoral method for the CE) or “reporting for the record” to (in the case of a change in the electoral method for LegCo) the National People’s Congress Standing Committee (NPCSC).

The Basic Law, although enacted in 1990, would only come into full effect in 1997 upon the establishment of the HKSAR. In the “transition period” between 1984 (the year the Joint Declaration was signed) and 1997, the British colonial government continued to govern Hong Kong. It introduced a series of measures for Hong Kong’s democratization in preparation for the handover of Hong Kong to China in 1997. Some of these measures were contested by the PRC government, which argued that constitutional reforms in Hong Kong during the transition period must “converge” with the model of the HKSAR political system prescribed by the Basic Law. Beijing did not object to all of the political reforms introduced by the colonial government. In fact, some of the political institutions created by the colonial government during the transition period were recognized by and incorporated into the Basic Law itself. The most important of such institutions was that of “functional constituencies,” the origins of which will now be elaborated.

In 1985, the colonial government introduced its first major measure towards Hong Kong’s democratization by creating twenty-four elected seats in the LegCo. Electoral colleges comprising the District Boards, the Urban Council, and Regional Council, which were largely consultative bodies at local levels, elected twelve of these seats. The other twelve seats were elected by “functional constituencies” consisting of business and professional groupings, such as chambers of commerce, industrialists’ federations, trade unions and members of professions such as lawyers, doctors, engineers and teachers. The original logic of functional constituencies, as explained by the colonial government, was that they represented sectors of society from which appointed unofficial members of LegCo were formerly drawn, and in the course of democratization, it was appropriate that the corporate bodies or individual members of these sectors

27. See generally Albert H.Y. Chen, From Colony to Special Administrative Region: Hong Kong’s Constitutional Journey, The Future of the Law in Hong Kong 76-126 (Raymond Wacks ed. 1989).

would elect their own representatives into LegCo. These two modes of election of LegCo members—elections by electoral college and functional constituencies—were incorporated into the Basic Law when it was enacted in 1990. Thus, the first LegCo of the HKSAR would consist of twenty members elected by universal suffrage, thirty members elected by functional constituencies, and ten elected by an electoral college. The number of members elected by universal suffrage would increase to thirty in the third LegCo.

Functional constituencies also have a role to play in the election of the election committee for the Chief Executive of the HKSAR. As prescribed in Annex I to the Basic Law, the election committee would consist of persons from four sectors, with an equal number of members from each sector. The sectors are: (a) business (comprising mainly corporate voters in various commercial, financial, and industrial fields), (b) professional bodies, (c) labor and other social sectors, and (d) the political sector (including legislators, Hong Kong deputies to the NPC, and Hong Kong members of the Chinese People’s Political Consultative Conference). Thus, in the election committee of 800 members, there were 200 members from each of the four sectors. (Annex I to the Basic Law was subsequently amended in 2010, increasing the size of the election committee to 1,200 members, including 300 members from each of the four sectors.)

III. Political Developments in the HKSAR

In the first few years of the history of the HKSAR, elections by the election committee to the office of the Chief Executive and elections of the LegCo took place in accordance with the relevant provisions of the Basic Law, with LegCo members elected partly by universal suffrage and partly by functional constituencies. A major turning point in the post-1997 history of Hong Kong was the Hong Kong government’s attempt to enact a national security law for the purpose of the implementing Article 23 of the Basic Law, which requires the HKSAR to enact laws on treason, secession, sedition, subversion and protection of state secrets. The legislative exercise was aborted after a march of an estimated half-million people in opposition to the bill for the proposed law on July 1, 2003. The bill was supported by the “pro-China” camp (also known as the “pro-establishment” camp) in Hong Kong politics but opposed by the “pro-democracy” camp (also known

29. See generally Functional Constituencies: A Unique Feature of the Hong Kong Legislative Council (Christine Loh & Civic Exchange eds., 2006).
30. The political reform of 2010 is discussed below.
31. This section and the following section draw on Albert H.Y. Chen, Development of Representative Government, in Law of the Hong Kong Constitution (Johannes Chan & C.L. Lim eds., 2d ed. 2015).
as the “pan-democrats”), which led the social movement against the bill. With their prestige bolstered by their success in opposing the national security bill, the pro-democracy camp launched a movement to demand the speedy democratization of the HKSAR. Pro-democracy politicians found in the Basic Law a powerful source of legitimacy for their demands. As mentioned above, the provisions of the Basic Law itself allows change to the existing system for the election of the third-term CE in 2007 and the fourth-term LegCo in 2008. Thus, the pan-democrats’ slogan was “double universal suffrage”: the introduction of universal suffrage for the election of the CE in 2007 and universal suffrage for the election of all legislators in 2008.

In early 2004, Beijing decided to respond to the democracy movement in Hong Kong. On April 6, 2004, the National People’s Congress Standing Committee (NPCSC) issued an Interpretation of the Basic Law. It elaborates upon Annexes I and II to the Basic Law by stipulating a procedure for initiating changes to the relevant electoral methods, dictating that the CE should first submit a report to the NPCSC on whether there is a need to introduce electoral reform, whereupon the NPCSC will decide the matter in accordance with Articles 45 and 68 of the Basic Law. After this interpretation was promulgated, Chief Executive Tung Chee Hwa submitted a relevant report to the NPCSC on April 15, 2004. Another session of the NPCSC was immediately convened to consider the report, and on April 26, the NPCSC promulgated its Decision on the matter. The Decision ruled out the introduction of universal suffrage for the CE and all legislators in

33. The basic cleavage in the politics of the HKSAR has been the division between the “pro-China” camp and the “pro-democracy” camp or “pan-democrats.” The pro-China camp supports the policies of the PRC government towards Hong Kong, including its cautious and gradualist approach to its democratization. The camp also supports one-party rule in mainland China and does not criticize its human rights record. The pan-democrats advocate western-style liberal democracy for Hong Kong, and is critical of authoritarian one-party rule in China and its human rights record.

34. See generally Ming Sing, Public Support for Democracy in Hong Kong, 12 Democratization 2, 244-261 (2005) (explaining the upsurge in public support for democracy in Hong Kong since the rally of July 1, 2003).

35. This was the second interpretation of the Basic Law issued by the NPCSC. For the first interpretation, see Hong Kong’s Constitutional Debate: Conflict over Interpretation (Johannes M.M. Chan et al. eds., 2000).

36. Id.


2007 and 2008 respectively, but permitted political reforms in 2007 and 2008 within certain parameters (e.g. the proportion of directly elected legislators to those elected by functional constituencies should remain unchanged).39

After the NPCSC Decision, the Hong Kong Government conducted public consultations on political reform for 2007–2008, leading to the publication of a reform proposal in October 2005.40 This was a major initiative on the part of Donald Tsang, who had succeeded Tung Chee Hwa following the latter’s resignation from the office of CE in spring 2005. The proposal involved the election of the CE in 2007 by an election committee of 1600 persons (which would include, inter alia, all members of the District Councils (formerly known as District Boards), and the expansion of LegCo in 2008 from sixty members to seventy members (including five new seats to be directly elected by universal suffrage and five new seats elected by District Councillors). Under Annexes I and II to the Basic Law, the adoption of the proposed reform would require the support of a two-thirds majority in LegCo. On December 21, 2005, the proposal was defeated by twenty-four “pan-democrats” in LegCo voting against it, mainly on the grounds that it was not democratic enough and that the Government had failed to provide a timetable for the introduction of universal suffrage.41

After the defeat of the political reform proposal in December 2005, discussion on political development continued to be carried out in the Committee on Governance and Political Development of the Commission on Strategic Development of the Hong Kong Government. Tsang established the Committee in late 2005, partly in response to criticisms that the Government was not able to provide any timetable for the introduction of universal suffrage.42 The deliberations in this Committee led to the publication of the Green Paper on Constitutional Development on July 11, 2007, which initiated a three-month consultation on the subject.43

On December 12, 2007, the Government published its Report on Public Consultation on the Green Paper on Constitutional Development.44 At the same time, Chief Executive Donald Tsang submitted his report to the NPCSC on “the Public Consultation on Constitutional Development and on whether

42. Id. at 542.
43. See generally Hong Kong, Green Paper on Constitutional Development (Hong Kong: Gov’t Logistics Dep’t 2007).
there is a need to amend the methods for selecting the Chief Executive of the HKSAR and for forming the Legislative Council of the HKSAR in 2012.

On December 29, 2007, the NPCSC enacted its Decision on Issues Relating to the Methods for Selecting the Chief Executive of the HKSAR and for Forming the Legislative Council of the HKSAR in the Year 2012 and on Issues Relating to Universal Suffrage.

According to this Decision, neither the CE nor all legislators may be elected by universal suffrage in 2012. But the electoral arrangements for the CE and LegCo in 2012 may be amended in accordance with the “principle of gradual and orderly progress,” provided that the ratio (50 percent to 50 percent) of legislators elected by universal suffrage to those elected by functional constituencies would remain unchanged.

The Decision also stated that the NPCSC was “of the view that . . . the election of the fifth CE of the HKSAR in the year 2017 may be implemented by the method of universal suffrage; that after the CE is selected by universal suffrage, the election of the LegCo of the HKSAR may be implemented by the method of electing all the members by universal suffrage.”

On the basis of the 2007 Decision of the NPCSC, Mr. Donald Tsang introduced the political reform exercise of 2009-2010, which was designed to revise the models for the election of the CE and LegCo in 2012. This exercise began with the publication in November 2009 of the Government’s Consultation Document on Methods for Selecting the Chief Executive and for Forming the Legislative Council in 2012, which put forward proposals for electoral reforms in 2012 largely similar to, but designed to be an improved version of, the reform proposals of 2005. After considering the views of the public, the Government on April 14, 2010, formally announced its Package of Proposals for the Methods for Selecting the Chief Executive and for Forming the Legislative Council in 2012—a constitutional


47. Id. at 11.

48. Id.

49. The document was published on November 18, 2009 and was available in both hard copy and electronically.
reform proposal (“the Reform Package”) that was basically the same as that proposed in the Consultation Document.

Since the publication of the Consultation Document, the pan-democrats had publicly stated their opposition to the Reform Package on the ground that it was not democratic enough. The scenario as of early June 2010 was that the motion for the Reform Package would be vetoed by the pan-democrats—a repetition of what happened in December 2005. To the surprise of most observers, the Government in the middle of June decided to grant a major concession to the pan-democrats by modifying the Reform Package substantially to adopt the Democratic Party’s counter-proposal regarding the five additional District Councils functional constituency seats in LegCo being elected by all voters in Hong Kong who did not already have the right to vote in any existing functional constituency.50 Although not all the pan-democrats in LegCo supported the modified Reform Package, the Government with the support of the Democratic Party secured the necessary two-thirds majority in LegCo for the modified Reform Package to be passed by LegCo on June 24-25, 2010.51

IV. The Struggle for “Genuine” Universal Suffrage in 2013-15

To the pan-democrats, the political reform of 2010 was only of limited significance since Hong Kong’s political system was still far away from achieving the goals of what they called “double universal suffrage”—the election of the CE and the election of all members of LegCo by universal suffrage. As the NPCSC, in its 2007 Decision, had set the target date for the implementation of universal suffrage for the election of the CE at the year 2017, a third exercise in political reform (following the first two exercises in 2005 and 2010 respectively) would need to be conducted in 2013-15 to work out the precise model for such election. Pro-democracy activists in Hong Kong started to prepare for this exercise in early 2013.

On January 16, 2013, associate professor Benny Tai of the law school of the University of Hong Kong published a newspaper article in which he put forward the idea of an “Occupy Central” campaign to pressure Beijing and the Hong Kong government to introduce a model for universal suffrage that is consistent with international standards of democratic elections.52 The idea was widely circulated on the Internet and received much media attention, snowballing into a real “Occupy Central” campaign supported by many civil

50. Approximately 200,000 persons had the right to vote in existing functional constituencies. According to the DP’s proposal, more than three million registered voters would be enfranchised with regard to the five newly created LegCo functional constituency seats, and all voters in Hong Kong would have two votes—one in a geographical constituency, and one in a functional constituency.


52. The article was in Chinese and entitled “The most powerful weapon of civil disobedience” and was published in the Chinese newspaper Hong Kong Economic Journal.
society groups and the pro-democracy politicians in Hong Kong. “Occupy
Central”53 in this context referred to demonstrators practicing civil
disobedience and occupying the Central District—the central business
district of Hong Kong—to paralyze it in case the government failed to come
up with a model for universal suffrage that complies with international
standards on free and fair elections.54

On October 17, 2013, Chief Executive C.Y. Leung announced the
establishment of a Task Force on Constitutional Development, which would
launch a public consultation exercise on the electoral reforms for the LegCo
and the CE to be elected in 2016 and 2017 respectively. The exercise
formally commenced on December 4, 2013, with the publication of the
Consultation Document on Let’s talk and achieve universal suffrage.55 During
the consultation period, many political parties and civil society groups,
including those which are “pro-China” and those which are “pro-
democracy,” put forward their proposed electoral models.56 On July 15,
2014, the government released its report on the outcomes of the
consultation exercise. On the same day, the Chief Executive submitted to
the NPCSC his Report on whether there is a need to amend the methods for
selecting the Chief Executive of the HKSAR in 2017 and for forming the
Legislative Council of the HKSAR on 2016, recommending the introduction of
universal suffrage for the election of the CE in 2017, and recommending no
constitutional change regarding the electoral arrangements for LegCo in
2016.57

On August 31, 2014, the NPCSC rendered its Decision on political
reform in the HKSAR.58 It accepted the CE’s recommendation that no
constitutional change regarding the election of the LegCo was called for in
2016. On the question of the election of the CE by universal suffrage, the
Decision stated that the CE of the HKSAR may be elected by universal
suffrage “starting from 2017.” As regards the “number of members,
composition and formation method” of the “broadly representative

54. See generally Alvin Y. Cheung, Road to Nowhere: Hong Kong’s Democratization and China’s
Obligations Under Public International Law, 40 BROOK. J. INT’L. L. 465, 494-98 (2014); Michael
C. Davis, The Basic Law, Universal Suffrage and Rule of Law in Hong Kong, 38 HASTINGS INT’L &
55. See Method for Selecting the Chief Executive by Universal Suffrage, available at
57. See Method for Selecting the Chief Executive, supra note 55.
nominating committee” that would nominate candidates for the CE in accordance with Article 45 of the Basic Law, the Decision stated that provisions “shall be made in accordance with the number of members, composition and formation method of the Election Committee for the Fourth Chief Executive.”

“The nominating committee shall nominate two to three candidates for the office of the Chief Executive in accordance with democratic procedures. Each candidate must have the endorsement of more than half of all the members of the nominating committee.” The Decision explained as follows:

Since the Chief Executive of the HKSAR shall be accountable to both the HKSAR and the Central People’s Government in accordance with the provisions of the Hong Kong Basic Law, the principle that the Chief Executive has to be a person who loves the country and loves Hong Kong must be upheld. This is a basic requirement of the policy of ‘one country, two systems.’ It is determined by the legal status as well as important functions and duties of the Chief Executive, and is called for by the actual need to maintain long-term prosperity and stability of Hong Kong and uphold the sovereignty, security and development interests of the country. The method for selecting the Chief Executive by universal suffrage must provide corresponding institutional safeguards for this purpose.

The Decision of the NPCSC was met by strong protests from pro-democracy forces in Hong Kong, which condemned the electoral model as “fake universal suffrage” because it was perceived that only pro-China political figures and no pan-democrats would be able to gain majority support from the nominating committee so as to become candidates in the election of the CE by universal suffrage. Students and other democracy activists launched the “Umbrella Movement” or “Occupy Central Movement” that started in late September and continued until mid-December 2014, resulting in the occupation by demonstrators of central business and government districts in Admiralty, Causeway Bay and Mongkok. After the occupation came to a peaceful end, the Government, on January 7, 2015, launched the “second round consultation” on political reform by publishing the consultation document entitled 2017 Seize the Opportunity: Method for Selecting the Chief Executive by Universal Suffrage Consultation Document, for the purpose of consulting the public on the concrete model for electing the CE in 2017, which was to be formulated on

59. See The Basic Law of the HKSAR of the People’s Republic of China, art. 45 (H.K.) (Article 45 refers to “the selection of the Chief Executive by universal suffrage upon nomination by a broadly representative nominating committee in accordance with democratic procedures”) (hereinafter “The Basic Law of the HKSAR”).
60. Id.
61. Id. (emphasis added).
62. See generally JASON Y. NG, UMBRELLAS IN BLOOM: HONG KONG’S OCCUPY MOVEMENT UNCOVERED (Hong Kong: Blacksmith Books, 2016).
the basis of the parameters set by the NPCSC Decision. The pan-democrats boycotted the consultation exercise, stating that they would reject any electoral model that conformed to the parameters set by the NPCSC Decision.

On April 22, 2015, the Government published a policy document entitled 2017 Make It Happen! Method for Selecting the Chief Executive by Universal Suffrage: Consultation Report and Proposals, proposing a concrete model for nominating candidates for and electing the CE in 2017. The proposed model was subsequently introduced in the Legislative Council and put to a vote on June 18, 2015. With twenty-eight (including twenty-seven “pan-democrats”) of the seventy members of the Council voting against the proposal, it failed to secure the requisite two-thirds majority for amendment of Annex I to the Basic Law. The veto meant that the existing system of the election of the Chief Executive by a 1200-member Election Committee would continue in force in the foreseeable future.

V. Concluding Reflections: Contradictions and tensions inherent in the project of “One Country, Two Systems”

Why did Beijing design the electoral model for the election of the CE of the HKSAR by universal suffrage that was stipulated in the August 2014 Decision of the NPCSC? Why did the Occupy Movement and the pan-democrats reject the model?

Beijing would like to ensure that the candidates for election by universal suffrage to the office of the CE are all acceptable, trustworthy and appointable from Beijing’s point of view, in the sense that they are not “confrontational” towards the Central Government or ideologically opposed.

64. Id.
65. Hong Kong Reform Package Rejected as pro-Beijing camp walk out in Miscommunication, SOUTH CHINA MORNING POST (Jun. 18, 2015), http://www.scmp.com/news/hong-kong/politics/article/1823398/hong-kong-political-reform-package-voted-down-legco-leaving. Actually the Government’s motion was rejected by a vote of eight (for the motion) to twenty-eight (against). Id. Less than one minute before the voting took place, thirty-one pro-Government legislators walked out of the chamber en masse, intending to precipitate an insufficient quorum so that the voting could delayed until one absent pro-Government legislator (Lau Wong-fat) could come back to vote with the others. Id. Due to failure in coordination and communication, nine pro-Government legislators did not join the walk-out, hence the quorum (half of the membership of LegCo) was still satisfied and the voting in the chamber was completed a few seconds after the walk-out. Id. In the state of confusion, one of the nine pro-Government legislators who stayed in the chamber failed to press the voting button in time, hence only eight votes in support of the Government’s motion were recorded. Id. Jasper Tsang, President of LegCo, followed the convention of the President not voting. Id.
to the “socialist political system” in mainland China. The system of nominations of candidates by a nominating committee as provided for in Article 45 of the Basic Law enables this objective to be achieved if the majority of the members of the nominating committee are “pro-China” or “patriots” and if the nominations the committee makes are “institutional nominations” expressing the majority will of members of the committee. Thus, the 2014 Decision of the NPCSC requires the size and composition of the nominating committee to closely follow that of the pre-existing election committee for the Chief Executive. The political reality since the handover in 1997 has been that with the four-sector composition of the Election Committee and its members being largely elected by functional constituencies in these sectors, the majority of the committee’s members were indeed “pro-China,” “pro-Establishment,” or “patriots,” and those who were pan-democrats or sympathetic to them only constituted a minority (slightly more than one-eighth) in the Election Committee.

On the other hand, the pan-democrats were firmly opposed to any “screening” to be performed by the nominating committee for the purpose of preventing persons (such as leading members of the pan-democrats) who have considerable public support among Hong Kong voters but are not “patriots” in Beijing’s eyes from becoming candidates for election by universal suffrage to the office of the Chief Executive. In their view, this would be “fake” universal suffrage and inconsistent with international standards of democracy and elections, which prohibit unreasonable restrictions on the right to be a candidate in an election (such as restrictions or discrimination based on a person’s political opinion). “Genuine” universal suffrage, in their view, requires a truly competitive election in which candidates with different platforms and political opinions (including opinions critical of Beijing and its policies towards Hong Kong or the mainland itself) may freely and fairly compete for votes. Given that the pan-democrats had always obtained a majority of the popular votes for LegCo

66. Qiao Xiaoyang, Chairman of the Law Committee of the NPC, in his speech in Shenzhen to “pro-Establishment” Hong Kong legislators on March 24, 2013, stressed that the CE of the HKSAR must be a patriot and could not be someone who was “confrontational” towards the Central Government in Beijing or sought to change the socialist political system in mainland China. See Joshua But & Colleen Lee, Opponents of Beijing Ineligible to be CE: Top Chinese Official (Mar. 24, 2013), http://www.scmp.com/article/1199015/opposition-camp-members-cant-run-chief-executive-says-npc-official.

67. The concept of “institutional nomination” (jigou timing) was first mentioned by Qiao Xiaoyang in his speech on March 24, 2013. Id.

68. See The Basic Law of the HKSAR, supra note 59. In the existing system for election of the CE by the Election Committee under Annex I to the Basic Law, a candidate may be nominated jointly by at least one-eighth of the members of the Election Committee, followed by election by members of the Election Committee. In the CE elections of 2007 and 2012, persons supporting or sympathetic to the pan-democrats won more than one-eighth of the seats in the elections to the Election Committee, and thus Alan Leong (of the Civic Party) and Albert Ho (of the Democratic Party) were nominated respectively as one of the two candidates in the 2007 election and one of the three candidates in the 2012 election.

69. See Cheung, supra note 54, at 494-98; Davis, supra note 54, at 289.
seats that were elected by universal suffrage (as distinguished from seats elected by functional constituencies), they believed that any nomination system for the election of the Chief Executive by universal suffrage which makes it impossible for their leaders to be nominated as candidates would not be genuine universal suffrage. Therefore, the pan-democrats and their supporters condemned the model for universal suffrage stipulated in the NPCSC Decision, vowed to boycott the government’s “second round” of consultation regarding more detailed arrangements for universal suffrage, and eventually vetoed the Government’s electoral proposal based on the model stipulated by the NPCSC.

The Decision of the NPCSC in August 2014 might be understood as the outcome of a cost-and-benefit analysis conducted by Beijing regarding the introduction of elections of the Chief Executive by universal suffrage in Hong Kong. The benefit would be the appearance of honoring the promise of universal suffrage made in the 2007 Decision of the NPCSC and in the Basic Law and to win the support of Hong Kong people who aspire towards democracy. Furthermore, some believed that the Hong Kong Government would become more effective if its CE was elected by universal suffrage and thus has a popular mandate and greater legitimacy to govern Hong Kong. On the other hand, an electoral model that was acceptable to the pan-democrats would be one in which the pan-democrats would have a reasonable chance of getting their leader(s) nominated by the nominating committee as candidate(s) in the CE election by universal suffrage. For Beijing, agreeing to such an electoral model means to accept that there is a chance that a pan-democrat would be the winner in the CE election by universal suffrage. Beijing would have assessed the likelihood of this scenario materializing, and considered how to deal with this scenario should it materialize. Would it appoint the pan-democrat as Chief Executive? Or would it decline to make an appointment—a power which it has under the Basic Law, so that another election should be held? What would be the nature and magnitude of the political crisis in Hong Kong should this happen? How would such a crisis (taking into account its likelihood and its magnitude) compare with the crisis (including, for example, “Occupy Central” materializing) that would be precipitated by the electoral model favored by Beijing being unacceptable to the pro-democracy forces in Hong Kong? These, then, were probably some of the considerations which Beijing

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70. Ever since direct election by universal suffrage was introduced for a portion of LegCo seats in 1991, the pan-democrats have consistently won approximately 55-60 percent of the popular votes in each election, and the pro-China camp approximately 40-45 percent of the popular votes. Such distribution has hardly changed in twenty years.

71. See The Basic Law of the HKSAR, supra note 59. Art. 15 of the Basic Law provides that “The Central People’s Government shall appoint the Chief Executive and the principal officials of the executive authorities of the Hong Kong Special Administrative Region in accordance with the provisions of Chapter IV of this Law.” Id. In Chapter IV, art. 45(1) provides that “The Chief Executive of the Hong Kong Special Administrative Region shall be selected by election or through consultations held locally and be appointed by the Central People’s Government.” Id.
took into account when it reached the Decision in August 2014 on the model for universal suffrage for the Hong Kong Chief Executive in 2017. The Decision implies, that according to Beijing’s analysis, the risk and negative consequences of a non-patriot winning an election by universal suffrage and of a crisis precipitated by Beijing refusing to appoint him or her as CE are more serious than the risk and negative consequences of “Occupy Central” materializing or of any discontent or unrest flowing from Beijing’s model for universal suffrage being rejected by the pro-democracy forces in Hong Kong.

Interestingly, a cost-and-benefit analysis may also be used to explain why the pan-democrats in LegCo vetoed the model of universal suffrage for the election of the CE proposed by the HKSAR Government on the basis of the NPCSC Decision of August 2014. As the composition of the Nominating Committee and the high nomination threshold specified by the Decision effectively rules out the possibility of at least one leader of the pan-democrats being nominated as a candidate to compete in the CE election by universal suffrage, the adoption by LegCo of the electoral model proposed by the Government would effectively mean that the CE election by universal suffrage in 2017 would be a competition among two or three “pro-China” candidates considered to be “patriots” by a majority of the members of the Nominating Committee. The candidate eventually elected can then claim a popular mandate and political legitimacy greater than that of any leader of the pan-democrats. This would work against the interests of the pan-democrats, because their claim would then be weakened that they represent the majority of Hong Kong voters—a claim which they have been able to make continuously so far because the majority of Hong Kong voters who voted in LegCo elections from 1991 to 2012 actually voted for the pan-democrats rather than “pro-China” or “pro-Establishment” candidates. For the pan-democrats, therefore, there was little to be gained, but much to lose, from the introduction of universal suffrage for the election of the CE in 2017 in accordance with the nomination model prescribed by the NPCSC Decision of August 2014. This, then, can explain why they vetoed the electoral package in LegCo, despite the fact that opinion polls showed that members of the public who supported the electoral reform outnumbered those who were opposed to it.72

72. Public Opinion Programme, University of Hong Kong, http://www.hkupop.hku/english/report/superSurvey2015/index.html (last visited Nov. 26, 2016). The LegCo vote on the electoral reform proposal took place on June 18, 2015. The following opinion polls conducted in June 2015 are thus particularly relevant. According to the “Survey on 2017 CE Election Proposal” conducted by the University of Hong Kong’s Public Opinion Programme, among those polled on June 5-14, 2015, 51 percent supported LegCo adopting the proposal, while 37 percent were opposed to it. According to the “Joint-University Rolling Survey on 2017 CE Election Proposal,” among those polled on June 12-16, 2015, 47 percent supported the Government’s electoral reform proposal, while 38 percent were opposed to it. Public Opinion Programme, University of Hong Kong, http://www.hkupop.hku.hk/english/features/jointUrollingSurvey/.
To conclude, it may be observed that the concept of “One Country, Two Systems” as embodied by the Hong Kong Basic Law has not only provided for the co-existence of two economic systems—one socialist and the other capitalist—within the PRC, but also envisioned a process of democratization in Hong Kong towards eventual election of the CE by universal suffrage and election of all legislators by universal suffrage, thus moving the political systems of Hong Kong and mainland China further apart in the course of time (unless the latter also democratizes). Here lies the inherent contradiction or tension within “One Country, Two Systems” under which the “One Country” adheres to the supremacy of the Chinese Communist Party and must resist Western-style liberal democracy in order to survive. The Occupy Central Movement and the failure of the political reform initiative of 2014-15 have revealed such contradiction or tension.

It is unlikely that this tension and contradiction can be resolved in the foreseeable future. The most likely scenario is that the existing “semi-democratic” political system in Hong Kong will be maintained without further democratization, and the confrontation and stalemate between the “pro-China” camp and “pan-democratic” camp in the politics of the HKSAR will continue to plague it and make it difficult to govern. Thus, there seems to be an inexorable logic that the political costs, and ultimately also the economic and social costs, of “One Country, Two Systems” are rising as a result of the clash between Hong Kong people’s aspirations towards Western-style democracy and the Chinese Party-State’s insistence that the Government of the HKSAR must be led by “patriots” loyal to the Party-State. Whether such costs can be contained and whether social stability and economic prosperity can continue to be maintained in Hong Kong, amount to a severe challenge for the people of Hong Kong and the government of the PRC in the years to come.

73. The existing political system of the HKSAR has been described as a semi-democracy. See MA NGOK, POLITICAL DEVELOPMENT IN HONG KONG, 26 (Hong Kong: Hong Kong Univ. Press, 2007); William H. Overholt, *Hong Kong: The Perils of Semidemocracy*, 12 J. OF DEMOCRACY 5 (2001); Ming Sing, *Origins of Anti-Partyism in Hong Kong*, 21 EAST ASIA 37 (2004); SONNY SHIU HING LO, HONG KONG’S INDIGENOUS DEMOCRACY: ORIGINS, EVOLUTION AND CONTENTIONS (New York: Palgrave MacMillan, 2015).

74. The difficulties of Hong Kong’s governance have been exacerbated by the filibuster in LegCo by radical pan-democrats which has steadily increased in scale since 2012 and resulted in partial paralysis of the LegCo's functions of law-making and financial approval.
Why We Read *The International Lawyer* – Answers Parsed from Works of Two International Lawyers

**Patrick Del Duca**

*The International Lawyer’s* penetrating, permeating, multi-faceted, multicultural, cross-boundary, cross-disciplinary, and global treatment of the many dimensions of international law fascinates me, and no publication over the last fifty years has so consistently engaged practicing lawyers in creating that fascination. Nowhere else does such a diverse assortment of practitioners of international law of all kinds lay out the issues that they address in perspectives keenly grounded in both practice and theory. The contributors to *The International Lawyer* and its readers share an appreciation not only of the importance of the rule of law, but also an appreciation of how an understanding of the law in multiple contexts and of how the law bridges those contexts can advance the law and the interests of those subject to it, as well as the careers of those who seek to practice it.

We, the readers of, and contributors to, *The International Lawyer* are restless souls, ever seeking fresh perspectives on the challenges that we confront in our professional lives, motivated not only by immediate client needs, but also by a sense that the law is a global endeavor, fundamental to human achievement. Of course, we are lawyers and hence not timid in claiming that our chosen profession offers, perhaps even uniquely, the tools to resolve the truly important problems, much as economists, political scientists, philosophers, and theologians might likewise argue that their respective professions afford.

I. Two International Lawyers

As illustrations of shared motivations of our community focused on the American Bar Association Section of International Law and its flagship law review—*The International Lawyer*—here I focus on the work of two international lawyers, both of whom, deeply believing in the contribution of the tools of law, have been willing to undertake what might broadly and loftily be characterized as wrestling with the challenges of world peace and global prosperity.

These lawyers are my father, Louis Del Duca—deceased November 2015—and Boris Kozolchyk, actively guiding the National Law Center for

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Inter-American Free Trade. Louis, born 1926, and Boris, born 1934, each illustrate a lifetime of passion for the law and for probing in comparative and international contexts not only how the law works, but also how and why it can work better.

To illustrate the profundity of their motivations and ambitions, I have selected one work of each. Concerning Professor Del Duca, it is what I believe to be one of his first legal works published, an essay written and published in Italian in 1953 to challenge Italian preconceptions of American legal philosophy. Concerning Professor Kozolchyk, it is a recent textbook that I hesitate to label career capping, because his career to date implies that he is far from done with legal trailblazing. Nonetheless, it is a seasoned lawyer’s work, reflecting decades of experience in its subject matter. Notwithstanding the two works’ elaboration at opposite poles of progression of legal careers, both illustrate the zest and the motivations that prompt us all to be part of the community that reads and writes The International Lawyer.

My allusion to the motivation of each as seeking “world peace and global prosperity” is not the banality of world peace trivialized as a pageant contestant’s stock response in the “personal questions” phase of competition to subvert those who would be challenged by signs of intellectual effervescence. Rather, it is world peace in the sense that the “Greatest Generation” who fought the last world war understood in a personal way. It is world peace conceived as an antithesis to the moral and material privations that each of these two international lawyers experienced in their and their families’ contacts with dictatorships, World War II, Cold War conflicts, reverberations of colonialism, and their associated injuries to human dignity.

In a sometimes-confusing world of Brexit, post-Cold War ambiguity, politicians focused on walls rather than bridges, and lone wolf terrorists, the relevance of world peace and law to each other and that relevance as a motivator of legal careers might appear remote. The works of the two international lawyers here referenced, however, show this motivation to be real, tangible, and universal in that it has driven their careers as sophisticated practitioners of commercial law, both of whom in addition to practicing law in the conventional sense of assisting clients, have also motivated generations of law students from around the globe and actively contributed to law reform in numerous countries, including the United States. How does the building of a career as a practitioner of commercial law fit within the umbrella of pursuing world peace? For these practitioners the links between well-functioning commercial law and the prospects of peace and prosperity are as self-evident as they were to Adenauer, De Gasperi, Monnet, Schuman, and others who labored to re-stitch the fabric of Europe in the launch of what has become the European Union.

Each of the two international lawyers whose work is here in focus left his country of birth, respectively Italy and Cuba, as those countries wrestled

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with authoritarian regimes disrespectful of democracy, constitutional law, and the rule of law. Both advanced their education in the United States, but each benefited from advanced legal training, respectively in Italy and Cuba. Throughout their careers as practicing lawyers, legal academics, teachers, and law reformers, they shared a passion for commercial and financial law and for its expression through multiple legal systems. Although both became experts in all things pertinent to the Uniform Commercial Code, they each chose to complement that expertise with attention to other bodies of law of various jurisdictions and communities.

II. Observations on Philosophy of Law in the United States

Although Professor Del Duca declared in recent years to have lost count of his books and articles, his first publication of which I am aware is *Osservazioni sulla Filosofia del diritto negli Stati Uniti* (Observations on Philosophy of Law in the United States), published in 1953 in the *Rivista Internazionale di Filosofia del Diritto* (International Journal of Philosophy of the Law).*3 Then a recent Harvard Law School graduate and having completed two years in Rome on a Fulbright Fellowship, he wrote not in his primary language, English, but rather in Italian. He opens by defining as his task to examine the proposition that American legal philosophy reflects merely the utilitarian, positive, and pragmatic approaches of, respectively, Jeremy Bentham, John Austin, and William James. He concludes that the proposition is mistaken, having reviewed expressions of legal philosophy across the mosaic of U.S. history, culture, and intellectual environment, finding that natural law philosophy has deeply contributed to U.S. legal institutions and suggesting such philosophy's contribution to U.S. views relative to international law.*5

The review starts with attention to the role of natural law in the initial thirteen American states, noting the Declaration of Independence and the United States Constitution as embraces of natural law.*6 As an example, he cites the Declaration of Independence's proclamation as self-evident truths: “that all men are created equal, that they are endowed by their Creator
certain unalienable Rights, that among these are Life, Liberty and the pursuit of Happiness.”7

On the basis of these self-evident truths, he notes that a legal system is established to guarantee such rights, implying a limited role for government.8 He contrasts Newtonian notions of physics and astronomy with platonic concepts of deduction of natural law through examination of moral ideals, but noting that both imply the governance of nature by immutable and eternal laws and as such, jointly lay intellectual foundation for the notion of the inalienability of the rights articulated in the Bill of Rights and the due process clause of the Fourteenth Amendment.9 Although acknowledging the Commentaries of Kent and Story as practical efforts to adapt the norms of the common law of England to the realities of geographic and economic expansion in the United States,10 he offers an explanation of Marbury v. Madison’s11 assertion of the power of judicial review of constitutionality as an affirmation of the faith of the Constitution’s drafters in their ability to incorporate principles of natural law in a text capable of equitably governing the nation’s affairs.12

Professor Del Duca notes Roscoe Pound’s identification of the progress in the science of law as the change from a merely analytical to a functional approach to law, citing his writing in a 1919 edition of the Proceedings of the American Bar Association,13 and the efforts of Oliver Wendell Holmes to apply scientific methods to the practice and study of law.14 He considers the controversies over whether Holmes’ writing implied the presence or absence of moral considerations in a lawyer’s work (whether a lawyer’s role should be limited to predicting how a court would rule on the basis of extant law versus a lawyer’s duty to argue what the law should be) and the migration of Holmes’ innovative articulations of the law in the face of growing urbanization and industrialization of American society, from their initial expression in his dissenting judicial opinions to adoption in rulings by majorities of the Supreme Court.15 In the work of Holmes, he finds the influence of pragmatic and utilitarian approaches to the philosophy of law. In the work of Pound, and particularly his utilitarian thesis of “maximum satisfaction of human desires with minimum of sacrifice,” he finds the roots of concepts characteristic of American law, such as public policy, social

8. See id.
10. Id. at 490-91.
11. 5 U.S. 137 (1803).
12. Del Duca, supra note 3, at 490-91.
14. Id. at 493-96.
15. Id.
utility, social interest, and public interest, serving among other things, as foundations for developments of concepts such as strict liability in tort. 16

Concerning the role of judges and the process by which a judge determines how to rule, Professor Del Duca reviews works of John Chipman Gray (identifying the judge as the one who determines the law, drawing upon statutes, precedents, expert opinion, customs, and moral principles as sources), Jerome Frank (applying psychoanalysis to understand the conduct of a judge), and Benjamin Cardozo (examining the rational process by which a judge might rule). 17 He devotes particular attention to the then contemporary thought of Harvard Professor Lon Fuller that the law is comprised of the methods through which one achieves the possibility that people might live and work together. 18 He concludes his consideration of Fuller’s thought with contrast of how Fuller’s teleological approach contradicts the formalism of Hans Kelsen, in respect of how each would approach the role of the United Nations General Assembly in the event that the Security Council would be unable to reach the decisions necessary to accomplish its institutional purpose, finding that Fuller’s approach would afford the General Assembly the authority necessary to act as a supplement in the inability of the Security Council to act, and more broadly that the problems of the international community demand such a flexible approach. 19

Professor Del Duca concludes his work with attention to the writings of Joseph Keenan and Brendan Francis Brown on the Nuremberg and Tokyo Trials. 20 He notes the existence of positive treaty law to define crimes of conducting wars of aggression, war crimes, and crimes against humanity prosecuted in those trials, but highlights the thoughts of Keenan and Brown that those trials manifested a recognition not only of the positive law definition of specific crimes, but also of immutable and eternal values of morality found in legal history and in philosophy. 21

This work of a then recent law school graduate reflects an engagement with the leading lights of American legal thought of that time, a desire to translate those thoughts to another legal community—namely the Italian legal academy struggling to reconstitute itself as Italy determined what it meant to be a Republic rather than a monarchy and sorted through the heavy legacy of fascism and war, and an attention to the implication of those thoughts for international law. What followed its publication was a legal career that engaged its author deeply in the process of not simply addressing significant legal issues in one legal context, but also in considering and promoting awareness of the ramifications of those issues with an international perspective. In recognition of the achievements of that career, our Section of International Law earlier this year awarded him,

16. Id. at 496-97.
17. Id. at 498-501.
18. Id. at 501-04.
19. Del Duca, supra note 3, at 505-06.
20. Id. at 506-08.
21. Id.
posthumously, its Leonard J. Theberge Award for Private International Law.22

III. An Anthropologic Approach to Comparative Commercial Law

Professor Kozolchyk dedicates his opus, *Comparative Commercial Contracts: Law, Culture and Economic Development*, to family, three key mentors, and “the United States of America, the country that brought us together.”23 Those mentors, Hessel Yntema, Julius Stone, and Adamson Hoebel, were at the heart of the early development of legal realism and its application to legal systems extending beyond those of the United States, as well as the grounding of that elaboration in simultaneously sophisticated appreciations of the history of law (notably Roman law), comparative law, anthropology, and sociology. Like their pupil, Professor Kozolchyk, they benefited from cosmopolitan training and a first hand appreciation of the law as a tool to confront authoritarianism. Like them, Professor Kozolchyk is not simply a professor at a leading American law school; rather, he is an intellectual of the global traditions of the rule of law, a scholar of their dynamics, and a law reformer unconstrained by ephemeral boundaries of nation states and cultural norms.

For a bright student to study with Professor Kozolchyk, the rewards must surely include to be armed with the techniques not only of reading and researching the law in a formal sense, but also to parse the concurrent roles of altruism and selfishness, all with a view to understanding the role of formulation of the law as critical to the construction of community and society. For Professor Kozolchyk, this approach is not merely intellectual, it is also intensely personal, as his graduate training in law in the United States revealed to him a legal system that, in its preoccupation with justice, stood in stark contrast with his experience of the law as he grew up under Cuba’s Battista Dictatorship. Moreover, Professor Kozolchyk benefits from some twenty-five years of leading the National Center for Inter-American Free Trade as a premier center of commercial law reform initiatives, notably in Latin America, but also in Africa, Asia, and Europe. Thus, as both a scholar and as a practitioner of the disciplines of law reform, the focus of his 1,200 plus page *Comparative Commercial Contracts: Law, Culture and Economic Development* is “to facilitate a deeper understanding of the law of commercial

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contracts as it fulfills its purpose as an agent of economic development or fails to do so."

As an able educator, Professor Kozolchyk appreciates the value of a well-told story. For example, to underline the significance of standard and best practices in the development of effective commercial law, Professor Kozolchyk puts forward the experiences of a cast of historical thought leaders, running from the Roman jurist Ulpian, through Lord Mansfield and the drafters of the German Commercial Code, and on to Justice Cardozo. Likewise, to illustrate the values of transparency, he offers examination of what he labels “simulated contracts,” i.e. contracts nominally respecting a set form, but in fact intended by the parties to achieve a result otherwise disfavored by the law. He grounds his analysis of these practices and their dysfunction in the Roman and subsequent civil law “typification” of contracts to determine the remedies, rights and duties corresponding to a given type of contract, and also in current public law manipulation of municipal and national government financial statements, as well as in biologist Edward O. Wilson’s recent works on altruism.

Throughout, Professor Kozolchyk challenges his reader to invest the attention to garner the full riches of the work. The reader who is able, but limited in ambition, can pick chapters to support quickly learning how a specific body of law works. For example, embedded in Chapter 24 is a brilliant description of the law concerning letters of credit. In thirty-some pages, Professor Kozolchyk reviews their origins, lays out the fit between global letter of credit practice and the law of various jurisdictions within and without the United States, and offers any of the practicing lawyer, banker, or corporate financial officer the insight required to navigate their use in a business transaction and the related issues of definition and invocation of useful applicable law. To achieve the reward requires identifying this gem through penetration of the work’s table of contents that appears addressed to a far more ambitious reader, namely, the reader who seeks to understand how to contribute to the reform of the law of commercial contracts so as to contribute to economic development. For this latter reader, Professor Kozolchyk’s work offers a continuously thrilling ride, in scope that Professor Roy Goode rightly labels in its Foreword as “astonishing both in its subject-matter and in the variety of sources on which it draws.”

Professor Kozolchyk demonstrates the fearlessness of his analysis with a review of the U.S. Supreme Court’s failure in its 1986 decision of *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.* to appreciate the prevalence in Japan of

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24. Id. at 3.
25. Id. at 4-12.
26. Id. at 12.
27. Id.
28. Id. at 1049-80.
30. Id. at vii.
“pervasive social organization” over “law and free business activity. . . .”32  In Professor Kozolchyk’s view, the Supreme Court’s failure of appreciation led it, wrongly, to rule unfavorably in respect of the American manufacturers’ claims of conduct on the part of the Japanese competitors in breach of antitrust norms.33  Professor Kozolchyk finds confirmation for his view in the subsequent collapse of American television production.34  This review might be enough for a conventional lawyer, but Professor Kozolchyk promptly pushes it further in a microcosm/macrocosm analysis of the divergences of U.S. positions from those of Germany and Japan in his experience of the negotiation of the UN Convention on Independent Guarantees and Stand-by Letters of Credit.35  In the microcosm, Professor Kozolchyk commences with an exposition of the dynamics of independent guarantees and stand-by letters of credit, sufficiently detailed to warm the heart of any hard-core commercial finance lawyer.36  He quickly moves from the micro to the macro to paint the German and Japanese positions favoring a softening of the separation of a bank’s payment obligation under a letter of credit from any consideration of the adequacy of the performance of the underlying obligation as a further manifestation of his observation that appreciation of business culture is critical to understanding the substance of the law in action as well as its formulation.37  To wit, he identifies the German and Japanese positions as respectively flowing from the desire to protect national manufacturing interests even at the expense of the national financial sector and from the desire to penetrate global markets.38  He concludes this exposition with the example of a bank failure associated with the bank’s macro focus to consummate deals so as to acquire market share, rather than a micro focus to assure the prudence of each individual deal.39  In these twelve pages,40  Professor Kozolchyk manages a deep dive into a specialized area of contract law, but combines it with an appreciation of the dynamic connection between the legal details and the larger economic, social, and political contexts. Professor Kozolchyk’s deft combination of micro and macro elements in these pages is emblematic of what follows in the further 1,200 pages of his work.

32. KOZOLCHYK, supra note 23, at 28-29.
33. Id. at 25.
34. Id.
36. KOZOLCHYK, supra note 23, at 29-34.
37. Id. at 32.
38. Id. at 33.
39. Id. at 34.
40. Id.
Brexit poses the question of London as a European and global financial center.\footnote{And, it may work against the growing choice to employ English for the legal aspects of business. \textit{See} Patrick Del Duca, \textit{Choosing the Language of Transnational Deals: Practicalities, Policy and Law Reform} (2010).} Although Professor Kozolchyk published his work before the Brexit vote, his examination of why England developed a flourishing culture of commercial credit in the late 1600s and early 1700s while France did not, resonates with current commercial realities.\footnote{See Kozolchyk, supra note 23, at 776-82.} In particular, Professor Kozolchyk anchors his examination in analysis of the common law doctrines pertaining to reasonableness and trust relative to the formalism of French legal scholarship focused on concepts of \textit{causa} divorced from context that included both broad notions of usury and strong antipathy towards it.\footnote{Id. at 778-79.} In so far as the formalism antithetical to Professor Kozolchyk’s anthropological focus on context and real word practice persists in French law and those legal systems influence by it, he appears to offer insight as to why Paris struggles to become a global financial center akin to London or New York.\footnote{See id. at 776-82.} Ominously for Paris in any competition with Frankfurt or Dublin to advance as a financial center, Professor Kozolchyk digs into the thoughts of a leading German legal scholar instrumental in what would become the practical approach of the German Commercial Code, namely Rudolf von Ihering. Having laid out the limitations of French commercial law inherent in its conceptualization relative to German law, Professor Kozolchyk, towards the end of his work, offers a review of the development of English commercial law in ways that parallel and exceed those of German commercial law, with attention to the elaboration of the common law and the equity jurisdictions in England, and notably the interactions of Lord Mansfield, juries and merchants associated with English law’s facilitation of recognition of the negotiability of bills of exchange and promissory notes.\footnote{Id.}

Professor Kozolchyk is impatient with formalism and its advocates. Unfortunately for such advocates who might seek to wrap themselves in the flags of legal science or of tradition, Professor Kozolchyk is not only an insightful legal anthropologist, but also an avid student of legal history. Thus, to the Latin American formalist drawing upon the text of Chile’s influential Civil Code of 1857, to defend not only the confinement of the interpretation of a contract to the formally concluded text but also the sacrosanct quality of the requirement of conclusion of such a contract before an impartial notary, Professor Kozolchyk is quick to quote not only the words of that Code’s principal author, Andres Bello, to identify the initial contextual purpose of such a requirement as impeding the disposition of disputes by fraudulent testimony, but also to challenge the relevance of the initial premise in contemporary society where business dealings broadly and
successfully occur outside the framework of formalization of contracts as public writings before a notary.\textsuperscript{46}

Few authors can authoritatively take to task an array running from Andres Bello, through Oliver Wendell Holmes Jr., and Alan Greenspan, and on to Marx and Lenin, each for the vice of conducting analysis on the foundation of an “unrepresentative commercial archetype.”\textsuperscript{47} Professor Kozolchyk does not hesitate to do so, and he applauds those who get it right, e.g. Justice Cardozo in his elaboration of the standards for discharge of fiduciary responsibilities, that he anchored to the behavior of an archetypical “man of the most delicate conscience and the nicest sense of honor.”\textsuperscript{48} More deeply, Professor Kozolchyk takes aim at those who argue that civil law legal systems must rely on formalism to the exclusion of consideration of factual context. To those who argue that such formalism is in the tradition of Roman law, Professor Kozolchyk reviews the relevant practice of Roman law in Roman times to conclude that its classificatory formalism served largely for purposes of determination of procedure and choice of remedies.\textsuperscript{49} To those who argue that such formalism is justified as in a scholastic tradition rooted in Aristotelian concepts of essences, Professor Kozolchyk calls out the negative practical consequences of such formalism, including inequitable and unreasonable outcomes in dispute resolution and the susceptibility to bribery of judges insulated from the obligations to make factual findings as foundation for their rulings.\textsuperscript{50}

Professor Kozolchyk consistently lays out his claims, and then provides his foundations for them, e.g. detailed discussion of Justice Cardozo’s opinions in \textit{Meinhard v. Salmon}\textsuperscript{51} and \textit{MacPherson V. Buick Motor Co.}\textsuperscript{52} laying out his use of factual and analogical reasoning.\textsuperscript{53} In contrasting Justice Cardozo’s approach to a civil law lawyer’s formalistic approach to the drafting of a law of negotiable instruments, Professor Kozolchyk takes direct aim at his target, a mercifully unnamed Nicaraguan drafter of a negotiable instruments law.\textsuperscript{54} Professor Kozolchyk asserts: “[h]is method lacked the right goal, the proper analytical tool and the required data.”\textsuperscript{55} Ever the practitioner of law reform, Professor Kozolchyk then lays out the methodology of his National Law Center in its studies of the functioning of secured lending throughout the Americas.\textsuperscript{56} The methodology is evidence-based, and although it incorporates mastery of the nuances of the formal law, it addresses “the archetypal behavior of borrowers, lenders, appraisers of the value of

\textsuperscript{46} Id. at 38.
\textsuperscript{47} See Kozolchyk, supra note 23, at 38-47.
\textsuperscript{48} Id. at 44.
\textsuperscript{49} Id. at 49.
\textsuperscript{50} Id. at 53.
\textsuperscript{51} 164 N.E. 545 (N.Y. 1928).
\textsuperscript{52} 111 N.E. 1050 (N.Y. 1916).
\textsuperscript{53} Kozolchyk, supra note 23, at 59-65.
\textsuperscript{54} See id. at 65.
\textsuperscript{55} Id.
\textsuperscript{56} See id. at 75-76.
collateral, warehousemen or custodians, and other likely participants in the secured transaction, including lawyers and judges."

Professor Kozolchyk offers as a constant of commercial contracts “that they are means towards the end of facilitating trade and that as such they must be consistent with the cooperative instinct of the trading man.” Through the lens of this constant, Professor Kozolchyk examines the mutability of the dogmas espoused by the intellectual parents of the Code Civil, Grotius and Pothier, the persistence of familial and clan relationships in the contemporary practice of contract law in emerging economies such as China and India, and the inherent disposition of planned economies to failure by virtue of inability to accurately price the factors of production.

As an American law professor, Professor Kozolchyk does not confine himself to preaching. Rather, by way of example, Chapter 3 offers points for discussion and reflection, intriguingly focused around the intersection of anthropology and commercial law reform. These points cover the origins of contracts in agricultural societies, jural postulates as considered by Roscoe Pound, Edward Hoebel, and Karl Llewellyn, and the proper roles of comments and legislative history in statutory drafting in light of the views of Mexico’s Raul Cervantes Ahumada, who disfavored any explicit reference to such materials in statutory drafting. Professor Kozolchyk’s global ambition includes identification of the legal principles that make possible the transition from a pre-commercial society to a commercial society. In this quest, he guides the reader through the touchstones of standard comparative law courses focused on French and German legal materials and their roots in Roman law, but also digs deeply into Soviet and Chinese commercial law. From these materials he finds that the relevant legal principles include:

1. the parties’ freedom to enter into contracts, including their contractual power to limit their liabilities;
2. equal and fair treatment of merchants and consumers;
3. a view of contracts as the . . . receptacles of the parties’ reasonable expectations rather than as the result of “zero sum” negotiations;
4. the legal protection of third parties, including good faith purchasers and creditors, from equities and defenses derived from pre-existing or underlying transactions; and
5. a fair and predictable adjudication of disputes among merchants and their customers.

As Professor Kozolchyk initiates the journey into the world of comparative commercial law, he fortifies the reader with a grounding in

57. Id. at 75.
58. Id. at 82.
59. Kozolchyk, supra note 23, at 81-82, 86, 90-93.
60. See id. at 101-02.
61. Id. at 653.
Roman law. For both the common law lawyer and the civil law lawyer, Professor Kozolchyk's review offers insight into how Roman law really worked, thereby enabling the lawyer to critically evaluate contemporary assertions of justifications of formal positions in the world of civil law as derived from Roman law (hint: Professor Kozolchyk finds such assertions generally unjustified). For the student of intellectual history, Professor Kozolchyk's exposition of Roman law affords understanding of why the nineteenth-century German Pandectists regarded the *Corpus Juris Civilis* as the inspiration for their legal science, which took commercial law in a much more practical direction than the French Civil Code. As a reinforcement of Professor Kozolchyk's cosmopolitan and global approach to the examination of law and its roots, though not dwelled upon by Professor Kozolchyk, it is worth bearing in mind that after the split of the Roman Empire into Eastern and Western components, the *Corpus Juris Civilis* was issued from Constantinople (today's Istanbul).

Professor Kozolchyk extracts from a thousand years of medieval law the incubation of contemporary principles of the law of negotiable instruments, which resulted from the application of Roman law concepts as international trade resurfaced in the Late Middle Ages, the rise of "double-entry" bookkeeping, and the rise of concepts of commercial fairness in Mediterranean trade involving Arab and Jewish merchants. As evidence of the emergence and indeed celebration of the recognition of the value of entrepreneurialism, he offers the historical celebration of the English tale of St. Godric of Finchale and the early Spanish picaresque novel, *La vida de Lazarillo de Tormes, y de sus fortunas y adversidades*. He also notes the rise of the Medicis of Florence, the Fuggers of Bavaria, and the Ruizes in Spain and France.

He does not overlook the constraints of feudalism, i.e. the ability of those in hierarchical superior social status to assert privileges unavailable to others, and indeed offers this phenomenon as foreshadowing practices in contemporary emerging economies such as that of China, notwithstanding the simultaneous development of commercial law supportive of economic development. Likewise, he introduces the medieval emergence of the conceptualization of usury as both morally wrong and as extending to any charge of interest, a conceptualization as to which English King Henry VIII's 1545 Statute of Usury marks, at least as to the English-speaking world, a turning of the tide by defining only interest in excess of 10 percent

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62. See id. at 103-35.
63. See id. at 4.
64. See id. at 135, 410, 419-20.
66. See Kozolchyk, supra note 23, at 139-71.
67. See id. at 143-45.
68. See id. at 145.
69. See id. at 140.
as usurious. 70 Ever ready to advance his arguments as to the costs of the inadequacy of the view of commercial law as anything other than the law of a community collaborating in the accomplishment of fair dealing, he offers contemporary examples of the costs of commercial credit in Latin American jurisdictions as evidence of the dysfunction associated with the recurrent application of the medieval distrust of merchants and commerce. 71 He is also critical of Spain’s highest court for a 2000 decision in which it appeared, uselessly in Professor Kozolchyk’s view, to engage in a process of medieval, canon law scholastic reasoning to distinguish the imposition of interest in a simple loan agreement from the imposition of interest in a financial lease, i.e. a loan secured by a particular piece of equipment as to which the borrower would hold a purchase option. 72 Further, as part of his professorial role, he not only reviews the contributions of Maimonides to twelfth-century Jewish commercial law, but also frames questions for the reader in the nature of, “Maimonides applied Jewish commercial law with the result that . . . ; how would the law that you know best resolve the case?” 73

In the appendix to the chapter on medieval law, 74 Professor Kozolchyk poses further questions for the reader to ponder, based on materials relevant to decisions of commercial disputes regarding procedures that demand oaths from the counter-party and on materials related to the treatment of principal and agent relations in common law, European and Latin American civil law systems, and European Union law. In addition, this is all building on a critical examination of the continuing value of medieval remnants in the context of achieving a modern law supportive of commercial law as a tool for economic development. Professor Kozolchyk caps his review of medieval law developments with consideration of the emergence of the enforceability of contracts in the English wool industry in the thirteenth and fourteenth centuries. 75 Laying the foundation for conclusions later in the book, he sets forth the limitations of the advances achieved by the development of concepts of merely fraternal obligations of trust and fairness, as compared with the concepts established in the English wool industry, which foreshadowed the framework of the Uniform Commercial Code’s Article 9, providing for the lender and borrower not only to memorialize their deal, but also to provide public notice of it. 76

Professor Kozolchyk continues his criticism of unhelpful historical doctrinal and cultural remnants in his exposition of the late medieval organization of guilds and Colbert’s mercantilism, which were superseded by street markets and supranational trade fairs that ultimately enabled merchants, including providers of credit, to overwhelm the guild effort to

70. See id. at 150-56.
71. See id. at 146-48.
72. See Kozolchyk, supra note 23, at 152-53.
73. See id. at 157-62.
74. See id. at 171-89.
75. See id. at 164-71.
76. See id. at 167-71.
define monopolies, whether to assure subsistence of guild members or to capture monopoly rents. He ties the legacy of guilds and mercantilism to the duality of civil and commercial codes exemplified by French and German private law, the civil codes of each country imposing the use of a limited number of forms of contract with mandatory terms, and to varying degrees the commercial codes affording merchant parties greater autonomy in the definition of their contractual relationships. He also observes how the guild-influenced concepts of the civil law continue to resurge in various aspects of interpretation and application of the commercial law.

In describing the role of a civil law notary and contrasting it with that of a notary public, familiar under the law of the various states and related jurisdictions of the United States, Professor Kozolchyk varies his method of presentation. In addition to identifying the historical origins of the contemporary roles of civil law notaries in Roman law, medieval law, and early formulations of civil law codes in the French, German, and Spanish spheres of influence, he provides insightful anecdotal understanding of how the roles of civil law notaries varied in time and place in jurisdictions such as Austria, Belgium, Costa Rica, France, Germany, Mexico, and Sweden.

Through interviews, notably with Costa Rican and Mexican notaries, he effectively and sensitively brings out divergences between the formal written law and the actual practices, with attention to quality control, competition, and integrity. To the reader he poses the question of whether the guild-like monopoly of a notary as a neutral professional is required and beneficial for the conduct of commercial, financial, and real property transactions. His chapter on notaries, analogous to the quality of the insights offered by others of his work’s chapters, frames the salient issues in ways that arm the attentive reader to participate in debates about key topics of commercial law. In this instance, he invites the reader to consider the appropriate roles of notaries with the benefit of comparative insight. In 2014 the American Bar Association addressed this issue and adopted a resolution in favor of reforming the laws regarding cross-border verification of signatures, a development followed by the Uniform Law Commission’s adoption of an amendment to its Law on Notarial Acts that relaxes the requirement that a

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77. See id. at 191-208.
78. See KOZOLCHYK, supra note 23, at 211-13.
79. See id. at 212.
80. See id. at 215.
81. See id. at 216-40.
82. See id. at 229-37.
83. See id. at 237, 242; see also Patrick Del Duca, Why Some Civil Law Systems Burden Notice-Filing with a Civil Law Notary “Public Writing” Requirement, 44 UCC L.J. 1, 1-2 (2011) (framing assessment of the benefits of notarial involvement in the context of how the broader legal system functions).
notary public’s verification of the identity of a signer happen through the physical presence of the signer before the notary.\textsuperscript{85} The change, controversial in some circles, notably the notary professional associations, reflects an increasing responsiveness to the possibilities and use of a secure digital signature in various countries of the world and in some states of the United States.\textsuperscript{86} Professor Kozolchyk’s chapter, although written before these current developments, offers valuable and lasting insight into the structure of debates likely to endure for some time. By way of example, his insights enable a reader of the materials preceding the American Bar Association’s adoption of its relevant policy in favor of law reform to better understand the developments in notarial practice there reported in respect of numerous countries.

Comparative law courses, at least in American law faculties, typically devote attention to the development of codification in French and German law as influential across the range of civil law jurisdictions.\textsuperscript{87} Arthur Von Mehren’s classic casebook, \textit{The Civil Law System; An Introduction to the Comparative Study of Law} covers the material highlighting how French and German civil law courts have in fact at key moments fundamentally re-interpreted code provisions relevant to contract and tort law, notwithstanding the formal conceptualization of the role of such courts as merely to apply the law, rather than to make it.\textsuperscript{88} Professor Kozolchyk also addresses this subject matter, starting with the French \textit{Code Civil} of 1804, followed by treatment of the French Commercial Code and the German Civil and Commercial Codes, with the unique addition of treatment of their counterparts in Latin America, Russia, and China.\textsuperscript{89} But while Professor Von Mehren adopts a Socratic approach to lead the reader to understand his points, Professor Kozolchyk guides his reader more directly, focusing the reader on understanding his views of why the German approach has proven more fruitful for commercial law than the French approach.\textsuperscript{90}

Professor Kozolchyk does not hide his view of the importance of grounding commercial law in the empirical practices of those engaged in commerce.\textsuperscript{91} As he lays out the intellectual provenance of the \textit{Code Civil} in the writings of Grotius and Pothier, the Enlightenment, and Napoleon’s


\textsuperscript{87} See, e.g., ARTHUR VON MEHREN, THE CIVIL LAW SYSTEM: AN INTRODUCTION TO THE COMPARATIVE STUDY OF LAW 3 (2d ed. 1977).

\textsuperscript{88} See id. at 87-95, 617-32, 1127-61.

\textsuperscript{89} See Kozolchyk, supra note 23, at 245-746.

\textsuperscript{90} See id. at 434-35.

\textsuperscript{91} See id. at 334-42.
imposition of rationalism on the ashes of the French Revolution and its breaks with feudalism and guilds, Professor Kozolchyk reconstructs the *Code Civil* as a framework for the conclusion of contracts among the minority of France, comprised at the time of its 1804 adoption by the bourgeoisie, the limited number of French individuals with assets who accordingly prized respect of property rights and the certainty associated with formality in contracting, to the detriment of the fluidity required for active commerce. He also offers an appendix annotated with questions for the reader to appreciate how contemporary French law, faced with developments such as the conduct of commerce through the Internet, is stepping away, through court decisions and doctrinal writings, from the rigor of *Code Civil* requirements, e.g. those restricting enforceability of promises of deferred payment and performance. Nonetheless, in his review of the French Commercial Courts, he highlights what he sketches as their continuing retrograde character relative to the commercial courts of the medieval maritime and trade institutions of both northern and southern Europe, which he ascertains is derived from a combination of refusal to appreciate the social value of merchant activities, reluctance to embrace the functions of interest and secured lending, and failure to appreciate usages of trade and standard and best practices among merchants.

Through a comparative examination of French and Mexican Civil and Commercial Code provisions, Professor Kozolchyk drives home the relative weakness of the *Code Civil* approach. He demonstrates that Mexico’s enumeration, inspired by French law, of the kinds of transactions subject to application of commercial law creates similar problems of uncertainty as to whether to look to the Commercial Code or the Civil Code for governing law. He thus argues that it impedes effective conduct of business in regard to broad range of activities, spanning from agribusiness to insurance, swap, credit, and negotiable instrument transactions, to consumer transactions and also that it raises perceptions of inadequacy of Mexican judicial institutions. He offers this as an example of how “one of the most serious problems posed by the scholastically-inspired commercial law writings is their inconsistency with market practices and with prevailing custom and usage.” Along the way, and drawing upon French, Honduran, Italian, and Spanish materials, he indulges in the fun of shooting down an Argentine legal writer’s effort to

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92. See id. at 247-80.
93. See id. at 265.
94. See id. at 280-91.
95. See Kozolchyk, supra note 23, at 297-325.
96. See id. at 342-49.
97. See id. at 347-49.
98. See id. at 349.
99. See id. at 341.
better define the universe of “acts of commerce.”  

Professor Kozolchyk identifies the effort as divorced from socio-economic context and marketplace realities, further arguing as evidence of the deficiency of a scholastic focus on definitions, the ability of those definitions to “inspire a code drafted by law professors supported by a fascist state to do its bidding and by a Marxist scholar intent on providing a developing nation with the best of his legal science.”  

Ever the practitioner of law reform, Professor Kozolchyk reviews the 1994 Convention of the Organization of American States on the Law Applicable to International Contracts as an open invitation to parties and courts involved in international contracting to supersede the inadequacies that persist in national law relative to definition of commercial acts by accepting its invitation to take account of international commercial usages and customs.  

Professor Kozolchyk’s treatment of German civil and commercial codification reaches deeply into the work of the Pandectists—the nineteenth-century German scholars who sought to construct a legal science based on careful analysis of Roman law, notably as set forth in the Corpus Juris Civilis—and their contemporary rivals, the intellectual predecessors of the legal realists, notably Levin Goldschmidt.  

Professor Kozolchyk lays out the intellectual debates over the propriety of conceiving the law as a science to be set forth according to principles of scholastic reasoning versus an approach of empiricism focused on identification of actual practices and usages with a view to definition of standard and best practices. His exposition of these debates is based on a foundation of the history of German unification (the first one in the 1800s) and the transformation of its economy from one of feudalism and guilds as well as with the benefit of the initial drafting and subsequent amendments through to the present-day German Civil and Commercial Codes.  

In his view, the distinction between civil and commercial law in each of the French and German systems is ill-conceived for purposes of furthering economic development, but the initial German approach of according automatic merchant status, and hence applicability of the commercial code, to anyone who habitually conducted transactions listed as commercial transactions, afforded broader applicability of commercial law and greater openness to definition of that law with reference to the practices of merchants.  

As to both French and German law, Professor Kozolchyk offers review of their use of sources of law. He notes the relative unavailability of the texts of

100. See id. at 336-38.  
101. See Kozolchyk, supra note 23, at 338.  
103. See Kozolchyk, supra note 23, at 410-13, 441-46.  
104. See id. at 441-46.  
105. See id. at 377-407.  
106. See id. at 423.
judicial decisions, the parsimony with which they are written, and the formal
notion that they not have precedential effect.107 He contrasts this with the
reality of the significant persuasive effect of key judicial decisions and with
the reliance on doctrinal writings.108 Through the example of the Costa
Rican case of Picado Guerrero v. Rojas Dias, in which doctrinal writings that
address Mexican realities are misapplied, he trenchantly observes that
document as a source of commercial law is helpful only “as long as it takes into
account the peculiarities of the marketplace to which it is supposed to apply.”109

Turning to Latin American commercial law, Professor Kozolchyk reviews
the specific history of codification of commercial law in the region and how
it incorporates various European models.110 He provides an anthropological
perspective on the history of commerce in Latin America from colonial
times and contemporary manifestations of “familialism” and “legalism” as
impediments to economic development, associated with favoritism, bribery,
and further undesirable consequences of mischaracterization of prohibited
but desired transactions to simulate permissible dealings, e.g. achieving the
imposition of interest in the face of draconian prohibitions of any interest as
usurious and transferring ownership of land in the face of restraints on
alienation of indigenously or communally owned property.

Professor Kozolchyk’s exposition of Soviet commercial contract law is
grounded in a review of Marx’s concepts, their extensions by Lenin, Stalin
and Khruschev, and the prevalence of familialism and legalism leading to
bribery, adjudicative arbitrariness, legal uncertainty, and despotism, as well
as failure to address aspirations of economic development.111 He offers
snapshots through time of how the Soviet Union wrestled with the place of
law in an ideological context that expected the role of law to wither, the
definition of private property and its permissible uses, the relationships of
state planning to agreements among state enterprises, and the schizophrenia
of ideological demonization of individual profit-seeking behavior versus the
subversion of the priority of state interests with varying degrees of official
acquiescence.112 Exposure to perspectives on the developments in
revolutionary Cuba that Professor Kozolchyk experienced as a young lawyer
highlights the significance of not only how the Soviet legal system
continuously wrestled with how to come to grips with the lack of effective
pricing mechanisms in a planned economy and with the inherent human
tendency to seek personal gain that Adam Smith recognized as a foundation
of the salubrious invisible hand, but also its global broadcasting of a model of
legalism inconsistent with the rule of law, but supportive of despotism.113
the model of the effective teacher, Professor Kozolchyk offers a concluding assessment of the current state of Russian commercial law; he finds it encouraging for those aspiring to a “free marketplace of goods, services and ideas,” but that it replicates deficiencies of commercial law in civil law systems, e.g. in respect to secured lending and letters of credit.\footnote{114. See id. at 618, 619-20.}

Professor Kozolchyk reviews China’s commercial law in the sweep of Chinese history, with reference to Mao’s efforts of collectivization, in light of Chinese culture, and with reference to specific current problems of finance related to the diffusion of wealth through real property transactions by participants ranging from collective entities anchored in various levels of government to individuals.\footnote{115. See Kozolchyk, supra note 23, at 689-99, 700-23.} In the uncertainties that he finds relative to the application of law and the enforcement of rights, he identifies the scourges to economic progress of familialism and legalism.\footnote{116. See id. at 684, 695-723.} Indeed, he lays out the parallels between the Mexican familial conception of compadrazgo and the Chinese conception of Guanxi, both designed to protect their participants, but likely “at the expense of the rights of others or those who are, in turn, third parties or strangers to that relationship.”\footnote{117. Id. at 662.} With the benefit of review of the historical roots of anti-commercial attitudes and Confucianism’s lack of focus on actual practices and their improvement, he lays out how the scourges of familialism and legalism impeded development of the rule of law, and hence economic development, in Imperial China and how they continue to impede economic growth in contemporary China.\footnote{118. See id. at 633-64, 665-79.}

Lest anyone think that Professor Kozolchyk seeks only to address anthropologists and political scientists, the final eighteen pages of his China materials lay out exactly what a secured lender would want to understand about the specifics of the contemporary legal framework for secured lending and letters of credit in China, including what a good practicing lawyer would want to know about issues of enforcement of rights.\footnote{119. See id. at 728-46.}

Although Professor Kozolchyk’s work is a casebook meant as material for a semester-long law school course, there is much to commend reading it from start to finish like a novel. A class might work through 100 pages of materials a week, so as to cover the book in a typical thirteen-week semester, but the richness of the material and examples suggests that a semester’s course could address half the book while offering the class a full experience. No matter how it is read, the manuscript shows Professor Kozolchyk as an undisguised fan of empiricism, ever searching for evidence of how commercial law evolves and of its impact on development. His findings of the good that emerges from the circle of honest merchants and the practices that they define and the synergy that emerges when the law embraces and affirms those practices become ever more persuasive as he journeys with the
reader through regimes of commercial law across both historical and geographical confines.

Professor Kozolochyk dedicates the final portions of his work to aspects of Anglo-American law, escorting his reader through the distinct socioeconomic and legal contexts of commercial contracts under both English and U.S. law.\textsuperscript{120} He devotes attention to the formation of contracts, the principles of good faith and reasonableness as guiding principles for the interpretation of contracts, the mechanisms for incorporating commercial practices into contract law, the implications of trial procedure for commercial law and concepts of pre-contractual liability, excuse for non-performance, extra-judicial remedies and their relations to specific performance, and damages for breach of warranty under U.S. law.\textsuperscript{121} As he introduces these topics with rich historical and sociological context that includes attention to the early links between U.S. and English law, Professor Kozolochyk forthrightly lays out the bad with the good, a key instance of the bad being the role that slavery played in the early history of the United States and the consequent enrichment of commercial interests in England.\textsuperscript{122}

Professor Kozolochyk opens his chapter on good faith and reasonableness in commercial contracts with the affirmation: “The enactment of Articles 1 and 2 of the U.C.C. and the Restatement (Second) of Contracts . . . signaled a radical departure from a contract interpretation that searched for intent primarily ‘within the four corners’ of the written contract or in the ‘plain meaning of its words.’”\textsuperscript{123} He then proceeds to lay out the benefits of the evolution to attention to party conduct in the performance of contracts, especially with reference to courses of dealing and usages of the relevant trades.\textsuperscript{124}

For those who are not common law lawyers, as well as for common law lawyers who seek to understand the origins of their legal system, Professor Kozolochyk’s review not only of the early commercial law of both jurisdictions, but also of commerce as practiced in each and between the two, provides understanding of the emergence of current commercial practices and the corresponding law with respect to topics such as the organization of the retail sector, consumer credit, credit rating agencies, product warranties, commercial banking, bankruptcy, and the Uniform Commercial Code.\textsuperscript{125} Again demonstrating his delight in deeply immersing himself in doctrinal questions for the purpose of focusing current policy and law reform, Professor Kozolochyk plunges into the origins of the doctrines of contractual consideration as they developed in English and U.S. law, comparing them to

\begin{footnotesize}
\begin{enumerate}
\item[120.] See id. at 749-858.
\item[121.] See Kozolochyk, supra note 23, at 861-941, 943-1031, 1033-80, 1081-115, 1117-27, 1129-58, 1159-1214, 1215-45.
\item[122.] See id. at 760-65.
\item[123.] See id. at 943.
\item[124.] See id. at 943-99.
\item[125.] See id. at 792-831, 844-53.
\end{enumerate}
\end{footnotesize}
the concept of causa in French law. He shows how the doctrine of consideration furthered the progress of commercial law in common law jurisdictions, while the doctrine of causa did not. In escorting the reader through the thoughts of Professor Alan Farnsworth and on to those of Lord Mansfield followed by the Restatement 2nd of Contracts, Professor Kozolchyk lays out the benefits of the fading of consideration as a prerequisite to the enforcement of executory contractual promises. Having done so, Professor Kozolchyk offers as an appendix a series of materials comparing U.S., Spanish, and Latin American case law that address the associated questions of the role of solemnities and formalities in contracting. Not content simply to pose the questions of the foundation of these practices in differing normative views and assessments of the values of scholastic and pragmatic reasoning as reflected in his review of the topics of consideration and causa, he challenges the reader to consider the burdens of the formality associated with contemporary Latin American practices of notarial formality relative to the treatment of corresponding transactions in Spain and the United States.

Through his concluding chapters on Anglo-American law, Professor Kozolchyk celebrates the creativity of merchants and the ability of the law to incorporate that creativity in ways that enhance the conduct of economic activity. For the student of law, Professor Kozolchyk offers not only the cogent exposition of the relevant doctrines of commercial law, but also a grounding in the dynamics of their continuing elaboration. Ever the passionate critic and coach, Professor Kozolchyk further offers his reader understanding of why the culture, mores, and substance of commercial law as practiced in the United States furthered economic growth. Undoubtedly enthusiastic, Professor Kozolchyk is continuously vigilant in focusing on the living law to highlight not only the elements of law and practice that he presents as worthy of emulation, but also the elements that result in dysfunction.

IV. The Shared Optimism of Professors Del Duca, Kozolchyk and The International Lawyer in a Dynamic World

When Professors Del Duca and Kozolchyk began their lives, the legal systems of multicultural empires such as those of the Ottomans and Austro-Hungary were recent realities, not distant memories, the Communist Party had not come to power in China, and the Cold War had yet to begin. Their engagement with the law, as professors in American law schools and as practitioners of law reform on a global scale, has drawn upon their shared

126. See id. at 861-917.
127. See KOZOLCHYK, supra note 23, at 862-71.
128. See id. at 902-14.
129. See id. at 917-41.
130. See id. at 930-34.
131. See id. at 980.
understanding that the role of law in society and its importance to human endeavor transcend any narrow strictures, be they of national sovereignty, language, or cultural affinity. Yet, their work confirms the vision of each in which appreciation of the granularity of the workings of the law in a given subject-matter, time, place, and community affords the grounding to compare, and from the comparison, to offer insight into the ends achieved. Their common experiences of themselves moving from one country to another, of experiencing the consequences first hand of fundamental national transitions (Mussolini to launch of the Republic of Italy, Battista to Castro), and the shared legacy of families who transitioned from one continent to another in need and in search of a better future, empowered them to appreciate clearly the need for good law and the consequences of dysfunction in the working of a legal system.

In the fifty years of *The International Lawyer*, the restless curiosity of a community of able lawyers across a broad array of subject matters as to what the law is and what it should be is ever evident. It is the curiosity that Professors Del Duca and Kozolchyk demonstrate in the two works of present focus. It is the curiosity of able practitioners of the law not content with understanding a single legal system in isolation, but rather fascinated with the crossing of boundaries of culture, place, and time, and with what can be learned from comparison, integration, and interconnection. Although the two works of present focus come from opposite ends of long and distinguished legal careers, they each manifest the alert curiosity of an enduringly young mind, tempered with awareness of what is at stake in questions pertaining to the rule of law.

Roberto Mangabeira Unger concluded his work, *The Critical Legal Studies Movement*, with a stirring condemnation of the conventional legal academy as “like a priesthood that had lost their faith and kept their jobs [, standing] in tedious embarrassment before cold altars.” Those who have made the acquaintance of Professors Del Duca and Kozolchyk know that each throughout their professional lives has sustained an energetically optimistic view of his academic endeavors, mentoring of rising lawyers (men and women, of diverse backgrounds, and from around the world as well as the United States), and participation in rule of law reform initiatives. In their respective works here singled out for attention, they each eagerly dive into the enterprise of deconstructing orthodoxy that they find misplaced. In addition to the ability to be critical, they clearly share with participants of the critical legal studies movement an enthusiastic passion for the enterprise of understanding not only the law and how it works, but also to employ that understanding to good end. But, their motivations are not tinged with the “heart’s revenge” that Professor Unger found at the time in the “mind’s opportunity” of critical legal studies. Instead, their work appears infused with the optimistic spirit of Eleanor Roosevelt and others reflected in the opening declaration of the Charter of the United Nations:

WE THE PEOPLES OF THE UNITED NATIONS DETERMINED

to save succeeding generations from the scourge of war, which twice in our lifetime has brought untold sorrow to mankind, and
to reaffirm faith in fundamental human rights, in the dignity and worth of the human person, in the equal rights of men and women and of nations large and small, and
to establish conditions under which justice and respect for the obligations arising from treaties and other sources of international law can be maintained, and
to promote social progress and better standards of life in larger freedom,

AND FOR THESE ENDS

to practice tolerance and live together in peace with one another as good neighbours, and
to unite our strength to maintain international peace and security, and
to ensure, by the acceptance of principles and the institution of methods, that armed force shall not be used, save in the common interest, and
to employ international machinery for the promotion of the economic and social advancement of all peoples.\textsuperscript{133}

This is the spirit of optimism, ambition, and engagement that I read in the works of Professors Del Duca and Kozolchyk here considered and that I see reflected in the fifty years of publication of \textit{The International Lawyer} to date. As the members of our Section of International Law manifest this same spirit, and as they continue to esteem \textit{The International Lawyer} as a premier venue for our community of lawyers to publish and to read the contributions of their most thoughtful peers, \textit{The International Lawyer} has a bright future over its second fifty years.

Primary National Security Threats Facing the United States: The Magnitude of Their Threats and Steps That Have Been or Might Be Taken to Counteract Them

JOHN F. MURPHY*

Everyone would agree that the United States currently faces extremely serious national security threats; however, there is some disagreement as to what actually constitutes a national security threat. Is it—or should it be—limited to military threats, or should it have a more expansive focus and include economic, environmental, and other important facets of life? Ideally, I would favor the more expansive focus, because I certainly agree that economic and environmental threats can endanger national security. But because of time and space limitations, this article will consider only military threats to national security.

There is little, if any, resistance now to including military threats from violent non-state actors in addition to military threats from other nation-states. By way of violent non-state actors, this article will use as its primary examples, the Islamic State, Al Qaeda, and other forms of Islamic jihadists. The nation-states included in this article, pertaining to national security threats to the United States, are China, Russia, and North Korea.

I. Traditional Threats to U.S. National Security: Nation-States

Traditionally, and historically, primary threats to U.S. national security have emanated from other nation-states. This is hardly surprising, because many, indeed most, nation-states regard the development of resources...
adequate to allow them to resort to military armed force, when vital to national interest. As we shall see later in this article, one of the many extraordinary, and challenging, aspects of the Islamic State is its ability to use military force in conventional battles—which quite often defeats the forces of nation-states.

Sadly, there are surely more than three nation-states that, at least under certain circumstances, might constitute a threat to the national security of the United States. But for reasons that I hope will become clear, China, the Russian Federation, and North Korea, all deserve special attention. We begin with China.

A. CHINA

Many commentators, when considering whether China constitutes a military threat to U.S. national security, adopt what might be called a quantitative approach. That is, they focus on the number and type of military assets available in each country. According to this approach, if China compares favorably to the United States, it means that China constitutes a military threat to the United States. A 2008 article adopting this approach concludes that China does not constitute a military threat to U.S. national security. The authors add some sarcasm to their conclusion: “Only those who believe that Fu Manchu is alive and well in the Middle Kingdom and fulfilling his dreams of world domination through a large and aggressive army, air force, and navy still subscribe to a notion that China poses a global military threat.” But the article noted above was written eight years ago, and the Chinese have greatly increased, and improved, their military assets; thus, it is still probable that China has limited ability to project its military power on a global basis. But China’s possible military threat to U.S. national security is primarily regional, rather than global, in nature.

To illustrate, major tensions have arisen between the United States and China because of China’s extravagant territorial claims over the South China Sea. The South China Sea is part of the Pacific Ocean, and encompasses an area from the Singapore and Malacca Straits to the Strait of Taiwan.

2. After comparing the air, naval, and weapons capabilities of China with those of the United States, the authors conclude that categorically “China is not a military threat to the United States.” See Henry Rosemont & John Feffer, Is China a Threat?, FOREIGN POLICY IN FOCUS (Feb. 6, 2008), http://fpif.org/is_china_a_threat.

3. Id.

4. See, e.g., Stephen G. Brooks & William C. Wohlforth, The Once and Future Superpower: Why China Won’t Overtake the United States, 95 FOREIGN AFFAIRS 3 (May/June 2016). (In which the authors claim that “Economic growth no longer translates as directly into military power as it did in the past, which means that it is now harder than ever for rising powers to rise and established ones to fall . . . . Even though the United States’ economic dominance has eroded from its peak, the country’s military dominance is not going anywhere, nor is the globe-spanning alliance structure that constitutes the core of the existing liberal international order (unless Washington unwisely decides to throw it away)).

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The strait that separates the island of Taiwan from mainline China. China essentially claims territorial sovereignty over the entire South China Sea. This claim, however, comes into direct conflict with the territorial claims made by its “smaller and weaker neighbors,” especially Vietnam and the Philippines. All of these nation-states make “claim[s] to islands, coral reefs, and lagoons in waters rich in fish and potential gas and oil reserves. China’s recent construction of artificial islands . . . complete with airstrips and radar stations,” plus neighboring nation-state’s naval patrols “challenging Beijing’s vast territorial claims have raised concern that the strategically important waters could become a flashpoint.”

The United States has made no territorial claims, and has resisted China’s claims, to the waters of the South China Sea. But on April 19, 2016, the U.S. military protested China’s landing of a military jet on a man-made island in South China Sea. U.S. military officials have said that any attempt by China to fly military aircrafts from the man-made island would not deter U.S. flights over the area because the United States believes that these man-made islands are not islands entitled to territorial seas or exclusive economic zones under the U.N. Convention on the Law of the Sea of 1982.

Interestingly, China is a party to the U.N. Convention, but the United States is not, due to their objections to the deep sea-bed provisions of the Convention. The United States, however, claims that most of the other provisions of the Convention are binding under customary international law.

It is noteworthy that the Philippines has challenged China’s territorial claim over the South China Sea before a U.N. arbitration tribunal. But China has refused to recognize the tribunal’s jurisdiction, and has indicated that they will not carry out any decision the tribunal might issue against them. Indeed, “China claim[ed] ‘indisputable sovereignty’ over the territory, and rejects arbitration as ‘a political provocation in the guise of law.’”

Although the Philippines has been described as being “decades away from having a credible defense force,” the United States and the Philippines have entered into an agreement that allows the United States to build facilities at

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7. Id.


10. See id.

11. See id.
five Philippine military bases. 12 This will spread more American troops, planes, and ships across the island nation, which some analysts suggest could “tilt the balance of power” in the South China Sea region. 13 Be that as it may, the agreement and planned U.S.-Philippine joint military exercises may, at a minimum, cause China to be more cautious in its relations with the Philippines.

In the past, the Taiwan Strait has been a “dangerous flash point for conflict.” 14 Tensions between the People’s Republic of China (CPRC), the government of the Chinese mainland, the Republic of China (ROC), and the government of Taiwan, date back to the end of the Chinese Civil War, when the Chinese Communist Party defeated the losing Nationalist Party (the Kuomintang, or KMT) which fled to Taiwan. 15

The cross-strait relationship was characterized by tensions and periodic crises during the 1950s and 1960s, and the ROC, in 1954 signed an alliance treaty with the United States. Washington did not establish diplomatic relations with the PRC until 1979, at which point it severed diplomatic ties, and abrogated its alliance with the ROC. 16

As a result of this tension, the United States does not have any formal diplomatic ties with Taiwan, and therefore, does not have a treaty obligation to come to Taiwan’s defense if it is attacked.

While “Taiwan prepared for its first direct presidential election in 1996,” China increasingly feared that Taiwan was moving toward formal independence, and consequently, “a prolonged crisis erupted in the Taiwan Strait.” 17 China not only conducted “missile tests in [the] waters near Taiwan,” but also threatened to invade the island. 18 Former U.S President Bill Clinton, however, defused the crisis when he decided to “deploy two [armed] aircraft carrier battle groups into the area,” and was ready to come to Taiwan’s defense if necessary. 19 But it is unclear whether today a U.S. President would be willing to send aircraft carriers to defend Taiwan, in a like manner, because China has developed advanced cruise and ballistic missiles that could pose a significant threat in any future conflicts with the United States. 20 According to former Chief of U.S. Naval Operations,

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12. Id.
13. Id.
14. See Scott L. Kastner, Is the Taiwan Strait Still a Flash Point?: Rethinking the Prospects for Armed Conflict between China and Taiwan, 40 INT’L SEC. 54, 54 (Winter 2015/2016).
15. See id.
16. Id. at 56
17. Id. at 57.
18. Id.
19. Id.
20. Kastner, supra note 14, at 70.
Admiral Jonathan Greenert, China could pose a great threat to the United States, especially if the conflicts were in proximity to China.21

In addition, it is unclear whether the status of Taiwan poses a current threat of armed conflict. In January 2016, Taiwan elected Tsai Ing-Wen, its first female President. During her pre-presidential career, Tsai has expressed her support for Taiwan becoming independent; however, there are indications that she will be cautious in expressing such views now that she has become president, especially because China has stated on several occasions that it would invade Taiwan if Taiwan were to declare itself independent.22 Moreover, Tsai’s immediate presidential predecessor, Ma Ying-jeou, first elected in 2008, pursued a “détente with Beijing,” in which during his time in office, China and Taiwan concluded “twenty-one agreements covering, among other things, economic and cultural cooperation.”23 Also, cross-strait trade increased by almost 100 percent.24 All of this has benefited both China and Taiwan, however, it is highly probable that many of these benefits would disappear if conflict were to erupt, especially if it were to escalate into a war between the United States and China.

One major risk that is hard to measure is miscalculation. Miscalculation is present in the United States’ relations with China, and as we shall see in the next section of this article, may have an even greater presence in the United States’ relations with Russia. If China were to conclude, for example, that the United States is no longer committed to defend Taiwan in the event of an armed attack, the risk of China deciding to use armed force to incorporate Taiwan within its territorial sovereignty would increase. Similarly, with respect to the South China Sea, there is considerable danger of various miscalculations in relations between China and its dealings with the United States, as well as with China’s neighbors, such as Vietnam and the Philippines. The continuing rise of nationalism in China and other Asian nation-states only exacerbates the problem.

B. RUSSIA

In 1991, the month of December was a momentous time for the Soviet Union (former USSR). On December 8, 1991, “[Boris] Yeltsin, as head of the Russian Republic, declare[d] Russia’s independence in the Minsk Accord,

24. Id.
which [Yeltsin] sign[ed] with the Ukrainian and Belorussian republics."25 Yeltsin declared that the USSR, "as a subject of international law and geopolitical reality no longer exists."26 And on December 26, 1991, the "Supreme Soviet [formally] recognize[d] the dissolution of the USSR," which culminated with "the United States and the Russian Federation establish[ing] diplomatic relations" on December 31.27 Prior to these happenings, specifically in 1989 and 1990, the countries of Central and Eastern Europe became independent, and non-Communist.28 Contested elections were introduced into the USSR, as were limited versions of freedom of speech and publication.29

NATO took advantage of the dissolution of the USSR, and expanded its membership to include those nation-states previously under Soviet control. On March 12, 1999, the first expansion of NATO took place "with the addition of Poland, Hungary, and the Czech Republic."30 On March 19, 2004, the "largest single expansion of membership" took place when seven nation-states: Estonia, Latvia, Lithuania, Slovenia, Slovakia, Bulgaria, and Romania became members.31 To date, "the final expansion of NATO's membership took place on April 1, 2009," when Albania and Croatia joined NATO.32 As pointed out by Arthur Downey, with the addition of Albania and Croatia, since 1949, NATO had expanded from its original membership from twelve nation-states, to twenty-eight nation-states, over the sixty-year period.33

Russia challenged the legality of all three NATO expansions on the ground that the expansions violated promises "that the West made to the Soviet Union at the time of German reunification, namely that NATO would not expand eastward."34 In the Russian view, "the USSR was willing to agree to the unification of Germany"—even as a new, western influenced Germany within NATO—provided NATO did not move eastward.35 This argument is problematic because, as Downey has pointed out, "there is no written evidence—or document—of such a Western agreement to refrain from the eastern expansion of NATO,"36 and it is highly unlikely that the West would make such a promise without reducing it to writing for legally binding effect.

26. Id.
27. Id. at 190.
28. Id. at 188.
29. Id.
30. Id. at 45.
31. Downey, supra note 25, at 45-46.
32. Id. at 46.
33. Id.
34. Id.
35. Id.
36. Id.
The collapse of the Soviet Union had a devastating effect on Russia’s military situation. As one scholar put it:

The Russian military rotted away. In one of the most dramatic campaigns of peacetime demilitarization in world history, from 1988 to 1994, Moscow’s armed forces shrank from five million to one million personnel. As the Kremlin’s defense expenditures plunged from around $246 billion in 1988 to $14 billion in 1994 . . . . the government withdrew some 700,000 servicemen from Afghanistan, Germany, Mongolia, and Eastern Europe. So much had the prestige of the military profession evaporated during the 1990s that when the nuclear submarine Kurst sank in Barents Sea in 2000, its captain was earning the equivalent of $200 per month.37

No doubt in large part because of Russia’s greatly weakened military position after the collapse of the Soviet Union, Russia was initially very cautious in its use of military force. For example,

from 1991 to 2008, during the presidency of [ ] Yeltsin, and the first presidential term of Vladimir Putin, Russia used its scaled-down military within the borders of the former Soviet Union, largely to contain, end, or freeze conflicts there. Over the course of the 1990s, Russian units intervened in ethnic conflicts in Georgia and Moldova and in the civil war in Tajikistan[—]all minor engagements.38

In its weakened military state, Russia for some time, actually “sought a partnership with the United States,” and cooperation with NATO, when it came to taking action beyond the borders of the former Soviet Union.39 This led to Russia “joining the peacekeeping operation led by [NATO] in Bosnia and Herzegovina in 1996.”40 The situation changed, however, in the mid-1990s, when Russia realized that there was no chance that it could achieve membership in NATO.41 Russia then “protested vehemently against [NATO’s] eastern expansion, its 1999 bombing campaign in Yugoslavia, and the 2003 U.S. invasion of Iraq, but Russia’s military was too weak to block any of these moves.”42 Instead, Russia relied on its “nuclear deterrent” to guarantee its “security and sovereignty.”43

Vladimir Putin soon adopted a much more aggressive posture. Beginning in 2008, Putin decreed military reforms, and sponsored a “massive increase in defense spending to upgrade Russia’s creaky military.”44

38. Id.
39. Id.
40. Id.
41. Id.
42. Id.
43. Trenin, supra note 37, at 23.
44. Id.
More recently, Russia has shown a willingness to use force to get what it wants.

First, in February 2014, Moscow sent soldiers in unmarked uniforms to wrest control of Crimea from Ukraine, implicitly threatening Kiev with a wider invasion. It then provided weaponry, intelligence, and command-and-control support to the pro-Russian separatists in Ukraine’s Donbas region, checking Kiev’s attempts to defeat them. And then, in the fall of 2015, Russia ordered its air and naval forces to bomb militants in Syria fighting President Bashar al-Assad, intervening [militarily] in the Middle East for the first time in history.45

It is perhaps time to pause and consider whether this Russian military build-up and aggressive behavior constitutes a threat to United States national security. There is no question, of course, that Russia has once again become a military power after a quarter century of military weakness and that it has shown a willingness and capacity to compete militarily with NATO. It is nonetheless debatable whether Russia has become a national security threat to the United States. Gideon Rose, the Editor of *Foreign Affairs*, in his Preface to the Section on *Putin’s Russia* in the May/June 2016 issue has stated,

[t]ogether, these articles suggest pessimism about the future of Putin’s regime, which has glaring structural weaknesses and limited prospects for advancement. But they also suggest that it does not pose a major imminent threat to world peace and stability. The current chapter of Russia’s story is unlikely to end well, yet external pressure or provocation seems likely to inflame the situation rather than improve it. Dealing with such a challenge successfully will require a careful hand and a combination of firmness, prudence, and patience.46

Sadly, Mr. Rose’s view of the current situation may be overly optimistic. This is because at the time I am writing this article a major crisis is brewing in the Baltic countries of Lithuania, Latvia, and Estonia.47 According to reports, “Western allies are preparing to put four battalions—a force of about 4,000 troops—in Poland and the Baltic countries as part of an effort by NATO to reinforce its border with Russia as it steps up military activity.”48 U.S. Deputy Secretary of Defense Robert Work said the buildup was in response to Russian movement of troops right up against the borders.49 In an interview Mr. Work said “From our perspective, we could argue this is extraordinarily provocative behavior.”50 It is important to note

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45. Id.
48. Id.
49. Id.
50. Id.
that Poland and the Baltic countries are members of NATO, and the United States and other member states of NATO have an international obligation under article five of the NATO Treaty to come to their aid if they are subject to an armed attack.\textsuperscript{51}

As I mentioned above in the section on China, the risk of a miscalculation by a U.S. adversary is especially worrisome. If the Putin administration believes that it can engage in aggressive armed force in the Baltic countries without a military reaction by United States and other NATO members, he will have made a very serious miscalculation indeed, one that could result in armed conflict between the United States and Russia. One hopes that this can be avoided by intensive diplomatic negotiations between the two countries.

Russia’s 2008 war in Georgia was a clear success for Putin.\textsuperscript{52} According to one scholar,

Russian forces routed troops loyal to the pro-Western president, Mikheil Saakashvili, and secured the breakaway republics of Abkhazia and South Ossetia as Russian protectorate. . . Moscow prevented Nato (sic) from expanding into a former Soviet state that was flirting with membership, confirmed its strategic supremacy in its immediate southern and western neighborhood, and marked the limits of Western military involvement in the region.\textsuperscript{53}

In the fall of 2015, Russia took a momentous step: it intervened in Syria’s civil war. Prior to this action, Russia had tended to project force only within the borders of the former Soviet Union.\textsuperscript{54} But with respect to Syria, Russia dispatched several dozen aircraft to strike the Islamic State and other anti-Assad forces.\textsuperscript{55} In addition, Russia “established advanced air defense systems within Syria, sent strategic bombers on sorties over the country from bases in central Russia, and ordered the Russian navy to fire missiles at Syrian targets from positions in the Caspian and Mediterranean Seas.”\textsuperscript{56} UN sources have estimated that the war in Syria has killed over 250,000 people

\textsuperscript{51} North Atlantic Treaty art. 5, Apr. 4, 1949, 63 Stat. 2241, 34 U.N.T.S. 243 provides “The Parties agree that an armed attack against one or more of them in Europe or North America shall be considered an attack against them all; and consequently they agree that, if such an armed attack occurs, each of them, in exercise of the right of individual or collective self-defense recognized by Article 51 of the Charter of the United Nations, will assist the Party or Parties so attacked by taking forthwith, individually and in concert with the other Parties, such action as it deems necessary, including the use of armed force, to restore and maintain the security of the North Atlantic area. Any such armed attack and all measures taken as a result thereof shall immediately be reported to the Security Council. Such measures shall be terminated when the Security Council has taken the measures necessary to restore and maintain international peace and security.”

\textsuperscript{52} See Trenin, supra note 37, at 24.

\textsuperscript{53} Id.

\textsuperscript{54} Id. at 26.

\textsuperscript{55} Id.

\textsuperscript{56} Id. at 25.
and driven 11 million from their homes. The 11 million driven from their homes have fled to Greece and other countries in Western Europe and created an enormous refugee problem for these countries. The United States is greatly concerned over the adverse effect that this has had on some of its closest allies, especially the threat to their national security.

Earlier, in response to reports that President Assad of Syria was using chemical weapons against the rebels, U.S. President Barack Obama drew a so-called “red line” against such attacks and threatened military force against Syrian forces if they used chemical weapons. When there were further Syrian chemical weapons attacks, however, no U.S. military response was forthcoming. Instead, at Putin’s suggestion, the United States and Russia agreed that international inspectors should destroy Syria’s chemical weapons and Syria agreed to this process. Destruction of the Syrian chemical weapons supply was completed in June 2014.

At the time of this writing, a fierce battle for the northern Syrian city of Aleppo threatened a cease-fire arranged by Russia and the United States. There is also fighting in the city of Afrin, northwest of Aleppo, between U.S. allied Kurds and rebels aligned with Turkey that is hindering the international effort to destroy the Islamic State. The United States’ priority is to destroy the Islamic State. Russia is not opposed to this policy, but its priority is to help the Assad regime stay in power, and to this end, Russia is generally battling, with an air campaign, the rebels who are fighting against Assad, some of whom the United States is backing.

There is no question of the strength of the adversarial relationship that exists between the United States and Russia. Nonetheless, the cease-fire arranged by the joint effort of both countries shows that cooperation is possible if both countries’ interests coincide, and both countries have decided that at the minimum there should be a pause in the armed conflict in Syria. It is also in the interest of both countries to destroy the Islamic State, even if at the moment this goal is not Russia’s top priority. According to Reuters, however, Muslim minorities make up 14 percent of Russia’s population, and it is worth remembering that in 1994, Boris Yeltsin sent the Russian military into Chechnya in an attempt to crush a Muslim separatist rebellion. In light of all this, and the complexity of the challenge posed by

58. Id.
61. Id.
62. Id.
63. See Sam Dagher & Dion Nissenbaum, Aleppo Battle Blunts Truce Effort, WALL ST. J., Apr. 30-May 1, 2016, at A8.
64. Id.
Russia to U.S. vital interests, Mr. Rose’s advice that this challenge will “require a careful hand and a combination of firmness, prudence, and patience” is compelling.66

C. NORTH KOREA

Speaking of challenges to U.S. vital interests, President Obama has recently stated that North Korea poses a “massive challenge” for the United States.67 He reported that the United States is repositioning its missile-defense system “so that even as we try to resolve the underlying problem of nuclear development inside of North Korea, we’re also setting up a shield that can at least block the relatively low-level threats they are posing right now.”68 Obama told his interviewer, Charlie Rose, that North Korean leader Kim Jong Un is “personally irresponsible.”69 He added, “we could obviously destroy North Korea with our arsenal, but aside from the humanitarian costs of that, they are right next door to our vital ally South Korea.”70 U.S. efforts to persuade China, North Korea’s only ally, have been modestly successful at best, although China has supported UN sanctions against North Korea.

At the time of this writing, North Korea was about to hold the seventh Congress of the governing Workers’ Party the next day.71 Meeting for the first time in a generation, the Congress was expected to cement Mr. Kim’s status as supreme leader.72 The New York Times has aptly summarized Mr. Kim’s ruthlessness:

Mr. Kim was still in his late 20s when the death of his father, Kim Jong-il, in 2011 catapulted him to the top of the secretive regime. Outside analysts who had predicted openness and diplomatic compromise under his young leadership—Mr. Kim had spent time in Switzerland as a teenager—had a surprise in store.

The young man had more than 100 senior party officials or generals, including his own uncle, executed while he also let the Workers’ Party regain its influence on the military. Thousands more were demoted or banished. He engineered purges with such frequency and ruthlessness that President Park Geun-hye of South Korea called Mr. Kim’s rule a “reign of terror.”

66. See Gideon Rose, supra note 46, at 10.
67. See David Nakamura, Obama: U.S. is ‘setting up a Shield to Block North Korean Missiles, WASH. POST, Apr 26, 2016, at 1.
68. Id.
69. Id.
70. Id.
72. Id.
His main selling point domestically has been his image as a strong young leader able to arm his country with nuclear weapons. In recent months, North Korea has tried to bolster that image by reporting success in a flurry of tests of technologies needed to acquire a nuclear strike capability, including the test of what it called a submarine-launched ballistic missile.73

Dealing with North Korea is indeed a “massive challenge” to the national security interests of the United States. Not only does the United States have to interpret China’s ambiguous policy toward North Korea’s threats and actions, it also has to decide whether the mutual assured destruction (MAD) doctrine that effectively barred a first strike nuclear policy during the Cold War will work against North Korea. There is also a serious question whether the economic sanctions imposed against North Korea will in any way hinder the development of their nuclear strike capacity. Although Mr. Kim tries to promote his so-called byungjin policy, which calls for simultaneously developing achieving both a nuclear arsenal and economic development, the history of North Korea indicates that if faced with a choice, it will opt for a nuclear arsenal. During the 1990s, millions of North Koreans died of hunger during a famine.

II. Now for Something Really Different: Islamic State, Al Qaeda, and Other Forms of Islamic Jihadism

The U.S. invasion of Iraq and the overthrow of Saddam Hussein in 2003 have been sharply criticized by many commentators and for various reasons. For example,

[t]he subsequent breakdown of state institutions and the American occupation’s failure to fill the security vacuum caused by the dissolution of both the army and the Bath Party allowed the Islamic State to gain a foothold in Iraq where it fought a guerilla war against the United States and the Shia led government of Nuri al-Maliki.74

Later, in Syria, after civil war erupted in 2011, the Islamic State “began to morph into the behemoth we see today.”75

Initially, the Islamic State became an Al-Qaeda affiliate in Iraq after swearing allegiance to Osama bin Laden.76 It later broke free from Al-Qaeda because of disagreements over strategy and methodology.77 Some of Al-Qaeda’s primary characteristics and differences between it and Islamic State have been described as follows:

73. Id.
75. Id.
76. Id.
77. Id.
Al-Qaeda is part of a long tradition of ultra-conservative Salafi movements with roots in Saudi Arabia and largely informed by the teachings of Sayyid Qulb, a radical Islamist from Egypt who died in 1966. The group relies heavily on suicide bombers and armed hit squads to strike at its—mainly western—enemies outside the Middle East, primarily the United States (e.g., the USS Cole and 9/11 attacks) and to a lesser extent Europe (e.g., the attack on Charlie Hebdo in Paris). Al-Qaeda has been highly critical of the Islamic State’s televised beheadings through the years and condemns its violence against the Shia, which the former views as part of the wider Muslim community (the umma).

In comparison, the Islamic State (IS) is a hybrid organization that merged a rogue Al-Qaeda affiliate with elements of the defunct Baath Party and Iraqi military during the insurgency. Many of the group’s top battlefield tacticians are in fact former military commanders who once served in Saddam Hussein’s army. The group’s overall objective is the establishment, expansion and defense of an Islamic Caliphate through territorial conquests and by waging jihad against all perceived infidels, foreign and domestic, including Shiite Muslims. Although IS does dispatch suicide bombers and armed militants to strike certain targets, it is more insurgent army and state building enterprise than classic terrorist organization.  

In other words, the Islamic State can be described as “something really different” because it has many of the characteristics of a nation-state, and a very powerful one at that. To be sure, it seeks to establish an Islamic Caliphate through territorial conquests rather than a new country, but it has a military force with highly competent commanders, which help it hold its own against national militaries, often defeating them in individual battles. Particularly impressive is the Islamic State’s effective use of the Internet and social media to disseminate propaganda in multiple languages. Its mass executions, beheadings, and other shocking atrocities are quickly turned into finely produced videos. These videos serve both to keep the Islamic State in the news and to entice potential recruits who want to be part of something successful. Also, in the videos, Islamic State spokesmen argue that the West, specifically the United States, is engaged in a “War on Islam” and has committed numerous atrocities against individual Muslims as part of this war. In its early days, the Islamic State relied on funding from wealthy

78. Id.
79. Sedgwick, supra note 74.
80. Id.
81. Id.
benefactors in the Arabian Gulf, especially Saudi Arabia and Kuwait. But in recent years, it has become close to self-sustaining through its control of oil fields in various locations, such as eastern Syria. Through propaganda and other means the Islamic State has become a truly global operation.

There are a number of developments that have contributed to the nature of the threat the world faces today. These developments include the withdrawal of U.S.-led coalition forces from Iraq in 2011 and the drawdown from Afghanistan in 2014, the Arab Spring fallout in the Middle East, and the flow of fighters in thousands from all over the world to Iraq and Syria, among other places. More specifically, post-Arab Spring political chaos and instability in the Middle East have enabled fledging, mostly marginalized, groups to reorganize and pose threats to the security and stability of the world.

These developments have resulted in a substantial increase in the number of Islamic jihadist groups in the world. These actors can conveniently be divided into old actors and new actors. Perhaps the best example of an old actor is Al-Qaeda and its affiliates, such as Al-Nusra Front. The old actors are struggling to retain their prominence. New actors like the Islamic State, are competing for supremacy and legitimacy in the global jihadist arena. As one commentator has noted, “this has polarized radical and violent Muslim groups and individuals worldwide.” Some groups have pledged allegiance to the Islamic State, while others remain loyal to Al-Qaeda. At the same time, the sectarian divide between Shiites and Sunnis within the Muslim world has hardened significantly, leading to increasing levels of violence in many countries.

The Islamic State in particular has enjoyed affiliates that have pledged allegiance. Perhaps the most striking example is the October 2015 downing of a Russian passenger plane over Egypt’s Sinai Peninsula, which killed 224 people. Although the Islamic State claimed responsibility, “a different beast” caused the crash. The “different beast” was an Islamic State affiliate that had pledged its loyalty to Abu Bakr al-Baghdadi, the Islamic State’s self-declared Caliph. The Islamic State calls these affiliate groups “wilayat, Arabic for ‘provinces.’”

83. See Sedgwick, supra note 74.
84. Id.
86. Id.
87. Id.
88. Id.
89. Id.
90. Id.
92. Id.
93. Id.
94. Id.
The Islamic State’s provinces are far-flung. If these provinces have begun to align their actions with those of the Islamic State, then its geographic reach has expanded extensively. This expanded reach poses a serious threat to Western interests in that it makes local groups more deadly in their regional conflicts.

The provinces of the Islamic State are quite a phenomenon. The center of the Islamic State is in the Sunni-populated parts of Iraq and Syria, and it splits headquarters between Mosul (Iraq) and Raqqa (Syria). But the Islamic State claims to be the ruler of all Muslims, and it operates throughout the Muslim world. “It has already declared wilayat in parts of Afghanistan, Algeria, Egypt, Libya, Libya, Nigeria, Pakistan, Saudi Arabia, Yemen, and the Caucasus. Terrorists or fighters operating in Isis’ name have also conducted attacks in Bangladesh and Kuwait.”

One writer has identified Egypt and Libya as containing the “most worrisome” provinces. The Egyptian affiliate, Sinai Province, at first focused its attacks on Egypt’s military and police. But it soon raised its ambitions and went after UN targets, beheaded a Croatian expatriate (supposedly in revenge for Croatia’s participation in the international anti-Isis coalition), and attacked the Italian consulate in Cairo. Then, as noted above, they downed the Russian airliner.

“The Libyan province emerged from the strife that followed the overthrow of the Libyan dictator Muammar al-Qaddafi in 2011.” The U.S. Government’s decision to support the rebels who overthrew the Qaddafi regime was one of the worst decisions, in national security and foreign policy terms, ever made by a U.S. administration and deserves some consideration as a backdrop to the creation of the Libyan province.

The background to the creation of the Libyan province, at least for purposes of this article, begins on March 17, 2011, when the UN Security Council adopted Resolution 1973, with the administration of U.S. President Barack Obama pushing hard for its adoption. The resolution authorized military intervention in Libya. In explaining U.S. support for military intervention, President Obama said it was necessary to save the lives of peaceful, pro-democracy protesters who found themselves the target of a
crackdown by Libyan dictator Muammar al-Qaddafi. Additionally, he added that Qaddafi was posed to commit a bloodbath in the Libyan city where the uprising had started. According to President Obama, “[w]e knew that if we waited one more day, Benghazi—a city nearly the size of Charlotte—could suffer a massacre that would have reverberated across the region and stained the conscience of the world.” Two days after the UN authorization, the United States and other NATO countries established a no-fly zone throughout Libya and started bombing Qaddafi’s forces. “Seven months later, in October 2011, after an extended military campaign with sustained Western support, rebel forces conquered the country and shot Qaddafi dead.”

U.S. officials were triumphant after the military victory. Writing in 2012, Ivo Daalder, the then U.S. Permanent representative to NATO, and James Stavidis, the then supreme allied commander of Europe, declared, “NATO’s operation in Libya has rightly been hailed as a model intervention.” In the Rose Garden after Qaddafi’s death, President Obama said, “without putting a single U.S. service member on the ground, we achieved our objectives.”

The President’s statement, however, raises a key question: What were the Obama Administration’s objectives? In a comment on Alan J. Kuperman’s article, Derek Chollet and Ben Fisherman argue that it was Qaddafi’s intransigence, and not NATO that turned the intervention from a mission to protect into something that led to regime change.

In a reply, however, Kuperman noted to the contrary that, “[t]he facts show otherwise. Just three days into the bombing campaign, it was the Obama administration that unilaterally terminated peace negotiations between U.S. Africa Command and the Qaddafi regime.” Kuperman also raises some other, quite disturbing facts and developments:

The most repugnant part of Chollet and Fishman’s response comes when they blame Qaddafi for his own torture and execution. It was because of the Libyan leader’s refusal to acquiesce to NATO bombing, they insist, that ‘the way Qaddafi ended his rule—on the run and hiding in a sewer pipe, before being killed—was inevitable.’

107. Id.
108. Id.
109. Id.
110. Id.
111. See Kuperman, supra note 105.
112. Id.
113. Id.
116. See Kuperman, supra note 105.
Not so. This gruesome denouement was hardly inevitable. Instead, it was the result of the Obama administration’s serial errors: starting a war of choice based on a faulty premise, exceeding the UN’s mandate to protect civilians, rejecting Qaddafi’s peace offers, insisting on regime change, and supporting an opposition composed of radical Islamists and fractious militias.

After Qaddafi’s death was confirmed in October 2011, a gloating Secretary of State Hillary Clinton declared to a television reporter, ‘We came, we saw, he died!’ She was justified in claiming credit on behalf of the Obama administration for the outcome in Libya, including Qaddafi’s brutal murder. Back then, however, she and her colleagues believed their intervention was a success. Now that it has turned into a dismal failure, it is too late to shed responsibility. As President George W. Bush learned the hard way, ‘mission accomplished’ can be declared, but subsequent events may haunt you.117

It is important to note exactly what Secretary Clinton was gloating about: the possible commission of three international crimes by the rebels aided and abetted by the support of the U.S. government. Although the primary reason supporting military intervention was that it was necessary to protect civilians from attacks by Qaddafi forces, Kuperman seems to question this by noting that, “striving to minimize civilian casualties, Qaddafi’s forces had refrained from indiscriminate violence.”118 In sharp contrast, the rebels used armed force indiscriminately, often deliberately targeting civilians, including women and children, which would constitute an international crime.119 A second possible international crime committed by the rebels was the alleged torturing of Qaddafi after he was captured.120 Torture is prohibited by an international convention121 and is a crime under U.S. law subject to criminal penalties.122 The third possible international crime committed by the rebels was the execution of Qaddafi.123

117. Id.
118. Id.
119. Id.
122. See The Torture Convention Implementation Act of 1994; 18 U.S.C. Section 2340 et seq. (2000). In Section 2340 A (b), Congress has established federal criminal jurisdiction over torture committed or attempted outside the United States if: (1) the alleged offender is a national of the United States, or (2) the alleged offender is present in the United States, regardless of the nationality of the victim or alleged offender.
123. Rayner, supra note 120.
Not surprisingly, the defeat of Qaddafi forces has been followed by chaos and battles between militias seeking to come to power in Libya. It has also been followed by increasingly successful efforts by the Islamic State to expand in the country. As the Islamic State expands, the threat of uncontrolled migration arises as people flee from the advancing Islamic State forces. Libya’s Mediterranean coast is a main departure point for migrants to Southern Europe.

At this writing, after attending a conference in Vienna, the United States and twenty other nation-states have pledged to consider training and arming the Libyan government as it struggles to stop the Islamic State onslaught.124 The Islamic State currently controls the Mediterranean port of Sirte and in recent weeks has gained territory in government-held areas.

It is perhaps ironic that the Islamic State is expanding the territory it holds in Libya, because other recent reports indicate that elsewhere the Islamic State is losing territory in the “grinding war in the Middle East.”125 As a result, the Islamic State is engaging less in pitched battles with the forces of nation-states and turning instead to direct attacks on the softer target of civilians, especially in the form of suicide bombngs. For example, in three straight days of bombings in Baghdad starting on May 11, 2016, they killed more than 100 people.126 Such attacks minimize the casualties that the Islamic State suffers compared with the number of people they kill and the property damage they inflict. More important, these attacks may play an important role in the Islamic State’s propaganda efforts, as they are examples of taking the fight to their enemies. This may help to counter the negative impression given by reports of loss of territory by the Islamic State.

A happy development, from the perspective of the United States, Great Britain, and other nation-states fighting against the Islamic State, Al-Qaeda, and other forms of jihadism, is the election of Sadiq Khan as London’s first Muslim mayor in the early hours of May 7, 2016.127 Khan is the son of an immigrant Pakistani bus driver. He is also a British citizen trained as a lawyer, who has appeared on platforms with Islamic extremists as a human rights lawyer defending them. British authorities report that at least 800 people have left the United Kingdom to fight for the Islamic State in Iraq

127. For an excellent article on Mr. Khan’s victory and his background and qualifications, see Mark Leftly, Citizen Khan: London’s first Muslim mayor aims to be an “antidote” to Islamic extremism, TIME (May 23, 2016), available at http://www.ramclaughlin.com/mag/Assorted%20Magazines%20Bundle%20-%2020May%202016%20(20%20PDF)/Time%20Magazine%20-%2020May%202016%2020.pdf.
and Syria, but nearly half of these largely young fighters have returned, raising fears that some could be plotting terrorist attacks on home turf.\textsuperscript{128} London has been hit at least twice by Islamic terrorism—first in the bus and subway bombings of July 7, 2005, which killed fifty-two people, and again in 2013, when a twenty-five year old soldier was hacked to death near his barracks in Greenwich.\textsuperscript{129} Khan is well aware of the need to respond to such terrorism and suggests that he is highly qualified to do so:

\begin{quote}
I am a Londoner, I’m British, I’m of Islamic faith, Asian origin, Pakistani heritage, so whether it’s Daesh [Arabic for Islamic State] or these others who want to destroy our way of life and talk about the West, they’re talking about me. What better antidote to the hatred they spew than someone like me being in this position?\textsuperscript{130}
\end{quote}

It seems highly likely that there is no better antidote to Islamic extremism than Mayor Khan. It is also likely that there are few if any other antidotes to Islamic extremism that are Mayor Khan’s equal. The sad reality has been that the response of moderate Muslims to Islamic extremism has, on the whole, been grossly inadequate. It is unrealistic to expect the U.S. government or the governments of other Western nation-states to fill this gap. Mayor Khan’s participation in the fight against Islamic extremism is most welcome, but it will not be enough by itself. The hope is that he will convince other Muslim leaders to join the “antidote” movement against Islamic extremism.

This Islamic extremism is aided by the support given to the Islamic State Caliphate by a number of mosques in Western countries, especially in Australia, the United Kingdom, and Canada.\textsuperscript{131} Although such efforts might raise complex free speech issues, governments need to consider the possibility of criminalizing acts of advocating, supporting, and inciting religious hatred or participating in conflicts overseas, as well as promoting coexistence, moderation, and tolerance through schools, youth organizations, and strategic communications platforms.

The Middle East has been the primary focus of Islamic extremism, and indeed of media attention.\textsuperscript{132} Recently, however, there has been more focus on North and Central Africa, especially on increased collaboration between Boko Haram, which has its primary base of operations in Nigeria, and the

\begin{footnotes}
130. See \textit{Leftly}, supra note 127.
131. See Gunaratna, supra note 85, at 7.
\end{footnotes}
Islamic State. Boko Haram pledged allegiance to the Islamic State in 2015. As The New York Times has accurately summarized,

In recent years the [African] continent has increasingly become a battleground in the West’s war against militant Islam. [Obama] administration officials insist that the increased influence of groups like Boko Haram, and now the Islamic State, has some of its roots in the economic disparities and human sufferings often brought on by authoritarian governments in which strongmen often cling to power.

But at the same time, the United States is supporting such governments as they battle Boko Haram and other extremist groups. In the Lake Chad area, which includes countries like Nigeria, Niger, Chad, and Cameroun, American Special Operations forces are training and advising African militaries in the fight against Boko Haram, Al Qaeda in the Islamic Maghreb, and now the Islamic State.

Boko Haram’s actions are often as horrific as those of Al-Qaeda or the Islamic State. For example, Boko Haram is increasingly using children, especially girls, to deliver its explosive packages to markets. They often drug young girls, wrap them in explosives, and send them into crowds. Their assumption is that when their victims see a female child, they will not suspect that she could be carrying a bomb.

The Pentagon is reportedly putting forth a proposal that would allocate $200 million this year to help train and equip the armies and security forces of North, Central, and West African countries. The United States is also constructing a $50 million drone base in Agadez, Niger, that will allow Reaper surveillance aircraft to fly over the Lake Chad Area.

The influence and the actions of the Islamic State and Al-Qaeda continue to spread on a worldwide basis. In Southeast Asia, for example, the impact of the Islamic State was especially felt in Indonesia and Malaysia, with a number of their citizens either joining the fight in Iraq or Syria or recruiting fighters for one or both of these countries.

134. Id.
136. Id.
137. Id.
139. Id.
140. See Gunaratna, supra note 85, at 6.
Tunisia constitutes an especially interesting but frustrating case. "In the first days of 2011, thousands of young people from the suburbs poured into downtown Tunis to demand the ouster of the country’s corrupt and autocratic leader, Zine el-Abidine Ben Ali." And “[w]ithin two weeks, he had been overthrown in what became known as the ‘Jasmine Revolution.’” To further quote the journalist George Packer, “[t]his sudden change was soon celebrated around the world as the first sprout of the Arab Spring.” “Before the revolution, Tunisia had been kept rigidly secular.” But after the revolution, “[t]he black flag of radical Islam flew over many buildings, and hard-liners known as Salafis—the work refers to the original followers of the Prophet Muhammad—took advantage of the new openness and tried to impose Sharia in their neighborhoods.”

Then, in 2013, the Salafis were faced with a state crackdown. After, they soon went underground and began disappearing from their neighborhoods in Tunisia. People left to fight in Syria and Iraq and to join the Islamic State in Libya. The main reasons some people gave for leaving were reportedly “marginalization and joblessness.” In the words of a young man who was asked why he was joining the Islamic State, replied, “I can’t build anything in this country. But the Islamic State gives us the chance to create, to build bombs, to use technology.” In July 2013 this young man blew himself up in a suicide bombing in Iraq.

Many of the young people who left Tunisia to join one Islamic jihadist group or another adopted the ruthless behavior of their particular group. For example, a young local man named Maghraoui went to Syria and joined Al-Nusra Front, Al-Qaeda’s affiliate there. In 2010, he returned home to tell war stories at his favorite café. He then went back and joined the Islamic State. Last February, he became famous in Tunisia when a video was posted to YouTube showing him help capture Moaz al-Kasasbeh, a Jordanian Air Force Pilot, who was then burned alive. Maghraoui was killed in September, in an American air strike.

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142. Id.
143. Id.
144. Id.
145. Id.
146. Id.
147. Id.
148. Id.
149. Id.
150. Id.
151. Id.
152. Id.
153. Id.
154. Id.
155. Id.
156. Id.
Tunisia has managed to establish a semblance of a democracy, although much more remains to be done. In the meantime, police continue with their beatings, and other forms of oppression. Also, young people continue to leave Tunisia to engage in jihad in other countries. “It is estimated that between six and seven thousand Tunisians have gone to Syria and Iraq to wage jihad.”

III. Complexity Compounded: The Case of Syria

In its previous sections, this article focused first on nation-states that arguably constitute primary national security threats to the United States and then on non-nation-state Islamic jihadist threats like the Islamic State, Al-Qaeda, and Boko Haram. In this section, however, we turn to Syria and its crisis, which involves an unusual mix of participants, including the U.S. and Russian governments, and various Islamic jihadists.

When the so-called Arab Spring protests broke out in the Middle East, unlike countries like Tunisia and Egypt, whose reaction, at least at first, was to permit the protests to continue, Syrian President Bashar al-Assad suppressed the protests with heavy armed force. This set off a vicious civil war and as of early 2005 more than 200,000 people had been killed, a million had been injured, and more than three million Syrians fled the country, according to the United Nations. Jonathan Tepperman, the managing editor of Foreign Affairs, suggested in an interview with President Assad, that Syria increasingly was divided into three mini-states: one controlled by the government, one controlled by ISIS and Jabhat al-Nusra, and one controlled by the more secular Sunni and Kurdish opposition. President Assad responded by denying that these groups were mini-states, and instead labeled them as factions that are not stable and have no clear lines of separation between different forces. Tepperman next noted that Hezbollah, Iran’s Quids Force, and Iranian-trained Shi’ite militias were all playing significant roles in the fight against rebels in Syria and asked whether Assad was worried about Iran’s influence over his country. In response, Assad claimed that Iran didn’t have any ambitions in Syria, and that Syria would not allow any country to influence its sovereignty; Syria would allow cooperation with Iran. By contrast, he suggested, the United States and the rest of the West want to have influence without cooperation.

In 2015 Russia intervened in Syria. According to The Economist, posters hanging at Russian army installations throughout Syria state “Russian armed
forces are the guarantor of world security." Furthermore, The Economist reports that when Russian forces intervened in Syria, they sought to provide television spectacles for the masses at home, re-establishing itself as a global power and forcing the West to account for Russian interests. Last March Mr. Putin said that "the main part" of Russia's forces could now leave Syria, their mission having been accomplished. But as The Economist explained,

[t]he curious thing about Russia’s withdrawal... is that it has not actually happened. To leave would be to hand Syria over to Mr. Assad’s other ally, Iran. Rather than withdrawing his forces, Mr. Putin has retrenched. The March announcement was really 'a way to reconceptualize the presence as permanent, rather than as part of a specific mission,’ says Dimitry Gorenburg, an expert on the Russian armed forces. Russia did recall a handful of aircraft—a signal to Syria’s stubborn president, Bashar al-Assad, not to take it for granted. But its footprint in Syria remains heavy.

Both Russia and the United States are engaged in heavy bombing in Syria, but often they are targeting different targets. The United States has refrained from targeting the Syrian forces, although they are strongly in favor of the removal of President Assad from power, because Russia is still strongly supporting keeping Assad in power. Both the United States and Russia favor bombing the Islamic State or Al Qaeda, but Syria and Russia have often targeted moderate rebels favored by the United States. Assad has tried to “convince the world that he is fighting jihadists rather than his own angry citizens." His bombing of moderate rebels has helped to drive many of them into the arms of the Islamic State or other extremists. Russia and the United States have been trying hard to arrange and maintain a ceasefire and then a negotiated settlement of the conflict, but are having problems bringing this about.

IV. Some Brief Closing Observations

China and Russia individually constitute formidable adversaries for the United States and the Western countries. Acting together in a formal alliance, China and Russia would be even more formidable adversaries and greater threats to the national security. There has been some speculation that China and Russia are moving in this direction.
There is no question that China and Russia have taken steps that they believe will benefit them both, especially by increasing their international status and influence. There are also, however, still obstacles in the way of their creating a formal alliance. Some of the developments that point to a closer relationship between the two countries include, among others, their entering into a huge national gas deal in 2014 that is worth about $400 billion. They also conducted a joint naval drill in the East China Sea, which sends a deterrence message to Japan and the United States. China and Russia vetoed a draft UN Security Council resolution that would have sent Syria to the International Criminal Court for an investigation of alleged war crimes. China and Russia had previously vetoed three UN Security Council resolutions condemning Syria.

Some of the obstacles to a formal China/Russian alliance are historical mistrust, the lack of a common threat, and conflicting interests in Central Asia. Moreover, China could be dragged into an unnecessary war by Russia, and Russia is unwilling to be China’s junior partner in the relationship. Hence, unless the United States makes a strategic mistake that both China and Russia believe threatens them, it is unlikely there will be a formal alliance between China and Russia in the near future.

When it comes to the Islamic State and other Islamic jihadist threats, however, as we have seen, through the creation of its so-called provinces and its highly effective propaganda, the Islamic State has succeeded in spreading its threat worldwide and expanding and strengthening its military might. Nonetheless, Barron’s has recently published a lengthy article arguing that: “An unlikely coalition of the U.S., Russia, Iraq, Syria, Israel, Iran and Saudi Arabia will continue to take territory from ISIS. The endgame should come next year. Terrorist threats are sure to persist, particularly in Europe.” As a result, “ISIS will fall soon.”

But the Islamic State and other Islamic jihadists have shown themselves to be nothing if not resilient. They are also flexible in terms of willingness to change tactics and strategy. Recently, they have shifted their focus to suicide bombings in markets that have killed large numbers of people, especially in

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170. Id.
172. Id.
Iraq. My suspicion is that in the end the most effective response to the barbarism of Islamic jihadism will be greatly improved opposition on the part of moderate Muslims like the new Mayor of London, aided with better coordination among the “unlikely coalition” of countries, with the United States leading from the front rather than the rear.
Financial Technology Law – A New Beginning and a New Future

GEORGE WALKER*

I. Introduction

Banking and financial markets have been subject to significant change in recent decades. Markets have benefited from substantial advances in all forms of technological operation including computer hardware and software capability, massive downsizing in circuitry and processors, telecommunications speed and efficiency, mobile access, in particular, through mobile telephony, tablets, and other hand-held devices, and wearables, and substantial reductions in manufacturing and service costs.

Parallel deregulatory processes in many market sectors including banking, securities, and insurance as well as telecommunications and media services have accompanied all of this. Deregulation has substantially increased capital and investment flows in banking and financial markets which has, in turn, increased liquidity and reduced borrowing and funding costs significantly.

International financial markets are nevertheless also still dealing with the significant costs and impacts of the global financial crisis beginning in 2007–2008. Substantial recent advances in financial technology and FinTech service and product models have then created important possible opportunities for growth with increased efficiency and earnings in the aftermath of the crisis; although, this has also created significant new threats especially in terms of market and counterparty fragmentation, and consequent regulatory and supervisory dislocation, disconnection, division, depletion, and distraction as well as a resource demand and potential skills deficit.

FinTech has emerged as a powerful new market force as a result of the coming together of a number of disconnected trends. Significant advances have occurred in the areas of computer and digital technology, the Internet, mobile telecommunications as well as economics and finance, which have transformed traditional areas of study and created important potential new business structures and operations. The Internet, or World Wide Web (www), specifically has emerged from two earlier phases of the static Net 1,
to the interactive Net 2, with the current phase constituting the beginning of Net 3, or the Value Net or Value Web, and the full realization of the potential to digitalize and monetize all online banking and financial and other products and services. Net 4 is expected to follow this, with the semantic or machine Net, and then the immersive or sensory Net. All of this can be considered to be associated with the emergence of the digitalization, mobilization, disintermediation, personalization, and democratization of financial services activities and functions. All industries will have to become aware of the possibilities of disruptive technology replacing existing industrial business structures, products, and services.

Law and regulation have been sensitive to these changes although slow to respond to date with no meaningful coherent program constructed to date.

The purpose of this paper is to examine the meaning and nature of FinTech and other associated terms including regulatory technology (RegTech), incubators, accelerators and catapults, law technology (LawTech), electronic banking and finance, digital currencies, and the digital economy. Market size and location studies are referred to. The FinTech market is explained in terms of its various sub-sectors and components. The specific technology underlying distributed ledgers and some of the most recent developments in digital currencies are also considered. Relative advantages and disadvantages of this new exciting market area are noted with a provisional set of comments and conclusions drawn on its current and potential future value and direction. It has to be stressed that these can only

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2. Skinner describes the Value Net in terms of financial markets having moved from paper-based localized systems to online digital models that allow the transfer of value in real time at almost zero cost. See generally Chris Skinner, ValueWeb: How FinTech Firms are Using Mobile and Blockchain Technologies to Create the Internet of Value (Marshall Cavendish Business 2016).

3. This is also referred to as the “internet of things” (IoT) or internet of objects (IoO). The term was first referred to by Kevin Ashton to refer to inter-connected devices in 1999. Alex Wood, The Internet of Things is Revolutionising Our Lives, but Standards are a Must, The Guardian (Mar. 31, 2015), https://www.theguardian.com/media-network/2015/mar/31/the-internet-of-things-is-revolutionising-our-lives-but-standards-are-a-must. Berners-Lee has referred to Web 3.0 as the Semantic Web, or Linked Data, which involves the development of common data formats and exchange protocols to allow data transfer between computers and systems. This is included with Net 4.0 and the machine net for the purposes of this paper. See Tim Berners-Lee, James Hendler & Ora Lassila, The Semantic Web, Scientific American Magazine (May 2001), http://www.scientificamerican.com/article/the-semantic-web/.

4. This refers to a further highly personalized stage where people effectively live inside the Internet. Skinner refers to this as with 4.0 and predicts that it will arrive around 2015. See generally Chris Skinner, ValueWeb: How FinTech Firms are Using Mobile and Blockchain Technologies to Create the Internet of Value (Marshall Cavendish Business 2016).

be considered to be pre-emptive and exploratory observations at this stage in light of the new and fast changing nature of the subject matters covered.

II. Financial Technology and FinTech Language

The substantial growth in FinTech technologies and applications in recent years has been associated with the emergence of a new technical and media language. This is in addition to the general digitalization, mobilization, disintermediation, personalization, and democratization of financial services activities and functions referred to. FinTech has been associated with a growth in incubators, accelerators, catapults, and regulatory sandboxes, which provide different forms of support services for early start-up companies. Start-up companies are commonly referred to as unicorns, with an initial market value of over $1 billion, decacorns, with a value of over $10 billion, and most recently hectocorns, with $100 billion. Groups of FinTech companies are also often referred to in collective terms such as with Fangs, BEGgars, MisFiTS, and BANTS.

This is an exciting area of study, although, one in which the limitations of current language become apparent. A number of new terms, or neologisms, and specifically syllabic abbreviations on predictive translations, are

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7. Facebook (estimated market value $307 billion), Amazon ($250 billion), Netflix ($42 billion), and Google ($503 billion). Apple ($534 billion) may also be included. See, e.g., Julia Greenberg, The Market Wants Tech Companies to Prove Their Worth, WIRED (Jan. 20, 2016), http://www.wired.com/2016/01/the-market-wants-tech-companies-to-prove-their-worth/.


11. See Syllabic Abbreviation, World Heritage Encyclopedia (2002), http://www.self.gutenberg.org/articles/syllabic_abbreviation. Syllabic abbreviations are words made from syllables from existing words. Syllabic abbreviations used in this text include TechLaw, TechReg, BankTech, CoinTech, LoanTech, PayTech, SecTech or TradeTech, InterTech, GovTech as well as SmartTech for smart contracts, TechRisk and FinRisk, and FinReg, SuperTech, ResTech, SupTech (or TLR), and the NonNet. Predictive translations are used to refer to the expected Latin terms for modern areas of law such as lex digitalis, lex
accordingly developed through this paper. The objective is not to confuse but to contribute to the emergence of the useful new technical vocabulary and language under construction in this area.

A. **FINANCIAL TECHNOLOGY AND FINTECH**

Financial Technology (FinTech) refers to the use of technology in the banking and financial area. There is no official definition of the term and it is often used in different ways by different writers and in different reports. FinTech was originally used to refer to a Citicorp (now Citigroup) Financial Services Technology Consortium to promote rather than obstruct technological cooperation with outside firms. The term was initially used to signify technological cooperation between new market entrants and incumbent firms, although, many now only discuss FinTech in terms of disruption.

FinTech can generally be understood in terms of the electrification and digitalization of banking and financial services, bank accounts and ledgers, and their use in innovative and unconventional ways. FinTech can be defined either in terms of market function, market institutions, market technology, market structure, or market impact and disruption. FinTech has, for example, been defined as referring “to technology enabled financial solutions” or “to the use of technology to deliver financial solutions.” Solutions can be understood in terms of functions, which, for the purposes

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13. Catherine A. Allen, who assisted develop the Smart Card Forum, refers to Citicorp (Citigroup) adopting a new “language of cooperation between companies and across industries” and as having “shed its historical insistence on calling its own technological tune.” Citicorp had earlier adopted an Automated Teller Machine (ATM) system in the 1970s based on its own Magic Middle System, which was incompatible with other machines. The Smart Card Forum promoted common standards between 30 and up to 60 operators. Allen had stated that, “Citicorp is participating because times have changed” and that “Cooperation is necessary for common industry standards.” See Jeffrey Kutler, *Citibank is Shedding Individualistic Image*, AMERICAN BANKER (Sept. 25, 2015), http://www.americanbanker.com/bankthink/friday-flashback-did-citi-coin-the-term-fintech-1076875-1.html.

14. For the purposes of this text, electronic is understood to refer to anything relating to the use of electronic circuits, devices or systems including computers and mobile telecommunications instruments. Digital refers to programming based on discontinuous data inputs (0 and 1) or binary digits (bits) rather than continuous analogue measures which digital programs replicate. (A byte consists of 8 bits.) Electronic accordingly generally refers to devices and digital to programming. *Bits and Bytes*, https://web.stanford.edu/class/cs101/bits-bytes.html.

of this text, consist of savings and deposit, lending and credit, payment, investment and risk, or loss management.

Other definitions consider FinTech in terms of the companies rather than markets concerned. The report on UK FinTech commissioned by HM Treasury and prepared by Ernst & Young in March 2015 adopts an entity-based approach. This defines “FinTechs as high-growth organizations combining innovative business models and technology to enable, enhance and disrupt [financial services].” Ernst & Young also identify certain common characteristics focusing on consumers, user experience, low costs, and simple modelling. The report generally adopts a “Classic” classification of FinTech characteristics (based on Customer-centric, Legacy-free, Asset light, Scalable, Simple, Innovative, and Compliance light), which follows the earlier LASIC principles developed by David Chuen and Ernie Teo. The FinTech sector would then include start-ups and new entrants as well as scale-ups (expanding), maturing companies, and non-financial services companies, including telecommunication providers and e-retailers. While this adopts an institutional approach, it also emphasizes characteristics and impact in terms of enabling, enhancement, and disruption.

Other reports adopt a technological approach. Separate UK government commissioned official reports refer to FinTech generally as “technology applied to financial services” or the use of financial technology to provide financial services. Financial technology can be defined as innovation in financial services. The UK Government Chief Scientific Adviser, Sir Mark Walport, defines FinTech as “financial technologies that integrate finance and technology in ways that disrupt traditional financial models and businesses and provide an array of new services to businesses and consumers.” This stresses the “hybridization of technology with the traditional processes of finance—[including] working capital, supply chain, payments, processing, deposit accounts and life assurance . . . [which]
replaces traditional structures and working models with new technology-based processes."

Many other definitions include reference to disruption with the implication that FinTech has to damage existing market positions. Disruption may be more generally understood simply in terms of market impact with any important new technological advance resulting in necessary systems and process changes. While many of the larger banks and other financial institutions may have resisted change previously, there is now active cooperation and participation in many areas. Small FinTech start-up companies and new market entrants are not disadvantaged by assuming the costs of managing multiple legacy systems at the same time as larger incumbents benefit from necessary capital pools, personnel, expertise, and other infrastructure as well as established client bases. While some FinTech companies have initially operated with a supporting bank and then expanded to such an extent that they are able to separate themselves, such as with TransferWise, many start-ups may simply sell their technology to existing incumbents or be taken over by them.

The natural FinTech cycle will accordingly operate through a combination of internal technological investment as well as external competition, cooperation, product purchase, or outright corporate acquisition. While many new design products may have been set up to challenge the banking and financial industry, many start-ups will sell their products to a single bank and especially those that may have provided incubator or accelerator services. Wider industry change may then be dependent on the adoption of common industry standards and compatible systems by the incumbents themselves at the same time as they develop appropriate models to replace legacy systems. This could either be achieved on a parallel system, systems revision or more fundamental systems replacement model, or a combination of these. When uncompetitive incumbent institutions may have to leave the market, these may simply be absorbed into other existing firms or groups that have the capital and resources to manage the transferred clients and services.

The term FinTech can accordingly be used to refer to new functional delivery channels, new market entrants, new technologies, market challenge and disruption, or to the future of banking and finance more generally. FinTech is used in an inclusive and constructive manner in this text.

24. Id.
25. See, e.g., id. at 21.
26. See, Hochstein, supra note 12; see also, Kutler, supra note 13.
27. See Walport, supra note 23.
29. See, Waters, supra note 5.
30. See Walport, supra note 23, at 21-22.
31. The term FinTech is used for the purposes of this text to refer to the new marketplace as a whole including new entrants and incumbents. Marc Hochstein notes that the term has
B. Regulatory Technology or RegTech

Regulatory technology (RegTech) refers to the use of financial technologies for regulatory and supervisory purposes. The UK Government’s Chief Scientific Adviser refers to this in terms of “regulatory technologies encompass[ing] any technological innovation that can be applied to or used in regulation typically, to improve efficiency and transparency.” \(^3\) Technology can be used to assist both internal firm conduct, and misconduct, surveillance and penalties, as well as, external forward-looking supervisory and early intervention action by regulatory authorities. The separate more general term technology regulation (or TechReg) is used in this paper to refer to the new regulatory structure adopted to deal with expanding technology as a whole rather than just the specific area of RegTech, which uses technology for internal compliance purposes.

Some of the issues involved were examined by the Bank of England in its *Fair and Effective Market Review* in June 2015, which recommended that firms had to improve surveillance while authorities strengthened regulatory approaches\(^3\) and with HM Treasury separately recommending that the most appropriate regulatory tools were used by authorities in particular cases.\(^4\) Relevant technological tools included pattern analysis, big data techniques, predictive coding, and digitalization of voice communications.\(^5\) RegTech may also assist develop data driven regulation and compliance, regulatory infrastructure and training, and education.\(^6\)

C. Distributed Ledgers

Distributed ledgers are based on mathematical algorithms, or structured programs, that can act as powerful, “disruptive innovations that could transform the delivery of public and private services and enhance

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\(^2\) See Walport, *supra* note 23, at 47.


\(^6\) See *id.* at 49–51.
productivity through a wide range of applications.” Block chain algorithms specifically allow transactions, or transfers, to be aggregated into blocks and added to existing chains using public and private key cryptography. The fundamental difference between digital currencies and conventional currency is that they avoid the need for intermediaries, including central banks and commercial banks, through the creation of a global “collaborative” endeavour.

Distributed ledgers operate through the maintenance of multiple shared copies of the database which avoids single point attack or failure as with existing large legacy IT systems. Legacy systems are costly and administratively burdensome to maintain and often suffer from significant complexity and connectivity problems. They also become easily out of date and can be manipulated without detection either through the abuse of authorized passwords or hacking.

Distributed ledger technologies could also be used to allow governments to collect taxes, deliver welfare benefits, issue passports and control immigration, maintain land registries as well as manage the supply of goods and services and ensure the integrity of government records and services. Health services may specifically be assisted through the managed provision and authentication of service delivery and through the sharing of confidential records in accordance with prescribed rules. This should in turn allow end users the ability to limit and control access to their data files, as well as monitor any access use.

D. LAW TECHNOLOGY AND FINANCIAL TECHNOLOGY LAW

LawTech refers to the use of technology to improve legal business management and services more generally. This is again often based on computer databases and algorithms, in particular, for legal research, proof reading and document validation. The wider term Technology Law (TechLaw) is used in this paper to refer to the law governing the Internet and telecommunications including computer law. TechReg can be used to refer to the regulation applied to technology and FinReg the regulation governing FinTech specifically. RegTech, TechReg and FinReg are

38. See id. at 21.
39. See id. at 6.
40. Id.
41. Id.
42. Id.
43. Relevant issues are, for example, discussed at various LawTech Futures events with relevant issues also being examined by the British Legal Technology Forum. See BRITISH LEGAL TECH. FORUM 2017, https://britishlegalitforum.com/ (last visited Aug. 30, 2016).
collectively referred to as Financial Technology Law or *lex technologica financialis* for the purposes of this paper.44

E. INCUBATORS, ACCELERATORS, LABORATORIES, FACTORIES AND CATAPULTS

FinTech has been associated with a growth in Incubators and Accelerators, which provide different forms of support services for early start-up companies. Incubators may cover a wide market area or focus on specific sectors; incubators provide start-up companies with workspace, possible administrative and personnel support as well as possible funding support. Furthermore, incubators often co-work with other start-up companies within the incubator facility. Shared resources are provided with experienced support staff and mentorship. Incubation periods may be flexible. Government entities, financial institutions and other corporations and possibly venture capital firms generally provide incubator services.45

Accelerators assist operational companies grow and expand their business. This may again include workspace with network access and seed investment although accelerator programs tend to be more flexible than incubator structured services.46 FinTech factories or laboratories can be considered to constitute internal development facilities for banks and other financial situations to develop their own innovative products, services and systems for their customers.47 Digital catapults generally consist of innovation centers designed to support innovative companies within a digital community.48 FinTech hubs tend to focus on cooperative research and innovation although

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44. See Syllabic Abbreviation, supra note 11.
the term hub can also be used as a collective term for any group of activities, which may include any of the above.

F. Electronic Banking and Finance

FinTech can also be understood with reference to other existing areas of financial development. E-banking refers to any banking activity carried out using electronic devices and digital banking to any services provided through pre-loaded computer programs. E-finance can be understood to refer to any financial activities carried on using electronic or digital devices, including electronic trading, electronic money, electronic payment and communication. Internet banking refers to the provision of any banking services over the Internet. E-money consists of stored value or prepaid payment devices that allow payment to be made. E-trading refers to the conduct of market making (principle) or brokerage (agency) dealing in securities using electronic devices.

G. Digital Currencies

Digital or virtual currencies generally consist of private token or coin systems issued in a digital form. The International Monetary Fund (IMF) examined virtual currencies, which were defined as “digital representations of value, issued by private developers and dominated in the own unit of account.” The European Central Bank (ECB) considered the nature and impact of virtual currency schemes on central banks in October 2012 and February 2015. The documents define virtual currencies as any “type of unregulated, digital money, which is issued and usually controlled by its


50. The Basel Committee defines electronic money as any stored value or prepaid payment mechanisms permitting payment to be effected “via point of sale terminals, direct transfers between two devices, or over open computer networks such as the Internet.” Electronic money may include “‘hardware’ or ‘card-based’ mechanisms (also called ‘electronic purses’) and ‘software’ or ‘network-based’ mechanisms (also called ‘digital cash’).” Basel Committee, Risk Management for Electronic Banking and Electronic Money Activities (Mar. 1998) at 3, https://www.bis.org/publ/bcbsc215.pdf.

51. This includes electronic trading systems which are defined by the Committee on the Global Financial System (CGFS) defines an electronic trading system as a “facility that provides some or all of the following services: electronic order routing (the delivery of orders from users to the execution system), automated trade execution (the transformation of orders into trades) and electronic dissemination of pre-trade (bid/offer quotes and depth) and post-trade information (transaction price and volume data).” CGFS, The Implications of Electronic Trading in Financial Markets 3 (2016), http://www.bis.org/publ/cgfs16.pdf.


developers and used and accepted among the members of a specific virtual community.  Three types of scheme are distinguished. A number of different purposes are established including virtual community use, float revenue generation, business flexibility, and traditional currency competition. The paper provides a short historical review of money and the nature of money in a virtual world. The nature of virtual currency schemes is examined and two case studies provided of Bitcoin and the Second Life scheme.

The Committee on Payments and Market Infrastructures (CPMI) issued a paper on Digital currencies in November 2015. While previous CPMI reports referred to virtual and cryptocurrencies, the preferred term has become digital currencies. The report identifies three features of digital currencies with the assets having some monetary characteristics but not tied to a sovereign currency, transfers through distributed ledgers and principal development through non-bank institutions. Specific issues were referred to in terms of global use, lower cost and increased security and trust. The report explains the key features and uses of digital currencies and examines factors influencing the development of digital currency markets including supply and demand side factors and the role of regulation.

The Bank of England has issued a number of papers on digital currencies. The Bank distinguishes four types of innovative payment technology: wrappers (services which improve user interface and accessibility to existing payment systems architecture), mobile money (with value stored on smart cards or system-providers’ books), credits and local currencies (alternative

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55. Digital currencies provide for the purchase of goods or services online without physical coins and banknotes or the use of bank account transfer systems. These include software based models, referred to as cryptocurrencies, although virtual currencies have restricted use within a specific online community. Type 1 consists of closed virtual currency schemes; type 2 operate on the basis of a unidirectional flow which allows the purchase of virtual goods and services; and type 3 currencies with bidirectional flows which can be used to purchase virtual or real goods and services. Id.
56. Id.
57. Id. at 9-12.
58. See id. at 21-32. The ECB has examined the implications of the Second Life Scheme established by Linden Research Inc. in June 2003 to support a “multiplayer online role-playing game.” Id.
60. Id. at 1 n.2.
61. Id. at 1.
62. A taxonomy of money and exchange mechanisms including physical, electronic and digital systems is provided. Id. at 1 fig.6.
63. Id. at 4–7.
64. Id. at 7-11.
units of account purchased with money), and digital currencies (including decentralized payment systems and currencies with most of these being based on cryptography and constituting cryptocurrencies).65 These can be contrasted from other online fantasy currencies used for gaming and other non-monetary purposes on the Internet. The evolution of payment technology is examined with modern payment systems contrasted with new innovative techniques. The nature of Bitcoin is referred to and importance of the distributed ledger as a key technological innovation within payment systems and beyond. The Bank also studied the economics and macroeconomics of digital currencies.66

H. DIGITAL ECONOMY

FinTech will form an important part of the development of new Digital Economies. The Digital Economy and digital society can be considered to constitute those parts of the economy and society operating through or tied to digital systems including principally the Internet and digital telecommunications. It was estimated that in 2015, the digital economy represented around 22.5 percent of the world economy, or $19,159 billion, and which would grow to 25 percent by 2020, or $24,615 billion.67

Although the terms are not separately defined, the digital economy and digital society are referred to by the European Commission as part of its Digital Single Market program. The DSM is explained in terms of the free movement of goods, persons, services and capital with citizens, individuals and businesses having seamless access to and being able to exercise online activities under conditions of fair competition and with a high level of consumer and personal data protection irrespective of nationality or residence.68 The DSM has been referred to as one of the Commission’s top priorities managed through The European Commission Directorate General for Communications Networks, Content & Technology. This is

based on three pillars: access, conditions, and growth. The Commission has specifically consulted on the regulatory environment for Digital Platforms; including online intermediaries, data and cloud computing, and the collaborative economy. The cloud and cloud services consist of pooled data storage and processing facilities made available through the Internet on a demand basis.

The UK Government has been promoting the use of technology more generally and the establishment of a Digital Economy including assisting with the establishment of the European Union (EU)’s Digital Economy. The Government published a Blueprint for Technology in 2010, which focused on supporting technology based innovation within the UK. Innovate UK was set up as an executive non-departmental public body sponsored by the Department for Business, Innovation & Skills to promote science and technological innovation. Innovate UK produced a Digital Economy Strategy 2015-2018 in 2015.

The Office for National Statistics (ONS) conducted a consultation on Measuring the Digital Economy from August to October 2014 with a new annual bulletin to be produced. The Government also set out its vision for the EU’s digital economy, which identified existing problems and set out 13 recommendations based on increased mobility and security and innovation


71. Cloud computing allows for the delivery of computing resources as a utility service through a network on a “flexible, location-independent basis that allows for rapid and seamless allocation of resources on demand.” CLOUD COMPUTING LAW 3 (Cristopher Millard ed. 2013). The largest cloud services providers were Amazon Web Services and Microsoft followed by Google and other more specialist firms such Rackspace, Virtustream, CenturyLink and VMware. Magic Quadrant for Cloud Infrastructure as a Service, Worldwide, GARTNER (Aug. 3, 2016) fig.1, https://www.gartner.com/doc/reprints?id=1-2G2O5FC&ct=150519.

72. HM GOVERNMENT, BLUEPRINT FOR TECHNOLOGY, 2010.


74. This strategy set out how the Government would spend £30 million every year for four years to support innovative business projects including funding for the Digital Catapult Center, Open Data Institute and Tech City UK. INNOVATE UK, DIGITAL ECONOMY STRATEGY 2015-2018, 2015.

75. See OFFICE FOR NATIONAL STATISTICS, CONSULTATION ON MEASURING THE DIGITAL ECONOMY, 2014, OFFICE FOR NATIONAL STATISTICS, RESPONSE TO THE ONS CONSULTATION ON MEASURING THE DIGITAL ECONOMY, 2014.
through competition. Furthermore, a 2009 Digital Britain report contained a number of recommendations on extending broadband access, Internet use and revision to public service broadcasting. The US has one of the most sophisticated digital economies, although this has to a significant extent been market led and it is largely market-led. The Department of Commerce released a Digital Economy Agenda in February 2016. This Report listed a series of “Grand Policy Challenges” based on the global free exchange of information, online trust and security, access and skills and innovation and emerging technologies. A series of associated opportunities and policy priorities were highlighted for 2016 with a number of structural initiatives including the establishment of a Digital Economy Board of Advisers (DEBA), export assistance and the development of commerce “Policy Labs.”

III. FinTech Market Size

FinTech activity has grown substantially in recent years. FinTech is expected to grow even further in the future although this may be partly offset by a decline in traditional financial services earnings. FinTech is expected to disrupt many areas of activity including automotive and telematics (telecommunications and informatics such as navigation systems), media and micro-payments, healthcare and insurance and real estate and mortgage investing. It is estimated that one third of jobs in the banking area could be lost with legacy firms losing 20 percent of the business. Only 72 percent of senior banking executives considered that they had a proper strategy in place to deal with digital innovation.

77. DEPARTMENT FOR CULTURE, MEDIA AND SPORTS AND DEPARTMENT FOR BUSINESS INNOVATION AND SKILLS, DIGITAL BRITAIN: FINAL REPORT, 2009, Cm. 7650, at 53, 63, 136 (UK).
78. The U.S. had the largest digital economy in 2015, making up 33 percent of the gross domestic product at a value of about $5.9 trillion. MARK KNICKREIM, BRUNO BERTHON & PAUL DAUGHERTY, ACCENTURE, DIGITAL DISRUPTION: THE GROWTH MULTIPLIER 4 (2016).
79. The digital economy accounted for 5 percent of gross domestic product (GDP). In the US the digital economy is estimated to boost US GDP by up to $2.2 trillion by 2025. The US was the largest global export of services and exported $662 billion in 2013. ALAN DAVIDSON, U.S. DEP’T OF COMMERCE, DIGITAL ECONOMY AGENDA 3 (2016).
80. Id. at 7.
81. GOV’T OFFICE FOR SCI., supra note 37, at 55.
In 2014, FinTech was worth between $12 billion and $197 billion in investment around the world.84 It was estimated that UK FinTech generates around £20 billion in annual revenue.85 This included £10 billion in payments, £4.2 billion in financial software, £3.8 billion in financial data and analytics, and £2 billion in platforms.86 Banking and securities firms spent around £319 billion ($485 billion) on IT in 2014.87 Financial services in the United Kingdom represented around 9.6 percent of gross domestic product (GDP) and 14.5 percent of GDP after the inclusion of professional services.88 Internet-related services generated around 8.3 percent of GDP.89 Over 2.4 million people worked in high technology industries in the United Kingdom, with 825,000 of these in science, technology, engineering and mathematics (STEM) positions and 135,000 of these involved with financial services technology.90

In 2014, the United Kingdom had a large digitally active user base, with 91 percent of adults having Internet broadband access and 58 percent of adults having mobile phone Internet access.91 The Government Office for Science reported that 58 percent of consumers were aware of alternative finance, but only 14 percent had used it.92 Paralleling this awareness, in 2013 consumers were found to have a very low confidence level of 23 percent in U.K. banks.93

86. Id.
92. Walport, supra note 23, at 58.
93. ERNST & YOUNG, supra note 17, at 10.
IV. FinTech Market Centers

FinTech activities have been growing substantially across the world. The seven leading FinTech centers are in the United Kingdom, California, New York, Singapore, Germany, Australia, and Hong Kong. A 2016 Ernst & Young report on the progress of FinTech globally for the prior year (EY Cutting Edge Report) confirmed that the United Kingdom remained the most significant FinTech ecosystem across four attribute categories: talent, capital, policy, and demand. In terms of capital, the U.K. FinTech market was estimated to be around £6.6 billion; New York at £5.6 billion, California at £4.7 billion, Germany at £1.8 billion, Australia at £0.7 billion, and Singapore and Hong Kong at £0.6 billion.

The EY Cutting Edge Report further described the United Kingdom an “all-rounder,” with £6.6 billion in market size, £524 million in investment and 61,000 FinTech staff. The report also noted that the United Kingdom had a “very good pool of talent, with exceptional access to financial expertise,” with concerns remaining about the “future tech talent pipeline,” but California led overall for the talent category. Capital availability in the United Kingdom was strong, especially for early-stage investment, but California remained the dominant FinTech center in this category as well. For the policy category, the United Kingdom was considered to have “the strongest FinTech policy environment with the most supportive regulatory regime,” including the FCA’s Innovation Hub and Project Innovate, but Singapore and Australia were described as “increasingly progressive.” As far as demand went, FinTech demand remained healthy in the United Kingdom due to London’s position as an international financial center, but demand was also strong in New York, evidenced by “the highest rate of consumer adoption.” California was described as “established and efficient,” New York as “proximity to expertise and customers,” Singapore “increasingly progressive regulatory regime,” Germany “large but complex,” Australia “up and coming” and Hong Kong “potential.”

The EY report warns that the United Kingdom’s dominant position could be lost with the increase of policy initiatives by other markets, the emergence of specialist regions, and China’s potential to become the largest FinTech provider in the world. China is home to seven of the world’s thirty-one FinTech unicorns, with the Chinese FinTech sector concentrated...
in Beijing. The EY Cutting Edge Report develops two scenario analyses for the United Kingdom based on a “policy momentum loss” situation and a “proactive FinTech agenda” course of action, and formulates nine recommendations to protect the United Kingdom’s position as the lead provider of FinTech.

V. FinTech Market

Globally, the FinTech market has grown substantially and continues to show potential for further growth across all market sector areas. Electronic and digital systems were earlier used in the securities area, especially with the development of links between traditional stock markets and exchanges and then the development of new electronic markets. Investment firms utilized these systems to develop early forms of algorithmic trading, high frequency trading (HFT), and off-market dark and grey pools.

There were estimated to be around 4000 FinTech start-ups at the end of 2015, with over twelve considered “unicorns” – meaning they have a market valuation of over £1 billion. The most substantial innovations occurred in the area of retail payments, and these changes have specifically led to the unbundling of a number of more traditional financial services and the turn to low-cost foreign exchange (FX) services by firms. More recently, advances have occurred in the payments area with integrated payment systems, contactless payments, peer-to-peer payments and lending, debt

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103. The EY Cutting Edge Report notes that Beijing’s venture capital (VC) market grew from £1 billion in 2012 to £8.6 billion in 2015, second only to San Francisco. Regulatory authorities in China supported FinTech companies and allowed them to expand substantially. Alibaba, for example, was found to process over eighty million transactions per day with a £65 billion online money market fund. Id. at 16.

104. These recommendations are: (1) create a FinTech “delivery body” to drive high impact policy initiatives to implementation as quickly as possible; (2) build on the FCA’s position as the most progressive regulatory body globally; (3) deliver practical business support to FinTechs; (4) build FinTech “bridges” to support UK FinTechs expand internationally; (5) strengthen the UK’s talent pipeline especially on tech talent; (6) establish regional “Centres of Excellence” in the UK; (7) initiate investor-focused programmes to improve access to growth capital; (8) broaden tax initiatives to drive greater investment in UK FinTech; and (9) promote government, consumer and financial institution adoption of FinTech services. Id. at 17-19.

105. These include electronic communication networks (ECNs) in the United States, alternative trading systems and alternative trading platforms (ATSs and ATPs) in the United Kingdom and multilateral trading facilities (MTFs) and organized trading facilities (OTFs) as well as firm based internal markets (internalization) in the E.U. See Financial Markets and Exchanges Law 9-10 (Michael Blair QC, George Walker & Stuart Willey eds., 2013).


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crowdfunding, and money management tools. Further expansion is expected in identity management, financial inclusion, and off-rail payments. Lending has principally grown in the peer-to-peer sector and crowdfunding. Shares can also be purchased on a low contribution basis through equity crowdfunding.

Other innovative services, especially in connection with retail investments and pensions and investment management, wholesale banking, and capital markets have included engaged investing, visualization tools and the provision of algorithmic advice, or “robo-advice,” in addition to smart contracts. More general technological tools include machine learning and cognitive computing, big data analytics, optimization and fusion, and other future technologies, such as the Internet of Things and the Semantic Web, and possible further innovation in the area of quantum—rather than digital—computing.

**A. DIGITAL BANKING (BankTech) AND DIGITAL CURRENCIES (CoinTech)**

Early innovations in banking occurred through the use of computers for account and data processing and storage, electronic funds transfer, and later cash provision through automated teller machines (ATMs). More recent developments in digital banking have principally taken place through the establishment of online and Internet banks, as well as through innovations in

109. Ernst & Young, *supra* note 17, at 23, fig. 7.
110. Id.
111. Id. at 23, fig. 7; Why Fintech Won’t Kill Banks, *supra* note 107 (explaining P2P lending). Peer-to-peer lending operates by the matching of fund lenders and borrowers directly either on a secured or unsecured basis subject to a management company or platform fee and credit checking charge.
112. Jack Preston, How Marillion Pioneered Crowdfunding in Music, Virgin (Oct. 20, 2014), https://www.virgin.com/music/how-marillion-pioneered-crowdfunding-in-music. The first modern crowdfunding was to sponsor the rock band Marillion’s tour in 1997, with $60,000 being raised. Kara Scharwath, Top 10 Crowdfunding Sites, TriplePundit (July 16, 2012), http://www.triplepundit.com/special/raise-of-the-sharing-economy/emerging-next-generation-crowdfunding-platform-roundup/. There were estimated to be over 500 crowdfunding platforms in 2012. Cat Cochrane, 10 Crowdfunding Platforms in the UK You Need To Know About, Crowdsourcing Week (Mar. 10, 2016), http://crowdsourcingweek.com/blog/10-crowdfunding-platforms-uk/. (UK crowdfunding sites include Crowdcube, Seedrs, Syndicate Room, CrowdFunder, Crowdshed, Spacehive, Ratesetter, Zopa and Funding Circle and LendInvest); UK Crowdfunding, http://www.ukcfa.org.uk (last visited Aug. 30, 2016). A number of these companies are members of the United Kingdom Crowdfunding Association (UKCFA). Crowdfunding operates by raising small amounts of funds from a large group of contributors through the establishment of online and Internet banks, as well as through innovations in
the production of private digital currencies. U.K.-only Internet banks include Atom Bank (established 2016), Tide (2016), OakNorth (2015), Starling (2014), Tandem (2015), Monzo (2015), and Smile (1999) formed by The Cooperative Bank.115 Goldman Sachs set up the digital bank, GS Bank, with Infosys, in 2016.116 Other significant U.S. online-only banks include Ally Bank, Discover Bank, Connexus Credit Union, First Internet Bank of Indiana, Bank of Internet USA, Capital One 360, iGObanking, Alliant Credit Union, and Bank5 Connect.

Digital currencies are considered to be another online banking innovation. In 1990, DigiCash was originally developed by the American cryptographer David Lee Chaum using cryptographic protocols, however, DigiCash Inc filed for bankruptcy in 1998.117 In 1998, digital currencies progressed in the form of “b-money” by Wei Dai,118 while American cryptographer Nick Szabo proposed the development of “bit gold.”119 In July 2016, about 723 digital currencies existed, with a total market capitalization of $12.924 billion and a market capitalization of over $1 million for about seventy-four of these.120

119. Peck, supra note 118. Szabo developed the idea of solving cryptographic equations as proof-of-work which produced new coins. Szabo was concerned to remove the involvement of banks as trusted intermediaries as with Chaum’s DigiCash and have the new digital currency behave like gold without any central authority.
B. LENDING AND CREDIT (LOANTECH)


The Financial Conduct Authority (FCA) in the United Kingdom has regulated peer-to-peer lending and crowdfunding since April 1, 2014. Crowdfunding allows “people and business (including start-ups) . . . to raise money from the public to support a business, project, campaign or individual.” The FCA is responsible for loan-based and investment-based crowdfunding rather than donation or pre-payment and rewards-based crowdfunding.

C. PAYMENT (PAYTECH)

A number of major innovations have taken place in the area of mobile payments through both FinTech start-up companies and established technology firms. Companies such as PayPal, which was initially set up in 1998 and acquired by eBay in 2002, developed new forms of electronic payments. By 2014, PayPal had 153 million digital wallets and processed around “$203 billion in payment volume” before being separately floated...

Venmo allows payments to be made through mobile telephones, and was acquired by Braintree in 2012 for $26.2 million; Braintree was then acquired by PayPal in 2013 for $800 million. Tilt is a crowdfunding platform that allows money to be collected and transferred between social groups. The largest online payment platform in China is Alipay, with 300 million customers; in 2004, it was set up as a payment vehicle within the market website Alibaba, and in 2011, it was separately incorporated for licensing purposes.

Wholesale payment markets have been dominated by improvements in market standards and harmonization such as with the Single Euro Payments Area (SEPA) and the second generation of the Trans-European Automated Real-time Gross Settlement Express Transfer System (TARGET2), which came into operation in November 2007. SEPA’s objective is to create a single cross-border payments market within the E.U. with TARGET2.
establishing a real-time interbank payment system for euro transfers.\textsuperscript{138} TARGET2 is supported by TARGET2-Securities, which provides a centralized delivery versus payment (DvP) settlement system for European securities trades.\textsuperscript{139}

It was expected that national and international payment systems would have an “end-state” that was “largely unrecognizable” by 2020 due to the expansion of PayPal and the entry of “social media companies such as Amazon, Google and Facebook” into the payments market, with many developing countries simply “leapfrogging” into media development stages.\textsuperscript{140} Large technology and social media companies may be able to “leverage, even monetise, their considerable customer reach by presenting attractive, straightforward and secure payment propositions” with non-bank offerings which would dis-intermediate banks outside of the new global payments business.\textsuperscript{141} A number of banks were nevertheless responding to the challenges.\textsuperscript{142}

D. SECURITIES AND INVESTMENT (SEC'TECH OR TRADETECH)

Digitalization has already been used in the securities area especially with the dematerialization of many shares and bonds. Many country’s laws provide for the issuance of corporate shares or bonds and government debt instruments in an uncertificated or dematerialized form.\textsuperscript{143} Such dematerialization generally operates through the maintenance of a single, central register by the issuing company with the shares being dealt with either on over-the-counter markets, or through formal physical or electronic stock markets, which retain a separate admission to trading register. The earlier unregistered trading in over-the-counter (OTC) financial derivatives contracts has, to a substantial extent, been transferred to official counterparties (OCCs), with transaction records being kept through Trade Repositories (TRs). In the future, companies in a distributed ledger or block chain form could issue blocks of shares.

Important new companies in the securities area include MarketAxess (2000), Markit (2003), BATS Global (2005), IEX Group (2012), Kensho (2013), Digital Asset (2014), and TruMid Financial (2014).\textsuperscript{144}


\textsuperscript{141} \textit{Id.} at 3.

\textsuperscript{142} \textit{Id.} at 4.

\textsuperscript{143} See, e.g., \textit{The Uncertificated Securities Regulations, 2001 S.I. 2001/3755 (U.K.); see also U.C.C. art. 8 (stating that dematerialised securities may also be issued in the United States).}

\textsuperscript{144} \textit{Ranking the Top Fintech Companies, supra} note 121.
personal finance and investment management companies include Envestnet (1999), Yodlee (1999), Mint (2006), Credit Karma (2007), Betterment (2008), LearnVest (2009), NerdWallet (2009), Personal Capital (2009), Motif (2010), and Wealthfront (2011). 145

E. INSURANCE (INSURTECH) AND SMART CONTRACTS (SMARTTECH)

FinTech has also affected the insurance sector with current areas of development, including telematics (telecommunications and vehicle technology), social insurance, and wearable devices such as FitBit, with further growth expected in the areas of the Internet of Things, autonomous vehicles, and block chain. 146 It was expected that “motor, home and mobile phone insurance” could be purchased “on a mutual or group basis” to allow collective savings. 147

Digitalization could also be extended in the insurance area through the issuance of policies in a smart contract form. 148 These digital contracts could provide for the collection of premia payments with policy payments being made automatically depending upon the terms and triggers agreed. 149 Groups of standard form contracts could be issued in distributed ledger or block chain form, which could also allow for reinsurance cover and transfers to be dealt with on a digital basis.150 The European Commission published a Green Paper on financial services and insurance in December 2015.151

The U.S. insurance markets were considered to be ripe for disruption, and insurance has been referred to as the next frontier for FinTech.152 Very little has changed in the U.S. insurance area for some time, apart from the enactment of the Patient Protection and Affordable Care Act (PPACA) in 2010, which sought to increase the quality and affordability of health insurance within the U.S. healthcare system and was based on the Medicare and Medicaid programs that were established in 1965.153 Total net premia in the United States were in excess of $1.2 trillion annually.154 It was expected

145. Id.
146. Ernst & Young, supra note 17, at 23, note 6, fig.7.
149. See id.
150. See id.
154. Dickinson, supra note 152.
that new products would be launched in the insurance area for the new economy, substantial improvements would be made in data provision and analysis, and new means of managing risks and providing capital with new structures for acquiring companies would be developed.\textsuperscript{155} Important new companies in this area include Oscar, Metromile, SURE, and PolicyGenius.\textsuperscript{156}

F. Operations, Risk Management, and Data Analysis

Substantial advances are expected in the areas of machine learning and cognitive computing, with systems learning and developing original tasks through new algorithms. Cognitive computing uses machine learning algorithms to simulate human thought processes.\textsuperscript{157}

Big Data analytics involves the processing of the large volume of information stored by computers on the Internet, and new businesses are developing as a result of these information-gathering exercises.\textsuperscript{158} This includes data-centric computing, data management, and the development of new application programming interfaces (APIs). Digital and mobile payments systems bring forth the “consumerization” of technology, with new FinTech operators focusing on customer appetite and experience.\textsuperscript{159}

G. Interface and Digital Platforms

Many new FinTech companies only operate as new interface devices that place themselves between traditional financial customers and incumbent financial institutions. The new platforms are simply intermediate interfaces, or “veneers,” that attract customers through their novelty, branding, or topical design. Many of the companies are not authorized to engage in financial businesses with all of the traditional account and other trading work carried out through existing institutions. While this creates a sort of parasitic relationship, this can benefit both the start-up and incumbents, as evidenced by the new U.K. Internet-only bank Tide. Designed principally for small businesses using the latest technology, Tide was able to obtain $2 million in seed funding. But, Tide’s core banking is undertaken through Barclays.\textsuperscript{160}

\textsuperscript{155} Id.
\textsuperscript{156} Id.
\textsuperscript{157} Walport, supra note 23, at 19 (suggesting that artificial intelligence is expected to develop through the stages of assistance (where computers absorb massive amounts of domain knowledge), understanding (deciphering), decisioning (the provision of semi-autonomous unbiased advice), and discovery (with the provision of new insight and new value)).
\textsuperscript{159} Id. at 19-21.
\textsuperscript{160} Id.
H. Government Services

FinTech could have a significant impact on government operations and services. The U.K. government commissioned a report to investigate the potential of distributed ledger technology. The report produced eight recommendations to promote and support the development of digital register systems within the United Kingdom. These were principally based on leadership and capability, investment, demonstrator development, optimum regulation, integrity, security and privacy standards production, identification and authentication protocol construction, application trials, and capacity and skills promotion.

Distributed ledgers can be used to assist government service provision through reduced operational costs, greater transparency, improved financial inclusion, increased data protection, critical infrastructure protection, reduced market friction, and the promotion of more general innovation and economic growth. This could be used to manage payments by HM Treasury (HMT) and the Department for Work and Pensions (DWP), including uses in connection with tax collection and welfare support delivery. This could reduce fraud and error, ensure financial inclusion, manage provision and ensure efficient operation.

Distributed ledgers could also be used to develop new types of information marketplace by removing market friction and promoting innovation, especially for small and medium sized enterprises (SMEs) using smart contracts and new asset registers or “smart assets.” Distributed ledgers could have substantial benefits in terms of managing micropayments, decentralized exchange, token earning, and spending and transfers not possible on the existing world wide web. Distributed ledgers could assist strengthen international aid provision, particularly through the production of new digital coins with double spending avoided and expenditure managed.

VI. Distributed Ledgers

The development of distributed ledgers has been one of the key technological developments in the FinTech area. A distributed ledger

161. See Gov’t Office for Scl., supra note 37.
162. Id. at 9-15.
163. Id. at 65-71.
164. Id. at 67 (“The DWP pays out £166 billion each year in welfare support with £3.5 billion lost through fraud (£1.2 billion), claimant error (£1.5 billion) and official error (£0.7 billion) with only £930 million being recovered.”).
166. See generally id. (suggesting distributed ledgers could assist reform business licensing, registration, insurance, taxation management and pension data management); see generally Melanie Swan, Block Chain: Blueprint for a New Economy (O’Reilly Media 2015).
167. Swan, supra note 166, at 68-69.
A continuous chronological order with copies being held across multiple sites, institutions and countries. A block chain can constitute a more specific type of distributed ledger in which items are collected in blocks and then linked or chained together. While distributed ledgers and block chains are only record or information management systems, they hold a new significance in the world of FinTech because they are governed by a specific set of common rules or operating protocols that determine the operation. Specific transactions can also be programmed within the ledger or block chain to operate in accordance with their own particular rules, or business logic, which creates smart contracts.

Debt record systems date from ancient Mesopotamia with the use of clay tablets around 5000 years ago. Bank accounts constitute a simple form of payment record with banking dating back to ancient Mesopotamia. Bank accounts were also used in Greek and Roman times, such as the Greek trapezai and Roman argentarii. Sophisticated accounting systems were developed during the Renaissance period, especially with the Great Fairs in Italy and other northern European cities.

Early payment instruments were developed with promissory notes used to create a debt by one party and bills of exchange to transfer payment obligations from one party to another. Promissory notes became most commonly used as private and then public bank notes in the city of London and elsewhere. Bank accounts gained importance again in London with the

168. Similar components are identified in the U.K. Gov't Office for Sci., supra note 37, at 17.
169. Id.
170. Id.
171. See id.
172. Debts were recorded in clay tablets, which were then stored in a clay ball, or bulla. These could also be held together on a length of cord or string. Simple early forms of correspondence accounting were developed with small hard clay objects being used to represent specific items with the number of objects representing the total number of items involved. The physical artefacts were then converted into notches on tablets with a simple system later developing for original or raw materials, such as agricultural produce, and more sophisticated notations for manufactured goods, such as bread or wine. The simplified notations later emerged to form counting systems with the more complex systems developing into hieroglyphics and then writing. See generally Denise Schmandt-Besserat, Before Writing (Univ. of Texas Press, 1st ed. 1992); see generally Denise Schmandt-Besserat, How Writing Came About (Univ. of Texas Press, 1st ed. 1996).
173. See generally Benjamin Geva, The Payment Order of Antiquity and the Middle Ages: A Legal History (Hart Publishing 2011) (stating that one of the first early banking families were the Egibi).
175. See id.
growth of goldsmith bankers around the 1640s with gold and silversmith receipts for deposited specie circulating as private banknotes. The use of electronic distributed ledgers would constitute a significant departure in this history of the record and payment systems.

A. LEDGER STRUCTURES

Different types of ledgers can be distinguished. These include determined or centralized registers, which would include, for example, land registers, other high asset value registers, or in the financial area, commercial bank reserve accounts held with the central bank. Decentralized registers include separate registers and distributed or shared registers. A separate or parallel ledger system would include, for example, bank accounts maintained by commercial banks for their customers with each bank holding a separate set of entries in a common format. A distributed ledger operates through the creation of distinct but identical multiple registers operating across the Internet without any single location. Each register is held at a node point within the system.

A shared ledger is a collective term for different types of multiple register systems. Shared ledger technology has been tested in a number of countries including the United Kingdom, United States, China, Singapore, and Latin America. This technology could be used to increase efficiency within the civil service, legislation and the oversight and management of the economy. The five countries of the United Kingdom, Estonia, Israel, New Zealand, and South Korea, form the “Digital 5” group of countries (D5) to promote research and exchange of information on the adoption of new digital technologies. The government in Estonia has carried out a number of large-scale tests using distributed ledger technology, in particular, through its Keyless Signature Infrastructure (KSI), which was developed by Guardtime. This allows individuals to confirm the integrity of the records

178. Gov’t Office for Scl., supra note 37, at 36, fig. 2 (suggesting that ledgers can, for example, be classified as being centralized, decentralized, or distributed).
179. Id.
180. Id.
181. Id.
182. Id. at 18 (“The term shared ledger was developed by Richard Brown, formally at IBM and subsequently Chief Technology Officer of the Distributed Ledger Group, to refer to any database and application that was shared by an industry or private consortium or open to the public.”).
183. Id. at 26.
184. Gov’t Office for Scl., supra note 37, at 26-29.
185. Id. at 7.
186. Id. at 6.
and avoids internal interference or manipulation. The KSI system supports Estonia’s e-Business Register and e-Tax system.  

A number of operational variants can be created within each type of register or ledger. Registers may be closed with some form of access or password protection or cryptography (permissioned), or open (non-permissioned). Closed systems will generally be based on proprietary software, while unrestricted access systems will generally use open source software freely available on the Internet. Registers may be owned by a single party or limited group or have no assigned ownership. Ledgers may generally operate on a controlled or consensus basis with control meaning subject to entry correction being carried out by a single party with consensus referring to different possible models for allowing entries across separate registers to be reconciled by more than one party.

For the purposes of this paper, further distinctions can be drawn between denominated and non-denominated ledgers and static or active ledgers. Denomination is used to refer to accounting or record systems that measure value in terms of existing official currencies, such as the U.S. dollar or pound sterling. Non-denominated systems use new reference values, such as Bitcoin or other new forms of digital coin. Assets that are denominated in an official currency can be referred to as monetary assets, while other assets use a digital reference asset known as investment assets. Static systems record ownership to the specific asset concerned with active or dynamic systems, including an element of execution—such as payment—under a smart contract.

Reference may also be made to single, or unitary, ledgers and bi, or multi-chain, ledgers. Multi-chain ledgers consist of variants with separate functional sidechains that can be used for different purposes without increasing or decreasing the digital coin within the ledger. Ledgers may also potentially be connected or disconnected for different purposes. The

188. GOV’T OFFICE FOR SCI., supra note 37, at 17.
189. Id.
190. Payment may be made on a continuous basis such as with share dividends or bond interest payments. Payments may also be made in the event of a specific contingent event arising such as under an insurance policy or credit derivative contract.
191. See Tim Swanson, Blockchain 2.0 – Let a Thousand Chains Blossom, LTB NETWORK (Apr. 8, 2014), https://letstalkbitcoin.com/blockchain-2-0-let-a-thousand-chains-blossom. The article suggests that Sidechains have been developed as part of “Blockchain 2.0” for altering the core protocol. This would, for example, allow Bitcoin to be used as a transactional currency in connection with a number of other asset types in sidechains including shares, smart contracts, derivatives or other user assets. Consensus building and confirmation could also be extended to sidechains through a fee rather than additional coin reward system. See also Nicolas Courtois, Is Bitcoin Going to Split in Two?, WORDPRESS (2015), http://blog.bettercrypto.com/?p=1811 (commenting on the difficulties in securing agreement on using larger blocks, increasing transaction speed, lowering fees, and securing wider adoption of Bitcoin).
most common forms of future ledgers use different aspects of these various features.

B. LEDGER USE AND APPLICATION

Distributed ledgers are inherently low cost, and avoid duplication and inefficiencies in control and coordination through the use of an open common ledger without the need for continuing reconciliation.192 While manufacturing companies generally focus on product innovation and service companies on process innovation, digital technology can lead to more substantial effects in terms of business model innovation.193 One can even call the FinTech movement a “revolution,” as revolutions are generally associated with substantially lower costs, new communication channels, and adjusted infrastructure and logistics.194

Title holdings in almost all assets can be digitalized and kept on distributed ledgers. This could be extended to include securities clearing, settlement, custody and registration services,195 corporate action processing,196 smart contracts,197 and diamonds.198 Smart contracts could form the basis of a new “programmable economy,” based on decentralized networks and agents operating as distributed autonomous organizations.199 This could, for example, be used in the motor insurance area—with contracts containing both information on the condition of the driver and the car.200 Additional specific attribute information could be included, such as in digital currencies, only to allow them to be used for specific purposes.201

C. LEDGER SECURITY AND PRIVACY

The effectiveness of technology is dependent upon how it is designed, implemented, and governed—with systems being subject to external and

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192. GOV’T OFFICE FOR SCI., supra note 37, at 56-57.
193. Id. at 53.
194. Id. at 54.
195. A peer-to-peer securities transactions block chain has been developed by SETL in London. Post-trade administrative costs are estimated to be between sixty-five–eighty billion dollars, which could be saved using block chain technology. Id. at 58.
196. Codel is developing a block chain system, using digital notary software, to process corporate actions with an Instant Actions registry for corporate action data developed by Codel and industry participants. Corporate actions concern the processing of company announcements through data vendors and custodian and fund manager intermediaries. Global costs are estimated to be around ten billion dollars per year. Id. at 58-59.
197. Ethereum has been developing a decentralized platform for the processing of smart contracts. Id. at 57.
198. Everledger has developed a block chain technology and digital passport system to record the provenance and transfer of diamonds using a cryptographic fingerprint. GOV’T OFFICE FOR SCI., supra note 37, at 56.
199. Id. at 57.
200. Id.
201. Id.
internal attacks, and component failure. Security systems are generally based on specificity, resilience, and robustness. The theoretical advantage of distributed systems is that they operate on a decentralized and consensus basis, without any single or central point of trust or failure. Cryptography prevents the abuse of private and public keys, while complex consensus protocols manage reconciliation.

Further issues arise regarding privacy. Bitcoin was described as an anonymous system in the original 2008 paper, although it is possibly better considered pseudonymous with substitute names being used. An unlimited number of wallets can be held in unconfirmed names, with no identification or money laundering requirements applied. This is explained in terms of a matter of design choice for Bitcoin, which may otherwise have limited its use at the same time by undermining the fungibility of Bitcoin as a currency. This pseudonymity is nevertheless restricted because wallet owners can be identified, and all relevant transactions then become visible on the publically transparent block chain.

Digital currency payments can be more transparent than traditional online transactions, where identities are only revealed between parties. Additional privacy can be provided through various techniques, including addresses and wallets, to prevent individual identification, or through the use of group signature algorithms that confirm that coins are held, although not the specific coins which breaks the link between current and previous transactions.

D. Ledger Governance and Regulation

Distributed ledgers are managed by legal rules and regulations, and technical and computer code. Technical code includes both software and protocols. The modern financial system can already be considered substantially digitalized and operates on the basis of internal technical program, especially in terms of record creation and amendment. External

202. Id. at 47.
203. Id. at 48.
204. Gov’t Office for Scl., supra note 37, at 47.
205. Id.
206. See, e.g., S. Meiklejohn et al., A Fistful of Bitcoins: Characterizing Payments Among Men with No Names para. 9 (2013).
207. Gov’t Office for Scl., supra note 37, at 50.
208. Id. at 50.
209. Id.
210. Id.
211. Id.
212. This is used in Zerocoin, Zerocash, Pinocchio Coin, and other Sigma protocols. Id. at 51.
214. Id.
regulation is then applied to manage the risks produced by internal code activity. Governance can be distinguished from regulation—with governance referring to internal decision-making processes.

Distributed ledgers benefit from low compliance costs, as they are controlled by technical rather than legal code. Market bodies can develop separate sets of standards to govern the operation of particular systems, such as with the Visa Core Rules produced by Visa Inc. Technical codes also have to be maintained and revised over time. Difficulties have, nevertheless, arisen with the private governance arrangements surrounding Bitcoin with differences of opinion having arisen as to the future development of the code and with no resolution having yet been achieved. Some parties wish to revise the code, for example, to operate faster with larger header blocks and other revisions, while others wish to remain with the original code.

Permissioned ledger systems can be more directly controlled, as they generally operate under the auspices of a particular owner or group of proprietors. Unpermissioned ledgers have only been directly controlled to date through the imposition of regulatory obligations on authorized institutions that deal with ledger operators or digital coins. This can also be extended to service operators such as exchangers or wallet providers. The New York State Department of Financial Services required businesses providing digital currency services to New York residents to be licensed with a BitLicense in August 2015. Digital currencies can also be made subject to specific, developed technical codes using public funds, and without any direct public direction. Internet and World Wide Web protocols have, for example, been developed by the international non-profit organization, the Internet Society. This could then be applied with regard to both permissioned and unpermissioned systems, with a split or multi-governance level approach being developed for FinTech regulation.

E. INTERNATIONAL LEDGER DEVELOPMENT

Distributed ledger technology can be used both to assist domestic companies’ growth internationally, and for countries to construct larger digital economies that can support trade growth and expansion. Blockchains could also be used to distribute foreign aid payments. A number of countries along with the EU have adopted specific digital economy

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215. Id.

216. The Chief Scientific Adviser refers to this in terms of private rulemaking governance. Separate individual micro and wider macro systems external regulation is then applied. Id. at 42.

217. Id. at 80.

218. Id. at 44.

219. Id.


221. Gov’t Office for Scl., supra note 37, at 44-45.

222. Id. at 49.
programs. Digital economies can aim to secure speed, reach, and efficiency. Successful digital economies are based on a necessary degree of trust, including identification and verification, and interoperability, with data and policy interoperability and effective collaborative implementation of relevant standards. Trust within digital economies is dependent on securing a necessary degree of internationally defined level of assurance (LoA) and multiple agency authentications through Federated Identity Management (FIM). A significant amount of work is being carried out in each of these areas.

VII. Digital Currencies

Distributed ledger technology has attracted particular attention recently in connection with its use in digital currencies, specifically Bitcoin. Nevertheless, this only represents one possible application of ledger models. A number of other digital currencies have also been created in addition to Bitcoin that operate on a similar basis, although with variation.

The following further points may be made with regard to block chain technology in the currency area.

A. Digital Establishment and Objectives

Digital currencies, such as Bitcoin, operate as a peer-to-peer payment system for the transfer of electronic cash. A programmer named Satoshi Nakamoto created Bitcoin in 2008. In 2009, the software was made available on an open source basis, and a nine-page paper published in October 2008. The identity of Nakamoto has remained unclear despite a number of unsubstantiated attempts to name the originator or claims to

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223. Id. at 78.
224. Id. at 77.
225. Id.
226. Id. at 74.
227. GOV’T OFFICE FOR SCI., supra note 37, at 74.
authorship. The amount of coding directly carried out by Nakamoto was nevertheless limited.

The original Nakamoto paper refers to the need to avoid having to use a trusted third party as an intermediary in order to avoid double spending in any cash system—prevented through the use of a peer-to-peer network and times tamped transactions. This is carried out by hashing, or converting the transactions into a fixed string of characters, and recording them on an ongoing chain of proof-of-work, which creates a record that cannot be amended without correcting all of the previous proof-of-work. Proof-of-work is a form of participation condition that is difficult to solve but easy to verify. The longest chain within the block acts as proof of the sequence of earlier transactions and proof that this was generated on a consensus basis by the verification miners with the largest pool of computer power.

Nakamoto notes that online commerce relies almost exclusively on financial institutions acting as trusted third parties to process electronic payments which trust can be replaced by cryptographic proof. Key parties are able to transact directly without the need for a trusted intermediary with transactions that are computationally impractical to reverse preventing double spending and fraud. The paper nevertheless accepts that the system is only secure as long as “honest nodes [computer terminals holding the complete block chain] collectively control more CPU power than any cooperating group or attacker nodes.” This is referred to as the 51 percent attack problem.


230. Nakamoto was attributed with only having developed 2 percent of the total Bitcoin code before transferring responsibility to the Australian programmer, Gavin Andresen, and other programmers. Andresen was responsible for 6 percent with Jeff Garzik contributing five percent, Mike Hearn six percent, Vinnie Falco 12 percent, Wladimir J van der Laan 16 percent, and Pieter Wuille 22 percent. GOV’T OFFICE FOR SCL, supra note 37, at 43.

231. Nakamoto, supra note 228, abstract 1

232. Id.

233. Id. at 1.

234. Id.

235. The Bitcoin Develop Guide accepts that a 51 percent attack could be carried out against the transaction history if an operator was able to acquire a majority of the network’s hashing power. Id. at 1. An attack could also be carried out with even less than 50 percent of the hashing power. Bitcoin Developer Guide, BITCOIN, https://bitcoin.org/en/developer-guide#stratum (last visited Sept. 1, 2016).

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The total number of bitcoins is fixed at 21 million to protect their value over time. These are released on a controlled basis with the final coins expected to be generated around 2040. Bitcoins can also be dealt with in subunits referred to as millibitcoins (10^-3), microbitcoins or bits (10^-6), or Satoshis (10^-8). Bitcoins can either be referred to as XBT, which conforms to ISO 4217, or BTC, which is not officially recognized. Nakamoto defined “an electronic coin as a chain of digital signatures.”

B. DIGITAL OPERATIONS

Bitcoins are described as being stored in wallets that are privately held. Coins are not actually stored in the wallets, but rather, move through transactions across a block chain. Rather than hold coins directly, wallets store the private digital credentials necessary to transfer coins. Wallets are separately loaded onto private computers using open-source software. Transfers are carried out through transactions using unspent outputs from previous transactions.

The first of each set of transactions in a block is referred to as the coin base or generation transaction, which uses the block reward coins. Coins are transferred by digitally signing a hash of the previous transaction and the public key of the next owner is then added to the end of the coin. This allows payees to “verify the signatures to verify the chain of ownership.” Double spending is prevented through the use of a timestamp server, which publicly discloses each timestamp, including the previous timestamp, to create a chain. Each block also produces a nonce, which is a random number that can be used to attempt to calculate the correct hash for a specific block.

The network operates with new transactions being broadcast to all nodes, and with nodes collecting new transactions into blocks. Each node calculates the proof-of-work for the block and broadcasts this to all other nodes. All full nodes validate blocks using the same consensus rules. Other nodes only accept the proof-of-work if all transactions are valid and not already spent. This is accepted by creating the next block in the chain

238. Nakamoto, supra note 228, at 2.
240. Davis, supra note 229.
241. Id.
244. Id.
using the hash of the last accepted block. Duplication and double-spending are prevented with nodes working on the first chain received, therefore reserving any other notified chains. The correct chain is then confirmed when the proof-of-work is confirmed and the correct chain identified.

C. DIGITAL CRYPTOGRAPHY

Bitcoin uses a combination of private and public cryptographic keys. Private keys are always kept confidential within an individual’s wallet. Bitcoin uses an Elliptic Curve Digital Signature Algorithm (ECDSA). The private key will be a randomly generated number expressed as a single unsigned 256-bit integer (thirty-two bytes). The public key is used to confirm that signatures are genuine and are based on the private key, although the private key cannot be determined from the public key. Signatures confirm signing, which is mathematically generated from the hash of the transaction, and the private key. Signatures are either seventy-three, seventy-two, or seventy-one bytes long.

D. DIGITAL MINING

An anonymous peer-to-peer verification system is created through the use of miners, which are independent, powerful central processing units. Miners receive new coins upon the creation of each new block, as well as transaction fees for the transactions carried out within the block. Mining can be conducted on an individual basis using powerful processing devices, although, in practice, most mining operations are carried out using stacks of large numbers of processors together, which are often based in less developed countries due to the cheap cost of electricity. Many of the largest mining operations are organized into pools or guilds.

Mining computers carry out their proof-of-work by randomly attempting to match the block hash; the apparent number of total combinations is around 1 to 250 trillion. Every time a specific mining computer selects the correct hash, it is distributed across the other nodes for confirmation. The correct solution receives a twenty-five bitcoin reward, which will eventually be replaced by a fee system once all of the bitcoins have been

245. Id.
issued.  

E. DIGITAL ADVANTAGE AND DISADVANTAGE

Bitcoin is claimed to create a fast, secure, and efficient money generation and payment system. The system is, nevertheless, arguably too complex, with over 380,000 blocks already generated and held within a forty-five gigabyte ledger.  

The system is also slow and only allows for two transactions per second as compared to Visa allowing over 1,736 transactions per second.  

Additionally, the blocks are too small in size and only contain around 140,000 transactions each.  

Substantial delays can occur in using transferred coins, with payees having to wait up to one hour.  

Further, historically, the value of a bitcoin has fluctuated widely.  

Mining involves a massive waste of energy of around forty terawatts a year. This also represents a significant amount of computational waste that could be used for other purposes.  

The system lacks transparency in terms of adjustment, and there appears to be a lack of effective governance and oversight, with disputes arising regarding amendment and revision. It is accepted that the network is theoretically subject to a 51 percent attack, if not less.  

The highly technical nature of the software used also creates substantial technological dependence. Bitcoins are generally not accepted as currencies, and therefore deposit protection or other central bank lenders of last resort do not support transactions. The ability to use unspent coins also requires that private wallets are protected, with coins being irrevocably lost if the wallet is lost or damaged. Substantial difficulties also arise with regard to controlling the volume and price of money as part of central bank monetary operations.

252. Id.  

253. The solution speeds are controlled by adjusting the difficulty value in the consensus protocol. The network calculates the number of seconds for the generation of 2,016 blocks with the difficulty value being adjusted to ensure that they are produced around every two weeks (1,209,600 seconds). Bitcoin Developer Guide, supra note 235.  


255. The Magic of Mining, supra note 254.  

256. Id.  

257. This occurs as one of the mining pools was able to receive two lots of coin successively with users having to wait up to 6 times 10 minutes, or one hour, before the transactions are confirmed. Id.  

258. The value of Bitcoin peaked in April 2013 at $266 and rose to a high of $1240 ($914) in December 2013 before falling to $339 ($245) in April 2014. ECB, supra note 53, at 26.  

259. Id.  

260. The Trust Machine, supra note 254.
VIII. FinTech Advantage

The arrival of FinTech has been heralded as generating a number of important advantages and disadvantages. The advantages and disadvantages will have a significant impact on the development of banking and financial products, and services, especially as FinTech brings together financial, technological, and social media advances. All of advantages and disadvantages have to be properly identified to fully understand FinTech market development.

The principal advantages can be summarized in terms of increased access, quality, speed of service at lower cost and with greater control, and additional security, depending upon the specific cryptographic function and options adopted. While this will have a disruptive effect on incumbent business models, to a significant extent, this simply brings forward necessary change and reform that will make banking and financial markets more efficient, competitive, and innovative over time. Although there may be some immediate employment loss, FinTech will create new opportunities, while at the same time forcing improvement in relevant educational and training standards. This can lead to improved growth, earnings, taxation receipts, and overall welfare and social benefits.

The advantages of FinTech may be considered more specifically under the headings that follow.

A. Technology

A number of inherent advantages arise as a result of the new technology used in the FinTech area. The IMF noted that these technologies are driving transformational changes in the global economy, including home goods, services, and asset exchange.\(^{261}\) Distributed ledgers and block chains can provide specific benefits in terms of cryptographic reconciliation, replication, granular (individual or component level) access control, transparency, and privacy.\(^{262}\) Specific advantages are identified in the headings that follow.

1. Speed and Capacity

New digital systems can be considerably faster than earlier electronic analog or physical processing models, and have considerably greater capacity. This is principally generated through the use of microprocessors, which have become substantially smaller in size in recent decades due to

\(^{261}\) Int'l Monetary Fund [IMF], *Virtual Currencies and Beyond: Initial Considerations*, at 5 (Jan. 20, 2016).

\(^{262}\) Gov't Office for Sct., *supra* note 37, at 22.
Moore’s law, which refers to the doubling of the number of components in an integrated circuit every year.263

2. Cost and Efficiency

New systems can be manufactured at considerably lower costs, which makes their use substantially more efficient in relation to income generation and profit.

3. Security and Confidence

New technology can benefit from substantial improvements in security, which, in turn, promotes user trust and confidence.264 This may be of particular importance, following the global financial crisis and mistrust in traditional financial markets, with many people placing more reliance on cold technology, rather than pilloried intermediaries.

4. Digitalization and Durability

A number of specific advantages arise as a result of the digitalization process itself.265 This allows continued accuracy, perfect copying, efficient amplification, replication, consequent scalability, and overall improved durability. Digital replication of ledgers avoids the need to manually update multiple registers within a single institution, across companies, or government departments.266

5. Transferability, Expansion and Evolution

Many specific types of digital products are easily transferable, including digital coins and dematerialized securities. A number of further benefits may arise directly from the use of the new technology used, such as machine learning and cognitive computing; block chain and digital currencies; Big Data analytics, optimization and fusion; distributed systems, mobile payments, and peer-to-peer applications; and in-memory computer capability, data clouds, and service technology.267

264. Society for Worldwide Interbank Financial Telecommunication (SWIFT) and Accenture refer to distributed ledgers’ core advantages in terms of trust in a disseminated system, efficiency in broadcasting information, complete traceability of transactions, simplified reconciliation and high resiliency. SWIFT and Accenture, SWIFT on Distributed Ledger Technologies, 3 (Apr. 20, 2016), http://www.ameda.org.eg/files/SWIFT_DLTs_position_paper_FINAL1804.pdf.
265. ERNST & YOUNG, supra note 17, at 2.
266. GOV’T OFFICE FOR SCI., supra note 37, at 21-22.
B. Business Models

The establishment of large numbers of new FinTech start-up companies and the adoption of FinTech changes within incumbents will lead to significant changes in business practices and models. New technologies can have a major impact on business operations, including developing innovative new products and services; generating alternative management models and additional revenue streams; producing lower cost operations; and streamlining organizational structures. While the term disruption may appear critical and negative, it can also be considered simply to refer to the need for change, reform, and the bringing forward of innovation and evolution within natural or evolutionary business cycles.

1. Growth and Efficiency

Financial technology solutions may generate substantial new income-generating capabilities at significantly lower costs, which will improve earnings and overall efficiency.

2. Competition

Competition will be substantially increased by new start-ups competing with incumbents, and by incumbents competing with each other to develop the most efficient and profitable FinTech solutions. Many official bodies have promoted this as a key objective. The Competition and Markets Authority (CMA) in the United Kingdom recently published a paper on the supply of personal current accounts (PCAs) and banking to small and medium-sized enterprises (SMEs). The paper includes a recommendation that the major UK banking groups develop common electronic data exchange standards to allow the creation of an “Open Banking” marketplace, within which customers are able to transfer the accounts between institutions easily through mobile applications.269

268. Gov’t Office for Sci., supra note 37, at 53.
270. The recommendation has been criticized partly for not going far enough in ‘breaking up’ the banks and partly for opening the financial sector to criminals and the “dark web,” with Open Banking allowing the exchange of massive amounts of highly sensitive customer data that can be abused. One of the core criticisms has been the charges imposed for unauthorized overdrafts, which could have been dealt with simply by imposing charge caps. For comment, see e.g. Jonathan Guthrie, CMA: Swipe Right to Disturb Banks, FINANCIAL TIMES (last updated Aug. 9, 2016, 10:29PM), https://www.ft.com/content/cdf050c7-5e15-51e6-bb77-121a8aabd95. The earlier Independent Commission on Banking (ICB) promoted the creation of a current account redirection service to allow the switching of current accounts for individuals and small businesses, in addition to its core recommendation of structural regulation and the fencing retail and SME banking from investment banking. Indep. Comm’n on Banking (ICB), Final Report: Recommendations, ch. 8 (Sept. 2011).
3. **Innovation**

External and internal FinTech development will substantially increase the amount, quality, and depth of innovative change in financial product design and service provision.

4. **Open Access and Cloud Services**

The nature and operation of many parts of the banking and financial system will substantially change with the adoption of new practices as systems move from pre-FinTech to post-FinTech conditions. There will be substantial conversion and transformation of business structure, product designs, and service provision.

Cloud servicing and computing is expected to receive additional substantial growth, as smaller start-ups have to rely on shared resources initially, while new digital platforms also operate on a collaborative basis. Incumbent systems may also be increasingly open and operate on a shared rather than closed basis. The Financial Conduct Authority (FCA) in the United Kingdom supports the possibility for financial institutions to use cloud storage facilities and it issued guidance in 2015. The UK challenger bank, OakNorth, transferred its core systems to Amazon’s Web Services in 2016.

5. **Business Support**

A number of new innovative project development models have already been created to promote innovation, change, and support FinTech development. These include digital Incubators, Accelerators, Factories, and Laboratory and Catapult services in the United Kingdom and elsewhere, which provide a wide range of funding, continuing support, and mentoring. Substantial amounts of capital are also provided through specialist firms, including venture capital funds, such as Lightbank, or possibly individual angel investors, who invest in firms directly, rather than through managed funds.

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271. Cloud computing involves the provision of scalable and elastic IT capabilities using Internet technologies with the most common form being referred to as Infrastructure as a Service (IaaS).


273. Emma Dunkley, **OakNorth Takes UK Banking into the Cloud, FINANCIAL TIMES (May 26, 2016, 12:05AM), https://www.ft.com/content/36e8e8e2-2280-11e6-9d4d-c11776a5124d.**

C. USERS AND STAKEHOLDERS

FinTech evolution will lead to substantial change and benefits for users and other stakeholders.

1. Choice and Quality

Banking and financial customers will receive substantial benefits regarding the access to and quality of service provided, especially on a mobile basis through new applications and digital platforms. Start-ups and incumbents will both have to focus on customer service quality, support, and satisfaction in order to build and protect market share. This shift of attention from firm to customer focus reflects the wider changes in the demand for new ethical approaches to be adopted by financial institutions following the global financial crisis. The natural adoption of FinTech solutions may have more of an impact in this area than other forced ethical changes.

2. Access and Inclusion

The use of mobile access channels and, in particular, digitally based applications will allow customers to choose from a wider range of services and service providers. New application interfaces (APIs) will also increasingly allow customers to move from one service and platform to another, which will again increase the overall depth and quality of service provided at the same time as increasing competition.

3. Work and Employment

While some employment positions may inevitably be lost with the adoption of new forms of technology, large numbers of new opportunities will also become available, either in setting up and designing new FinTech companies and programs, or in managing FinTech services within new operations and incumbents.

4. Education and Human Capital

The evolution of the market will also lead to substantial change in education and training, with a number of government and official initiatives already adopted to improve standards in this area. This should also lead to the creation of an even larger specialized, and highly qualified workforce in this area that will continue to grow as firms and service providers compete within Europe and globally.

5. Government and Central Banking Operations

The government has clearly indicated its willingness to use digital solutions to improve the nature of its operations and interaction with the public. FinTech options could substantially improve the quality and cost of many government operations and services. The government will act as an
“expert customer” in this area, which will support FinTech development further. Many central banks are also looking at FinTech opportunities to support, or partially replace, some of their own operations, subject to careful oversight and control.

D. GLOBALIZATION

FinTech growth will further support the development of borderless online virtual markets and, with this, globalization more generally. Growth in physical trade and services will be paralleled by growth in the online exchange of goods and services. This can specifically benefit many of the principal financial centers, including the City of London, as well as support wider regional, and, in particular, European, international, and World Trade Organization (WTO) integration initiatives.

1. Trade in Goods and Services

The physical purchase, sale, and movement of goods and provision of services on a cross-border basis will continue under existing international trade and WTO arrangements. There has already been a substantial growth in globalization over recent decades although further progress has hesitated following impasses in post-Doha Round negotiations, especially in the more protected conditions that have applied following the global financial crisis. Growth in trade and services may nevertheless receive separate stimulus through FinTech expansion with new solutions being made available to locate and source goods and services and in the creation of more sophisticated supply chains. This may also be supported by the larger growth and expansion of Internet based exchange and the move towards the Value Net as the next phase of Internet development. FinTech could have a substantial impact in bringing customers and goods and service providers closer together.

2. Payment, Liquidity, and Capital Mobility

FinTech companies and solutions have already confirmed their ability to improve cross-border payment and foreign exchange. This could, in turn, lead to further increases in liquidity provision and capital mobility. Total global wealth will not be diminished, and will potentially increase, with FinTech, as investors and wealth managers move financial and monetary

assets around in order to benefit from the new investment opportunities available.278

3. **International Financial Center Growth**

FinTech growth may specifically benefit the expansion of many of the existing leading international financial centers. While specific markets may contract in the face of FinTech based change, the liquidity and capital involved can be transferred to other FinTech driven market options and opportunities. The City of London may specifically be able to benefit substantially if the United Kingdom can continue to act as a major player in international FinTech development. This may affect all of the key financial sectors including savings, lending, payment, investment, and insurance and risk management.

4. **EU and Regional Integration**

The European Commission has indicated its strong commitment to the development of a European Digital Market, which will include a significant FinTech element. Mutual recognition and the creation of legally enforceable cross-border access rights can support FinTech companies within Europe and act as a model for further regional and international expansion of the sector. The European model is based on the mutual recognition of access rights, minimum harmonization of relevant regulatory standards, and the fundamental allocatory principle of home country control.279 These could be reapplied as governing principles within any new digital and FinTech operational framework or architecture. Care only has to be taken to ensure that unnecessary restrictions and obstructions are not imposed on FinTech services in a disproportionate and distortionary manner, which will only limit innovation and competition within the EU and between the EU and the rest of the world.

5. **Global Integration and the WTO**

FinTech solutions can be used to support international trade in goods and services more generally, specifically locating and paying for desired items, and obtaining credit, liquidity, and investment support. FinTech may then support continued growth of the international mercantile economy and of development finance.280 The growth of FinTech will also support the continued expansion and strengthening of the online Internet digital trading system through the purchase of digital only assets, such as news,

280. See GOV’T OFFICE FOR SCI., supra note 37, at 68-69.
information, and media, or access to social communities, without any physical element. FinTech can accordingly support growth in both the traditional mercantile and the new virtual or digital global economies. The development of new global treaty solutions may be further stimulated by the decision under the UK referendum to leave the European Union on June 23, 2016, after entering into many new bilateral and international treaties on a mutual recognition and equivalence basis of all without the same underlying mandatory treaty access rights and supporting complex institutional structure.281

E. GOVERNANCE AND REGULATION

FinTech could allow substantial improvements in the quality and content of internal firm risk identification, measurement, and management, as well as external market regulation, supervision, and wider oversight. Technology can be used both to assist risk management and control within financial institutions and the supervision of firms by the authorities and wider market and systems oversight.

1. Authorization

Regulatory obligations can be tailored to more precisely match specific risks by setting calibrations much more accurately to capture the particular risks involved, providing the necessary cover either in terms of capital or liquidity, and limiting debt or leverage levels. A number of new reporting obligations have been imposed on banks, securities firms, and insurance companies under recent major international and European measures including Basel III, CRD IV, MiFID II and Solvency II. FinTech could allow a more specific set of relevant, necessary, and accurate requirements to be imposed.

2. Compliance

FinTech systems allow financial firms to comply automatically with new reporting requirements, as well as with any trigger ratios being monitored and signalled in the new compliance systems set up. FinTech can assist both with measurement and identification of risk, with wider risk management. FinTech facilities may also allow for the automatic adjustment of positions, especially with regard to liquidity, capital, and leverage levels, as necessary. Compliance could become considerably more automated, automatic, and autonomous.

3. **Supervision**

Supervision by authorities would become correspondingly more efficient with the more accurate reporting of data by firms in near real time. Necessary analytical systems can be developed within authorities to map data reports and highlight any concerns. With compliance, supervision would move from being static and retrospective or retroactive, with possibly considerable delays, to becoming more precise, accurate, and effective with almost real time monitoring and collection.

4. **Connections and Networks**

Authorities will have to extend the scope of their supervision to cover increasingly complex delivery chains and connections between service providers within all financial sectors. This will involve monitoring all of the specific operational relations that firms maintain. This may require substantial improvement in the quality of supervision and the creation of a form of new “MicroTech” supervisory procedures and standards to support this work.

5. **Systems Oversight**

In addition to being aware of connections at the firm level, authorities will have to monitor increasingly extended inter-firm relations and wider systems and systemic threats. The new forms of macro-prudential oversight are currently under construction in many of the principal financial centers, including with the Financial Stability Oversight Council (FSOC) in the United States, European Systemic Risk Board (ESRB) in the EU, and Financial Policy Committee (FPC) in the United Kingdom, will have to be extended to create a new form of “MacroTech” oversight. This will require specialist expertise with macro-prudential agents and increased cooperation between micro and macro-monitoring authorities.

IX. **FinTech Disadvantage**

Corresponding ranges of potential areas of concern or disadvantage have to be considered with the move to FinTech driven financial services, markets, and systems. A range of new and more specific technology risks, referred to as “TechRisk,” and wider FinTech systems, “FinRisk,” will have to be considered while FinTech effects may also increase other existing primary and ancillary risks.

The principal difficulty that will arise with FinTech is the fragmentation of function and dislocation of service delivery, which will also become necessarily online and virtual. Many of the new exposures can be considered to constitute a form of extended operational risk, which, in itself, creates wider systems effects and exposures. Five specific areas of concern may be identified with: technology risk, complexity risk, network risk, systems contagion and emergence risk, and supervisory omission risk.
Technology risk can be considered to involve a range of more specific operational risks, which can be classified in different ways and would include program error, model error, and connection error. Complexity risk will arise in that FinTech systems will become considerably more sophisticated and extended. Separate network risk arises with the increasingly complex nature of the connections that will arise between separate systems and platforms in larger extended chained arrangements.

The high degrees of interconnection and transmission speeds will also make contagion a much more serious threat with the further complication of complex systems being inherently emergent and susceptible to multiple levels of dynamic chain effects. Complex causation and emergence can substantially decrease predictability and increase uncertainty. Omission error may arise when authorities have inadequate powers and tools necessary to identify and respond to the new exposures that may arise. While this is an aspect of perimeter review, it also involves having the necessary tools available to respond to the exposures that arise.

A number of corresponding difficulties will then arise in the FinTech arena that will have to be balanced against the benefits referred to. These may generally be summarized in terms of possible technology default and dependence; business disruption; customer and stakeholder damage; unforeseen or uncontrollable international competitive effects; considerably more complex regulatory and supervisory demands; infrastructure; and possibly significant threats to the conduct of traditional monetary policy and financial stability in general.

These FinTech limitations may be considered in further detail.

A. Technology

As FinTech is technology driven, the effectiveness of specific new FinTech products and services will be dependent on the error-free nature of the FinTech solution involved. A number of specific difficulties may arise with regard to operations, complexity, integrity, efficiency, and dependence.

1. Relative Speed and Size

The value of any new technology will largely depend on its speed and size of the processable amount of information involved. Design decisions also have to be taken with regard to the size of new digital blocks, with larger sizes possibly increasing complexity and reducing processing speeds.

282 See IMF, supra note 52, at paras. 31-64. The IMF examines potential FinTech disadvantage in terms of regulatory challenges, financial integrity, consumer protection, taxation, exchange controls and capital flow management, financial stability, and monetary policy. Id. The IMF developed five principles in terms of future regulatory response. Id. at paras. 32–37. The IMF stated that more could be undertaken at the international level to develop an effective framework for new currency regulations with standards and best practices being developed over time. Id. at para. 37. The evolution of the market and changing policy challenges created had to be monitored and examined over time.
2. Cost, Complexity and Competence

Digital programs are inevitably considered more complex than earlier simple paper and analogue electronic double-entry bookkeeping accounts. This complexity necessarily increases initial design and production costs, although subsequent replications may be cheap and cost effective. Complexity, nevertheless, requires specialist training for operators while also making maintenance, correction, and revision more difficult and costly. Many financial firms will increasingly and disproportionately become dependent on a small group of specialist technicians, without whom they would not be able to maintain all of their connected processing systems. Separate issues arise with regard to the ability of algorithms and programs to carry out sophisticated decision-making in the financial area, such as with regard to peer-to-peer lending and insurance assessments.\(^{283}\)

3. Security and Integrity

Internet-based systems necessarily create substantial additional risk of attack and interference. Many systems use cryptographic devices to improve security, although these necessarily further increase complexity and cost. Even with Bitcoin, it is theoretically subject to a 51 percent attack if 51 percent of the computer systems used by miners become manipulated by a single program. It has to be accepted at the present time that no digital system is fully secure. The degree of relative security would also be proportionately reduced in open access, or permissionless, systems, such as Bitcoin, as opposed to other controlled access, or permissioned, systems.

Possible technology error and security issues also necessarily raise additional concerns with regard to systems and data integrity. The accuracy and validity of specific inputs may be undermined even without full systems attacks or failure. Additional problems also arise with regard to maintaining backup systems and continuity planning. This can become a difficult and costly issue for any large institution, or smaller institutions that are data dependent. Related legal issues also arise in being able to evidence and maintain authoritative and unchallengeable entry records of entitlements for official registers and judicial proceedings, as well as in protecting personal data storage, accuracy, and access.

4. Efficiency and Waste

While modern digital systems may be exceptionally fast, they may also involve substantial waste depending upon the model or arrangements used. Validation within Bitcoin relies on the separate processing capability

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\(^{283}\) See Naomi Rovnick, City Grandee Lord Turner Warns on Peer-To-Peer Lending Risks, FINANCIAL TIMES (Feb. 10, 2016, 10:41 AM), http://www.ft.com/cms/s/0/e123234c-cfd4-11e5-92a1-c5e23e099c77.html#axzz4i2ch0mi. Lord Adair Turner, former CEO of the Financial Services Authority (FSA), has warned of potential substantial losses in the peer-to-peer lending market as a result of pure credit assessment quality. Id.
maintained by mining computing. This involves substantial energy usage and waste, with the system also being dependent on external third parties over whom operators, users, and authorities have no direct control. This creates substantial concerns at times of reduced energy use and environmental protection, while a system’s integrity is also undermined by the reliance on external third party exposure.

5. **Dependence and Substitution**

Many FinTech systems may become wholly reliant on technology. Wider systems would be subject to technological dependence as FinTech use expanded. Separate problems with substitution would arise where FinTech devices were allowed to take over more traditional financial instruments or whole areas or sectors. In the event of a FinTech device failure, it may not be possible to return to any previous simple paper or other electronic option. The financial system and society would then be subject to both technological dependence and have no effective substitution or replacement. This could create significant difficulties in the event of, for example, the failure of a large firm, platform, dominant private digital currency, or uncertificated security asset.

### B. **Business Disruption**

Distributed ledger technologies have the potential to disrupt economies and societies. FinTech will necessarily impose a degree of business disruption, depending upon the extent to which and speed with which it grows and expands. This will necessarily affect incumbent business structures, the availability of many business models, the nature and extent of possible extended business relations, competition, and overall innovation.

1. **Business Model Displacement**

Many existing core financial services may be subject to substantial disruption with new market entrants or the application of new systems to existing practices. This has to be welcomed to the extent that it brings forward necessary updating and business chain or cycle revision, although care has to be taken to ensure that this does not become economically and socially disruptive. Much of this will depend, in practice, upon the extent to which authorities permit or restrict new FinTech companies and devices to enter incumbent markets and grow. Particular problems may arise if the effects and the impact of uncontrolled FinTech advancements are not

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284. Bitcoin is estimated to use around 2-40 terawatt hours annually which is equivalent to the energy consumption of seven million people or two thirds of the London population. *The Magic of Mining*, supra note 254.

285. GOV’T OFFICE FOR SCI., supra note 37, at 53.

monitored and managed effectively in sensitive areas. While competition authorities promote competition, the wider impact of widespread economic and social disruption also has to be monitored. This is an area in which the government will have to assume lead role and responsibility.

2. **Extended Model Management**

Many existing business models will have to be updated and revised substantially, while others may become inoperable in light of the effects of new FinTech use.\(^{287}\) This will also lead to the development of extended links and complex product supply chains. This can impact FinTech start-up companies, existing incumbent financial institutions, non-financial market entrants, and existing large manufacturing and service companies. Many areas of business and management study, strategy, and modelling may have to be substantially revised in light of the effects of FinTech impact.

3. **Business Relations and Networks**

FinTech will necessarily change the structure of many financial markets and sectors, especially with the influx of new start-up companies and FinTech growth companies.\(^{288}\) While some of these companies may, at least, initially attempt to compete with incumbents, over time many may operate on an agency or outsourcing basis, sell their technology to existing firms, or have their companies acquired by incumbents. Significant dislocation of function could necessarily create a fragmented and much more complex marketplace with wide ranging new business relationships having to be entered into, at least, until the market settles. This could create specific challenges for supervisory and competition authorities.

4. **Competitive Damage and Distortion**

Governments have been promoting the development of FinTech in an attempt to increase competition within the financial area specifically. This is necessary to place pressure on existing firms, especially large oligopolistic incumbents, to reduce costs and provide higher quality services to customers. Governments and competition authorities must nevertheless be aware of all of the more sensitive and difficult issues that arise in this area. Incumbents are subject to the costs of maintaining, updating, and replacing multiple legacy computer systems and the higher costs of complying with many substantial post-crisis regulatory reforms. This may, for example,


include having to offer fixed terms or prices to existing customers, rather than adjust their rates accurately to reflect market prices.

The effect of all of this will be to create an unlevel playing field with new FinTech start-up companies for which no specific authority is responsible. While promoting competition is generally fully supported, concerns arise in such areas as financial services, where specific firms, or outliers, reduce prices below cost or generally accepted risk levels, which other incumbents have to compete with. This arose before the financial crisis, for example, with sub-prime lending in the United States and with institutions such as Northern Rock in the United Kingdom being allowed to provide 125 percent loan to value mortgages on very low, and possible self-certificated, income ratios.289 Competition and regulatory authorities must cooperate to ensure that unacceptable market practices do not undermine market stability.

C. INNOVATION AND REGULATORY BALANCE AND CONFLICT

Regulatory and competition obligations must also be properly balanced to promote high degrees of both innovation and market stability. It is arguable that a number of the post-crisis reforms adopted have become excessive and undermine traditional banking and financial function without any appreciable or corresponding improvement in financial stability.290 This may, for example, apply to the introduction of structural regulation (ring fencing) in addition to the existing reforms imposed on banks, especially with regard to capital, liquidity, leverage, governance, remuneration, resolution, standards, and ethics.291 The IMF has recommended that regulatory reaction should be commensurate to the risks involved without limiting innovation.292

An appropriate balance of permission and regulation must be achieved between new FinTech companies and incumbents, as well as with all financial firms more generally, to ensure that market control, regulation, innovation, and advantage are all properly and proportionately balanced.

292. IMF, supra note 52, at para. 66. The IMF developed five regulatory principles governing virtual currencies: regulatory response had to be risk commensurate; responses had to adapt to changes in the new landscape; authorities had to design approaches that would take into account the novel business models inherent within new schemes; regulation had to deal with market conduct issues and the financial soundness of financial intermediaries; and consideration had to be given to the degree of integration between the conventional financial system and the new market. Id.
Specific difficulties could arise in the United Kingdom where the FCA has developed a highly credible Project Innovate facility to support FinTech start-up companies in the financial services area; Project Innovate includes an innovation Hub, advice unit, and Regulatory Sandbox in which the implications of innovative new products, services, and business models can be tested from a regulatory perspective. While the FCA has an express statutory consumer protection objective, care has to be exercised to ensure that market innovation and stability issues are properly balanced, especially with the separate Prudential Regulation Authority (PRA) being responsible for prudential bank supervision.

D. USERS AND STAKEHOLDERS

A series of related concerns arise with regard to protecting the interests of users and other stakeholders in new FinTech driven systems. Specific issues arise with regard to identification, capacity, control, privacy, and relevant consumer protection, ethical and social standards, as well as government function.

1. Identification and Authentication

Firms need to ensure that customers are who they claim to be and customers need to be able to ensure that their identity has not been misused. This requires error free identification and authentication. Error free identification and authentication can be achieved through the various forms of electronic signatures and digital documentation execution available, and can also be supplemented with the use of cryptographic tools.

2. Legal Capacity and Authority

Firms must also be able to rely on online users having necessary legal capacity and, where appropriate, authorization. This is connected with identification and authentication, although it goes further in ensuring that parties have necessary legal capacity to act and bind themselves or their employers or principals. Where this is relevant to a particular transaction, online service providers may have to undertake additional checks, such as confirming an age or that corporate officers have the necessary authority. This may include providing copies of corporate documentation and board resolutions in larger value cases. The House of Lords ruled that local authorities in London could avoid liability under complex swap contracts on the basis that they had no legal capacity to enter into the contracts and that the hedging transactions were accordingly ultra vires.

Capacity is a type of legal risk. Other forms of legal risk include substantive validity, legal execution, judicial recognition, and subsequent execution and enforcement of court judgements. Proper contract drafting involves ensuring that parties have all the necessary rights and remedies, including appropriate self-help remedies, such as netting, set-off, or selling security. Enforcement considerations include ensuring that particular countries have adequate court systems with well-trained and impartial judges that can consider and rule on potentially large value complex commercial facts. Enforcement includes considering insolvency law implications in the event of a bankruptcy of an individual or winding-up of a company, as well as the ability to enforce court orders in particular countries, such as through attachment of funds in bank accounts with execution including the seizure and sale of assets.

3. Privacy, Confidentiality, and Data Protection

Customers have to be able to ensure that any information they place on the Internet, or hold in a digital format accessible through the Internet, is subject to appropriate privacy and confidentiality protections. Difficulties may arise where customers are careless in loading information, as well as where firms holding information become susceptible to unauthorized access, attack, or hold information in countries with less protection. Customers must also be able to know that personal information is used in an appropriate manner with necessary data use and exchange protection controls in place. All of these issues become significant concerns where online systems are subject to any degree of possible infiltration and attack. All of this may again become more complex as FinTech expands.


Appropriate consumer protection laws and regulations must be imposed in all countries that have an appropriate consumer oversight body in place. Users and other stakeholders must also be able to confirm that FinTech operators or other operators on the Internet behave in an ethical and social manner. This specifically requires that appropriate governance arrangements and ethical codes of practice or conduct be in place. Ethics nevertheless raises difficult issues with regard to the standards to be imposed because they are dependent on popular expectations, which shift over time, but also need to secure an appropriate allocation of loss and responsibility. This is an issue that could be managed by relevant trade associations or other Internet user groups.

5. Government Function

All legitimate government interest and functions must be properly protected. This includes ensuring that any operations transferred to

296. See IMF, supra note 52, at paras. 45–46.
distributed ledgers, such as passport lists or electoral registers, are safe and secure. This would also apply with regard to welfare and pension payments. Care will also have to be taken to ensure that FinTech activities do not facilitate tax avoidance at the national or international level.  

E. GLOBALIZATION

Additional concerns arise with regard to the cross-border nature and impact of many FinTech and other Internet activities in terms of trade and service damage, payment, liquidity and capital stability, competitive conflict, and potential regional or global obstruction.

1. Trade and Service Damage

Disruption to FinTech services may damage associated trade and service activities especially with regard to national and cross-border payment flows. The competitive ascendency of FinTech companies or sectors in specific countries may also damage the competitive position of other trade and service sectors either directly or indirectly.

2. Payment, Liquidity, and Capital Instability

While FinTech platforms may increase payment options, liquidity volumes, and capital mobility, care has to be taken to ensure that all of this is properly managed and monitored. Any damage to payment systems could have substantial knock-on effects in goods and services markets. Appropriate alternative or continuity arrangements have to be in place to support payment patterns in the event of a failure of a specific payment platform. The authorities must also be sensitive to sudden spikes in liquidity provision, consequent debt levels, and a destabilization of capital movement between countries. FinTech operators must also comply with all relevant foreign exchange controls.

3. Competitive Conflict and Decline

National competitive positions may be damaged by the growth in FinTech activities elsewhere. While competition may benefit local markets, it may damage cross-border sectors and institutions. The development of powerful FinTech centers across the world could damage existing financial centers, such as the City of London, with governments anxious to attempt to protect and develop their position and status.  

297. Id. at paras. 47-51.  
298. Id. at paras. 52-53.  
299. Adi Levanon, Berlin Bids to Replace London as Post-Brexit Fintech Capital, FINANCIAL TIMES (July 6, 2016), http://www.ft.com/cms/s/0/8958b02e-3f90-11e6-8716-a4a71e8140b0.html#axzz4IrGXBlnLS.
4. Regional Delay and Obstruction

Uneven FinTech development within regional systems, such as the European Union, can impact the competitive positions of members of the specific trading block and also those between blocks. Care nevertheless has to be exercised to ensure that regional laws and regulations do not unnecessarily or disproportionately obstruct the development of FinTech activities globally. An appropriate balance has to be achieved in all cases.

5. Global Obstruction and Inconsistency

Equivalent issues arise at the international level with FinTech and non-FinTech sectors possibly being affected by the development of technology activities in other countries. Care must also be taken to ensure that countries are not allowed to adopt inappropriate protectionist positions or that global rules obstruct FinTech evolution more generally. Appropriate monitoring of attendant difficulties and possible instability must also be maintained on a continuing basis.

F. Regulation and Control

A number of separate issues arise with regard to the regulation and control of FinTech activities. Authorities generally have to protect the soundness of individual institutions as well as the integrity of markets. Existing laws governing the regulation and supervision of financial institutions groups will have to be revised to ensure that they cover new simple and extended FinTech structures. This prudential regulation of firms also has to be supported by effective conduct regulation to protect the integrity of specific markets and markets as a whole. This will form part of the newly developing MicroTech regulation and supervision.

A number of specific issues arise with regard to market and institutional regulation, market integrity, relevant laws and protocols, revision, ownership, and market access.

1. Market and Perimeter Regulation

All FinTech activities and other Internet and online operations must be subject to appropriate regulation and governance. Regulatory parameters must be reviewed and reset accordingly. This may include large numbers of different market and official parties being set up with different multi-level governance arrangements. It is desirable that as many operational matters as possible are governed by markets themselves, or by market operators acting in association or collectively, although some level of oversight will generally

300. See generally SWIFT & Accenture, supra note 264 (summarizing the challenges for distributed ledgers in terms of requiring strong governance, data controls, regulatory compliance, standardization, identity framework, security and cyber defense, reliability, and scalability).
be necessary, with possible intervention being used in specific well-defined cases or situations.

Specific difficulties arise with regard to FinTech activities in that these break up or fragment traditional product and service chains. It is necessary to ensure that regulated activities are subject to proper oversight with connecting or ancillary operations also being brought within the scope of regulatory definition and attention. The IMF notes that digital currencies create definitional challenges for regulators with schemes that have been difficult to monitor.

FinTech operators could assist with this by attempting to set up and develop appropriate trade associations and ensure that they act in a responsible manner and reflect the full range of interests involved. The promotion of FinTech and other e-commerce and digital national interests will generally be assigned to a specific government department with particular legal or regulatory issues assigned to specific authorities, such as domestic or regional competition agencies or financial regulatory authorities. All of these bodies must be able to act in a cooperative or coordinated manner to the extent necessary.

2. Market Integrity

Authorities have to ensure that FinTech platforms and activities are not used to facilitate improper conduct, such as insider trading and market abuse. Relevant markets, including digital currency exchanges, must also operate properly and safely without threat of closure or failure and counterparty or customer loss. Concerns also arise with regard to financial system integrity, especially in terms of money laundering and anti-terrorist financing. The European Banking Authority (EBA) issued warnings to customers in December 2013, regarding the threat of digital coin loss, criminal activity, and taxation, with a separate opinion addressed to

301. See Comm. on Payments and Mkt. Infrastructures, supra note 59, at 3, 10-13 (discussing the role of regulation, regulatory issues, and approaches).
302. See IMF, supra note 52, at para. 32.
303. Id.
304. See Ben McLannahan, Bitcoin Exchange Mt Gox Files for Bankruptcy Protection, FINANCIAL TIMES, at 2 (Feb. 28, 2014, 12:35PM), https://www.ft.com/content/6636e0e8-a06e-11e3-a72c-00144feab7de; see Crypto Currencies, EXCHANGE, THE GLOBAL MAGAZINE OF DE LA RUe, Spring 2015, at 13, available at https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=4&ved=0ahUKEwjn28m1zZXPAhUo2IMKHUuQD4QFfgg2MAM&url=http%3A%2F%2Fwww.delarue.com%2F%2Fmedia%2FFFiles%2FD%2FDelarue%2FFindsight-and-innovation%2Fdlr-exchange-15.pdf&usg=AFQjCNFRqbcUCgdW0AIHsyoF13J6ZipEONg. 850,000 bitcoins were stolen from the digital wallet of the Tokyo Mt Gox Bitcoin exchange. Id. Mt Gox was set up in July 2010, but training was suspended in February 2014, and the exchange was placed into liquidation in April 2014. Id.
national competent authorities, the European Commission, Council, and European Parliament in July 2014.306

3. Digital Laws and Protocols

All countries must ensure that they have necessary laws and regulations governing FinTech and other online or Internet related activities. A number of important laws have been developed in key areas, such as recognition of electronic and digital signatures,307 promotion of electronic commerce and digital markets, privacy, confidentiality, and data protection.308 Much of this is, unfortunately, uncoordinated. Appropriate laws should also be prepared where necessary in order to govern other elements, such as to clarify rights and obligations and protect remedy and loss allocation mechanisms. The possibility should also be considered of developing standardized, substantive sets of common terms and conditions or service arrangements to promote uniformity and provide minimum levels of protection for FinTech, online, and Internet usage.

It is also necessary to ensure that appropriate codes or protocols are in place governing the use and operation of technical systems. This is necessary to promote standardization and limit abuse or interference. This should so far as possible be industry and specialist practitioner led although governments may assist in bringing the necessary parties together or possibly in providing appropriate legal recognition or incorporation.

It is specifically necessary to ensure that commonly used technical systems can be properly maintained, such as by removing defects and making necessary reforms or revisions over time. Operational standards will be set out in the relevant protocols, although suitable arrangements must be in place to allow these to be revised or updated as necessary. Specific difficulties, for example, have arisen with regard to the amendment of the core Bitcoin software, with separate schools of opinion emerging. Unavoidable conflicts, delays, or prevention of necessary work must be avoided.

4. Ownership and Participation

Ownership rights to FinTech assets have to be clearly assigned and protected. This may raise difficult issues with regard to the application of traditional intellectual property laws, including copyright, trademark, patent, and other rights in the FinTech and Internet area.309 In addition to

308. See generally id. at ch. 10-11.
309. See generally CHRIS REED, supra note 307, ch. 6-9.
protecting relevant interests, laws must also ensure that intellectual property rights are not abused and that market access is not unnecessarily restricted. This could become a significant problem, as the largest technology firms assume increasingly larger shares of the total global marketplace. Governments should attempt to ensure that appropriate guidance is provided and that domestic laws are revised as necessary in order to provide appropriate protection and competition.

5. Market Access and Development Support

FinTech and mobile communications may specifically be able to assist with exclusion problems in particular countries where, for example, bank account availability levels are low. Low cost and easily accessible FinTech solutions may be able to provide substantial assistance in reducing exclusion numbers. Residual groups may nevertheless still not be able to access a full range or possibly specific financial services or may simply not wish to use them. It is for this reason that alternative cash and non-digital payment methods may have to be continued in almost all societies across the world. This might be considered necessary for constitutional, political, and moral reasons because not all members of all societies wish to convert to using digital savings, payment, investment, and other digital means. This might be referred to as a form of cash retention, market retention policy, “non-net” parallel, or alternative model system.

G. Infrastructure

A series of similar concerns may arise with regard to infrastructure stability where significantly disruptive new FinTech systems are allowed to develop in an unmonitored and unmanaged basis. Specific difficulties may arise with regard to integrity, inter-operability and network connections, integrity, contagion, and wider infrastructure systems stability.

1. Payment System Integrity

Authorities have to ensure that all of the major large value payment systems continue to operate effectively. The CPMI refers to risks to central bank management of the safety and efficiency of payment systems, including explaining value fluctuations, preventing fraud, limiting payment risk, problems anticipating future disruptions, legal risk, settlement risk, and possibly anonymous money laundering and criminal activity.310 The CPMI also warns about wider infrastructure impact.311

The ECB examines the nature of payment-related aspects of virtual currency schemes in further detail, including with regard to key actors and rules, diversity, differences, emerging business models, data, and use of

Users were nevertheless subject to payment system-like risks including credit, liquidity, operational, and legal risk. Virtual currency schemes were considered not to pose a threat to payment system stability, subject to future changes in connection and increased use and transaction volume.

2. **Platform Inter-operability and Network Integration**

FinTech devices will need to be sufficiently inter-operable to ensure that they can work with other common or standard program systems, as non-operable models will be ineffective and uncompetitive over time. Inter-operability of itself may cause concerns where a rogue system or unauthorized access through a new system could damage connected programs or platforms.

The inherent need to connect systems to larger networks exposes the networks to component attacks either directly, through defects in the component’s software parts, or indirectly, through unauthorized access through the inclusion of insertion of new components within a larger network or chain. Individual components create complexity risks in themselves, while the establishment of new systems connections necessarily increases overall network risk.

3. **Attack**

FinTech and other electronic and digital systems are never immune from intervention or attack. Full systems or networks and any component within the network then become vulnerable to attack through any point of access within the extended system created, and as such, the risk of attack is accordingly magnified manifestly due to the susceptibility of any point in extended network chains and component parts.

4. **Confusion and Contagion**

The high degree of inter-operability, connection, and speed of transmission substantially increases the further risk of contagion. The nature of the uncertainty created becomes substantially greater through emergent effects within the complex and dynamic chains of causation that arise as a result of the combination of network complexity and complexity within individual component parts within the system.

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312. ECB, supra note 53, at 7-22.
313. Id. at 42.
314. Id. at 37.
5. **Systems Infection and Insulation**

Infrastructure systemic risk is substantially magnified for all of the aforementioned reasons. It may be necessary to consider how various forms of insulation and separation, such as with circuit breakers, could be established to limit contagion between network parts. It would also be necessary to ensure that appropriate continuity planning arrangements are in place, including necessary means of transferring technology or core accounts to new systems service providers as necessary.\(^{316}\)

### H. **Central Banking and Monetary Policy**

Domestic authorities will have to ensure that significantly disruptive FinTech activities do not create unnecessary or unavoidable difficulties in managing domestic or regional monetary policy and stable international financial monetary arrangements more generally. Domestic monetary policy is generally based on certain specific objectives, including, most commonly, price stability, and some form of targeting, such as inflation or foreign exchange rate measures. FinTech functions may raise specific difficulties in this area, especially where private digital currency systems are allowed to expand substantially, which could destabilize domestic currencies either in the same or another country. Specific concerns then arise with regard to the conduct of domestic monetary policy, managing liquidity and credit supply and protecting price stability, as well as regional and global market stability more generally.

The ECB examined the relevance of virtual currency schemes for central banks in terms of risks to price stability, financial stability, payment system stability, regulatory loss, and reputational risk.\(^{317}\) The implications of digital currencies for central banks were considered by the CPMI in terms of payment systems, financial stability, and monetary policy, including market infrastructure, financial and market intermediation, bank seigniorage and monetary policy, as well as the possible issuance of digital currencies by central banks in the future.\(^{318}\) Distributed ledger technology was an important innovation that could have substantially wider applications, especially with regard to financial market infrastructures (FMIs) and the wider economy. Central banks had to continue to monitor and assess the implications of the development of digital currencies and distributed ledger technology over time.\(^{319}\) Few specific conclusions were drawn at this stage, and further work is required.

\(^{316}\) See id.

\(^{317}\) ECB (Oct. 2012), supra note 53, at 33-45; see also ECB (Feb. 2015), supra note 53, at 23-29.

\(^{318}\) Comm. on Payments and Mkt. Infrastructures, supra note 59, at 13-16.

\(^{319}\) Id. at 14-16.
1. Monetary Control and Oversight

Domestic monetary authorities must ensure that they are able to comprehend all monetary conditions in a particular country.\textsuperscript{320} This will involve having all necessary data and information available, including with regard to new FinTech tools, and especially with regard to payment and lending. Authorities must be able to monitor the development of FinTech activities to ensure that these complement and support, rather than undermine, stable domestic monetary conditions. The CPMI notes that monetary policy effects were expected to be similar to potential e-money impacts, which were examined by the BIS in 1996.\textsuperscript{321}

2. Liquidity and Money Supply

Authorities must continue to be able to ensure an appropriate money supply on a continuing basis. This is generally secured by maintaining sufficient notes and coin in circulation with an appropriate level of lending and credit supply, and with commercial banks also being able to draw under wholesale central bank facilities as necessary.\textsuperscript{322} In practice, this is often dealt with through the use of central bank base or bank rates and open market operations. This could be substantially undermined if a sufficiently large volume of a private digital currency was allowed to amass without official control or management.

The IMF concludes that virtual currencies did not present any significant implications for monetary policy at the present time, although this could change with increased use.\textsuperscript{323} The Bank of England also notes that the monetary policy implications of digital currencies were minimal to the extent that digital currencies were only used for limited payment volumes, with some possible fragmentation arising where a group of individuals sought only to transact in digital currency.\textsuperscript{324} The most significant issues would arise where the economy became “Bitcoinised” over time and with a substantial abandonment of sterling for payment purposes, although this was considered an unlikely event given the current impediments to the

\textsuperscript{320} IMF, supra note 52, at 33-35; see also Comm. on Payments and Mkt. Infrastructures, supra note 59, at 16.

\textsuperscript{321} Comm. on Payments and Mkt. Infrastructures, supra note 59, at 16-17.


\textsuperscript{323} The IMF adds that the fixed supply nature of currencies could result in structural deflation with the loss of a flexible money supply, the ability of monetary policy to manage the business cycle could be diminished over time, virtual currencies could not easily replace the lender of last resort function of central banks with institutions having to be able to provide emergency liquidity to avoid crises and that it was expected that virtual currencies would be more widely adopted in countries with less credible monetary policy systems. IMF, supra note 52, at 33-35.

\textsuperscript{324} Ali, Barrdear, Clews & Southgate, supra note 65, at 8-9.
widespread adoption of digital currency schemes and the implausibility of a severe collapse in confidence in fiat currency.\footnote{325}

Many central banks may still consider issuing “blocks” of digital currency, either directly or indirectly, through private banks or other currency suppliers.\footnote{326} It has to be expected that this will be tightly controlled at the beginning, with digital currency blocks simply replacing equivalent amounts of notes or central bank reserve balances. Such digital money will generally be denominated in the form of the country’s official currency and reference asset, thus allowing commercial banks to issue blocks of currency under central bank permission and oversight which would have the advantage of transferring system management costs to private banks. An appropriate model for this would be the production of private bank notes by Scottish and Northern Irish notes in the UK, with issuing banks effectively purchasing the right to issue their own notes by depositing an equivalent amount of sterling notes with the Bank of England.\footnote{327}

3. Credit Supply

Closely associated with ensuring that sufficient continuing liquidity is made available within the system is managing credit supply. Most economies ensure the provision of credit on a flexible basis by delegating private lending to commercial banks that assess and price credit quality on an individual basis. Funding for this purpose is made available partly through the banks’ deposit base and secondary market activity, including inter-bank borrowing, but where necessary, the larger banks can always draw further funds down from the central bank through their reserve balance accounts at the prevalent bank or discount rate. While the system is often criticized for being private bank-based, the model is highly flexible and has worked well for around 300 years while specifically avoiding the politicization of the credit process.

Equivalent difficulties would arise in ensuring an adequate and flexible supply of credit as ensuring necessary liquidity for general payment or emergency lender of last resort purposes. It is not possible to see how this could work as stably or effectively using a private digital currency, such as Bitcoin in particular, with a fixed volume of supply and fluctuating value. It

\footnote{325. Id.}
\footnote{326. The Bank of England has examined the macroeconomic effects of issuing Central Bank Digital Currency (CBDC) with a CBDC issuance of 30 percent of GDP against government bonds raising GDP by 3 percent due to reductions in real interest rates, distortionary taxes and monetary transaction costs. Countercyclical CBCC price or quantity rules could also improve the central bank’s ability to stabilise the business cycle as a secondary monetary policy tool. See Barrdear & Kumhof, supra note 66, at 3; see also Comm. on Payments and Mkts. Infrastructures, supra note 59, at 16-17.}
is accordingly unlikely, again, that authorities would allow private digital currencies to replace existing central bank-controlled monetary arrangements supported by private bank credit provisions outright.

4. Price Stability

Connected with the issues that would arise in terms of liquidity and credit supply would be the need to protect the value of the dominant domestic currency in place over time, as well as wider price stability. It is necessary to manage the value and control inflation growth over time. Most central banks do not attempt to ensure a zero inflation rate, but a low rate of between two and three percent to reflect a general increase in the money supply and economic demand over time. It could be impossible for central banks to manage price stability and inflation if countries generally converted to a private digital currency model.

5. Regional and Global Monetary Stability

Substantial domestic currency disruption could easily be transferred to a regional or global level quickly, where unofficial private digital currencies are allowed to expand quickly in one or more countries and where these are not tied to an official domestic reference currency asset. Different experiments with official and private digital currency models could have significant regional and global impacts, with countries being materially damaged by instability imported from another country through the absence of local country oversight. Difficult issues of regional and global cooperation and coordination could clearly arise in this area. The emergence and growth of private money models could make the need for regional and international monetary coordination of more importance, with the IMF and the BIS assuming an important role in this regard.

I. Financial Stability

While FinTech may bring substantial benefits, significant potential financial stability difficulties also arise with the heightened risks involved, in addition to the issues concerning technology, business disruption, user and stakeholder interest damage, globalization, regulation, infrastructure, and monetary policy. While the issues that arise with regard to digital currencies have been considered by a number of official bodies, including the IMF, BIS, ECB and the Bank of England and other national central banks, FinTech has received less direct attention.

Mark Carney, as chairman of the FSB, announced in February 2016 that FinTech developments would be brought within the areas of consideration.

329. The IMF paper on virtual currencies warns about potential financial stability issues if market values and transaction volumes increase. IMF, supra note 52, at 31-33.
of the FSB, with specific work being carried out during 2016 and the FSB reporting end of summer.\(^{330}\)

Some of the specific important issues that arise may be considered in terms of regulation, revision, resolution, and oversight. These key areas of the defect in overall market control that contributed to the global financial crisis remain of continuing relevance to date.

1. RegTech and FinReg

New FinTech activities must be subjected to an appropriate regulatory framework and necessary standards. While RegTech will be of assistance in improving firms’ ability to comply with existing general, and possible new FinTech obligations, this only represents the area in which technology assists compliance. Difficult issues also arise with regard to the wider FinTech environment with this larger regulatory framework being referred to as FinReg for the purposes of this text. Existing regulations, or new regulatory requirements, may have to be extended and adjusted as necessary.

Regulatory parameters must be reviewed to ensure that all FinTech-related activities are properly controlled. New regulatory obligations may specifically include additional governance requirements on FinTech product services or relations, FinTech product and company acquisitions, outsourcing and with appropriate adjustments being made to capital, liquidity, and leverage ratios as necessary. Other, more particular regulatory, obligations may have to be considered over time.

Appropriate obligations must also be imposed on both new FinTech market entrants and incumbent firms as necessary. Relevant minimum standards must be imposed in all cases. The issue of the uneven playing field that has been created has already been referred to, with incumbent firms

\(^{330}\) Mark Carney stated in a letter to G20 Finance Ministers that, “A number of technological innovations with potentially transformative implications for the financial system, its intermediaries and users are now receiving close attention.” He added that, “The regulatory framework must ensure that it is able to manage any systemic risks that may arise from technological change without stifling innovation,” and that “The FSB is evaluating the potential financial stability implications of emerging financial technology innovation for the financial system as a whole, working with standard setters that are monitoring developments in their respective sectors.” He noted that “We are also working to understand better the potential impacts on financial stability of operational disruption to core financial institutions or infrastructure.” Fin. Stability Bd., To G20 Finance Ministers and Central Bank Governors (Feb. 22, 2016), at 6, http://www.fsb.org/wp-content/uploads/FSB-Chair-letter-to-G20-Ministers-and-Governors-July-2016.pdf. The FSB noted following its meeting in Tokyo on 30-31 March that, “The Plenary reviewed major areas of financial technology innovation, including distributed ledger technology, and proposed a framework for categorising them and assessing any financial stability implications. Plenary members discussed the issues raised for public authorities by these technologies, possible steps to address potential risks, and opportunities for cooperation in the FSB and with the standard-setting bodies to deepen analysis and develop regulatory perspectives.” Fin. Stability Bd., Meeting of the Financial Stability Board in Tokyo on 30-31 March, at 3, Ref No: 6/2016 (Mar. 31, 2016), http://www.fsb.org/wp-content/uploads/Tokyo-plenary-press-release.pdf.
being under a substantial cost disadvantage that regulatory and competition authorities should take into consideration in the longer term.

2. **FinTech Supervision (SuperTech)**

The term RegTech includes a number of devices that are essentially more supervisory and reporting-related than regulatory in nature. RegTech may substantially assist wider FinTech supervision. Authorities must also be able to supervise all relevant risks at the firm level, with firms having all necessary reporting obligations in place and authorities having appropriate systems to receive, examine, and analyse the data provided and take relevant action as necessary. Ensuring effective FinTech oversight at the firm level may be referred to as “MicroTech” as opposed to wider “MacroTech” systems oversight, which would form part of an extended form of macro-prudential monitoring.

3. **FinTech Resolution (ResTech)**

Existing post-crisis resolution mechanisms should also be extended to deal with any potential new FinTech exposures. This should again apply both with regard to new market entrants and incumbents. The objective would specifically need to ensure that the failure of a specific platform, program, or firm did not materially disadvantage customers or other financial counterparties, or generate wider systemic threats or exposures. Larger FinTech companies that become subject to authorization and supervision should be required to comply with relevant resolution requirements, including preparing Resolution and Recovery Programs (RRPs). This could either be on a bank and security firm or possibly a major infrastructure firm model. This would certainly apply where any FinTech company grew to such an extent that it was considered to be systemically relevant or important. A new category of systemically important FinTech companies (‘SIFTCs’) or systemically important FinTech risks (SIFTRs) categories could be created.

Of more importance in practice would be ensuring that all client accounts or other client, firm or market data could be moved quickly and efficiently in the event of the failure of a specific FinTech platform or program. This could either take the form of technology, or an account transfer mechanism. This is related to the inter-operability point referred to earlier, with systems being designed in such a way that they allowed for quick restoration or transfer.

Relevant official resolution systems, including the Special Resolution Regime (SSR) arrangements set up under the Banking Act 2009 in the United Kingdom, would also have to be reviewed and revised as necessary to

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allow for official action to be taken in the event of a FinTech company failing to avoid possible user, counterparty, or other stakeholder loss.

4. **Lender of Last Resort (LLR) and Technology of Last Resort (TLR)**

   Where official bodies were involved, this might be considered to involve a form of Technology Restoration Program ("TRP") or Technology Transfer Program ("TTP") with official bodies, such as regulatory authorities or central banks, possibly ultimately having to act as Technology providers of Last Resort ("TLR" or "TpLR"), at least for a period, to protect critical systems and accounts in a crisis management situation.

5. **MacroTech**

   All of the new FinTech systems, relations, and possible impacts on other financial systems and the wider economy will also have to be monitored over time. The regulation and supervision of FinTech companies will, to the extent necessary, be dealt with on a MicroTech basis, which would include both the regulatory and supervisory aspects of controlling FinTech activities at the firm level. This would then be supplemented by a wider macro-prudential, or MacroTech, function at the systems level. The most appropriate agencies to undertake this task would be the FSOC in the US, EBRD in the EU and FPC in the UK, as well as the FSB at the international level more generally.

X. **Financial Technology Comment and Conclusions**

   The new FinTech world will create significant challenges and opportunities. This may bring substantial longer-term customer, firm, government, and wider economic and social advantage. It is only necessary to manage all of the new risks and exposures created and limit any more significant damage beyond the underlying and necessary technological disruption that will drive marketing and business innovation in these areas.

   The following, more specific, provisional conclusions may be drawn with regard to the FinTech revolution at this time.

A. **FinTech**

   The meaning of FinTech remains subject to debate. Pro-FinTech and anti-existing market commentators generally adopt a narrow approach based on new entrant control technology and significant incumbent market disruption. FinTech companies are clearly forcing change in the structure and operation of many aspects of banking and financial service provision and market operation. A number of the largest incumbents are nevertheless responding to the FinTech challenge positively by developing their own internal technology laboratories and innovation platforms, as well as investing in and supporting new FinTech firms and practices.
Many FinTech companies also have to operate with existing institutions to benefit from their size, customer base, capital, existing financial regulatory expertise and licenses, and supporting personnel and compliance systems. Many veneer operations may only focus on the development of new customer interfaces and services at this stage in their evolution cycle. Some companies, such as TransferWise, have been able to grow and separate themselves from their supporting regulated institution, although many others may either continue to work with or be absorbed into existing financial institutions or groups. FinTech is expected to have a significant impact on banking and financial markets, although much of this may be more internal, voluntary and passive rather than external, forced and destructive.

For the purposes of this text, a more general and inclusive meaning of FinTech is adopted based on the use of technology to improve the provision or carrying out of financial function and, in particular, savings, lending, payment, investment, and risk or loss management. This will include internal and external developments as well as full and partial systems changes. This may also be public or private sector body-driven and include developments at the national, regional, including European, and international levels. FinTech itself is also viewed in positive and constructive, rather than negative and destructive, terms.

B. DIGITAL CURRENCIES, COINS AND CLAIMS

FinTech developments will have an impact across the banking and financial area. This was initially expected to focus on customer interfaces, principally through new mobile telephone applications, and then payment, including foreign exchange services. This has extended into credit provisions, especially through microfinance and then peer-to-peer lending and crowdfunding, as well as through the provisions of the development of automated (Robo) credit assessment, trading and advisory software programs in the banking, securities and insurance areas. The development of new electronics and digital-based technology has already had a significant impact in the securities area, including with algorithmic trading, high frequency trading (HFT), and the construction of a large number of electronic stock markets and exchanges (including ATPs, ATSs, ECNs, MTFs, OTFs, and systemic internalizers).

More significant impact may potentially occur in the area of the development of digital currencies and other assets, including digital securities and digitally-based insurance, including through smart contract provisions. The most important new digital coin has been Bitcoin, which has confirmed the potential value of distributed ledger technology. Bitcoin nevertheless suffers from a number of significant disadvantages, including with regard to speed, block size, mining dependence, waste, amendability, governance, limited supply, and total quantitative limits, as well as a

332. FINANCIAL MARKETS AND EXCHANGES LAW, supra note 104, at 77-78.
substantially fluctuating value. It is highly unlikely that a private distributed model currency such as Bitcoin could replace existing official currency systems, at least in the near future.

Central banks could still use distributed ledgers to produce official digital coins in “currency blocks,” or “block coin,” which would replace specified amounts of existing note production, with physical coin and note circulation operating in parallel with official digital monies. Central banks in particular countries may also decide to allow some private production of digital coins, although this may, at least, be made conditional on depositing an equivalent amount of domestic currency to support the private issue. Regulatory authorities may also allow other private token systems, not denominated in the form of an official reference asset, to be used to the extent that these do not threaten the stability of domestic currencies or monetary arrangements, or operate within available exemptions. A range of regulatory provisions may nevertheless still be applied, including with regard to payment regulation, anti-money laundering and terrorist financing controls, data protection, and other consumer protection measures.

It has to be expected that a number of new FinTech operators will continue to develop alternative digital asset value systems which can carry out many of the same functions as traditional official domestic currencies. These may be attractive to particular groups of users or members of society in particular countries, as with Bitcoin. Many systems users may nevertheless wish to continue to use official currency or new official digital currency assets, at least for high-value or long-term savings purposes in light of the security and value protection provided. A mixed digital market model may accordingly emerge, although this would continue to be underpinned by official currency assets and monetary management.

C. DIGITAL CLASSIFICATION

Significant difficulties remain with regard to the proper legal classification of digital currencies, especially in terms of property law. Various opinions have been expressed, although these are generally inconclusive, and the matter remains unresolved pending judicial determination or statutory clarification. Conflicting positions have been adopted in the U.K. and in

333. A model for this already exists with the deposit of Bank of England notes by Scottish and Northern Irish banks under the revised currency arrangements contained in Part 6 of the Banking Act 2009. See Banking Act 2009, c. 6 (Eng.); The Scottish and Northern Ireland Banknote Rules 2015 (Eng.), supra note 327.

334. See Crypto-Currency Market Capitalizations, supra note 120.


the U.S. on the point. 337 Under English law, property is generally divided between land and personal property. 338 Personal property is considered in terms of tangible and intangible, which either consist of choses in possession or choses in action. 339 Intangible moveable property generally is comprised of documentary intangibles which are instruments representing goods, such as bills of lading, or financial instruments, including bills of exchange, promissory notes and cheques, and pure choses in action which are personal claims. 340 A number of distinct types of choses in action can be identified which can be considered to include rights under contracts. 341

Property is given a wide and inclusive statutory definition for insolvency law purposes under English law. 342 The courts will apply a four-point test based on definition, identification, transferability, and permanence. 343 The importance of independence has also been highlighted and common rights stressed. 344 For the purposes of this text, these rights may be summarized in terms of holding, encumbering by way of security, bequest (and inheritance),

transfer (including by gift or sale), and cancellation or destruction.\textsuperscript{345} Other writers also develop the idea of independence or separation.\textsuperscript{346} The nature of rights has been subject to separate theoretical examination.\textsuperscript{347}

While digital currencies would satisfy the various conditions referred to, including definability, identification, transfer, permanence, as well as independence, or separability, and protectability, the core difficulty remains in identifying the precise nature of the property interest concerned. Digital currencies, such as Bitcoin, do not create rights of actions against other individuals, or entities, as with banknotes or bank accounts.\textsuperscript{348} Digital currency is not issued by a specific issuer.\textsuperscript{349} Holders of digital currency arguably do not have any separate property interest in the distributed ledger or block chain as a whole.\textsuperscript{350}

Despite these difficulties, it is arguable that the owner of a digital currency owns, or more specifically holds, the rights attached to the currency including specifically to sell (or gift) it with the ancillary title rights referred to of encumbering, bequeathing and cancelling.\textsuperscript{351} The property interest is arguably then in the rights attached to the digital asset. Bitcoin specifically is only defined as a ‘chain of digital signatures’ to which a series of associated rights can be considered to be attached.\textsuperscript{352}

Other types of intangible property can be considered in terms of collections of rights. EU allowances (EUAs), created under the EU Emissions Trading Scheme (ETS)\textsuperscript{353} have been defined as the ‘sum total of secure debts, acquired (in the olden days) by a husband on marrying its owner.” OBG Ltd. et al. v. Allan et al. [2008] 1 AC 66, per Lady Hale.\textsuperscript{345} These are referred to as the core title rights for the purposes of this paper.\textsuperscript{346} Penner defines property in terms of a “separability thesis” and an “exclusion thesis.” J.E. Penner, The Idea of Property in Law (Oxford Univ. Press 1997).\textsuperscript{347} Hohfeld classifies legal interests as rights, privileges, powers and immunities with corresponding, or opposite, inabilities (no right), duties, disabilities and liabilities. Wesley Newcomb Hohfeld, Some Fundamental Legal Conceptions As Applied in Judicial Reasoning, 23 YALE L.J. 16, 58 (1913); Hohfeld, Fundamental Legal Conceptions As Applied in Judicial Reasoning, 26 YALE L.J. 710, 717 (1917).

349. Id.
350. Id.
351. It is arguable that the holder of a digital currency cannot destroy the currency as such, which is dependent on controlling the ledger or block chain, although a party may unilaterally declare an amount of digital coin cancelled and refuse to transfer it further which would block any subsequent use. See Blockchain, Investopedia, http://www.investopedia.com/terms/b/blockchain.asp (last accessed Sept. 13, 2016).
rights and entitlements conferred on the holder pursuant to the ETS. Corporate securities and, in particular, dematerialized securities issued without a physical certificate, can also be considered to constitute bundles of associated rights. Interests in securities are also intangible rights with real rather than personal actions being available to protect them. A digital right does not have to be enforceable against a specific individual with this having been rejected by the English courts. The fact that a new digital asset is created by way of a private scheme controlled by computer protocols and code rather than a statutory or public scheme may also appear to be irrelevant to whether a new property asset has or has not created.

Although the matter remains untested, a digital right can arguably be considered to constitute property in the form of a special chose in action with a series of associated title rights to hold, encumber, bequest, transfer (by gift or sale) or cancel. The digital asset is definable, identifiable, transferable, stable and independent. The digital coin does not have to be enforceable against a specific issuer although the rights attached to the asset may be enforceable against society generally while a personal action will lie against the transferor for any defect in the transferred title. This may also apply with regard to any scheme established privately or by public statute.

The law could nevertheless still be clarified either by classifying digital assets as special choses in possession (through legislation or the development of a judicial doctrine of constructive digital possession) or, at minimum, by attaching expressly real effects for transfer, security and title registration purposes and real remedies in the event of interference to ensure the full and proper protection of such increasingly important assets under law.

D. TechRisk and FinRisk

All FinTech related exposures have to be properly identified and managed. This may be considered in terms of technology risk (TechRisk) and larger

354. Armstrong DLW GMBH v. Winnington Networks Ltd. [2013] EWHC (Ch) at para. 50 (Eng.).
355. These rights would include to information, voting at general or special shareholder meetings and a right to payment by way of dividend. Pretto-Sakmann, for example, concludes that shares are not personal property due to the significant contractual element. ARIANNA PRETTO-SAKMANN, BOUNDARIES OF PERSONAL PROPERTY LAW: SHARES AND SUB-SHARES (Hart Pub. 2005).
356. Benjamin notes that interests in securities are intangible rights. While intangible rights and obligations both constitute property in the form of things, real rather than personal actions are still available against third parties. JOANNA BENJAMIN, INTERESTS IN SECURITIES 307 (Oxford Univ. Press 2000).
357. See Armstrong DLW GMBH, [2013] EWHC (Ch) at paras. 48, 61 (Eng.) (enforcing a digital right is unnecessary).
358. See Re: Celtic Extraction Ltd [2001] Ch 475 (CA) (confirming the need for a statutory scheme of establishment in the English license cases). But see Swift v Dairywise Farms Ltd [2000] 1 WLR 1177, aff’d [2001] indicating that it may be sufficient even if the quota system had been set up by some private rather than statutory arrangement provided it has commercial value and legal effect). For similar comment, McGrath, supra note 336, at 27.
FinTech systems risk (FinRisk). Technological advance does not necessarily create new forms of risks as such although it does create new applications of existing risks which may be amplified and have additional contagious effects. The principal new sets of exposures that have to be considered with regard to FinTech are operational and technology related risks which may arise inter alia in the form of design error, program flaw, manufacturing defect, non-interoperability and connection failure as well as other types of operational risk including internal and external fraud and systems failure. This may also create increased cost and complexity and require specialist installation, maintenance, management and correction as well as emergency intervention. The overall effect of this may be to create increasingly high levels of technological dependence the effects of which could be more severe in the event of technology failure if there was no technological or non-digital monetary substitutes available. Significant concerns accordingly arise both with regard to dependence and substitution or replacement.

A series of additional issues may also arise with regard to how this technology would work with other technology and in a larger economy. This would create further issues with regard to single systems complexity, connection or network risk, complex causation or emergence, possibly massively increased uncertainty and increased overall aggregate or total risk. All of these new exposures and threats will have to be identified, measured and managed effectively over time.

E. LAWTECH AND TECHLAW

Additional legal risks also arise in connection with FinTech. FinTech companies have to ensure that they and their products or services comply with all relevant laws including applicable restrictions on financial promotions, licensing, authorization and permission, raising funds, consumer credit provision, general consumer protection laws trading on stock markets and exchanges and complying with other relevant banking, securities and insurance laws.

This has to be considered from the perspective of both the law applicable to FinTech solutions (LawTech) and all of the other additional areas that would apply in using technology in the financial area more generally (TechLaw).

Specific private and public law issues arise with regard to FinTech directly. These include advertising and financial promotions, contract negotiation (possibly using standard terms and conditions and service arrangements), contract execution (including electronic and digital signatures), privacy and confidentiality and contract and data protection. The complexity of consumer protection may require the addition of a new form of FinTech related consumer protection law (or ConsumerTech). Other public law issues would arise with regard to criminal offences, including theft and fraud, slander and libel, harassment, stalking and hacking. Many aspects of traditional private and public law will have to be reconsidered to confirm their relevance and use and application in the FinTech area.
F. RegTech and FinReg

Developments in compliance technology and RegTech will substantially assist firms monitor and manage the financial risks that their activities generate and report these more efficiently and effectively to supervisory authorities. RegTech could substantially increase the quality of internal firm risk management and external supervisory oversight and consequent financial stability overall. A number of initial initiatives have been adopted in such areas as data analysis and almost real time reporting.

RegTech is nevertheless only concerned with the use of technology for compliance purposes with a wider area of FinReg emerging which is concerned with the need to regulate the FinTech sector as a whole and banking and financial institutions and markets affected by FinTech developments more specifically. This can be considered to constitute a particular form of technology connected financial regulation more generally although FinReg would extend to overseeing the financial system as a whole and dealing with all potential new risks and exposures.

G. Financial Resolution and TechResolution (or ResTech)

As well as technology related regulation and supervision, a key issue would be ensuring that FinTech companies and products are subject to adequate resolution mechanisms. Resolution became a key issue following the global financial crisis as a number of firms had grown to such a size and complexity that the authorities considered that it was impossible to close them down with official financial support having to be provided. One aspect of dealing with this too-big-to-fail problem has been the need to construct effective crisis management mechanisms to ensure that all large banking, securities and insurance firms are subject to effective resolution. This includes both pre-crisis firm internal Resolution and Recovery Programs (RRPs) with subsequent external official Special Resolution Regimes (SRRs) being available in the event that the RRPs fail. Many of the largest financial groups have had to prepare their own RRPs with authorities ensuring that they have the necessary powers under their SRRs procedures to deal with any major crisis.

These arrangements will have to be extended in the FinTech arena especially where service providers, platforms or devices become systemic (SIFTCs) or even materially disruptive. The most effective way of dealing with this may be through the establishment of new specialist Technology

360. See Banking Act 2009, supra note 327 (establishing a dedicated Special Resolution Regime (SRR) for banks following the global financial crisis under the Banking Act 2009 which includes private bank transfers, bridge bank and nationalization options as well as a special bank administration procedure and bank insolvency procedure); see also Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), Pub. L. No. 111-203, 124 Stat. 1376 (2010) (providing an Orderly Liquidation in the US under Title II).
Restoration Plans ("TRPs") or Technology Transfer Plans ("TTPs") in the event of the failure of a specific firm or operator. This would ensure that their technology could either be taken over internally or transferred to another operator. In the event that neither of these options were possible, or successful, authorities may consider providing some form of "Technology support of Last Resort" ("TLR") by either stepping in to run a technology program or having it transferred to an official central bank or government system. This TLR will operate in addition to more general post crisis lender of last resort ("LLR") as well as other forms of individual institutional funding ("FLR"), general market liquidity ("MLR"), capital support ("CLR"), official guarantees ("GLR") and asset protection or insurance ("ALR") schemes set up following the global financial crisis.

H. DIGITAL PRIVATE LAW AND DIGITAL DISPUTE RESOLUTION

Technology law must also operate on a cross-border basis. While online systems are typically referred to as being virtual and borderless, in practice, all contracts, services and engagements are governed by particular domestic laws and capable of specific location. Parties are generally free under the principle of autonomy to select a governing law applicable to particular contracts and the jurisdiction to determine inter-party disputes. Countries will generally not apply their laws on an extraterritorial basis under the principle of comity. In the absence of election, various principles are applied under International Private Law (IPL), or conflicts of law, to determine the law with which a contract or event has its closest connection. In the financial area, this may include the lex causae (substantive law of the action), lex fori (law of the forum) and lex monetae (law of the money of payment). International Conventions have also been adopted on conflicts under the Hague Conference with specific regulations applying in the EU area.


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Difficulties have arisen in this area in developing an appropriate set of rules to govern Internet contracts despite repeated attempts. The most appropriate solution will probably be some form of direction or targeting theory which operates on the basis of the law from where a service is provided as well as the law of the country into which services are directed or targeted. This could either operate on a simple or adjusted basis with the two separate laws applying to different aspects of the contract or relations.

In the absence of international agreement and any clear set of governing provisions, online counterparties could attempt to apply targeting theory principles in common standardized digital contracts which would effectively reflect party implied intention. New principles of international Digital Private Law (DPL) may then emerge.

Parties may also wish to consider using some form of alternative dispute resolution (ADR) in the digital area which may evolve into a form of “Digital Dispute Resolution” (DDR) or Online Dispute Resolution (ODR). ADR generally operates either through formal arbitration or informal mediation or conciliation all of which could be adjusted to apply in the digital area. This could save substantial costs and make settlement quicker and easier. Specialist “digital arbitrators” could be appointed using agreed panels of existing arbitrators or specially trained arbitrators appointed by technology relevant private trade associations or technology connected public bodies. Special sets of digital arbitration, mediation and conciliation rules could then be developed for specific use in online transactions. The objective would not be to avoid or replace domestic law but clarify its relevance and application. Supporting “digital execution” measures could also be


365. See Regulation (EC) No. 593/2008, supra note 364, at art. 6(1)(b); Council Regulation No. 44/2001, art. 15(1)(c), 2000 O.J. (L 12) 1 (EC); Regulation (EU) No. 1215/2012, art. 17(1)(c), 18(1), 2012 O.J. (L 351) 1 (protecting freedom of choice with consumer contracts governed by the law of the country of the contract supplier or habitual residence of the consumer where the supplier “by any means, directs such activities to that country”).

366. See Michael A. Geist, Is There A There? Toward Greater Certainty for Internet Jurisdiction, 16 Berkeley Tech. L.J. 1345 (2001); Thomas Schultz, Carving up the Internet: Jurisdiction, Legal Orders, and the Private/Public International Law Interface, 19 EJIL 799, 819-22, 838-39 (2008) (supporting the adoption of some form of targeting approach as opposed to either an activity or effects test supported by possibly home and host state technological filtering of offensive material by internet service providers (ISPs)) (while this would apply vertically, Internet communities and groups could also develop separate horizontal standards to promote practices).

367. See Regulation (EU) No 524/2013, 2013 O.J. (L 165) 1 (adopting online dispute resolution (ODR) platform); Commission Implementing Regulation (EU) 2015/1051, 2015 O.J. (L 171) 1; see also, Civil Justice Council, Online Dispute Resolution for Low Value Civil Claims (Feb. 2015) (reporting on the establishment of an Internet based service for the resolution of civil disputes of less than £25,000) ODR is used in this text to refer to wider global initiatives which will include European and other domestic exercises.

developed to allow for the practical enforcement of digital awards domestically and across open border basis.

I. DIGITAL IDENTIFICATION, EXTENSIONS AND THE DIGITAL ECONOMY AND GOVERNMENT

A number of digital techniques could clearly be extended from the prevailing sale and social media area to operate in connection with FinTech activities. These could then be further extended into other private and public law areas. Work is already being carried out in connection with the development of legal entity identifiers (LEIs) for banks which could be extended to cover all other firms and parties.\textsuperscript{369} An equivalent set of digital standard identification systems could also be brought into effect for transactions which would include the nature of the transaction, date of execution (or completion or both) and the identities of the parties involved. All of this could substantially assist ensure the accuracy and effectiveness of identification procedures used online and, in particular, ensure that all parties had relevant legal capacity to act and authority as well as limit money laundering, other criminal activity and tax evasion.

Specific digital tools, such as the distributed ledger, could also be extended for use in other areas which is already being considered.\textsuperscript{370} This could include land registers, vehicle ownership registers, other high value asset registers, such as art, and other official government, public and private record systems.\textsuperscript{371} The advantages would be reduced public cost and speed of transaction with continuity planning being enhanced with the existence of multiple parallel registers. The disadvantages would be the openness of the system to multiple attacks depending upon the extent to which interference could be limited in multiple access permissioned or permissionless systems.\textsuperscript{372} It is highly likely that appropriate models will be developed in time that allow for a sufficient degree of security with separate systems or hybrids possibly being used for closed and open public and private registers in parallel.

Digital technologies developed in the FinTech area could then be extended to apply in many areas of government and society more widely. This would assist create a more substantial Digital Economy as proposed by many governments and predicted by many commentators. This would be

\textsuperscript{369} A Legal Entity Identifier (LEI) Regulatory Oversight Committee (ROC) was set up in January 2013 to coordinate the development of a Global LEI System based on unique 20 character, alpha-numeric LEI codes for every entity engaged in financial transactions. A separate Global LEI Foundation (GLEIF) was established on June 26, 2014 in Zürich following recommendation by the FSB. The Legal Entity Identifier Regulatory Oversight Committee – LEI ROC, LEI ROC, https://www.leiroc.org (last visited Sept. 2, 2016).

\textsuperscript{370} Jeroen van Oerle, Patrick Lemmens, Distributed ledger technology for the financial industry 7 (Robeco 2016).

\textsuperscript{371} Id.


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further enhanced by the identification systems referred to earlier. Care would simply have to be taken to avoid unnecessary attack, interference and abuse. Parties should be prepared to provide accurate and valid identification, and authority to act where necessary, in a wide range of transaction arrangements including for official purposes and other high asset value related transactions. Parties should not be allowed to use the anonymity of the Internet to avoid proper identity disclosure and liability in appropriate cases. While this may facilitate increased monitoring in these areas, this should not objectionable in theory where identification is relevant for legal purposes.

Separate issues arise in connection with other non-official and smaller value exchange transactions as well as on social and media platforms. While controlled, transparent and anonymous registers, including distributed ledgers, may be necessary in official and high-value transactions; open, permissionless ledgers may be used in other cases including smaller value purchase and sale transactions using either official or private digital currency. Parallel closed and open systems may then operate. Certain issues arise with regard to identity disclosure on social media sites where people commonly use pseudonyms. This is not objectionable provided that everyone is aware that alternative names are commonly used and that identification is not guaranteed provided that no separate illegal or criminal activity is involved. People have to be responsible for their own conduct and for the treatment of others on social media platforms with appropriate controls and remedies put in place as necessary.

J. Private Systems and the NonNet

Separate issues again arise as to whether it may ultimately be possible to replace all existing physical coin and note production through public or private digital currencies. Specific concerns already arise with regard to financial exclusion and non-bank communities in many parts of the world. While digital facilities have extended bank account and other financial services availability substantially across the world, this may always be far from complete for unavoidable practical reasons or simply through user or consumer choice in particular cases. There may accordingly always be an argument to retain some form of cash or physical exchange markets especially for small value transactions. Internet facilities may specifically not be available in all countries, or parts of countries at all times, with the need for a “NonNet” as well as the new Internet and digital commercial marketplace and society. A number of legal arguments may be developed to support this either on constitutional, human rights, political, moral and ethical grounds. Governments and legislatures must be aware of the issues involved.

374. Id.
K. Digital Documentation and International FinTech

The commonality of the Internet and worldwide web create new levels of interconnection never before experienced in domestic and international commerce and in human history. Markets have become also more open through specific public international law initiatives, such as with the GATT, WTO and separate trade rounds, as well as globalization more recently. The degree of connection created has been substantially further enhanced by the integration facilitated by the Internet. As digitally connected companies deal with counterparties and customers across the world on common terms, standard sets of terms and conditions and practices will inevitably emerge. This could then support the development of common standardized provisions in many areas of activity, as already occurs with the provision of online services and consent clauses, provided only that these were fair and balanced and accepted across countries and jurisdictions. A degree of digital standardization could then be promoted either by financial or technology related trade associations or by relevant government agencies. Standard sets of common digital terms and conditions could then be produced quickly. These would necessarily allow for incorporation, amendment or exclusion either in whole or part in particular individual cases as the parties desired. The objective would not be to limit party choice or the legal relevance and application of underlying domestic jurisdictions but only to create available standard sets of provisions where this was appropriate. This could reduce negotiation and contract times, lower costs and substantially increase certainty.

Countries could also consider to what extent internationally agreed intergovernmental or public international digital law related activities could be usefully set out in a treaty or convention. This may be relevant in the financial area specifically or with regard to ecommerce more generally. This may include the development of a form of “Bretton Woods III” Treaty which initiatives were discussed following the global financial crisis although subsequently aborted. This could specifically cover such matters as international payment, capital flows and monetary arrangements including clarifying the role and function of international financial institutions, such as the IMF and World Bank, in the new digital global economy. The IMF may specifically become involved in the issuance of public and private digital currencies either directly or indirectly, including through the possible use of

375. Models already exist with the international loan documentation produced by the Loan Market Association (LMA) for use in the banking area, capital market documents by the International Capital Markets Association (ICMA) and derivatives documentation by the International Swaps and Derivatives Association (ISDA). Financial Markets and Exchanges Law, supra note 104, at chs. 1, 2.

adjusted Special Drawing Rights (SDRs) as an international transferable
digital currency or digital reference asset (“DRA”) for other digital monetary
assets. Such a treaty could also clarify applicable Private International Law
rules and possibly recognize and give legitimacy to special Digital Dispute
Resolution mechanisms as well as cover such other matters as taxation,
money laundering and the prevention of anti-terrorist financing and
criminal activity. Other matters relevant to the effective operation and
governance of a global digital economy could also be considered for
inclusion as appropriate.

L. Financial Stability, Advantage and Benefit

The Internet creates substantial inter-connection as well as inter-
dependence and inter-exposure. New FinTech and larger digital
developments may bring substantial opportunities and benefits for specific
market operators and users, although care has to be taken to ensure that
none of this destabilizes existing financial and other markets. It is also
necessary to ensure that all potential disruption is properly monitored and
managed to the extent necessary and benefits shared to the extent
appropriate. Market authorities will specifically have to monitor the
potential build-up of latent risks and exposures as a result of FinTech
companies or activities that may threaten the stability of specific sectors or
markets.

The possibility of wider contagion must also be avoided. This will
specifically involve the inclusion of a more technology specific element
within new macro-prudential practices, such as those applied by the FSOC
in the US, the ESRB in the EU and FPC in the UK. This will create a form
of MacroTech, which will involve the oversight of more general systems
stability in addition to the more specific MicroTech review applied at the
individual firm level. For this purpose, macro-prudential bodies will have to
develop dedicated additional technical data collection and analysis
techniques to monitor such exposures and extend their cooperation and
coordination activities as necessary. The FSB has already assumed a role in
this area at the international level through the inclusion of technology and
FinTech within its ongoing review activities although a considerable amount
of is required in this area.

XI. FinTech Close

FinTech represents a highly important new area and point of
technological and financial departure. FinTech has to be considered in an
inclusive manner including both narrow external disruptors and reforming
market incumbents and all aspects of technology driven market change.
This will necessarily have a significant impact on markets, business
structures and financial services more generally. A substantial amount of
disruption will inevitably occur although much of this may only accelerate
natural business cycles and it has to be expected that many new entrants will
have to work with incumbents over time who are developing their own internal systems. Inefficient incumbents may also simply be acquired by other large legacy financial groups. FinTech may accordingly work more by absorption and assumption rather than disruption and damage.

The most significant changes will initially occur in the areas of customer interface and the quality of service provision as well as payment and digital currencies with this being extended subsequently into other fields over time. It is expected that many firms and customers will experiment with new forms of digital valuation and digital value transfer. Many users, including large value and longer term wealth holders, may nevertheless wish to remain with digital assets denominated in the form of an official reference asset and supported by domestic central banks on government for reasons of security, value and price stability.

A key new element will be the creation of whole new set of digital rights, interest, entitlements, claims and record devices that allow of the creation, holding, transfer, exercise and cancellation of financial rights safely, securely and efficiently. This will inevitably arise as a result of the conversion and transformation of underlying existing legal rights into a digital form and origination through the creation of new digital entitlements.

The developing area of RegTech will assist manage rights and obligations over time and increase the effectiveness and efficiency of firm compliance. This nevertheless only forms one part of the larger more comprehensive regulatory structure that will have to be constructed to deal with all aspects of new TechRisk and FinRisk with the creation of wider FinTech solutions and operations. The immediate challenge will be in the banking markets although there will also be significant regulatory and supervisory disruption in other areas with financial authorities having to substantially increase their technical capability, expertise and knowhow. This will also then extend into non-financial sectors and across society more generally. All of this can be considered to fall with the new emerging area of Financial Technology Law or TechLaw.

While this may lead to significant short-term disruption, it will inevitably result in substantial medium and longer-term growth and development as new innovative techniques and products are absorbed into the evolving financial system. Again, rather than consider this as part of a narrow, fixed FinTech effect, this will operate within a larger new online, Internet, and virtual web environment. FinTech is important although it will only form one part of the larger evolution of the Internet through the Value Net, Immersive, and other iterations. All of this will increase customer and business service at cheaper cost and hopefully increase market and financial liquidity and efficiency. More fundamental transformations and innovative new practices and applications may also arise. Care only has to be taken to ensure that that any new emergent risks and exposures are properly identified, managed, and contained over time. The potential and future evolution of FinTech may be highly promising indeed. Change is inevitable and unavoidable.
Should the United States Withdraw Its CISG Article 95 Declaration?

PETER WINSHIP*

As a benefit of membership in the ABA’s Section of International Law, The International Lawyer ends up in the hands of thousands of practicing lawyers worldwide. As a consequence, The International Lawyer is an ideal place to solicit answers to questions like “Should the United States withdraw its Article 95 ‘declaration’ to the United Nations Convention on Contracts for the International Sale of Goods?” The following paper asks this very question. It does so in the hope that readers with practical experience with the CISG will respond. When considering an appropriate way to celebrate, the author wished to highlight the practical value of the most widely-circulated international law journal in the world today.**

Twenty-five years ago the United States ratified the U.N. Sales Convention (“CISG”).1 At that time it declared that it would not be bound by subparagraph (1)(b) of article 1—a provision that makes the Convention applicable when choice-of-law rules lead to the law of a State party to the Convention. Article 95 authorized the United States to do so.2 Should the United States now withdraw this declaration?3

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** The paper was presented several years ago to a meeting of the U.S. Secretary of State’s Advisory Committee on Private International Law. The text is reproduced as written but the footnotes have been modified to conform to standard citation form. The author has prepared a more elaborate analysis that, with the permission of the editors of The International Lawyer, will be published with appropriate acknowledgments.
2. Id. art. 95, at 189 (“Any State may declare at the time of the deposit of its instrument of ratification, acceptance, approval or accession that it will not be bound by subparagraph (1)(b) of article 1 of this Convention”).
3. Although the question is asked only about the CISG, the same question arises with respect to the Limitation Convention to which the United States is also a party. United Nations Conference on Prescription (Limitation) in the International Sale of Goods, New York, May 20-June 14, 1974, Documents of the Conference and Summary Records of the Plenary Meetings and of the Meetings of the Main Committees, U.N. Doc. A/CONF.63/15, as amended by the Protocol of Apr. 10, 1980. CISG, supra note 1, Annex II, at 191-92 [hereinafter Protocol]. As amended, the PUBLISHED IN COOPERATION WITH SMU DEDMAN SCHOOL OF LAW
Professor Harry Flechtner has made the case for withdrawal. This paper comments on his arguments. Before setting out these comments, however, the paper first examines the present effect of the article 95 declaration, the reasons for the declaration, and the consequences of withdrawing it in order to put the comments in context.

I. When ARE U.S. Courts Now Bound to Apply the CISG to a Dispute Arising from a Cross-Border Sale of Goods Transaction?

As a consequence of the article 95 declaration, U.S. courts are only bound to apply the CISG when subparagraph (1)(a) of article 1 is satisfied: “This Convention applies to contracts of sale of goods between parties whose places of business are in different States: (a) when the States are Contracting States (i.e., States party to the Convention)”, and even then only if the seller and buyer have not agreed to exclude its application as they are authorized to do under article 6. Thus, if an enterprise with its place of business in Texas agrees to the sale and purchase of goods with a business in Mexico, a U.S. court should apply the CISG to a dispute arising from the sales contract. Both the United States and Mexico are parties to the Convention and there is nothing to suggest that the seller and buyer have excluded application of the Convention. If, on the other hand, the Texas enterprise agrees on similar terms with an English company, a U.S. court will not be bound to apply the CISG because the United Kingdom is not yet a party to the Convention. (Note that while the court is not bound to apply the CISG, the court is not prohibited from doing so.)

In most cases, U.S. courts—and presumably practitioners aware of the CISG—have had little difficulty applying the scope provision in subparagraph (1)(a) of article 1. The only choice-of-law rule that the court must apply when faced with a non-U.S. plaintiff or defendant in a dispute arising from a contract of sale is this subparagraph. Although state (e.g., Limitation Convention has the same scope as the CISG and the Convention authorizes a declaration similar in effect to the CISG article 95 declaration. See Protocol, art. I & art. XII, at 191-92. The United States made such a declaration at the time it acceded to the Convention as amended by the Protocol. The U.S. declaration became effective on December 1, 1994, when the Convention entered into force for the United States. Id. 4. Letter from Harry Flechtner, Professor of Law, University of Pittsburgh, to Keith Loken, Attorney in the Office of the Legal Advisor, U.S. Department of State (Jan. 30, 2012) (See App. 1).

5. This paper has been prepared for a meeting of the U.S. Secretary of State’s Advisory Committee on Private International Law on October 11-12, 2012 and for a panel at the Fall Meeting of the International Law Section of the American Bar Association on October 18, 2012. A more detailed manuscript, with the usual academic elaborations and qualifications, will be published in a suitable law review in due course.

6. CISG, supra note 1, art. 6, at 5. (“The parties may exclude the application of this Convention or, subject to article 12, derogate from or vary the effect of any of its provisions”).

7. CISG, supra note 1, art. 1(1)(a), at 5.
Texas) conflict of laws rules would normally govern even international choice-of-law issues, the supremacy clause of the federal constitution makes the Convention the supreme law of the United States and thus the CISG scope provision displaces these state rules.  

II. What Would Be the Consequence of Withdrawing the Article 95 Declaration?

If the United States withdraws its article 95 declaration, U.S. courts will apply the CISG, rather than domestic sales law, when choice-of-law rules lead to U.S. law. Subparagraph (1)(b) of article 1 provides that the Convention also applies “when the rules of private international law [i.e., choice-of-law rules] lead to the application of the law of a Contracting State.” This subparagraph is irrelevant in a Texas-Mexico dispute because the Convention applies by virtue of subparagraph (1)(a), but is relevant in a Texas-England dispute. In the latter dispute, a U.S. court would have to determine whether applicable choice-of-law rules lead to application of the law of the United States, England, or a third State (in which case it must further determine whether that State is a Contracting State). If the court concludes that applicable choice-of-law rules do not lead to the law of a foreign State, the court would be bound—a absent the article 95 declaration—to apply the Convention by virtue of the supremacy clause.

For a variety of reasons, U.S. courts frequently end up applying U.S. law when the seller and buyer have not agreed on the applicable law. In many cases, of course, choice-of-law rules will lead to domestic U.S. law, but other practical considerations may also play a role. Judges and attorneys are notoriously gun shy of conflict of laws issues. The attorneys may conclude that the result would be the same no matter what law applies and fall back on local U.S. law; local attorneys representing foreign clients may be more comfortable arguing on the basis of familiar domestic law; a party may not succeed in proving the content of foreign law. This last reason, for example, is why the one U.S. court analyzing the issue in the context of an international sale—Prime Start Ltd. v. Maher Forest Prod., Ltd.—decided that because foreign law had not been proved it would apply the locally-enacted Uniform Commercial Code (UCC).

If the United States withdraws its article 95 declaration, the results in the cases outlined in the preceding paragraph would change. U.S. courts would
apply the CISG rather than domestic state law, usually the Uniform Commercial Code, unless the parties are astute enough to agree to exclude the Convention. Thus, the federal district court in the Prime Start case would now apply the Convention, rather than the UCC, as the default rule. Judges, counsel, and parties may be surprised by this change from familiar state law to the less familiar legal rules of the CISG. Not only would U.S. businesses and legal community be surprised by the application of the CISG rather than state sales law, but application of the CISG may be perceived as unfair. Following withdrawal of the article 95 declaration, a court—whether U.S. or foreign—will apply the CISG if U.S. law is applicable. If, however, the foreign party’s law is applicable the same court will look to that party’s domestic sales law. The U.S. party, in other words, gives up familiar (and modern) state sales law for the less familiar text of the CISG. The foreign party, on the other hand, will have the advantage of its familiar domestic law or the international text of the CISG, depending on whether choice-of-law rules lead to its law or U.S. law.

III. Why Did the United States Make the Article 95 Declaration in the First Place?

The public statement of the reasons for the article 95 declaration is found in Appendix B to the legal analysis accompanying President Ronald Reagan’s 1983 message to the Senate recommending that it give its advice and consent to ratification of the Sales Convention. The Senate consented to this recommendation and the United States ratified the Convention subject to the article 95 declaration.

Appendix B essentially provides two reasons in support of its recommendation: non-uniform choice-of-law rules would create uncertainty as to when the CISG would govern, and extended application of the CISG would be at the expense of the Uniform Commercial Code. The Appendix states in part:

The United States, in signing the Convention, stated that ratification subject to the Article 95 reservation was contemplated. This position,

14. The Uniform Commercial Code will “usually” be the relevant state law but it should be remembered that Louisiana has not adopted UCC Article 2, substituting instead a sales law that draws upon civil law, the UCC and the CISG. La. Civ. Code Ann. arts. 2438-2659 (1993). Later references in this paper to the Uniform Commercial Code alone should be read as subject to this qualification.


recommended by the American Bar Association, will promote maximum clarity in the rules governing the applicability of the Convention. The rules of private international law, on which applicability under subparagraph (1)(b) depends, are subject to uncertainty and international disharmony.

A further reason for excluding applicability based on subparagraph (1)(b) is that this provision would displace our own domestic law more frequently than foreign law. By its terms, subparagraph (1)(b) would be relevant only in sales between parties in the United States (a Contracting State) and a non-Contracting State. Under subparagraph (1)(b), when private international law points to the law of a foreign non-Contracting State the Convention will not displace that foreign law, since subparagraph (1)(b) makes the Convention applicable only when “the rules of private international law lead to the application of the law of a Contracting State.” Consequently, when those rules point to United States law, subparagraph (1)(b) would normally operate to displace United States law (the Uniform Commercial Code) and would not displace the law of foreign non-Contracting States.

The Appendix also notes that “parties who wish to apply the Convention to international sales contracts not covered by Article 1(1)(a) may provide by their contract that the Convention will apply.”

The Secretary of State’s Advisory Committee on Private International Law (“ACPIL”) had earlier endorsed the analysis in Appendix B at a meeting in 1981. That meeting had before it the ABA Report and a memorandum from Professor John Honnold, who had been a member of the U.S. delegation to the 1980 Vienna Conference. The meeting itself noted the issue of the scope of federal pre-emption.

IV. How Many Other States Have Made Article 95 Declarations?

As of October 2012, only seven of the seventy-eight Contracting States have made article 95 declarations. In addition to the United States, these States include Armenia, China, Czech Republic, Slovakia, Singapore, and St.

17. The ABA report states that “[t]he principal impact of this provision on traders of a contracting state appears to be that the Convention would be applicable in a greater number of cases but at the expense of the contracting state’s domestic law. The provision also reintroduces the uncertainties of private international law which the CISG was designed to avoid.” A.B.A., Report to the House of Delegates, 18 Int’l L. 39, 42 (1984).


19. Id. at 18.

20. As the author was the author of the ABA report and was present at the ACPIL meeting, the author is speaking from firsthand knowledge.

21. Id.
Vincent & Grenadines. Armenia is the most recent State to do so (January 1, 2010). None of these States has withdrawn its declaration although several authors have urged them to do so and China is reported to be about to withdraw its declaration.

That so few countries have made the declaration is somewhat surprising. At the 1980 diplomatic conference a motion to delete subparagraph (1)(b) of article 1 was defeated but the conference, notwithstanding general reluctance to permit reservations, adopted article 95. The reasons given for deleting or allowing States to opt out of subparagraph (1)(b) of article 1 are similar to those articulated subsequently by the United States: subparagraph (1)(b) adds complexity and involves serious problems of interpretation and application; it creates special difficulties for States with modern laws drafted with international trade in mind.

V. Are the Reasons for Making the Declaration Still Relevant?

On their face, the justifications for the initial decision remain valid: neither domestic nor international choice-of-law rules are noticeably more uniform, and application of subparagraph (1)(b) will displace domestic U.S. sales law but not the domestic sales law of a non-Contracting State.

What has changed, however, is the practical importance of these reasons. There were only eleven Contracting States at the time that the U.S. declaration became effective in January 1988. As of October 2012, however, there are seventy-eight Contracting States. Of the principal trading partners of the United States, only the United Kingdom is not yet a Contracting State. U.S. businesses that contract with enterprises in other Contracting States will find that the CISG will govern under subparagraph (1)(a) unless they agree to exclude its application. For them, subparagraph (1)(b) is not relevant. While it is true that the subparagraph continues to be relevant when a U.S. business contracts with an enterprise located in a non-Contracting State, the number of such cases will be smaller.

23. Id.
27. Id.
Appendix B of the Legal Analysis anticipates this diminishing importance of the reservation stating in part, “Widespread adoption of the Convention can be anticipated; hence it is expected that eventually a substantial portion of United States international trade will involve other Contracting States and will receive the benefits of the Convention by virtue of subparagraph (1)(a) of Article 1.”

VI. Should the United States Withdraw Its Article 95 Declaration?

Professor Harry Flechtner has written a brief in support of withdrawal of the article 95 declaration. He puts forward serious arguments in rebuttal of the justifications given originally by the American Bar Association and Appendix B of the Department of State’s Legal Analysis. These arguments should be addressed, but before doing so it should be noted that nowhere does Professor Flechtner suggest that U.S. businesses or lawyers are clamoring for withdrawal. This contrasts sharply with the initial push for adoption of the CISG in the 1980s, when not only the Secretary of State’s Advisory Committee on Private International Law and the American Bar Association supported ratification (with the article 95 declaration) but also a distinguished group of U.S. leaders of export-import corporations endorsed ratification (with the article 95 declaration). As Sherlock Holmes might observe, the failure of these same groups to ask for withdrawal is the dog that did not bark.

In the absence of business and professional support Professor Flechtner relies instead on three basic arguments. The most serious argument—and the one about which I suspect he and I will ultimately agree to disagree on—is that the CISG deals better with issues that arise in the context of international sales than does the Uniform Commercial Code. The second is that in some circumstances a court in another Contracting State will face a difficult question of interpretation. And, third, there is a trend to withdraw declarations and this trend is desirable because it removes unnecessary exceptions to uniformity. These last two arguments, I will suggest, are far less significant so I will begin with his first.


29. Professor Flechtner is an acknowledged expert in the field of international sales law. He is the editor (perhaps ironically in the present context) of the 4th edition of the Honnold treatise. John Honnold, Uniform Law for International Sales under the 1980 United Nations Convention § 47-47.6 (Harry Fletcher ed., 4th 2009) (see § 47-47.6 for discussion of subparagraph (1)(a) and article 95).

30. Soliciting reliable responses from U.S. export-import enterprises may not be worth the time and effort given the limited advantages claimed that arise from withdrawal of the article 95 declaration.
A. Comparison of CISG and UCC

Professor Flechtner compares Article 2 of the Uniform Commercial Code unfavorably with the CISG. The former he characterizes as a law designed primarily for domestic transactions and a law that has not been updated in at least forty years. The latter, younger (not updated in only slightly over thirty) law, on the other hand, was drafted with the special needs of cross-border contracts for sale in mind. He deploys this comparison in two contexts. He first considers application of the article 95 declaration in U.S. courts, which he suggests “produces results that are arbitrary and counter-productive” or “arbitrary and sub-optimal.” Later he deploys the same contrast to rebut at least one of the justifications given by Appendix B of the Legal Analysis. In both contexts the only example of sub-optimality he gives is the presence in UCC Article 2 of trade terms (“price-delivery” terms) that are no longer consistent with practice. On most of these points, I have reservations.

Karl Llewellyn, the principal draftsman of UCC Article 2 (Sales), is turning over in his grave as Professor Flechtner writes. From the beginning, Llewellyn self-consciously introduced into Article 2 a number of rules for cross-border sales, especially those involving carriage by sea. Among these terms were trade terms, such as F.O.B. and C.I.F. He was well aware, however, that mercantile usage changes over time. His Code was to be “semi-permanent”: its provisions are to be read “to permit the continued expansion of commercial practices through custom, usage, and agreement of the parties.” He defined “agreement” of the parties to include usages of trade and provided a lengthy section elaborating on “usage of trade.” By agreement, a seller and a buyer may vary the effect of virtually all of the provisions in Article 2.

With these flexible Code provisions in place, Professor Flechtner’s objection to the price-delivery terms is of minor significance. The UCC

31. Fletchner, supra note 4.
32. Id.
33. Id.
34. Id.
35. Id.
36. Id.
37. Fletchner, supra note 4.
38. Here I must confess interest. I am presently at work on a history of the Uniform Commercial Code, which will bear out the statements asserted in this paper. Llewellyn alone, of course, is not responsible for drafting the Code but this paper refers to “his” text because his ideas were the principal sources for UCC Article 2.
39. These include, inter alia, all or part of UCC §§ 2-319 to 2-325, 2-504 to 2-506, 2-513, 2-514, 2-613 to 2-616, 2-707.
41. U.C.C. § 1-103(a)(2) (2014) (originally § 1-102(2)(b)).
42. U.C.C. § 1-201(b)(3) (2014) (originally § 1-201(3)).
43. U.C.C. § 1-303 (2014) (originally § 1-205).
44. U.C.C. § 1-302 (2014) (originally § 1-102(3)).
trade terms are expressly stated to be subject to agreement otherwise and the Incoterms® may be evidence of that usage when a term is used for ocean carriage—as U.S. courts appear to state when they enforce Incoterms® when the CISG applies to the sale.\textsuperscript{45} Moreover, the perceived defect has apparently not caused problems in practice.\textsuperscript{46} Digests of UCC cases list very few international trade cases where the Code trade terms have been interpreted by the courts.\textsuperscript{47}

In the absence of further examples of how the CISG deals with international sales in a more “optimal” way than UCC Article 2, it is difficult to assess Professor Flechtner’s conclusion that the CISG is superior. But it should be noted that in some respects the CISG is less “optimal.”\textsuperscript{48} The Convention’s treatment of documentary transactions in particular is cursory at best and sometimes inconsistent with established law and practice.\textsuperscript{49} For example, it is not clear that a seller presenting nonconforming documents has the general right to cure even after the time for tender of the documents.\textsuperscript{50} Similarly, fancy legal footwork is necessary to avoid the rule that risk passes at the time of tender of the documents while the goods are in transit, rather than at the time of shipment, which has been the established rule.\textsuperscript{51}

The Convention is also less receptive of trade usages than the Code when the parties have not expressly agreed to the usages.\textsuperscript{52} In response to delegations from developing countries who objected to being bound by usages created by developed countries, the 1980 diplomatic conference decided that unless a seller and buyer adopt usages\textsuperscript{53} they would only be bound by “a usage of which the parties knew or ought to have known and which in international trade is widely known to, and regularly observed by, parties to contracts of the type involved in the particular trade concerned.”\textsuperscript{54} Although it is now probably too late to challenge the decisions, U.S. courts have followed neither the letter nor the spirit of paragraph (2) when they have held that Incoterms® bind parties even though these courts have not

\textsuperscript{45}. See infra note 66 and accompanying text.
\textsuperscript{46}. Id.
\textsuperscript{47}. It is true that the unsuccessful revision of Article 2 a decade ago did propose to delete the trade term provisions (§§ 2-319 to 2-325) but the proposal was originally agreed to because of the alleged wide-spread use of Incoterms® and the perceived preference to leave definition of these terms to usages, whether or not codified.
\textsuperscript{48}. See, e.g., CISG, supra note 1, arts. 34, 48, 67.
\textsuperscript{49}. Id. art. 34.
\textsuperscript{50}. Id. art. 48.
\textsuperscript{51}. Id. art. 67.
\textsuperscript{52}. See id. art. 9(2).
\textsuperscript{53}. Id. art 9(1).
\textsuperscript{54}. Id. art. 9(2).
heard evidence that Incoterms® satisfy the detailed particulars of paragraph (2) in a particular case.\footnote{55}

In sum, in the absence of examples, the implication by my younger colleague that the age of a text reflects its likely obsolescence is not persuasive.

B. **Uncertainty in non-U.S. Courts**

Professor Flechtner writes that “[h]ow other contracting states that have not made the article 95 declaration will treat the U.S. declaration is profoundly uncertain.”\footnote{56} The case he has in mind is a dispute brought before a court in a Contracting State between a U.S. party and a party with its place of business in a non-Contracting State.\footnote{57} If the forum’s choice-of-law rules lead to application of U.S. law, must the forum apply the CISG?\footnote{58}

The resolution of this question turns on whether the forum concludes that the United States is a “Contracting State” within the meaning of subparagraph (1)(b) of article 1.\footnote{59} Commentators differ. Germany was, as Professor Flechtner points out, sufficiently concerned that it has declared that it will not consider the United States a Contracting State in such circumstances.\footnote{60}

No commentator, however, has cited a single case where this issue has arisen. A moment’s reflection will suggest several reasons why: the result will often be the same whether the CISG or the UCC applies and most disputes will be litigated where one of the parties is located. Smaller businesses with a single place of business are less likely to agree to incur the expense of going to a foreign neutral jurisdiction. Multinational companies with several places of business, on the other hand, are the very companies that will have planned ahead to address the issue of the applicable law. Moreover, U.S. and multinational companies often arbitrate disputes and arbitrators usually have more leeway in determining the applicable law if the parties have not specifically designated that law.

In sum, while the legal issue is real and its resolution uncertain, it is an issue of profoundly little practical significance.

C. **Trend to Withdraw Declarations**

The declaration authorized by article 95 is one of five “reservations” authorized by the Convention.\footnote{61} Professor Flechtner correctly notes that

56. Flechtner, supra note 4.
57. Id.
58. Id.
59. Id.
60. Id.
61. See CISG, supra note 1, arts. 92-96.
States that initially have made declarations under articles 92 and 96 have withdrawn, or contemplate withdrawing, them. He reports also hearing that China plans to withdraw its article 95 declaration. He could have added that very few States have made declarations under any of these articles and that no State has made a new article 95 declaration after becoming a Contracting State.

But what is the significance of this “trend”? Each of the five deals with a distinct issue. Withdrawing declarations under one provision is not necessarily a ground for withdrawing other declarations. In each case, a declaring State will weigh its particular interests with a general interest in the promotion of “uniform law.” The United States recognized these other interests when it made its declaration. The issue is whether that initial calculation was wrong or conditions have changed so that the desire for uniform rules outweighs these other interests.

In sum, the trend provides no answer to the issue of whether or not to withdraw. That other States are reviewing their declarations suggests that it might be timely for the United States to do so also. That other States have decided to withdraw their declarations under articles other than article 95, does not address the weighing of interests that the United States should go through when making a decision on whether or not to withdraw its declaration under that article.

VII. Must Senate Be Asked for Its Advice and Consent if It Is Decided to Withdraw the Article 95 Declaration?

As a matter of public international law, it is clear the United States may withdraw its declaration and what steps it must take to do so. What steps the United States must take as a matter of U.S. law, on the other hand, is less clear. Whether the Senate must be consulted appears to turn on whether the article 95 declaration is a “declaration” or a “reservation” for the purposes of U.S. treaty practice. If it is a reservation the Senate should be consulted.

62. Fletcher, supra note 4.
63. Id.
64. See CISG, supra note 1, arts. 92-96.
65. Fletcher, supra note 4.
66. Under both the 1969 Vienna Convention on the Law of Treaties and the CISG itself, the declaration may be withdrawn at any time. See Vienna Convention arts. 22 & 23(4); CISG supra note 1, art. 97(4) (“Any State which makes a declaration under this Convention may withdraw it at any time by a formal notification in writing addressed to the depositary. Such withdrawal is to take effect on the first day of the month following the expiration of six months after the date of the receipt of the notification by the depositary”).
67. Note 4 of the Reporters Notes to section 314 of the Restatement (Third) of Foreign Relations Law (1987) states: “4. Withdrawal of reservation. If the Senate consented to a treaty subject to a reservation by the United States, the President must request Senate consent to withdraw that reservation. See, e.g., the request for consent to the withdrawal of a reservation to
The CISG does not give a definitive answer. Article 95 authorizes a State to declare that it will not be bound by subparagraph (1)(b) of article 1.68 Article 97 refers to “declarations,” but article 98 refers to “reservations.”69

The Restatement (Third) of Foreign Relations Law adopts the definition of “reservation” found in article 2(1)(d) of the 1969 Vienna Convention on the Law of Treaties.70 That definition provides that a reservation is “a unilateral statement, however phrased or named, made by a State, when signing, ratifying, accepting, approving or acceding to a treaty, whereby it purports to exclude or to modify the legal effect of certain provisions of the treaty in their application to that State.”71 The article 95 declaration has the legal effect of excluding application of a provision of the convention—subparagraph (1)(b) of article 1—and fits clearly within this definition of reservation.72

Even if it is decided that Senate advice and consent is not necessary, there is a prudential reason for consulting the Senate: the withdrawal will displace the state-enacted Uniform Commercial Code more often. The number of such cases may be small but there should be a forum where the merits of withdrawal may be debated.

In sum, if withdrawal requires consulting the Senate, the advantages, if any, of withdrawal may not be worth the time and effort.

VIII. Conclusion

When Keith Loken asked me last summer for my advice on whether the United States should withdraw its CISG article 95 declaration, I responded off the top of my head that “I am less enthusiastic about withdrawing the declaration than Harry is but it is not a proposal I would lie down on the railroad tracks to stop.” The proposal, however, is certainly worth debating. If it is debated in October, I would hope that both pros and cons would be presented.” To my surprise, I was subsequently asked to be a member of the ACPIL panel discussing the topic.

68. CISG, supra note 1, art. 95.
69. CISG, supra note 1, art. 98(1) ("No reservations are permitted except those expressly authorized in this Convention.") (emphasis added).
70. Restatement (Third) of Foreign Relations Law § 313, cmt. a (1987). This comment directs the reader to Comment b of section 314 for a distinctive use of the term by the Senate. The latter comment states that the president must include any condition ("reservation, statement of understanding, or other declaration relevant to the application or interpretation of the treaty") included in the Senate resolution of consent when the president deposits the U.S. instrument of ratification. It goes on to say that if the condition is a reservation then the reservation is the supreme law of the United States. By negative implication, the comment suggests that a Senate condition other than a reservation is not "law" within the meaning of Article VI, clause 2, of the federal constitution.
72. CISG, supra note 1, art. 95.
Even more to my surprise, I found that when I sat down to write my comments I slipped easily into the con side of the debate—although I still would not lie down on the railroad tracks. The justifications given for making the U.S. declaration remain valid although their practical significance has greatly diminished with widespread adoption of the CISG. It continues to be unfair that withdrawal of the declaration would displace U.S. domestic state law more frequently than foreign law. The business community is not lobbying for change. If the Senate must be consulted, the time and effort that this would take outweighs the practical value, if any, of withdrawal. It may be aesthetically pleasing to remove carbuncles on uniform laws but this carbuncle is—like the smile of the Cheshire cat—fading away.
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