a deposit account in one form or another. Their readiness to accept deposits is the only way of distinguishing banks from other financial institutions. The landmark case of *Foley v Hill* demystified the legal nature of the banker-customer relationship[2] by looking at the moment when a deposit could be treated as the banker's money. Specifically this looked at whether the bank had a right to use deposits to finance its lending business and then simply return an equivalent amount (plus interest) to the customer, or if the bank was under an obligation to keep the deposit in a vault and return the very same notes and coins on demand. If the House of Lords had suggested the latter then it would have halted the development of the banking system forever. The payment of the deposit into the account was instead explained as follows:

> money placed in the custody of a banker is, to all intents and purposes, the money of the banker, to do with it as he pleases; he is guilty of no breach of trust in employing it; he is not answerable to the principal if he puts it into jeopardy, if he engages in a hazardous speculation; he is not bound to keep it or deal with it as the property of the principal; but he is, of course, answerable for the amount, because he has contracted, having received that money, to repay to the principal, when demanded, a sum equivalent to that paid into his hands.[3]

6.006 This case not only established the debtor and creditor relationship,[4] but also a customer relationship with specific terms and conditions. A deposit is merely a debt owed to the customer by the bank to repay the deposit on the customer's demand in accordance with the specific terms and conditions of the contract.[5] This debtor and creditor relationship underpins the entire banking system in all parts of the world and creates an unsecured debt. If the bank becomes insolvent, the depositor ranks as an unsecured creditor, and therefore, he or she may only receive payment after preferred and secured creditors have been satisfied in full. To a bank, the deposit represents a liability on its balance sheets as well as being a contractual claim against the bank. This concept has legal and accounting implications on payments that use bank deposits because in reality, no money changes hands when a bank receives an instruction to transfer an amount of money to a third party. What a bank does is to reduce the deposit credit balance (in legal terms, the debt towards the customer is reduced) while the other party's balance increases (in legal terms, the debt owed to the counterparty by his or her bank is increased). At a later stage, the two banks will reconcile their positions among themselves. Every time an account balance goes up or down is a mere reflection of a decrease or increase of the debt owed to the customer by the bank.

6.007 The timing of acceptance or the point in time which constitutes the taking of a deposit plays a crucial role in the passing of ownership or title.[6] Thus, if a bank is robbed whilst a depositor is depositing a substantial sum of cash and the cashier is still

2 *Foley v Hill* 9 ER 1002.

3 *Foley v Hill* 9 ER 1002.

4 The customer being the creditor and the bank being the debtor. He or she is not entitled to enquire about the use of the deposited funds.

5 *Foley v Hill* 9 ER 1002.

6 *Balmoral Supermarket Ltd v Bank of New Zealand* [1974] 2 Lloyd's Rep 164.

in the process of counting the deposit, the uncounted money remains the customer's money, as the bank has not indicated its acceptance of it.[7]

6.008 This relationship would normally subordinate the banking contract to the law of the repayment of debts. The general law stipulates that the debtor must seek out the creditor and fulfil his obligation to him. It is unrealistic for the law to oblige the bank to seek out the customer at his home or business address to repay the deposit. In this relationship, the customer must present himself in the branch or any other contractually defined location to demand the repayment of the deposit. The strict application of the general law of debts would create a serious strain on this debtor and creditor relationship. Also, to ask for the repayment of the debt at any time or place is unrealistic. It was therefore sensible in terms of business efficacy to introduce certain rules applicable to the banker-customer relationship that would normally not apply in the context of a normal debtor-creditor relationship. Thus, in the case of *Joachimson v Swiss Bank Corporation*,[8] it was held that the obligation towards to the customer is not a simple debt but rather a debt for which a demand for repayment has to be made by the customer at the branch where the account is kept, and during normal business hours unless the parties agree otherwise. Although this was inconsistent with the general law of debts, it was dictated by practical business necessity.

6.009 Other than safekeeping and saving, bank deposits are a basis for making payments to third parties. Bank deposits are liquid and readily available, and, therefore, play an important role in the payment system. For example: Mike deposits $100 in his bank account with HangJames Bank., Mike also has a debt of $80 which he must repay to his friend Tom. A simpler and more efficient way of paying the obligation is to ask HangJames Bank to debit $80 from Mike's account to a bank account held by the payee Tom. HangJames Bank thus reduces the debt owed to the Mike while it credits Tom's account with $80. After the transaction is complete, the debt owed to Mike by HangJames Bank is reduced by $80. From a legal perspective, it is clear that Mike and HangJames Bank could make a special agreement that the debt owed to the customer by the bank in the form of the deposit can be repaid by transferring the funds to another account on Mike's request. This is a perfectly valid contractual agreement under common law.[9]

6.010 In July 2003, the sum total of US Dollars held in deposits in approximately 10,000 local and national depository institutions in the US was in excess of $5 trillion. A bank does not keep its deposits under the mattress. Funds flow domestically and internationally from savers to borrowers, who generally tend to be entrepreneurs and others in business who need capital to expand businesses, both at home and overseas. Deposits become an important source of this financial chain providing the raw material for these objectives. The second economic function relates to payments. A well-functioning bank requires a convenient and secure payment system. To this end, deposits are used as value for the performance of payments. Instead of visiting a

7 *Balmoral Supermarket Ltd v Bank of New Zealand* [1974] 2 NZLR 155.

8 [1921] 3 KB 110.

9 In the case of *N Joachimson v Swiss Bank Corporation* [1921] 3 KB 110 held that such special arrangement is implied The rationale being that the bank borrows the proceed and undertakes to repay them and that includes a promise to repay any part of the amount due against the written order of the customer addressed to the bank. The customer on his part undertakes to exercise reasonable care in executing his written orders so as not to mislead the bank or to facilitate forgery.

branch to take out cash to pay an electricity bill, the secured and stable infrastructure of the banking system does this by the mere adjustment of the balances of the two bank accounts. The customer's credit balance will be reduced while the bank's credit will be increased. In other words, the bank's liability to the customer is reduced. Where the customer and the electricity company have deposits with different banks, the customer will instruct the bank to reduce the credit balance, and in turn the customer's bank will instruct the electricity company's bank to increase the company's balance. In either situation, no physical exchange of money occurs while the payment is performed through consecutive adjustments and entries in the books kept by the banks. The legal framework governing the transfer of funds through the banking system will be discussed in detail in subsequent chapters.

6.02 BANKER-CUSTOMER RELATIONSHIP

6.011 The banker-customer relationship is simply a contractual relationship.[10] In this way, the customer enjoys the protection of some general rights by the law of contract. The technical term 'banker-customer' relationship refers to the special framework of a legal relationship which is established from the moment a bank account is opened.[11] In common law, the legal relationship of rights and obligations is established when a party opens and a bank accepts the opening of the bank account.[12] This is the case regardless of whether the customer continues to have further transactions with the bank. The mere opening of an account by a person confirms that person, be it a natural or a legal person, as a customer of the bank.[13] Therefore, habitual dealings are not a requisite requirement to sustain an argument about the status of being a customer of a bank. Contrary to the above, a casual service for a given person does not mean that the person is a customer, even if the services are sought on a regular basis.[14] The distinction arises because the person seeking these regular services does not maintain an account with the bank. Although the case where this occurred was actually contested within the ambit of the Bills of Exchange Act Section 82,[15] it nevertheless provides a useful analysis of the definition of a customer. In accordance with this Section of the Act, to make a person a customer of a bank, 'there must be some sort of account, either a current or a deposit account, or some similar relation'.[16] One case where this was seen was *Great Western Railway Co v London & County Banking Co*. H, having obtained a cheque from the appellants crossed "& Co." and marked "not negotiable" under false pretences, had taken it to the respondent bank.[17] The bank, at his request, paid part of the amount of the cheque into the account of one of their customers and handed the balance to H.[18]

10 M. Hsiao, *International Banking and Finance Laws: principles and regulations* (Sweet & Maxwell Thomson Reuter, HK 2011) p36.

11 *Ladbroke & Co v Todd* [1914-15] All ER Rep 1134; *Woods v Martins Bank Ltd and Another* [1959] 1 QB 55.

12 *Woods v Martins Bank* [1959] 1 QB 55.

13 *Ladbroke & Co v Todd* [1914-15] All ER Rep 1134.

14 *Great Western Railway Co v London & County Bank Co* [1901] AC 414.

15 1882.

16 *Great Western Railway Co v London & County Bank Co* [1901] AC 414.

17 *Great Western Railway Co v London & County Bank Co* [1901] AC 414.

18 *Great Western Railway Co v London & County Bank Co* [1901] AC 414.

After the respondents had received payment of the cheque from the bank on which it was drawn, H's fraud was discovered, and the appellants sued the respondents for the amount.[19] It was found that the respondents had received the payment in good faith and without negligence.[20] They had for years been in the habit of cashing cheques for H in a similar manner. He had no account or pass-book with them. Therefore, the House of Lords held that H was not a customer of the respondents, and that they did not receive payment of the cheque from him within the meaning of the Bills of Exchange Act 1882 Section 82. Naturally, the provisions with the Section do not afford him protection.[21] Therefore, an agreement to open an account in a person's name is deemed consent to enter into a regular business or personal relationship with a customer. The type of account opened or whether the account is overdrawn is immaterial.[22]

6.012 The definition of customer is also a key issue to the banking fraud case on the basis that there was no meeting of minds despite an account being opened. This is sometimes used as an alternative rebuttable defence. In the situation where an account is opened with a false mandate, the customer relationship is *void ab initio* due to lack of authorisation.[23] For example, where A forges G's signature to open an account in a third party's name, B, without authorisation, there cannot be a legal relationship of banker and customer between B and the bank.[24] Therefore, the moment at which an account is opened requires a meeting of minds or the identification of the real customer for it to constitute an actual customer.[25]

6.013 To open an account in the name of another or others requires consent being given tacitly before or after the event. The bank must identify its real customer.[26] This normally occurs when a foreign account is opened. The principle is that B, in whose name the account is to be opened, is A's nominee, and A is the customer.[27] In the case of *Rowlandson v National Westminster Bank Ltd*,[28] the bank was in breach to the customers (the grandchildren), whose account was opened by their grandmother (their nominee). Mrs M wished to give four of her grandchildren, the plaintiffs, who were minors, £500 each. Accordingly, two weeks before her death, she wrote out cheques for £500 for each of them but did not insert the date. On the same day, accompanied by her son M, who was the plaintiffs' father, she took the four cheques to a branch of the defendant's bank where she introduced M and instructed the bank to place the cheques on deposit for the plaintiffs. She did not specify in detail what she wanted done or how it was to be done. Neither Mrs M nor M nor any of the plaintiffs had an individual account at that branch but there were accounts held there by other members of the family, including "account 357" in the name of another son, A. On 18 July, the bank opened "account 608", which it described as a "trust account" for the plaintiffs, in the name of A and a third son, G. The four cheques were credited to that account.

19 *Great Western Railway Co v London & County Bank Co* [1901] AC 414.

20 *Great Western Railway Co v London & County Bank Co* [1901] AC 414.

21 *Great Western Railway Co v London & County Bank Co* [1901] AC 414.

22 *Clarke v London & County Banking Co* [1897] 1 QB 552.

23 *Stoney Stanton Supplies (Coventry), Ltd v Midland Bank Ltd* [1966] 2 Lloyd's Rep 373.

24 *Stoney Stanton Supplies (Coventry), Ltd v Midland Bank Ltd* [1966] 2 Lloyd's Rep 373.

25 *Stoney Stanton Supplies (Coventry), Ltd v Midland Bank Ltd* [1966] 2 Lloyd's Rep 373.

26 *Rowlandson v National Westminster Bank Ltd* [1978] 3 All ER 370.

27 *Rowlandson v National Westminster Bank Ltd* [1978] 3 All ER 370.

28 *Rowlandson v National Westminster Bank Ltd* [1978] 3 All ER 370.

may generate another risk because of the time difference.[11] This risk of settlement in between the time difference has been referred to as the Herstatt risk, which derived from a German bank that collapsed just before the US market opened.[12] The party in the US suffered a counter-party settlement risk due to the difference in time zone.[13]

10.004 A payment method called 'Payment vs Payment' (PVP)[14] was invented to overcome this risk for foreign exchange transactions. It operates simply on the basis that one currency would be delivered against another currency simultaneously only if that currency was available. Therefore its name 'Payment vs Payment' is self-explanatory.[15] As to the sheer volume, settlement normally takes place at the end of the business day purely on the administrative and computing purpose. The cumulative claims will be computed by system operators to generate an amount owed by and to each participant banks. These amounts are netted off on a multilateral basis resulting in a situation where each bank either owes a single amount or is owed one single amount. This reduces the volume of payments and gross exposures. Normally, the financial institution which operates the payment system is referred to as the settlement agent, or clearing house. However, each of these roles varies slightly in function. The settlement agent is where participants keep settlement accounts while a clearing house calculates the net position of the participants and notifies them accordingly.

10.005 Once a cross-border element is introduced into the settlement transaction, the legal position becomes more complex. For example, if a Hong Kong bank is to make payment in US dollars for a payee in a German bank, at least three different jurisdictions could become involved. Hong Kong law would govern the insolvency of the Hong Kong bank, German law would do the same on the German bank, and New York law would govern the US dollar settlement.

(a) Legal risk

10.006 The risk in the payment system is no different to the risk of a bank collapse in a particular market. Such risk if it occurs will lead to systemic risk if a large sum of payment failed to go through and the knock-on effect extends and spreads. Insolvency could be attributed to this risk of non-payment. However, prior to the insolvency the failed participant would have some form of assets. Therefore it matters if the law on the payment system could overcome the insolvency law to deal and maintain a regular netting process. In other words the system risk can be dealt with or minimised if the law of payment overrides the insolvency law.[16] The European Union has been a keen

[11] C K Y Ho, 'Renminbi Cross-Border Payment Arrangement' (2010) 25 Banking and Finance Law Review 435.

[12] C K Y Ho, 'Renminbi Cross-Border Payment Arrangement' (2010) 25 Banking and Finance Law Review 435.

[13] M. Hsiao, *International Banking and Finance Law: Principles and Regulations* (Sweet& Maxwell Hong Kong 2011) 14.001-14.48.

[14] E. McKendrick(ed), *Goode on Commercial Law* (4th edn Penguin Books 2010).

[15] P. Wood, *Law and Practice of International Finance* (1st edn Sweet & Maxwell London 2009).

[16] Clearing and Settlement Systems Ordinance (CSSO) (CAP 584) 2004 provides that a finality order overrides the insolvency rules.

player in ensuring that the default rules of the settlement system overrides insolvency rules to produce settlement finality.[17]

10.007 The credit risk in a payment system concerns every payee participant because it leads to liquidity risk and systemic risk. Liquidity risk is merely a shortfall in the amount of cash that the bank that was expecting in receiving the payment.[18] The payee participant has to look for alternatives. Systemic risk is thus triggered by a participant's default in the payment system that leads to liquidity problems for one or more other banks in the system and could ultimately cause another bank to default. However, the clearing and settlement system may itself run dry on a particular currency to clear, which forms another liquidity risk.[19] This systemic risk can extend to a foreign exchange transaction because of the risk of the replacement cost involved that one of the banks may default in between the date of agreement and the date of settlement.[20] The relevant currency could have fluctuated in value, and then the non-defaulting party is left with the risk of a loss.

(b) Legal Considerations

10.008 The fundamental issue is whether the point in time a bank is obliged to pay is legally recognised. The legal position of netting is itself of concern especially within a jurisdiction that has no legislative effect to recognise it.[21] The question is whether netting, be it bilateral or multilateral, is effectively recognised under the insolvency law of a defaulting bank or other law. There is the notion of the zero-hour rule which means that in some jurisdictions the timing of insolvency is back-dated to the beginning of the day on which the court order took effect, with the possible result that payments made the same day but before that decision are invalidated.[22] Insolvency is the invalidation of preferences or transactions at undervalue. In a typical common law jurisdiction, at the time of insolvency the relevant transactions would be dated back to two years before and it would be determined whether such transactions were given as a preference or undervalue at the time.[23] Conflicts of law are another concern in the international payment system, where multiple jurisdictions are involved in the transaction concerned.[24]

[17] The Settlement Finality Directive lays down a general rule about what law should be applied if a participant in a (designated) payment or securities settlement system fails. Article 8 states: "In the event of insolvency proceedings being opened against a participant in a system, the rights and obligations arising from, or in connection with, the participation of that participant shall be determined by the law governing that system". This, of course, applies only to direct participants in designated systems, and only in the EU context. It does not apply outside the European Union.

[18] C K Y Ho, 'Renminbi Cross-Border Payment Arrangement' (2010) 25 Banking and Finance Law Review 435.

[19] In such case, the HKMA has extended an agreement with the PBOC on a RMB Swap liquidity support to the Hong Kong CMU.

[20] M. Hsiao, *International Banking and Finance Law: Principles and Regulations* (Sweet& Maxwell Hong Kong 2011) 14.001-14.48.

[21] Clearing and Settlement Systems Ordinance (CSSO) (CAP 584) 2004 cf to the EU and UK Settlement Finality Directive 1998, art.3(3) 'No law, regulation, rule or practice on the setting aside of contracts and transactions concluded before the moment of opening of insolvency proceedings…shall lead to the unwinding of a netting.'

[22] Clearing and Settlement Systems Ordinances (CSSO) (CAP 584) 2004 dealt with this in line with the U.K and European directive.

[23] Clearing and Settlement Systems Ordinance (CSSO) (CAP 584) 2004 has taken into account of this under the Companies Ordinance and Bankruptcy Ordinance.

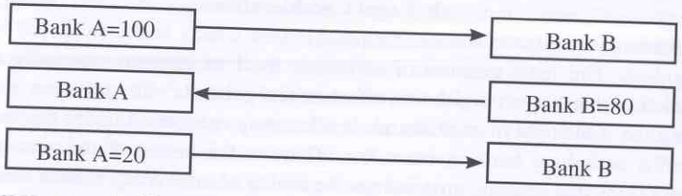
[24] Clearing and Settlement Systems Ordinance (CSSO) (CAP 584) 2004, s26(1)(a)-(b).

(c) Payment Obligations

10.009 The first thing to look at to determine liability is the terms of the contract. Another consideration is whether there was a master agreement governing multiple payment obligations. The cut-off point is normally when a payee's bank receives instructions to credit from the payor's bank. This follows the contract law principles of payment instruction whereby the payment instruction is revocable until the payee's bank acts on it, namely by crediting the payee's account. This also extends to the intermediary banks that are involved in the payment instruction. In foreign exchange transactions, the position is different because it concerns a different contract to deliver currency. There is thus an obligation on each bank from the outset.

(d) Netting

10.010 Netting is, nowadays, a paramount basis in payment systems. For example, on a purely bilateral basis, if Bank A is due to pay 100 to Bank B, and Bank B is due to pay 80 to Bank A, then netting would result in a single payment of 20 by Bank A to Bank B.



Source: M. Hsiao, *International Banking and Finance Law: Principles and Regulations* (Sweet& Maxwell Hong Kong 2011) 14.001-14.48

10.011 Bank B's exposure to Bank A is only 20. However, if netting was not effective in the event of the failure of Bank A, then Bank B would have to pay 80 to claim the 100 which Bank A owed Bank B. On the assumption that upon Bank A's liquidation, Bank B can receive half of its claim, namely 50. Bank B therefore ends up with a net loss of 30 which is a result of the 80 original obligations less half of the 100 claim. On the contrary, if the netting is recognised by the insolvency law, then the half of the 20 netted off resulting in a loss for Bank B of only 10 (20-10). On a multilateral netting structure, each bank ends up in a net-net position that represents the difference between the total amount to pay and the total amount it is due to receive. The effect of this net-net position reduces the number of individual payments that might be required.

10.012 Bilateral[25] netting is acceptable in many individual jurisdictions, while multilateral[26] netting is generally not regarded as valid in the case of insolvency because it involves using an asset of an insolvent company to pay another party's debt. Cross-border payment provides further doubt on the bilateral netting because it may be

[25] E. McKendrick(ed), *Goode on Commercial Law* (4th edn Penguin Books 2010) p511: in a bilateral settlement such as CHATS, a participant's entitlement or exposure is by agreement with its counterparty, measured solely by reference to its net position with that counterparty, not by reference to the system as a whole, though for administrative convenience it is the multilateral (net net) balances which are established at the end of the day and paid by transfers in the book of the CMU.

[26] E. McKendrick(ed), *Goode on Commercial Law* (4th edn Penguin Books 2010) p511: in a multilateral settlement, such as that used in the paper-based clearings, each participant's position is established in relation to all other participants in the clearing, that is, in relation to the system a s w hole, under the rules of the clearing by which participants are bound. Thus each participant ends up as a net-net debtor or a net-net creditor in relation to all other participants with whom it has dealt during the day and settlement.

recognised by the governing law of contract but not recognised by the applicable law to the insolvency of the failed bank where the payment obligation should be performed. Another potential risk derived from insolvency law is that the respective laws permit the liquidator to select or cherry pick which claims to continue – normally a favourable contract to the liquidator.[27]

10.013 Netting is not without legal issues because it is legally absent from some jurisdictions. The above is a clearing system based on an economic perspective of netting to generate a single amount. However, the legal rationale on this basis is absent or in other words, there is a lack of a legal concept to support this method other than that of economic benefit. Some of the jurisdictions may not have such a legal concept in netting, while some of the jurisdictions have amended legislation to accommodate this mechanism via insolvency law.

10.014 With the jurisdictions that do not have such legal concept, a set-off legal concept is misconceived as net-off. However, the two are distinguishable. Netting is a termination and valuation of rights before set-off kicks in to produce a single amount due. Moreover, set-off would normally have one party holding the assets of the counterparty with whom he seeks to offset the obligation. In contrast, in the netting structure, two parties may not have assets or collaterals held against each other in the executory contract. What netting effectively does is to value each party's executory value to the effect to terminate. Hence, the value will produce a difference as to which party is required to pay. It is this stage that has the analogy to the set-off with single difference among their obligations, unlike the set-off right, which is normally known as an alternative securities charge or collateral. In essence, netting is the difference in debt contracts: the obligation of the parties under the contract are not vested assets because the parties' obligations will be measured on the basis of the profits and losses arising from the measurement in order to proceed to set-off, which will produce a single amount payable by either party (this form of netting is a close out). Therefore, contractual set-off is not netting for numerous reasons. First, contractual set-off is an agreement that a mutual payment obligation may be set-off to reduce or eliminate the amount due to be paid.[28] Second, set-off does not terminate obligations, whereas netting provides that mutual payment obligations are terminated, and replaced with a single payment obligation. In short the distinction between set-off and net-off is that the former arose out of a mutual previous obligation, while the latter does not necessarily arise from a mutual previous obligation.[29] However, in most of the advanced markets like UK, HK, US, and Europe, the settlement systems in the respective regions seem to have adopted the economic structure of netting, and are largely identical in their legislation making.

[27] Lehman Bro Insolvency case across the globe in the U.K., U.S and Hong Kong as to the exercise of disclaiming the encumbered contract by the liquidator.

[28] Chapter thirteen.

[29] Chapter thirteen.

encouraged by the law to hedge.[9] The distinctive factor of the derivatives contract is the nature of its off balance sheet character. It is off balance sheet owing to the essence of its term that the future event or maturity will not be materialised today, and that the value at the future date (maturity) will not reflect upon the date of the contract. Therefore its value is represented at a nominal value. Due to this nominal or executory nature, it may not be taken as finalised value simply it may require future adjustment, but more because it is misleading to investors. However, some international organisations such as Basel have recommended alternative methods over this in banking book records[10] as mitigation with nominal value.

15.02 LEGAL STRUCTURE OF AUTHORISATION

15.003 Derivatives are certainly based on contract and the law of contract governs. However, the nature of the entity's business may have impact on the enforceability of the derivative contract. This section will first illustrate the organising principle of authorisation of the OTC derivative transaction in the context of ordinances and demystify the rationale behind it with common law cases. It is little surprise to anyone that a bank transacts derivatively very often and is required to do so to manage its assets portfolio. However, not many are aware of the legal authorisation. Authorised institutions (AIs) under the Banking Ordinance (Cap 155)[11] consist of three types: (a) bank (b) a restricted-licence bank or (c) a deposit-taking company.[12] Their power to conduct business is largely restricted to banking business and deposit taking.[13] Authorised institutions are permitted to enter a derivative contract because regulatory exclusion applies to the Gambling Ordinance (Cap 148) in any transaction proposed to be entered into by the AI. Section 137A of the Banking Ordinance (Cap 155)[14]explicitly states that the Gambling Ordinance(Cap 148)[15] shall not apply to any transaction proposed to be entered into, or entered into by an authorised institution.[16] This section has an implied term to the nature of the transaction entered into or proposed to enter into by the AIs in that it may incidentally resemble gambling or a wagering contract or such like. Consequently if an AI enters into a contract that incidentally falls foul of the nature of gambling, it would not be *void ab inito* or rendering restitution[17] in application.

9 Chinese Provisional Administrative Rules Governing Derivatives of Financial Institutions 2004 (Amendment 2006) was brought into force with two aims: hedge banking assets and for end-user (speculation). See also Lynn A Stout, 'Derivatives and the Legal Origin of the 2008 Credit Crisis'(2011) 1 (1) Harvard Business Law Review argued that the common law of contract for difference originated from the gambling, and extended to the insurance on the basis of social policy to hedge or protect against lost, then subsequently to the financial market. In sum, the crisis was change of law to permit derivatives.

10 Basel II Recommendation see at http://www.bis.org/list/bcbs/tid_22/index.htm accessed on 12 July 2012.

11 Banking Ordinance (Cap 155).

12 Banking Ordinance (Cap 155) s2.

13 See chapter two and also see D. Roebuck, DK Srivastava, HM Zafrullah & S. Tsui *Banking Law in Hong Kong Cases and Materials* (2nd edn LexisNexis Hong Kong 2009).

14 Banking Ordinance (Cap 155) s137A.

15 Gambling Ordinance (Cap 148).

16 Having the means of s2 of Banking Ordinance (Cap 155).

17 *Westdeutsche Landesbank Girozentrale v Islington LBC* [1996] AC 669, the restitution applied to the derivative contract.

15.004 In common law jurisdictions, contract law treats[18] a gaming, betting or wagering contract as null and void for public policy reasons, except where permitted by the Gambling Ordinance (Cap148).[19] The definition of a gaming contract is a matter of case law. *Carlill v The Carbolic Smoke Ball*[20] made a clear definition for a gaming contract as being where "two persons, professing to hold opposite views touching the issue of a future uncertain event, mutually agree that, dependent upon the determination of that event, one shall win from the other a sum of money." The spectrum of the gaming definition is arguably the origin of derivative contracts. Thus an exemption has to be made through ordinance.[21]

15.005 The Gambling Ordinance(Cap 148)[22] explicitly provides an exemption to a contract for difference,[23] which is listed on any specified stock exchange or traded on any specified futures exchange under the meaning of Securities and Futures Ordinance (Cap 571) (SFO).[24] The SFO has its own definition of a contract for difference as being an agreement the purpose or effect of which is to obtain a profit or avoid a loss by reference to fluctuations in the value or price of property of any description or in an index or other factor designated for that purpose in the agreement.[25] The authorisation mechanism is clear that had it not been an exclusion clause in the Banking Ordinance (Cap 155) and an exemption clause in Gambling Ordinance (Cap 148) to contract for difference, the derivative contract would be voided for not being an authorised or licenced activity. Therefore, the common law case illustrates the nature of the contract is gambling or wagering, yet the change of the law through ordinances permits such a contract.[26]

15.006 A gambling contract can be for a good purpose that public policy would support, namely insurance. One of the purposes of using a derivative contract is to hedge the position. Thus, the derivatives that fall into this function are largely referred to as credit derivatives. The issue is can authorised institutions enter or offer an insurance contract or credit derivatives without an insurance licence or authorisation? On the same flow

18 Lynn A Stout, 'Derivatives and the Legal Origin of the 2008 Credit Crisis'(2011) 1 (1) Harvard Business Law Review.

19 Gambling Ordinance (Cap 148).

20 *Carlill v The Carbolic Smoke Ball Co* [1892] 2 QB 484.

21 Banking Ordinance (Cap 155) s137A.(1) subject to subsection (2) the Gambling Ordinance (Cap 148) shall not apply to any transaction proposed to be entered into, or entered into, by an authorized institution. S137A(2) subsection (1) shall not apply to a transaction, or a transaction belonging to a class of transactions, specified by the Monetary Authority by notice n the Gazette as being a transaction, or a class of transactions, as the case may be, to which that subsection shall not apply. Cf this to the s412 of Financial Services and Markets Act 2000 (UK), contract falling within the section are not void or unenforceable because of Gaming Act. The definition of contracts which are by s412(2) that a contract if (a) is entered into by either or each party by way of business; (b) the entering into or performance of it by either party constitutes an activity of a specified kind or one which falls within a specified class of activity (c) it related to an investment of a specified kind or one which falls within a specified class of investment.

22 Gambling Ordinance (Cap 148) s29 this ordinance shall not apply to any contract for differences which is listed on any specified stock exchange, or traded on any specified futures exchange, within the meaning of section 1 of Part 1 of Schedule 1 to the Securities and Future Ordinance (Cap 571), save to the extent that this Ordinance applies to the contract by virtue of section 404(2) of that Ordinance.

23 Geoffrey Morse, 'Taking derivatives into account'(1996) JBL 613-616.

24 Securities and Future Ordinance (Cap 571) and Gambling Ordinance (Cap 148) s29.

25 Gambling Ordinance (Cap 148) s2 Ordinance Interpretation on contract for difference.

26 This analysis is an identical argument of Professor Lynn A Stout at her paper Lynn A Stout, 'Derivatives and the Legal Origin of the 2008 Credit Crisis'(2011) 1 (1) Harvard Business Law Review.

of logic, Part VIII of the Insurance Companies Ordinance (Cap 41)[27]exempted certain persons from the provision of the Ordinance and an AI is one of the entities on the list.[28] This exemption also extends to the person authorised under the Securities and Futures Ordinance(Cap 571).[29] This reflects the nature of the financial derivatives contract that is potentially at risk of being construed to be an insurance contract. The case of *Prudential Insurance Company v IRC*[30] defines the common law insurance to provide for the payment of a sum of money to meet the loss or detriment which will or may be suffered upon the happening of the event. The following passage of the case judgment forms a good summary of what is the operating nature of an insurance contract:

> ''What you do insure is that a sum of money shall be paid on the happening of a certain event. It must be a contract whereby for some consideration, usually but not necessarily the payment of a sum of money upon the happening of some event. Then the next thing that is necessary is that the event should be one which involves some amount of uncertainty. There must be either uncertainty whether event will ever happen or not, or if the event if one which must happen at some time there must be uncertainty as to the time at which it will happen. A contract which would otherwise be a mere wager may become an insurance by reason of the assured having an interest in the subject matter that is to say, the uncertain event which is necessary to make the contract amount to an insurance must be an event which is *prima facie* adverse to the interests of the assured."[31]

15.007 The common law definition of insurance is based on the social policy that someone's loss will be covered by someone else, which would otherwise fall on the state to deal with.[32] This encouragement by law to look after one's own affairs for loss resembles a hedge position.

(a) Hedge or Speculation

15.008 Hedge is an alternative name for risk management. Where a party is exposed to Hong Kong interest rates, a derivative can be employed to generate an amount of income which will offset any loss suffered from movements in interest rates. This matching of income and risk is known as hedging. The characteristic of this structure is achieved

[27] Insurance Companies Ordinance (Cap 41).

[28] Insurance Companies Ordinance (Cap 41), s51 the following persons are exempted from the provisions of this Ordinance (f) any authorized institution within the meaning of section 2 of the Banking Ordinance (Cap 155) to the extent only that such institution caries on insurance business of the nature specified in class G or H, or classes 16 and 17, or comprised in groups 1,7 and 11 in the First Schedule solely for the purposes of its banking business or deposit-taking business, as the case may be.

[29] Securities and Futures Ordinance (Cap 571) and Insurance Companies Ordinance (Cap 41), s51 the following persons are exempted from the provisions of this Ordinance (i)) a person who is authorized under Part III of the Securities and Futures Ordinance (Cap 571) to provide automated trading services within the meaning of Schedule 5 to that Ordinance only to the extent that it guarantees the settlement of transactions in securities or futures contracts as defined in section 1 of Part 1 of Schedule 1 to that Ordinance.

[30] *Prudential Insurance Co v Inland Revenue Commissioner* [1904] 2 KB 658.

[31] *Prudential Insurance Co v Inland Revenue Commissioner* [1904] 2 KB 658.

[32] Lynn A Stout, 'Derivatives and the Legal Origin of the 2008 Credit Crisis'(2011) 1 (1) Harvard Business Law Review.

by a product which will increase in value if the underlying risk generates a loss. For instance, a rise in interest rates may generate a loss in increased interest charges on bank debt, whereas an equity product might rise in value in line with increased rates. Buying into the equity in sufficient quantities will offset the loss caused by the rise in interest rates. Shielding against market movements is another function where derivative is employed. Purchasing the products will enable a market participant to guard against movement in any obligation or exposures which it owes as part of its commercial operations.[33] Hedging is also used to reduce the credit risk of the loan assets on the bank portfolio.[34] Rather, on the flip side of the insurance,[35] the wagering has connotations of a speculative act the nature of which arises from products enabling an investor to mimic the result of a reading on an underlying financial market by entering into an off market transaction with a financial institution. A person can obtain an investment type contract to bet on the index without actually having to buy shares in the companies listed in that index.[36]

15.009 In the early 1990s, the derivative contract had been tested and examined in the common law system and generally one side of the group of parties to the contract are local authorities or councils. The swap contracts that they entered into with the banks were in the commercial intention to improve their debt exposure while generating some collateral income. Those contract holders were sued by the authorities with "no other interest than seeking to profit from interest rate fluctuations."[37] The derivative transaction is primarily speculative because it amounts to a contract for difference. The interest rate swaps are not void gaming contracts on the basis that they are used for a commercial purpose in connection with the regulatory exemption.[38] However before reaching this, their lordship had found at least potentially a speculative character deriving from the fact that the obligations of parties were to be ascertained by reference to a fluctuating market rate, which may be higher or lower than the fixed rate at any time.[39] This identification of a speculative intention may render the derivative unenforceable against certain entities, particularly on a local authority. In light of the common law context, the derivatives contracts are regulated activities and the status of the entity that enters into the contract may render the contract void. However the provider of the contracts is normally exempted by their financial authorisation, which would otherwise be illegal.

[33] This is an example of Nicola Leeson's index trading against Japanese Nikki in mid 1990s. A relatively recent situation of loss was the Societe Generale in 2008, least so in Hong Kong context; see also *Fu Kor Kuen Patrick v HKSAR* [2012] 5 HKC 189.

[34] China, a particular case, is an example that specifically opens the derivatives market to the financial institution to hedge their asset portfolio. See Chinese Provisional Administrative Rules Governing Derivatives of Financial Institutions 2004 (Amendment 2006).

[35] S Edwards, ' The law of credit derivatives' (2004) JBL 617-655.

[36] Advantage being no registration or other costs involved, nor is the transaction subject to public scrutiny.

[37] Per Lord Templeman in *Hazell v Hammersmith & Fulham [1992] 2 A.C* 1.

[38] At the time of 1980s, the statutory provides exemptions to bank to offer something incidentally to the gaming or wager and insurance, s63 of the Financial Services Act 1986 and Per Hobhouse J in *Morgan Grenfell & Co Ltd v Welwyn Hatfield DC* [1995] 1 All ER 1.

[39] Per Hobhouse J in *Morgan Grenfell v Welwyn & Hatfield DC* [1995] 1 All ER 1.

(b) Counter Party Legal Capacity and Knowing Your Client

15.010 This can be a vexatious area of law in an international market, where a check on individual parties' legal capacity shall be carried out. Otherwise the contract between the parties will be void for lack of capacity. For example, it was held in *Hazell v Hammersmith and Fulham,* that a local council in the UK does not have the capacity to enter into a swap contract.[40] The general English common law jurisdiction would have company law designed to provide the third party entering into a contact with the company, which acts beyond its constituted power.[41] The overwhelming majority of end-users of financial derivatives are legal entities such as corporations, public authorities, municipalities, governments, pension funds and other corporate and institutional players in international financial markets. These entities are products of law and their legal powers and authority to enter into contractual and legal relationships are defined by law. They have the capacity to assume obligations and exercise legal rights only to the extent that the law governing their existence allows them to do so. In the unfortunate event that an entity lacks the legal capacity to enter into a legal relationship, the result will be that the agreement will be unenforceable against the legal entity or difficult to enforce, subject to onerous formalities.[42] In entering into financial derivative transactions, each party will therefore wish to examine and ensure that it and its counterparty have the legal capacity and can validly assume binding legal obligations under the derivative contract.

15.011 On a parallel development at the international level, there has been a similar provision incorporated under the ISDA Master Agreement[43] (international agreement), which is known as 'suitability' or 'knowing your client' that derived from the case law.[44] What that attributed to the international agreement is that the seller of the derivatives is required to ensure that the counterparty is aware of the risk and has the capability to enter a sophisticated derivative contract. This has become a term under the ISDA Master Agreement.[45]

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40 *Hazell v Hammersmith and Fulham* [1992] 2 AC 1. The landmark case concerned legal capacity to enter into derivatives contracts. The council of the Hammersmith and Fulham borough (local government), pursuant to section 1(2) of the London Government Act 1963 (incorporated by Royal Charter) entered a substantial transactions of speculative nature in the capital market between 1987 and 1989. For the years, the council, on the recommendation of its financial and administration committee, borrowed to meet its capital and revenue payments and authorized the director of finance to arrange and administer the council's borrowing on its behalf which includes arranging transactions in the London money markets in order to maximize gains on favourable interest rate movements. A substantial number of interest rate swaps, swap options, caps, floors, collars, forward rate agreements and other types of derivatives, were given. By 31 July 1989, the council had entered into a number of financial derivative transactions whose primary economic effect was that the council would benefit if interest rates fell and lose if interest rates rose. The issue of the legality of those transactions was litigated before the House of Lords, which ruled that swaps were beyond the legal capacity of a local authority under all circumstances resulting swaps were void from the beginning. The counterparties (banks) of the local authority were thus unable to enforce claims against the Council amounting to approximately $100 million. The case still stands as good law reminding legal practitioners of the due diligence exercise to ensure the legal capacity to enter into derivative contracts. The House of Lords was very clear that the power to enter into a swap agreement must be expressed and enumerated in the charter of the local authority. It cannot be implied by the circumstances nor will the courts be prepared to allow derivative transactions as 'incidental' to expressly enumerated powers.

41 Cf the UK s39 and s40 of Companies Act 2006 on the same effect.

42 *Westdeutsche Landesbank Girozentrale v Islington LBC* [1996] AC 669.

43 *Peregrine Fixed Income Ltd v JP Morgan Chase Bank* [2005] 3 HKLRD 1.

44 *Bankers Trust v. PT Dharmala Sakti Sejahtera* (No.2) (1996) CLC 518.

45 Subsequently incorporate onto Chinese regulation on derivatives activities under its Provisional Administrative Rules Governing Derivatives of Financial Institutions 2004 (Amendment 2006).

15.03 DERIVATIVE PRODUCTS

15.012 The *option* to buy foreign currency at a fixed and certain rate in the future is a valuable option for which the bank is prepared to pay a fee in return for an option because it will provide certainty in the management of the bank's foreign currency obligations. The bank will not have to worry about the uncertainty in exchange rate movements. The *option* is a basic form of financial derivative, essentially a simple reciprocal contract. The option-holder has the power to buy or sell a specified underlying asset at a given price at a specified time in the future. An option to buy an asset is a call option that gives the purchaser the right, but not the obligation, to call for delivery of the underlying instrument at a given price on a given date (or one of a number of given dates). An option to sell something is a put option that gives the purchaser the right, but not the obligation, to sell the underlying instrument at a given price on a given date. The right without obligation[46] is in contradistinction to the obligation to pay regardless of the profitability of the transaction that is bound up in forward and futures regardless of whether or not the contract is profitable for its buyer. A clear risk for the seller bound up in an option is if the option is exercised that will only be because it is profitable for its buyer. The options can be settled through a transaction which involves both the parties to have delivered to it (call option)[47] and to compel another to purchase (put option).[48] An option can be settled in cash. A bond option is an option to purchase bonds at a price at a date in the future. The bond option does not include an interest rate movement in the price. A bond option enables the holder to benefit from a movement in interest rates against the interest rate that is payable on the bond. An equity option gives the buyer the ability either to have delivered to it or to compel another party to purchase the underlying share, which is the subject of the contract. This can be an option to buy or sell shares or receive/pay the return on the appropriate stock exchange or index. Cash settled option enables the investor to speculate on the movements in the share price. The return on that investment is paid to the buyer in cash terms if the option is in the money. There is no obligation to pay under the option if it remains out of the money. A physically settled option involves the complexity of taking delivery of the shares not found in cash settled options and the requirement of one of the parties (where the option is in the money) purchasing those shares on an exchange. A currency option is an option to purchase a given quantity of a currency at a price at a date in the future. The currency option does not include an interest rate movement in its price. The option operates as a means of hedging against movements in the underlying currency or as part of a portfolio strategy which enables the investor to acquire the right to acquire currency at a price lower than the spot price if the option is in the money.

(a) Swap

15.013 Interest rate swap is another type of financial derivative, which is built on the basis of an option. It is an exchange of cash flows. Where one party has an obligation which it does not want, it exchanges that obligation with another party for an obligation it does want. An interest rate swap is simply an exchange of the rate of interest that a borrower

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46 A Hudson, *The Law of Finance* (Sweet & Maxwell London 2009) 43-17.

47 A Hudson, *The Law of Finance* (Sweet & Maxwell London 2009) 43-17.

48 A Hudson, *The Law of Finance* (Sweet & Maxwell London 2009) 43-17.