Kluwer Arbitration Blog

Negotiating Arbitration Provisions in the Derivatives Context: Perspectives

Stephen Trevis · Tuesday, September 4th, 2018

Part I

Over recent years we have seen an uptick in requests to insert arbitration clauses in derivatives and other financial product documentation, and most particularly in the Asia Pacific region. Indeed, the International Swaps and Derivatives Association (ISDA), which is responsible for producing the most widely-used industry template of the master agreement, has shown a keen interest in this area and in 2013 ISDA provided guidance on the use of arbitration clauses, allowing for a number of institutions and seats around the world. An ISDA working group continues to track relevant legal developments and regularly publishes guidance.[1)]

There are many reasons for the growing interest in this form of dispute resolution, broadly falling into two categories:

- reasons that are jurisdictionally or regionally driven; and
- those more relevant to the nature of the business being transacted.

In order to do some justice to these topics I have split this article into two, and in this first part I will focus more on cross border and jurisdictional considerations. In the second part I will discuss how the complexity and variety of arrangements between counterparties to these types of products can be drivers to choosing arbitration.

It is worth noting at this point how in-house teams responsible for negotiating these clauses are typically organized. After all, the final, executed version of the clause is of course derived at through a process of negotiation between the parties prior to execution of the documentation, and this will determine much of the course of any dispute that may arise. However, in-house legal teams typically split responsibility between negotiating these terms (and the transactional side of the businesses) on the one hand, and the dispute resolution side on the other. When a dispute occurs over this documentation therefore a certain degree of sympathy must be afforded to the litigation teams who are presented as a fait accompli with a contract they typically took no part in negotiating! I have somewhat unusual responsibilities as an in-house lawyer in that I see “both ends” of the documentation, as it were. My teams include those who deal with documentation negotiation and the transactional side, as well as dispute resolution specialists. It has been our

experience that there are distinct areas which regularly come up for discussion. From this perspective I would like to summarise some of the more commonly-negotiated terms of arbitration clauses we are currently seeing across the Asia-Pacific region.

Negotiations have to start somewhere, and this is by using one or other of the party's templates. A clear majority of the time the starting point is our (the bank's) template, and so the points that come up for discussion are interesting in as far as they are driven largely by the client's concerns. Our template is perhaps not untypical among international banks in nominating the London Court of International Arbitration, seat in London and under English law. The reasons for this starting point are, firstly, that we favour English law globally for our Markets documentation generally. Therefore to the extent that arbitration is considered appropriate, LCIA has historically been considered a natural choice. Much of the reasoning here is to do with the fact that London is a legal centre globally, with a legal profession and judiciary with long and deep experience in dealing with these types of transactions. I will discuss this in more detail in Part II of this discussion.

From our perspective bringing proceedings in a globally-recognised centre avoids many of the complications and uncertainties entailed in conducting the dispute resolution "onshore" or in the counterparty's jurisdiction. [2)] It is also clearly of central concern from the perspective of obtaining a fair and equitable result, that the entire process is disinterested and clean. These concerns with local dispute resolution, including the court process and judiciary in many countries, operate broadly speaking on two levels:

- Risk of interference by the local courts in the arbitration itself. The advantage of going down the arbitration route of a potentially quicker, more straight-forward process which is (broadly) not subject to appeal may well be nullified if the local courts actively involve themselves in the arbitration hearing, and allow the parties to appeal every stage;
- Possible difficulties with onshore enforcement. One might point out at this stage that if there are concerns with enforcement in the counterparty's jurisdiction, this should be the case regardless of whether the arbitration was conducted onshore or offshore. However in the cross border context there may well be assets located in multiple jurisdictions which may be of interest at the enforcement stage, and if so an arbitration award obtained in an internationally-recognised centre would be preferable from this perspective. Moreover it may be the case that an award obtained offshore will limit the scope for disruption of the enforcement process onshore.

At either of these two stages concerns may arise that the local court process is not free from bias or even corruption. Clearly, any suspicion along these lines has very serious implications for the integrity of the outcome.

This has one very clear effect on our template clause. We endeavour to insert a provision concerning the nationality of the arbitrators, in the context of a three-person panel. The stipulation is that each party shall elect one arbitrator who shall not have the same nationality as that party (and these two arbitrators then elect the Chair). The thinking behind this is to avoid any suggestion of bias on the part of any one of the arbitrators. However, this is regularly contested in the course of negotiations. The reasons for this resistance I believe are to do with ensuring (from the counterparty's point of view) as wide a choice of qualified candidates as possible. This provision could be viewed as severely or unfairly restricting the pool of candidates for the panel.

Concerns with bias or corruption do not generally arise in the context of India, where the concern is more to do with undue interference from the local courts in the arbitration process and award.

India-located counterparties very frequently take the position that they want the dispute resolution to take place onshore. So for example we may well see a request for International Chamber of Commerce with seat in Mumbai, or arbitration in Mumbai in accordance with the domestic provisions of the Arbitration and Conciliation Act. Historically there have been concerns over the extent to which the domestic courts would directly involve themselves in such arbitration should it come within these domestic provisions. This issue is well understood in India, however, and it will be very interesting to see what effect when implemented current proposed changes to the law will have on the extent to which domestic arbitration is insisted upon. We are watching the progress of the Arbitration and Conciliation Act (Amendment) Bill 2018 with interest! However, as things currently stand our compromise, which is normally accepted, is arbitration in Singapore; Singapore International Arbitration Centre (SIAC) rules, seat in Singapore. In other words concerns over domestic arbitration in India remain.

Governing law in the India context can be more complicated, with a wider range of possible outcomes. That said, in the majority of cases English law is still accepted regardless of the rules/seat outcome; so for example, English governing law with SIAC rules is not an uncommon end position. On Indian governing law, historically we have viewed such requests sympathetically. However, recently the advent of the recovery and resolution regime in the UK, with its requirements for contractual recognition of stays where the governing law is non-EEA, has complicated this issue, since the necessity of inserting such a provision is difficult to explain where the transactions contemplated are intended to take place entirely onshore (as is the case the majority of the time).

Lastly the nominated courts in relation to the arbitration itself, for such matters as injunctive or interim relief, are also a matter for regular negotiation. Where we are starting from the position of LCIA, we will normally just specify the English courts for such matters, although for applications or interventions taking place in India we would specify Mumbai courts to that extent. For India-based counterparties this is regularly resisted in favour of Mumbai courts exclusively or Singapore courts where SIAC has been agreed upon. As in the context of insisting upon offshore arbitration, the concern with the Mumbai courts here is one of undue interference and heavy-handed oversight, leading to delays and spiraling costs. Singapore courts for would also be a natural compromise for counterparties based in South East Asia, where SIAC is to be used.

In the context of counterparties located in the People’s Republic of China we favour arbitration for very different reasons to the India context. Here, the concern is more fundamentally to do with enforcement, given the lack of reciprocal enforcement treaties or other formal judicial recognition with the PRC. On the other hand, PRC is a signatory to the New York Convention (Convention of the Recognition and Enforcement of Foreign Arbitral Awards), and so in theory at least offshore arbitral awards should be enforceable onshore.

PRC-located counterparties are frequently willing to compromise on Hong Kong; so Hong Kong International Arbitration Centre, seat in Hong Kong and Hong Kong courts for purposes of applications or intervention, and this is frequently the end position.. This compromise normally comes with a request for Hong Kong as the governing law, and this is normally acceptable. Interestingly the doubtful position of waivers of sovereign immunity for state-owned entities before the Hong Kong courts makes the choice of arbitration all the more attractive in this context.

In our experience therefore the cross border nature of these relationships throws up many challenges which mitigate towards a choice of arbitration, and increasingly arbitration in the

region. In the next part I will focus more on the business context as a driver of this choice, and how that informs negotiations over the details of that choice.

Part II

In Part I of this article I noted the trend in favour of arbitration as a dispute resolution mechanism across the AP region in the context of derivatives and other complex financial instruments, and discussed primarily the jurisdictional and region drivers for this trend. In this second part I will focus more on the nature of the business relationship as a further possible dynamic.

I mentioned that our starting point for negotiation normally includes a nomination of the London Court of International Arbitration (LCIA) and London as the seat. This may reflect something of a bias towards the "home" jurisdiction, but also has solid technical reasons behind it, given London's position as a global legal centre with wide-ranging experience of derivatives and sophisticated financial products generally. It is important to choose a centre with deep experience and expertise among the judiciary AND a strong legal "hinterland" more generally among legal professionals and arbitrators. This issue of the availability and bench strength of both the legal profession and arbitrators who are qualified and experienced in considering these complex financial instruments is critical when negotiating the choice of arbitration centre.

So how does this play out in the Asia Pacific region, assuming parties are looking for a choice closer to home? Here the choices become very specific, at least from our perspective. The foremost choices are Singapore International Arbitration Centre (SIAC) and the Hong Kong International Arbitration Centre (HKIAC). [3)] Both Singapore and Hong Kong have sophisticated legal professions and independent judiciaries, and are international financial centres. So, the pattern that typically emerges during negotiations is for parties located in South or South East Asia to be more sympathetic towards SIAC, with parties based in greater China more open to the choice of HKIAC. SIAC probably has the edge in terms of size as a centre (i.e. number of disputes it deals with), but otherwise the drivers for these tendencies are as much cultural or geographic as they are technical.

Japan is an interesting one in this context; it clearly has a very sophisticated legal system and judiciary, including in the context of financial instruments. However the use of arbitration for dispute resolution is still unusual. This may be for a couple of reasons; firstly that sophistication and efficiency of process in the judiciary compare favourably to arbitration, and yet (unlike say London) the subject matter of disputes does not typically involve complex cross border issues where challenges around enforcement (by way of one example) may come into play. It is my view therefore that arbitration has not really taken root in Tokyo as a financial centre in the same way largely because the judiciary already meets the demands of dispute resolution as they arise there.

Disputes over these products frequently centre on the issue of their complexity. This begs the question of the required level of sophistication the parties would need to have a full understanding of the risks involved. Accordingly, it is common for the non-financial institution to present itself as the victim in having been sold something by the financial institution it could not reasonably have been expected to understand. Does this mean the financial institution owed some sort of responsibility to the non-FI party, either simply to explain the risks better on entering into the

transaction, or in more extreme cases a fiduciary duty of care to which liability is a natural consequence? Expertise and experience in these markets on the part of the arbitrators is therefore going to be key to unpicking such arguments.

Moreover these products are typically regulated activities, and therefore subject to complex laws and regulations in at least the counterparty's jurisdiction and the financial institution's home jurisdiction. Other laws such as currency controls may also be relevant. These regulations frequently come up as part of the dispute in an attempt to throw doubt on the legality and enforceability of the transactions. To choose just one example to illustrate the point of where legal and regulatory issues connect is the question, as a regulatory matter, of the appropriateness and suitability of the selling of such transactions to the non-financial institution. This is clearly an issue for the bank to answer, and connects closely to the question, as a legal matter, of how reasonable it is to treat such a non-bank party in this context as operating at arm's length and capable of assessing the risks for itself.

The need for sophistication and a high level of understanding of the subject matter of the dispute applies not just to the parties' lawyers and the arbitrators, but also to the courts of the legal system that may find themselves involved. The first requirement for the local courts in any jurisdiction where the arbitration is taking place is to allow the hearing to be conducted without undue interference. Hence the importance of clear legislation governing arbitration proceedings and clear and disinterested application of such rules by the judiciary. Secondly, during the conduct of the arbitration there may be legitimate need for recourse to the courts for such matters as injunctive or interim relief. Again in such cases, clear legislation and predictable application by the courts are key considerations. Again, SIAC and HKIAC compare favourably on both these point, and provide another reason for their frequent nomination during contract negotiations.

In the case of India, the risk is that any onshore process is susceptible to being dragged out for years on end through the courts (although there are reasons to believe the situation has been improving in recent years). There is little cause for concern over bias or corruption, and it is clear, at least in the higher courts, that sophistication and experience are also not worries. However there are persistent concerns that any onshore process may become embroiled in extremely lengthy appeals and counter-appeals. Of course when it comes to enforcement, onshore proceedings, at least to that extent, may well be unavoidable; much depends on the location of the parties' assets. However, the argument goes that once an award has been obtained offshore, the scope for delaying tactics in the local courts is at least restricted.

The nature of the transactions or banking relationship may also have a bearing on the attractiveness of arbitration for the parties. One frequently-touted reason is the fact that it tends to take place behind closed doors, in contrast to court litigation which tends to be public. However this may be a double-edged sword. In the case of investment banking, especially following the financial crisis and many of the scandals which followed in its wake (such as LIBOR setting) it may well be the case that the financial institution is publicity-shy, even where it believes itself to be in the right and on solid legal ground. Even in these cases, in many parts of the world a newspaper story detailing a financial loss incurred by a corporate from "Main Street", having purchased financial products from "Wall Street" may well be damaging from a reputational point of view regardless of the merits of the case. By contrast however in the private banking world many clients are equally if not more averse to publicity when it comes to their financial dealings, and so the incentive to use arbitration as the dispute resolution mechanism because of the avoidance of publicity may well lie on the client side.

So what are the trends at this point? Certainly Singapore is establishing itself more and more as not just a regional centre for arbitration, but globally too. The statutory backdrop, with its judicial support for arbitration and strong restraints on court interference in the process are one aspect of this. As more and more cases are held in Singapore, a virtuous circle starts to assert itself whereby more cases means an organic growth of expertise, a deeper bench of practitioners and a more familiar judicial backdrop, leading to more cases, so and on. It is safe to say that arbitration clauses will continue to be frequent points of negotiation in the context of derivatives for the foreseeable future. [4)]

References

?1 See e.g. Loukas A. Mistelis (Queen Mary University of London), Are Banks Changing? The New Big Industry for International Arbitration? Kluwer Arbitration Blog, October 2, 2013

?2 See e.g. Deyan Dragiev, Arbitration vs Litigation in Financial Agreements: A Policy Perspective, Kluwer Arbitration Blog, September 10, 2015

?3 See e.g. Joe Liu (Hong Kong International Arbitration Centre), The Use of Arbitration for Derivative Contracts, Kluwer Arbitration Blog, March 31, 2015

?4 See e.g. Maria Karampelia, Cross-border Disputes in the Financial Sector: A Trend towards Arbitration and the Release of the ISDA Arbitration Guide, Kluwer Arbitration Blog, October 24, 2013

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