Kluwer Arbitration Blog

Arbitration Trending in the Derivatives Context: Perspectives

Stephen Trevis · Saturday, March 7th, 2020

In my previous post in September 2018, I discussed certain trends in the negotiation of arbitration provisions in derivatives documentation. I mentioned at the outset that the International Swaps and Derivatives Association ("**ISDA**") had by then already provided detailed guidance on the use of arbitration clauses in the 2013 ISDA Arbitration Guide.

A year on, the ISDA published the 2018 ISDA Arbitration Guide, which builds on the earlier edition by providing an expanded range of "ISDA-fied" model arbitration clauses for a larger number of arbitration institutions and seats around the globe.

The 2018 ISDA Arbitration Guide reflects a trend I had noted in my previous post, that there is growing momentum for the use of arbitration in the financial services context generally, and in the derivatives context in particular. I would argue that this trend shows no signs of slowing down, particularly in the Asia Pacific ("**AP**") region. On the contrary, the advantages of arbitration clauses over court proceedings are becoming more widely understood and appreciated.

There are both commercial/business and regional factors underlying this trend. Among the former, one underestimated factor is an important concept underpinning the ISDA Master Agreement itself (and other master agreements). This concept is that of the "self-help" remedy. Briefly, this refers to the credit enhancement techniques that parties build into the documentation, which are designed to work without having resort to court proceedings. There are two main and inter-related mechanisms: close-out netting and collateralisation through title transfer.

Close-out netting is a feature of the ISDA Master Agreement (and other master netting documentation). Upon a default, all outstanding transactions are terminated, the amounts owing between the parties are calculated, and these amounts are netted off such that a single net sum payable from one party to the other is arrived at. It is crucial that insolvency does not interfere with this mechanism by, for example, allowing the liquidator to "cherry pick" and argue that only amounts owing to the insolvent company should be admitted. Parties would therefore seek jurisdiction-specific legal opinions to confirm that the onset of insolvency will not affect the operation of close-out netting.

The ISDA English Credit Support Annex (a very widely used document in cross-border transactions, particularly since the rolling out of regulatory uncleared margin requirements following the global financial crisis) uses the related technique of title transfer. Typically, exposures resulting from outstanding transactions between the parties are calculated and netted off on a daily basis. An amount equivalent to the outstanding net sum is then transferred as collateral

to the party that is in the money. This reduces the overall exposure to zero on a daily basis and should therefore, in theory, limit the amount owing from a default to that resulting from intra-day market movements on the day of the default itself. Again, this requires non-interference from insolvency proceedings and parties would seek legal opinions to confirm this.

In much the same spirit, arbitration is a consensus-based, private and (by and large) bilateral arrangement seeking to resolve disputes that arise without recourse to court proceedings. The contractual basis that underpins the ISDA self-help remedies and arbitration allows parties to retain maximum control over their agreement and the resolution of disputes or issues that arise therefrom. Parties are thus better able to ensure a commercially-minded and flexible dispute resolution approach when they adopt these methods. In contrast, reliance on court procedures may be inherently unpredictable.

This goes a long way in explaining the attractiveness of arbitration in the ISDA context and its growing use in the market.

The trend towards arbitration has been particularly strong in the AP region for several reasons. Here, cross-border transactions are particularly common, and the consequent complexities are exacerbated by the fact that there is no overarching commonality of law and regulation, as in the European Union or the United States. In the AP region, there is instead a bewildering array of legal systems and regulatory regimes. Moreover, it is commonly thought that the raft of new regulations implemented after the global financial crisis (*e.g.* mandatory central clearing, non-cleared margin, transactional reporting etc.) has made the landscape even harder to navigate. For example, compliance is a clear impossibility where central clearing for the same transaction is mandated in two different jurisdictions.

Moreover, the interplay between law and regulation in many jurisdictions can give rise to surprising results. For example:

- There is a risk that certain contractual obligations may be declared void on the grounds that they violate currency exchange control regulations; and
- The recent tendency for regulators in many jurisdictions to be more "activist" on behalf of customers of financial institutions can result in arguments, based on the regulations, that a legal duty of care has arisen in favour of the customer.

Adding on to those issues are the problems that may be encountered in onshore court proceedings in many jurisdictions. I listed many of these in my previous post. They include a lack of experience in the local legal profession and judiciary, time delays, a tendency to bias, political complications and corruption.

So, how does arbitration assist in addressing these challenges?

Foremost, the choice of arbitration centres in the AP region is relatively straightforward. The pattern we see in negotiations seems to be in favour of Singapore. At the risk of over-generalisation, parties based in South Asia and Southeast Asia usually prefer the Singapore International Arbitration Centre ("**SIAC**") while those based in Greater China and North Asia prefer the Hong Kong International Arbitration Centre ("**HKIAC**"). The International Chamber of Commerce ("**ICC**") is also a popular option.

The strength of these arbitration centres is growing not just regionally but also globally, and their

inclusion as standard options in both the 2013 and 2018 ISDA Arbitration Guides is encouraging. On every measure, these centres are establishing themselves as global centres for arbitrating financial disputes.

It is not difficult to see why, when we consider that these centres are situated in jurisdictions that boast impressive legal professionals and judiciary, who possess a deep well of experience in dealing with highly complex, cross-border and highly regulated transactions and products. This is a natural consequence of being international financial centres, but it is equally a result of conscious policy. In Singapore in particular, there have been strong efforts to create a legislative and judicial backdrop to arbitration that would allow it to operate with a minimum level of oversight and interference from the courts. Frequent updates to legislation have also kept Singapore on the cutting edge of global developments, and its reputation as a go-to centre globally has been growing rapidly as a result.

When looked at in comparison to the self-help remedies pioneered by the ISDA, these features are hugely important in maintaining the attractiveness of arbitration in the financial context. The parties are after all aiming for a dispute resolution mechanism that will be equally up to the task – flexible, sophisticated, unbiased and, by the way, also reasonably fast and inexpensive!

Examples of such flexibility in arbitration include how parties may choose a governing law for the arbitration clause which may differ from that of the contract, the arbitrators (with a preference for those with expertise in the relevant product/transaction and regulations) and sophisticated procedural features such as expedited proceedings and joinders. From an enforcement point of view, the high level of party control over the proceedings may well also reduce uncertainty of outcome.

Of course, there are several other features which may give arbitration an edge in a cross-border enforcement scenario. Prominent among these is the New York Convention that currently has over one hundred and sixty signatories and so enables recognition of arbitral awards in a large number of jurisdictions. This has benefits on two levels in the cross-border context (and particular resonance in the AP region given its number and variety of jurisdictions):

- First, the chances are much greater that one is dealing with a signatory country rather than with a country with whom one has a reciprocal enforcement treaty or that provides other means for recognitions of foreign judgments (for example, section 426 of the United Kingdom's Insolvency Act); and
- Second, enforcement of an arbitral award may be concurrently sought in multiple jurisdictions if the counterparty has assets in several jurisdictions, and such enforcement may remain available regardless of the outcome of onshore court proceedings.

Lastly, I have an (admittedly minor) observation on the 2013 and 2018 ISDA Arbitration Guides. The guides require multiple consequential amendments to be made to the documentation, following the replacement of the standard jurisdiction clause with an arbitration clause (for example, consequential changes will be required to references to "judgment" in other parts of the documentation). This makes the transition to arbitration in the ISDA context less user-friendly. As a general rule in negotiations, the more there is to argue about the longer the negotiations take.

Therefore, given all the factors highlighted above, it may be time for the ISDA to consider designating arbitration as the standard enforcement mechanism in its template documentation (with

the provision of suitable alternatives), rather than as a bolt-on alternative to the English or New York courts.

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