

# Kluwer Arbitration Blog

## The Use of Arbitration for Derivative Contracts

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In recent years, international arbitration has increasingly been recognised as the preferred dispute resolution mechanism for cross-border derivative transactions, particularly those involving parties from emerging markets. The key reasons for this popularity include the growing diversity of counterparties and jurisdictions involved in derivatives trading, worldwide enforceability of arbitral awards against assets located in over 150 countries, access to neutral and specialist decision-makers, and confidentiality requirements.

Due to the complexities and considerable risks associated with derivative transactions (including their customers' varying degrees of financial sophistication), there is room for legal uncertainty and a propensity for disputes. Common types of claims or defences raised by customers in derivative transactions include:

- that a party did not have the capacity to enter into a transaction;
- that the transaction documents are inaccurate or incomplete;
- that the valuation of the derivative position is wrong;
- that the financial institution mis-sold the financial product(s) to the customer;
- that the financial institution has breached a duty of care owed to the customer;
- that the financial institution made a misrepresentation that induced the customer to enter into the transaction(s); and
- that transactions are invalid or unenforceable under the alleged mandatory provisions of the law of the place of the customer.

Banks typically seek to invoke standard terms in the transaction documentation to defeat customers' claims, such as non-reliance, own-judgment, non-advisory and exclusion of liability clauses, relying on the principle of contractual estoppel. This principle is firmly established under both English and Hong Kong law. The Singapore courts, however, appear to have taken a slightly less bullish approach in applying the banks' standard terms. In *Deutsche Bank v Chang Tse Wen* [2013] SGCA 49, the Singapore High Court hesitated to apply the doctrine of contractual estoppel.

This holding was subsequently questioned by the Court of Appeal which, however, declined to elaborate on the issue, thus leaving unclear the status of the doctrine of contractual estoppel under Singapore law.

There are a number of advantages for parties in arbitrating disputes arising under derivative contracts. These advantages also apply to many other types of financial disputes. The key advantages are summarised below.

*Enforceability.* The increased use of arbitration is driven primarily by the worldwide enforceability of arbitral awards under the New York Convention. At the time of writing, 154 States have acceded to the New York Convention (including the world's most prevalent financial markets). The Convention requires the courts of the Contracting States to recognise and enforce arbitral awards, subject to limited grounds for non-enforcement. This is crucial in a derivative transaction with a counterparty that has assets in multiple jurisdictions, because arbitration allows the award creditor to enforce against assets in several places.

*Neutrality.* Many parties to derivative transactions involving emerging jurisdictions are increasingly reluctant to litigate disputes in their counterparties' local courts, given concerns of bias, corruption, delay, lack of expertise by judges and the use of local language in court proceedings. In contrast, arbitration allows parties to arbitrate their disputes in a neutral forum and with the ability to select suitable arbitrators and language.

*Relevant expertise of arbitrators.* Another significant advantage arbitration can add to the resolution of derivative disputes is the ability of the parties to select legal and derivatives experts with relevant industry expertise and experience to act as arbitrators. Judges in many local courts simply do not have knowledge of how derivatives work.

*Privacy and confidentiality.* Unlike court proceedings, which are usually public, arbitral proceedings are commonly held in private, and information disclosed and decisions made during the arbitral process are generally confidential. To allow a customer to disclose his/her losses or to broadcast the details of the dispute might result in a negative perception of the viability of the underlying derivatives and damage to the reputation of the bank or financial institution, as well as attracting similar claims from other customers.

*Narrow scope of disclosure.* The scope of discovery of documents in arbitration is generally narrower than in court proceedings in (for example) London or New York. The International Bar Association's Rules on the Taking of Evidence in International Arbitration 2010 (the IBA Rules) are often used as guidance or adopted in arbitral proceedings with respect to the production of documents. The IBA Rules allow a party to request the production of specific documents that are relevant to the case and material to its outcome. This can be advantageous to banks and financial institutions, which often bear the burden of disclosure in contentious proceedings.

An arbitration conducted under the Hong Kong International Arbitration Centre's Administered Arbitration Rules 2013 (the HKIAC Rules) offers a number of useful tools and procedures that the parties may use in resolving their derivative disputes cost effectively and efficiently. They include the following:

- HKIAC maintains a panel of approximately 400 international arbitrators, many of whom have extensive experience and expertise in complex financial disputes.
- HKIAC arbitrations in Hong Kong enjoy the complete protection of confidentiality, which covers arbitral proceedings, awards, related court proceedings and judgments.
- An HKIAC arbitral tribunal can order a wide range of interim relief in various forms, including orders to preserve assets and evidence, injunctions and security for costs. Where a party needs urgent relief before the tribunal is constituted, HKIAC can appoint an emergency arbitrator within two days and the parties can expect a decision from that arbitrator within 15 days. Such a decision is enforceable in Hong Kong under its Arbitration Ordinance (Cap 609), which expressly recognises the enforceability of emergency arbitrators' decisions.

- The HKIAC Rules also contain a comprehensive set provisions designed to deal with complex arbitrations involving multiple transactions, contracts or parties. An additional party can be joined to an existing arbitration provided that, *prima facie*, it is bound by the arbitration agreement that gives rise to the arbitration. Where multiple disputes arise out of the same or series of transactions involving a common question of fact or law, HKIAC has the power to consolidate them into a single arbitration proceeding. Alternatively, a party may simply commence a single arbitration under multiple contracts from the outset, provided that certain conditions are met. These provisions are particularly useful for derivative disputes, which commonly involve multiple parties and multiple contracts.
- HKIAC has an expedited procedure, which will normally result in the appointment of a sole arbitrator, the dispute being decided on a documents-only basis and a summary award being issued within six months from the date when the arbitrator receives the file. In a recent US\$420 million financial dispute, the parties agreed to apply the HKIAC expedited procedure and received a final award within two months from the commencement of the arbitration.
- Finally, the HKIAC Rules are the first to offer parties the choice of remunerating the arbitral tribunal on the basis either of the amount in dispute or on an hourly basis. This allows the parties to choose the most economical way of determining the tribunal's fees and so can effectively reduce the costs of arbitration.

HKIAC has witnessed an increasing number of financial disputes being referred to arbitration. With its leading arbitration rules in place and ample experience in handling financial cases, HKIAC arbitration provides an attractive forum for complex and high-value disputes arising out of cross-border derivatives and other types of financial transaction. In 2013, the International Swaps and Derivatives Association (ISDA) published its guidance (the *ISDA Arbitration Guide*) on the use of an arbitration clause with the ISDA Master Agreement as a result of a growing demand for the use of arbitration for disputes arising out of over-the-counter derivatives transactions. Recognising HKIAC's competence in handling such disputes, the *Arbitration Guide* recommends an HKIAC arbitration clause as one of the model clauses for use with the ISDA Master Agreement.

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