Kluwer Arbitration Blog

LIDW 2019: The Rise of Arbitration in Financial Services Disputes, 7 May 2019

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The nature and up-coming trends in the financial services dispute sector were one of the topics dealt with during the first day of the London International Dispute Week (LIDW). The audience had the opportunity to formulate an understanding of how financial disputes are treated by courts and tribunals.

The Right Honourable Lord Justice Hamblen gave the key-note speech emphasising on the joint work between the Chancery Division and the Commercial Court of the Queen's Bench division as an initiative to meet the needs of court users in financial cases. The prepared report set out recommendations which constituted the basis of the "Financial List". An interesting feature of this List was the need for a more formalised training for judges in relation to financial markets. The response to such a concern is the training of court judges through seminars arranged by the Financial Markets Law Committee (FMLC). The question that arises at this point is whether such expertise can be found (without rather than with training) in arbitral tribunals as an alternative to courtroom litigation.

Dr Jacomijn Van Haersolte-Van Hof focused on the arbitration of financial services disputes from the perspective of the LCIA. In terms of numbers, the significance of arbitration is not at all neglectable for this sector. Namely, 29% of the LCIA cases per industry sector concern banking and finance disputes. An important selection factor determining the parties' choice to arbitrate such disputes is the high quality of decision-making by experienced arbitrators within the industry sector. With this background in mind, the issue discussed in this post is: Is arbitration rising in the financial services disputes?

It is often maintained that innovation in finance is a reaction to an economically inefficient framework. No such reaction has yet occurred to the way in which financial services disputes are resolved in England. Unlike other sectors that rely heavily on arbitration, disputes in the world of finance (with the exception of project finance) have been settled through recourse to national courts of major financial centres (with London by a pre-eminent forum in this respect). According to the 2013 Queen Mary's International Arbitration survey, litigation ranked as the first choice (82%) for the financial service industry in terms of dispute resolution mechanisms. English courts have further cemented their leadership with the creation of the specialist Financial List that handles claims relating to the financial markets. Hence, as evidenced by the 2016 report from the ICC

Taskforce on Financial Institutions and Arbitration, financial institutions have fairly limited exposure to arbitration.

The preference for court-based dispute resolution is chiefly dictated by the requirement for legal certainty in a fast-evolving market (although the considerable case law that has developed since the 2008 financial crisis has provided helpful guidance in the financial sector), which, in England, is provided by a body of binding precedents. Additionally, in respect of certain highly regulated financial markets, public policy dictates a court involvement in the adjudication of disputes. Finally, the lack of binding precedents in arbitration generate significant concerns for banks and institutional investors that could be faced with arbitrating the same issue multiple times against different counterparties without the point at issue ever being resolved.

Thus, according to the 2018 Queen Mary's International Arbitration survey, when responding to the question "how likely is it that the use of international arbitration for resolving cross-border disputes will increase in relation to the following industries and sectors?", 56% of the respondents from the Banking and Finance Sector believed that this was likely. While this is an increase from the previous iteration of the survey, it appears a rather conservative view when contrasted with the over 80% expressed by respondents from the other sectors.

However, albeit with less enthusiasm than in other markets, this trend has started to shift in recent years and recourse to arbitration is on the rise. The increasing complexity in the nature of claims involving financial products, such as priority-of-payment disputes between noteholders in connection with structured investment vehicles (**SIV**s) and collateralized debt obligations, the availability of a pool of highly specialised arbitrators to adjudicate financial disputes (i.e. The Panel of Recognised International Market Experts in Finance, "**PRIME**" established in 2012), and the involvement of counterparties from emerging markets are some of the key drivers behind the use of arbitration in financial transactions.

In a sector that relies heavily on market standard provisions, the publication by the International Swaps and Derivatives Association (**ISDA**) of its "2013 Arbitration Guide" can be considered as an important step in providing market participants with an alternative dispute resolution option beyond litigation. Thereafter, the European Federation of Energy Traders (**EFET**) has followed the ISDA example by providing for dispute resolution through the London Court of International Arbitration (**LCIA**) or the German Institute of Arbitration in their master agreements for the delivery and acceptance of gas and electricity.

In December 2018, ISDA built on its success with the revision of its arbitration guide, which was expanded to include arbitration clauses (governed in all cases, bar one where the agreement is subject to Irish law, by either English or New York law) for use with 16 different arbitration centres. This diversification could also be considered as an attempt to address the gap between the number of proceedings and the availability of arbitration by widening the availability of different arbitral fora. It is often remarked that in areas such as derivatives there is a real need for arbitrators with a higher level of background in the instruments and practices of the market. While this may well be the case, often the recurrent themes in derivative matters being subjected to litigation are the same: mis-selling claims, disputes as to close-out procedure, suspension of payments, or validity of termination. These are issues that many commercial arbitrators are very familiar with and they may soon become less challenging with an industry-wide implementation of smart contracts.

Should one wish to address the immediate need for specialised arbitrators the establishment of a derivative industry-specific arbitration institution such as the London Maritime Arbitrators Association (**LMAA**) could be the way forward by introducing a standardised approach, reducing costs, and increasing efficiency. Such an institution could be highly beneficial for ISDA members in concentrating a deep pool of experts under one industry specific umbrella. This concentrated level of expertise could help to create an interpretative consensus through the publication of anonymised abstracts of awards (this is PRIME's approach) and convince institutional investors based in key financial centres to solve their disputes through arbitration.

While as a result of ISDA's approach there has been a growing number of derivatives related disputes being referred to arbitration, such disputes predominantly involve parties from emerging markets. This trend is shared amongst most financial services disputes in general. This was the reason why the China International Economic and Trade Arbitration Commission (**CIETAC**) has produced the Financial Disputes Arbitration Rules at an early stage (2003), while another decade was needed for ISDA and PRIME to produce theirs.

However, counterparties in emerging markets are increasingly pushing banks and financial institutions to have dispute resolution take place in neutral fora. This trend can be tracked in the marked increase in the number of disputes under the LCIA rules in the banking sector as evidenced in the LCIA 2018 Annual Case Work.

With the availability of the expedited procedure from The Arbitration Club, i.e. the Financial Sector Branch's "Financial Services Expedited Arbitration Procedure", and of some summary procedures provided under the rules such as the ones of the Singapore International Arbitration Centre (**SIAC**), it is believed that the remit of arbitration in finance can be expanded beyond plain vanilla banking, asset management or ISDA derivatives.

One of the areas that could benefit from the use of arbitration is an area of finance that relies exclusively on the courts' support – securitisation. In the context of securitisation transactions or other transactions involving insolvency remote special purpose vehicles (**SPV**s), by adopting this mode of dispute resolution for the Trustee (for the benefit of the SPV' securities holders) and for the other parties involved in the securitisation transaction (bearing in mind that the consensual nature of the arbitration process only binds the parties that agree to it), the SPV will ensure that the risk of court interference with the contractual structure selected by the parties is minimised. The advantage of using such procedure (a benefit that would extend to most non listed financial transactions) is, of course, that any proceeding will, to a large extent, be kept confidential.

Additionally, by forcing the holders of securities to be represented by the Trustee in the arbitration proceedings, multiple (and perhaps conflicting) proceedings by different classes of investors in the securities will be avoided. Further, since it has it has become apparent during the financial crisis that courts may be consulted for matters that are not strictly "disputes" (such as a request for direction from a Trustee under the trust instrument in a securitisation transaction), arbitration clauses will have to be drafted rather widely to capture these additional requests to be put to an arbitral tribunal. Moreover, arbitral tribunals with expert arbitrators appear to be rather suited to address such "additional request".

Finally, if arbitration were to be used as the default dispute resolution provisions in securitisation transactions, the structure's bankruptcy remoteness could be enhanced by limiting, through arbitration, the intervention of the courts in the area that poses the highest degree of risk to investors in a securitisation transaction – insolvency. This could be achieved, as mentioned above, by clarifying in the arbitration clause that any dispute or claim shall be adjudicated subject to the subordination, non-petition, and limited recourse stipulations; thus ensuring that such provisions are not derogated from or disapplied. However, it would not be possible to oust the jurisdiction of the courts completely. This is because even when it could be possible to restrict through arbitration courts having jurisdiction over the SPV, it would not be possible, as proven by the Lehman Brothers' insolvency, to oust the jurisdiction of the courts in respect of the insolvency of other parties (i.e. Trustee, Swap Counterparty, etc.) to a securitisation transaction.

While the growth in the use of arbitration in the finance sector continues, there are instances in which arbitration is not a viable tool. This may be determined by the nature of the subject matter (which is not arbitrable) of the dispute, by the existence of insolvency proceedings, by the characteristics of one of the parties (i.e. a public entity that should be submitted only to the transparency of a public hearing), or by their numbers (multiparty arbitration may not be a viable option or some of the parties may not have signed the relevant arbitration clause). Alternatively, the speed of litigation tools such as default or summary judgment may be warranted for although they are not awarded by courts too readily. Finally, there may be instances where the jurisdiction of the courts cannot be ousted. That being said, it would still appear that arbitration is suitable to solve most financial disputes and it will continue to gain popularity in the financial sector.

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