BANKING DISPUTES ALERT

Derivative transactions

ISDA Arbitration Guide 2013: Model clauses provide a step towards certainty

BACKGROUND

The 2013 ISDA Arbitration Guide was published last week (9 September 2013) following a two-year consultation with ISDA members. It provides model clauses for various forms of arbitration for use in derivative transactions. This is welcome news for the banking and investment community which has not always found the standard ISDA submission to court based adjudication of disputes to be ideally suited to complex cross-border structured product disputes.

The consultation process commenced with a memorandum to members dated 19 January 2011 entitled "The use of arbitration under an ISDA Master Agreement" and a further memorandum to members dated 10 November 2011 was followed by meetings and consultations with stakeholders around the world.

The purpose of the consultation was to gauge member interest in using arbitration in connection with derivative transactions documented under the ISDA Master Agreement. The results of the consultation proved positive and members clearly showed an appetite for international arbitration being used for derivatives disputes and indicated that model clauses would be helpful.

Historically, institutions have tended to use agreements governed by English or New York law and jurisdiction clauses which refer disputes to the English or New York courts (these are the options in the current 1992 and 2002 ISDA Master Agreements) because of their reputation and experience dealing with disputes involving derivative transactions. However, in recent times, an increasing number of parties to such transactions are based in emerging market jurisdictions[1] in which it is difficult or impossible to enforce a foreign judgment.

One way around this is to provide for disputes to be heard in the courts where the counterparty has its assets (often where it is incorporated) or where the relevant collateral is located. However, this can give rise to problems including:

- perception of bias in the local courts;
- delay;
- lack of experience in dealing with derivatives transactions;
- lack of familiarity with foreign law;
- failure to respect a foreign governing law clause;
- inconsistency; and
- need to litigate in unfamiliar language (including resultant difficulties of translation of documents, etc).

[1] ISDA now has over 840 member institutions from 60 countries. Further, a study undertaken by the Bank for International Settlements at the end of 2010 revealed that the derivatives markets in emerging markets had increased 300% since 2001 and by 25% since 2007. In addition, the emerging markets of Brazil, Hong Kong, Singapore and South Korea have now become major players in the derivatives markets (for example the Korea Exchange had a $270 billion daily turnover of equity-linked derivatives in April 2010 which was second globally only to the US CME Group (Source: http://www.bis.org/publ/qtrpdf/r_qt1012f.pdf).

This is where electing to use arbitration as the preferred dispute resolution mechanism in derivative contracts can be advantageous and may explain the appetite amongst members for ISDA model arbitration clauses to be published.

ADVANTAGES OF ARBITRATION IN DERIVATIVE TRANSACTIONS

Enforcement

One of the key advantages of arbitration as a dispute resolution mechanism is the global regime for enforcing arbitral awards under the New York Convention, one of the world's most successful conventions with, currently, 149 Contracting States.

The New York Convention imposes an obligation on courts in the signatory state to recognise and enforce foreign arbitral awards. There are only limited grounds for refusal and these do not include a review of the merits (which might be the case in some foreign courts). This gives arbitration a clear advantage over litigation in circumstances where foreign judgments can be difficult to enforce in certain jurisdictions. This is clearly of value in the derivatives market which is increasingly cross-border in nature.

Neutrality

There is a perceived neutrality with international arbitration. By agreement between the parties, their relationships and disputes are removed from the jurisdiction of national courts. Parties in emerging markets are often reluctant, for cultural or political reasons, to have a dispute heard in the English or New York courts, or for more practical reasons, such as exposing themselves to jurisdiction (particularly US jurisdiction) in respect of other matters.

Procedural Flexibility

Arbitral proceedings can be tailored far more readily to the particulars of a transaction than court procedures. For example, the parties can specify the number and qualifications of the arbitrators. Thus the parties can specify, for example, that the arbitrators must have 10 years' of experience in the specialist derivative sector. There is also flexibility in the procedures to be adopted which can be adopted to the transaction (eg the sequence of procedural steps, the omission of steps if appropriate, the inclusion of expedited timetables, etc).

Whilst the advantage of appointing an arbitrator who is experienced in complex derivatives transactions is obvious, any such requirement will have the consequence of limiting the pool of potential arbitrators and could result in experience based challenges.

Privacy and Confidentiality

Some jurisdictions (England, Hong Kong and Singapore) and institutional rules (LCIA, HKIAC, SIAC and the Swiss Arbitration Rules) impose duties of confidentiality imposed upon the parties. In addition, the parties can expressly provide for this in the arbitration agreement.

Confidentiality may be an important advantage for parties looking to preserve long-standing commercial relationships, which may be more difficult if the dispute is seen to be thrashed out in public.

However, confidentiality in arbitrations is sometimes seen by financial institutions as a disadvantage as these institutions will often want favourable decisions to be made public (to quell similar claims). The lack of precedent value to decisions by arbitral tribunals may also be seen by some financial institutions as a disadvantage of arbitration compared to litigation (of course, depending upon which way the decision goes).

Other advantages of arbitration

Other perceived advantages of arbitration compared to litigation include:

- the finality of arbitral awards and the limited rights to appeal;
- the (often) more limited document production obligations compared to Court litigation (eg compared to the wide discovery obligations in the US courts); and
- the opportunity in certain circumstances and under certain institutional rules (eg ICC and the HKIAC rules) to appoint Emergency Arbitrators to hear urgent applications and grant interim relief.

The Model Clauses

As stated above, there appears to be an increasing appetite for arbitration in derivative transactions. However, the absence of any clear ISDA guidance or arbitral provisions specifically related to the ISDA Master Agreement has led to parties 'doing it themselves' with the consequent risk of ineffectiveness and uncertainty. Thus ISDA has now set out model clauses which have been designed with cross border transactions in mind and based upon member feedback. Seats and institutions included in the Model Clauses were determined on the basis of member's comments as to which to prioritise.

The Model Clauses were designed for use with the 2002 Master Agreement although specific provisions have also been provided to deal with specific amendments for the 1992 Master Agreement. They have been drafted on the assumption that a new Master Agreement will be entered into (amending existing will require additional wording).

Of note is that ISDA has now seemingly bowed to member demand for a Model Clause specifically dealing with the Panel of Recognised International Market Experts in Finance (**"P.R.I.M.E. Finance"**) institutional rules for dispute resolution. This was not included in the six alternative Model Clauses ISDA published on 17 April 2013. However, ISDA has now drafted three such Model Clauses - one providing for London seat/ English law; one providing for New York Seat/New York law; and a third providing for The Hague seat/ English or New York Law with the law of the arbitration clause being Netherlands law.

P.RI.M.E. Finance is a new player in the market, set up in The Hague, the Netherlands in 2012 with the objective to provide arbitration and mediation services, expert opinions and judicial training and education in the area of complex financial transactions. A key advantage that P.R.I.M.E. Finance claims to offer is its panel of expert arbitrators, all of whom have specialist knowledge and extensive experience in the field of financial services. The P.R.I.M.E. Finance arbitration rules are, in essence, a customised version of the UNCITRAL arbitration rules. They offer the reliability of the framework of the UNCITRAL rules, which has proven its worth over the years, with added user-friendly options such as a procedure to appoint an emergency arbitrator similar to the ICC and HKIAC rules and a default mechanism (which fills a gap in the UNCITRAL rules) for the appointment of an arbitrator where the parties are unable to agree (the appointing authority in that case is the Secretary-General of the Permanent Court of Arbitration in The Hague).

A unique feature of the P.R.I.M.E rules which may be of particular interest to financial institutions is a clause which permits P.R.I.M.E. Finance to include in its publications excerpts of an arbitral award or an order and to publish an award or an order in its entirety, in anonymised form if no party objects to publication within one month after receipt of the award. It is understood that P.R.I.M.E. Finance included this publication clause with the specific aim to develop a body of case law and, consequently, to foster more certainty and predictability in a market where standard contracts and agreements, such as the ISDA Agreements, are the norm.

The ISDA Guide also provides model clauses for use with the major arbitral institutions as recommended by the ISDA members. Thus the Guide includes Model Clauses for use with the ICC, LCIA, AAA, HKIAC, SIAC, and Swiss arbitral rules and provides for a number of preferred seats including London, New York, Paris, Hong Kong and The Hague. Helpfully where a seat has two arbitration regimes (that is to say both domestic and international, eg Hong Kong and Switzerland), provisions have been included to make it clear that the Model Clause applies to the international regime.

Optional (or one-way) arbitration clauses have not been drafted by ISDA. This is because such Clauses are rare in derivatives contracts and give rise to potential enforcement risks - some countries (France) have refused to give effect to them and in many jurisdictions their effect is untested.

In countries where it was felt appropriate (Hong Kong and Singapore, but not France and Switzerland) clear wording has been included to confirm the governing law of the arbitration clause (eg for determining its validity or the termination of the agreement to arbitrate).

HOT TIPS

TIP 1: Typically, ISDA documentation used as the basis for or incorporated by reference into derivative transactions is signed up to by myriad parties and the number of documents and related agreements will vary according to the complexity of the transaction. As a result, where one of the new Model Clauses is used, consideration should be given to which other agreements should contain the same or similar arbitration agreements to avoid duplication of disparate dispute resolution mechanisms and a multiplicity of proceedings.

TIP 2: If you are amending an existing ISDA structured derivative transaction to introduce an arbitration mechanism using one of the Model Clauses, be sure to check each layer of ISDA documentation, including any amendments and any ISDA incorporated definitions to avoid conflicting provisions (eg submission to jurisdiction provisions, definition of proceedings, etc). Also, check the confidentiality provisions in the main contract and ensure it interfaces with any confidentiality provision incorporated through the arbitration rules adopted under the relevant Model Clause.

CONCLUSION

The publication of the ISDA Arbitration Guide and the Model Clauses indicates that there is a real appetite for arbitration as a dispute resolution mechanism for use in the derivatives market. In particular, parties are clearly drawn to the advantages in respect of enforceability and neutrality which international arbitration can provide. However, the Guide is clear in that these are Model Clauses which may not be appropriate in all cases, particularly in more complex transactions where more detailed arbitration provisions may be more suitable.

Parties are also advised to consider the Model Clauses carefully (they are not to be viewed as "boilerplate") in the context of the domicile of the counterparty and the location of the assets in order to determine whether any amendments are necessary to maximise recognition and enforcement in those particular jurisdictions. Except in the case of the simplest transactions, specialist advice should be sought.

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