Primetime

By Sala Sihombing

There were many fads in the eighties that did not catch on. Neon clothing, big shoulder pads and Wham! have passed into cultural history, however one fad has survived and thrived. Derivatives have grown from an 865.6 billion dollar market in 1987[1] to a 434,132.23 billion dollar market by 2011[2]. In response to the proliferation of derivative contracts, the financial industry formed the International Swap Dealers Association (ISDA, later renamed International Swaps and Derivatives Association, Inc.). ISDA and the financial industry now face numerous challenges, as the financial crisis has increased public and regulatory scrutiny; and market conditions have made the bull markets of the 90's a distant memory.

One area that has received attention from commentators and practitioners is conflict resolution. As a cloistered community, investment banks have been reluctant to approach the courts to adjudicate disputes with each other or with clients. However, the financial crisis has seen a blossoming of derivative litigation (much of it related to the Lehman liquidation) and thus a renewed interest in creating more options for dispute resolution. As part of this growth of interest in ADR, P.R.I.M.E. Finance (PRIME) has been established to act as an expert panel of neutrals specifically for financial disputes[3]. Mastering the context of market practice and the specific challenges applicable to arbitration will determine if PRIME succeeds or fails.

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[1] ISDA, ISDA Market Survey (http://www.isda.org/statistics/pdf/ISDA-Market-Survey-historical-data.pdf accessed on Apr. 17, 2012 at 12.15pm)

[2] *Id.*

[3] Herbert Smith, PRIME Finance: a new dispute resolution option for the financial sector (Feb. 22 2012) (http://www.herbertsmith.com/NR/rdonlyres/EB4C609F-5516-450F-8A97-2F65AD166854/0/PRIMEFinance.html accessed on Apr. 18, 2012 at 2.26pm)

ISDA was formed by industry players to reduce the inefficiencies caused by the battle of the forms. Each bank would have their own form of derivative agreement which had been carefully crafted, which would be met with the other party's equally carefully crafted derivative agreement. In an effort to increase efficiency, ISDA worked on creating a master agreement that could combine those terms that everyone could agree on (e.g. notice, events of default, etc.). In addition, ISDA provided an opportunity for users to tailor the master to their specific requirements by drafting schedules to reflect their key concerns. Master agreements and their accompanying schedules are typically signed prior to any transactions. Individual transactions are documented under confirmation templates, which allow for individual flexibility and which reference definitional guides developed for different types of transaction (e.g. equity, commodity, FX)[4].

The genius of ISDA was to envisage the concept of the master, schedules, confirmations and definitions as forming a 'single agreement'. Therefore regardless of when the documents are signed in time they are all read together as forming a single cohesive agreement. This has enabled ISDA to launch initiatives and impact market practice amongst users with amendments to the basic documentation structure of derivative transactions.

Over the years the constituent members of ISDA have diversified away from sell side to include buy side entities. Perhaps as a result of this increased constituency, ISDA has taken on a more interventionist role in working on developments within the derivative industry. ISDA is working to garner views from users as to the direction that they should go in, for example, provide a model

[4] ISDA (http://www.isda.org/publications/isdadefslist.aspx accessed on Apr. 17, 2012 at 3.55pm)

arbitration clause for use with ISDA, appropriate tribunals, etc.[5]. ISDA is collating responses at present[6].

The existing ISDA agreement provides for submission to a specific jurisdiction (e.g. New York or England and Wales[7]) but does not include any ADR mechanism. Interestingly, the Credit Support Annex does provide a dispute mechanism with an appeal to the Valuation Agent[8] (who determines the valuations in respect of collateral).

In reality many disputes revolve around issues of valuation, whether in relation to pricing, close-out amounts or collateral valuations. Often the Calculation Agent clause (contained in the Schedule to the ISDA Master Agreement) will be heavily negotiated to include dispute rights, or a mechanism to seek quotations from reference market-makers. These disputes are typically resolved through the ancient form of ADR known as negotiation. So with this background why would the industry consider moving towards arbitration for the resolution of its disputes? Without doubt, recent litigation must be providing a push towards arbitration.

Since the Lehman crisis, there has been litigation, which has challenged the interpretation by ISDA and their authority on the meaning of their own standard form documentation. In April 2012, the English Court of Appeal heard the cases constituting the Lomas & Ors. v Firth Rixson[9] suite and made their ruling. The English Court of Appeal found that the payment obligations

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[5] ISDA, Memorandum for members of the International Swaps and Derivatives Association Inc. (Nov. 10, 2011), generally

[6] Email correspondence with Peter Werner, Senior Director ISDA EMEA Office.

[7] ISDA 2002 Master Agreement, Clause 13 (b)

[8] ISDA, Credit Support Agreement Schedule to the ISDA 2002 Master Agreement, Paragraph 4

[9] England and Wales Court of Appeal (Civil Division), Lomas & Ors. V JFB Firth Rixson [2012] EWCA Civ 419 (http://www.bailii.org/ew/cases/EWCA/Civ/2012/419.html accessed on Apr. 17, 2012 at 6.02pm)

under Section 2(a)(iii) are merely suspended and not extinguished[10] and thus a Non-defaulting Party could withhold payment to a Defaulting Party.

The ruling is important as 'in at least one respect [the Court of Appeal] does not think that it works in the way that most market participants thought it worked'[11]. Briggs J when hearing the case in the High Court found that the interpretation of the provision proposed by ISDA was 'wholly inconsistent with any reasonably understanding of the Master Agreement'[12].

Whilst the fact that the English courts supported an interpretation different to the one held by ISDA would not in itself be an issue. It is possible for market participants to anticipate how the English courts will decide such cases and adapt accordingly. However, the issue becomes significant, when the New York courts make a ruling on the same question in the opposite direction. The United States Bankruptcy Court for the Southern District of New York held that a Non-defaulting Party could not rely on Section 2(a) (iii) to withhold payments[13].

Venkour and Marchetti attribute these different decisions to context, as they say 'contractual provisions cannot be viewed in a vacuum – context is everything'[14]. Whilst this may be a reasonable conclusion for academics, it is an unacceptable proposition for the industry. In my view, recent litigation history must be taken to be one of the main drivers for interest in arbitration for the derivatives market.

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[10] England and Wales Court of Appeal (Civil Division), Lomas & Ors. v JFB Firth Rixson [2012] EWCA Civ 419 (http://www.bailii.org/ew/cases/EWCA/Civ/2012/419.html accessed on Apr. 17, 2012 at 6.02pm), para 58

[11] Edward Murray, *Lomas v Firth Rixson: a curate's egg?,* Vol 7 No 1 Capital Markets Law Journal, 5

[12] England and Wales High Court (Chancery Division), Lomas (together the Joint Administrators of Lehman Brothers International (Europe)) v JFB Firth Rixson Inc. & Ors [2010] EWHC 3372 (Ch) (http://www.bailii.org/ew/cases/EWHC/Ch/2010/3372.html accessed on Apr. 4, 2012 at 10.20am), 78

[13] Sherri Venkour and Peter Marchetti, *Metavante vs. Section 2(A)(III)(1) of the ISDA Master Agreement: the context is everything*, 31 No. 4 Futures & Derivatives L. Rep. 19 (Apr. 2011), 1

[14] *Id.* at 9

The attractions of an arbitration solution have been touted by established figures within the industry such as Jeffrey Golden. In recent years, Golden has suggested the use of an international tribunal for the resolution of complex financial disputes[15]. He has focused on issues with the current situation of resolution through litigation including: lack of expertise in financial products; concerns about cost-effectiveness or timeliness; the risk of 'wrong answers'[16]. Proponents of arbitration for ISDA based disputes have advanced the usual arguments in favor of arbitration over litigation: including the perceived benefits of efficiency, enforceability of arbitral awards under the New York Convention, and the possibility of an expert panel[17]. In addition, the risks inherent in a standard form agreement, which typically provides for adjudication of disputes in accordance with the laws of either England and Wales or New York, are only too apparent.

The use of arbitration for derivative disputes is not new, and counterparties have been able to agree on arbitration in their private negotiations. ISDA has already included an arbitration clause in the ISDA/IIFM Tahawwut Master Agreement for Islamic derivative transactions under the International Chamber of Commerce (ICC) rules[18]. In eliciting feedback from members, ISDA has proposed considering four possible rule systems: (a) the United Nations Commission on International Trade Law (UNCITRAL), (b) the ICC, (c) the London Court of International Arbitration (LCIA), and (d) PRIME.

Although ISDA is considering the use of all four systems for the resolution of disputes, the only bespoke one, which directly addresses concerns about expertise, is PRIME. PRIME represents the

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[15] Jeffrey Golden, We need a world financial court with specialist judges, Financial Times (Sep. 9, 2009) (http://www.ft.com/intl/cms/s/0/df5acd84-9cd8-11de-ab58-00144feabdc0.html#axzz1r2eoKv2c accessed on Apr. 4, 2012 at 10.42am)

[16] Jeffrey Golden, Do we need a world court for the financial markets? (http://www/worldlegalforum.org/cms/images/docs/2008_WLF_Do%20we%20need%20a%20world%20legal%20court%20for%20the%20financial%20markets.pdf accessed on Apr. 14, 2012 at 11.30am)

[17] ISDA, Memorandum – The use of arbitration under an ISDA Master Agreement (Jan. 19, 2011) (http://www2.isda.org/functional-areas/public-policy/financial-law-reform/ accessed on Apr. 18, 2012 at 12.05pm)

[18] ISDA, *supra* note 5, at 3

efforts of Golden to create a dispute resolution service focused on complex financial products[19]. The aim of PRIME is to create a panel of recognized financial experts from around the world who would serve as neutrals and also to provide judicial training programs[20]. The use of an expert panel to administer both mediations and arbitrations is designed to facilitate settlements, reduce legal uncertainty and foster stability[21].

The arbitration rules for PRIME were released in January 2012[22] (PRIME Arbitration Rules) and have been based on the 2010 UNCITRAL Arbitration Rules[23] (2010 UNCITRAL Rules). There are some key additions made by PRIME in response to consultation with market participants, which reflect a keen interest in efficiency and speed[24]. Article 26 of the 2010 UNCITRAL Rules provides for interim measures, which enable a party to receive injunctive relief prior to the issuance of an award[25]. However, the 2010 UNCITRAL Rules do not provide any emergency measures. By contrast, the PRIME Arbitration Rules have included a series of measures to deal with emergency situations, for example, Article 2a provides for expedited proceedings in which the parties can agree to a shorter time lines with the approval of the arbitral tribunal[26]. In addition to interim measures, PRIME Arbitration Rules also provide for emergency arbitral proceedings, which would take place prior to the establishment of a tribunal[27]. Annex C sets out the procedures, which envisage the appointment of an emergency arbitrator within 72 hours by

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[19] Daniella Strik, Launch of P.R.I.M.E. Finance Arbitration Rules: dispute resolution in global financial markets, (Jan 17, 2012) (http://kluwerarbitrationblog.com/blog/2012/01/17/launch-of-p-r-i-m-e-finance-arbitration-rules-dispute-resolution-in-global-financial-markets/ accessed on Apr. 4, 2012 at 10.10am)

[20] World Legal Forum, Call for the establishment of an international dispute resolution facility for the financial markets in the Hague (http://www.worldlegalforum.org/cms/images/docs/WLF_20101025_Press_Financial_Roundtable.pdf accessed on Apr. 18, 2012 at 2.15pm)

[21] Strik, *supra* note 19

[22] P.R.I.M.E. Finance, P.R.I.M.E. Finance Arbitration Rules (First Edition – 16 January 2012)

[23] *Id.*

[24] Strik, *supra* note 19

[25] UNCITRAL, UNICTRAL Arbitration Rules (as revised in 2010), 17

[26] P.R.I.M.E., *supra* note 22, 2

[27] *Id.* at 19

PRIME themselves[28]. These additions can be seen as honoring the priority given to speed and efficiency. However, PRIME has gone beyond changes just to effect efficiency, and has included provisions to increase transparency.

Article 34 (5) provides that awards may be made public with the consent of the parties or if PRIME determines that disclosure is required under a legal duty or to protect a legal right before a court or other competent authority[29]. Further, Article 34 (5) enables PRIME to publish excerpts of an award or an anonymised form of award provided the parties do not object. This is a significant development. Typically, arbitration advocates point to the confidentiality of proceedings and the privacy that parties may enjoy. This lack of transparency means that decisions are specifically related to the issues before the arbitral tribunal and do not provide any type of precedent or guidance to those who come after. The intention for PRIME in providing transparency for awards is to create a body of decisions, which will assist the industry with their search for legal certainty[30]. De Brabandere describes the publication of award in international commercial arbitration as a relative novelty[31]. It will be interesting to see whether this option makes PRIME less attractive to market participants as a forum for arbitration of their disputes. Although legal certainty is a public good – not many investment banks consider themselves responsible for providing public goods. PRIME may encounter resistance to the risk that an award may be published counter to the parties' wishes.

Brunet and Johnson consider that to achieve fairness, securities arbitration needs to have both: substantive fairness i.e. appropriate application of legal principles; and also substantive

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[28] *Id.* at 38

[29] *Id.* at 25

[30] Herbert Smith, *supra* note 2

[31] Eric De Brabandere, P.R.I.M.E Finance: The role and function of the new arbitral institution for the settlement of financial disputes in The Hague, Insights Vol. 16, Issue 3, American Society of International Law (Feb. 8, 2011)

adjudicatory fairness i.e. a fair hearing and due process[32]. In terms of substantive fairness, arbitrators will have precedent in the form of cases, which went to litigation. However, the same issue, as arose with the Lehman cases i.e. different legal contexts applied to the same master agreement, will still arise.

Various commentators, point to the global nature of the derivatives business and courts, which are 'often inconveniently situated to do justice to the parties' claims'[33]. The key issue, which is the use of a single standard form agreement governed by different legal systems, has not changed. It is not reasonable to draft a complex agreement and expect that the interpretation of all clauses will be the same no matter which governing law is selected. The use of arbitration does no more than change the forum and the locus for the decision, as arbitrators will still be required to apply substantive law to disputes brought before the tribunal. Parties will continue to select governing law based on their own preferences or prejudices and this level of uncertainty is one, which the industry needs to come to terms with, regardless of the dispute resolution mechanism.

In addition, PRIME's much touted advantage, an expert panel may also function as a liability:

> The presence of an arbitrator with expert knowledge in a complex arbitration that invites the use of that knowledge, will always carry the potential to give rise to allegations of non-judicial conduct on the context of challenges to an Award[34]

Pengelley highlights that expert arbitrators have to be aware that they do not make improper use of their expertise to supply evidence not known to the parties and to form an opinion based upon

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[32] Edward Brunet and Jennifer J. Johnson, Substantive fairness in securities arbitration, 76 U. Cin. L. Rev 459 (2007-2008), 459

[33] Golden, *supra* note 16, at 261

[34] Nicholas Pengelley, *Toeing the Line: Arbitrators with Expert Knowledge, Advocates Quarterly*, Vol. 33, No. 3, pp. 363-382 (http://ssrn.com/abstract=1311073 accessed on Apr. 18, 2012 at 3.40pm), 18 (2007)

this expert knowledge without the opportunity for comment by the parties[35]. As Lord Denning M.R. commented:

> [an arbitrator's] function is not to supply evidence … but to adjudicate upon the evidence given before him. He can and should use his special knowledge so as to understand the evidence that is given…the usage of the trade – the dealings in the market…but he cannot use his special knowledge…to provide evidence …which [the parties] have not chosen to provide for themselves[36]

This will be one of the greatest challenges for the expert arbitrators who will sit on the PRIME tribunal. On the one hand they are being specifically selected for their expertise in derivatives and market practice, however, in their duty as an arbitrator they must ensure that they are not overstepping their position. In areas where there is a divergence of market practice this could become a critical factor and may influence arbitrator selection.

One concern for parties engaged in arbitration is often the lack of any meaningful appeal against awards. In general, courts in the US have been very supportive of arbitral awards and provide only narrow grounds for vacatur[37]. Folberg et al. note that when considering arbitration awards, US courts display deference to the arbitral tribunal in respect of both legal and factual determinations[38]. For industry participants this will be an issue of concern as there will be less ability to vacate awards perceived to be erroneous. In addition, given the use of PRIME experts as arbitrators it may be that courts will be even more deferential of awards based on the comparative lack of expertise the judiciary possesses as compared to the tribunal. For PRIME awards it is most probable that challenges to the award will come at the enforceability stage.

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[35] *Id.* at 5

[36] Annie Fox & ors. v P.G. Wellfair Limited 1981 WL 186914

[37] Jay Folberg, Dwight Golann, Thomas J. Stipanowich and Lisa A Kloppenberg, Arbitration selected pages from Resolving Disputes, Theory, Practice and Law (2d ed. 2010), 661

[38] *Id.*

Under the New York Convention, when a party seeks to enforce an arbitral award, he must present it to the domestic court in the country in which enforcement is sought[39]. The New York Convention provides limited grounds upon which a domestic court may refuse to recognize an award[40]. Again, given the global nature of the derivatives business, it is probable that enforcement proceedings may take place in any jurisdiction and not just in financial litigation hubs like New York and London. In these circumstances, it becomes even more unlikely that domestic courts will have sufficient expertise to question awards. Although from PRIME's perspective, this is a key reason why PRIME arbitration is a more appropriate route for resolution than domestic litigation.

In general, the reasons given for establishing PRIME and for ISDA to propose arbitration clauses are valid. Litigation can be costly and lengthy. Arbitration is designed to address these issues, particularly, with the special adaptations made by PRIME to their arbitration rules. Additionally, a lack of expertise is a matter of genuine concern for market participants. The allure of a panel of experts to beleaguered financial parties is comprehensible. Further, for parties who decide to use rules other than PRIME, there is also the appeal of a confidential process, which maintains their privacy. Rather than the corrosive experience of litigation, arbitration provides a more discreet process and potentially one in which settlement through negotiation is more easily achievable. Perhaps in arbitration, and especially PRIME, ISDA has found the answer to the conflict conundrum.

Of concern to me, though, is the fact that the Lehman cases reveal a structural flaw in ISDA's architecture. Even with derivative expertise, arbitrators will still need to apply the governing law to any conflict. The governing law does not exist in a vacuum as a lex mundi, but exists as a law specific to its home and context, and as such ISDAs will still be vulnerable to divergent results.

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[39] UNCITRAL, Convention on the recognition and enforcement of foreign arbitral awards (1958), Article IV

[40] *Id*. at Articles V and VI

Like all fads, there is an energy and focus on the current proposals for arbitration as the panacea for the ills of the financial markets. In the aftermath of the Lehman crisis, there was a move away from brokers established in non-United States jurisdictions based on the perception that Lehman customers in the United States (US) received better treatment during the liquidation process. It became a vogue amongst hedge funds to select a US prime broker. In this way, market participants sought to control the legal uncertainty that inevitably follows a prime broker liquidation. However, time has moved on and there is now greater understanding that customers in both the US and United Kingdom markets received substantially the same treatment through the Lehman liquidation process.

Will PRIME arbitration replace litigation and will it be able to provide a credible alternative system of precedents? Will PRIME be able to provide the stability and legal certainty that is it's stated goal? Time will tell whether this brave endeavor will succeed, perhaps the real test will only come with the next great financial crisis.