ICC report on financial institutions and international arbitration

On 9 November 2016, the ICC Commission on Arbitration and ADR (ICC) published a report on financial institutions and international arbitration. The report was the result of a two-year study by the ICC Task Force on Financial Institutions and International Arbitration (the Task Force), which examined the use of both international commercial and investor-state arbitration by financial institutions in a wide range of activities. Steven Finizio, Manuel Casas, Jonny Lim, and Rina See of WilmerHale consider the ICC's report and summarise the Task Force's findings and recommendations.

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The use of arbitration in financial disputes

The Task Force observed that, historically, many financial institutions have not used international arbitration to resolve their disputes, choosing instead to litigate in the national courts of financial centres like New York, London, Hong Kong and Frankfurt. Moreover, the Task Force found that, while many in the banking and finance sector were unfamiliar with arbitration, financial institutions are using international arbitration in a wide and growing array of transactions in various areas, and with various counterparties.

As a result of the changing regulatory environment following the 2008 global financial crisis and the general increase in the number and type of disputes by and against financial institutions, financial institutions have been involved in a greater number of arbitration claims, and now increasingly view international arbitration as a viable alternative.

This increasing interest in arbitration is reflected in a number of industry-specific arbitration initiatives. For example, the International Swaps and Derivatives Association (ISDA) released an arbitration guide in 2013 that offers model arbitration clauses for use with the ISDA Master Agreement for over-the-counter (OTC) derivatives transactions. PRIME Finance, an arbitral institution aimed at resolving complex financial disputes, was launched in 2012. Hong Kong's Financial Dispute Resolution Centre (FDRC) was set up after the global financial crisis by Hong Kong's bank regulator and arbitration institution. These initiatives join existing institutions such as the Financial Industry Regulatory Authority (FINRA), a private self-regulatory organisation in the United States that provides arbitration services in addition to its regulatory and enforcement roles.

Even so, financial institutions still do not use arbitration consistently or on a large scale. The Task Force found that, in the past five years, most (70%) of the financial institutions interviewed did not have any direct experience of arbitration, while a minority (24%) had experience with arbitration, but arbitration represented 5% or less of their disputes. Only a very small minority (6%) had arbitrated more than 5% of their disputes.

The Task Force also noted that investors have filed claims under investment treaties challenging state measures bailing out 'global systemically important banks' (G-SIBs), and that foreign investors can invoke the fair and equitable treatment protection in claims against bank regulators, even if there is an exclusive jurisdiction clause in the investment contract with the host state in favour of national courts. The Task Force predicts that mandatory bail-in provisions introduced by the EU Bank Resolution and Recovery Directive in 2014 could give rise to investor-state arbitration claims from bailed-in creditors and shareholders.

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Financial Institutions' perceptions and preferences

The Task Force identified financial institutions' perceptions towards international arbitration as compared to litigation, as well as their preferences with respect to conducting arbitrations.

Financial institutions indicated that international arbitration had a number of perceived advantages over litigation, including:

- The enforceability of arbitral awards under the New York Convention
- The ability to appoint arbitrators with specialised financial expertise
- Procedural flexibility which allows financial institutions the ability to tailor the procedures to meet their specific needs
- The ability to make proceedings confidential, and
- The finality of arbitral awards due to the limited right of appeal

At the same time, the Task Force also noted that financial institutions believe that arbitration has a number of perceived disadvantages compared to litigation, including:

- The belief that parties need to go to national courts to obtain interim relief before a tribunal is constituted
- The absence of summary proceedings and the perceived inability of arbitral tribunals to issue a default award when a party fails to appear
- Concerns about the availability of joinder and consolidation in arbitration
- The uncertainty caused by the inability to establish precedent
- Potentially greater costs
- The perceived lack of transparency and financial institutions' lack of comfort or familiarity with arbitration, and
- Limitations on an arbitral tribunal's powers with respect to insolvency proceedings

The Task Force noted that few financial institutions seemed to be aware that some of these perceived disadvantages are addressed in many arbitral rules. In particular, the institutions interviewed appeared to be unaware that the rules of many arbitral institutions now provide a procedure for the appointment of an emergency arbitrator to consider applications for interim relief before a tribunal is constituted, or that many rules have mechanisms for the joinder of additional parties and the consolidation of separate proceedings.

The Task Force concluded that financial institutions tend to favour arbitration over litigation when:

- The transaction is significant or particularly complex
- Confidentiality is a concern
- The counterparty is a state-owned entity, or
- The counterparty is in a jurisdiction where recognition and enforcement of foreign judgments may be more difficult than that of an arbitral award

As for preferences with respect to the conduct of arbitrations, the Task Force found that financial institutions:

- Generally prefer institutional arbitration over ad hoc arbitration, and tend to arbitrate under the ICC, LCIA, HKIAC and SIAC rules
- Frequently select Geneva, Hong Kong, London, New York, Paris and Singapore as arbitration seats
- Frequently select English as the language of the arbitration
- Generally prefer three-member tribunals, with the president appointed by the two party-appointed arbitrators
- Consider industry expertise and experience, availability and responsiveness, common sense, language skill, and independence and impartiality when selecting arbitrators
- Rarely use multi-tiered clauses (which require some form of alternative dispute resolution such as mediation or negotiation before a dispute may be submitted to arbitration), although they frequently use mediation without prior contractual commitment, and
- Use asymmetrical or unilateral option clauses (which allow only one of the parties to choose between arbitration or litigation) has decreased in recent years, mainly because their enforceability has been challenged in a number of jurisdictions

Types of transactions and/or disputes

The Task Force considered the use of arbitration across a wide range of banking and financial activities undertaken by financial institutions, whether undertaken by banks or by funds (including equity, investment or sovereign wealth funds). The Task Force, however, did not cover consumer and mortgage lending and insurance and third-party financing of disputes due to their specialised and jurisdiction-specific natures.

Derivatives

The Task Force first considered the use of arbitration for transactions involving derivatives, which are a financial product whose value is determined by fluctuations in the value of an underlying asset, and can be traded either on special derivatives exchanges or without an official exchange and OTC. Derivatives represent a significant area of financial activity—at the end of 2014, the OTC market alone had a total notional amount outstanding of approximately US$630trn. Derivatives-related disputes include:

- Those involving investment advice and allegations of mis-selling
- Calculation of payment streams and settlements, and
- Rights and obligations under the ISDA Master Agreement

The Task Force found that one of the main reasons why arbitration is less commonly used, particularly in Europe, is that arbitration is not yet viewed as a 'default' dispute resolution mechanism when financial institutions enter into contracts. However, interviewees generally said that they would be willing to consider providing for arbitration if a counterparty suggested doing so. This increasing willingness to use arbitration to resolve disputes arising from derivatives transactions is particularly evident where counterparties are from emerging markets, because of difficulties enforcing court decisions in those jurisdictions.

Given the complexity that can be involved in derivatives transactions, arbitration may also be advantageous because the parties can select arbitrators with the relevant experience. For disputes relating to derivatives, the greater confidentiality and potential for a speedy resolution may also lead parties to prefer arbitration over litigation. This is particularly true where parties may be concerned about systemic risk (the risk that events arising out of one transaction can lead to instability or collapse of the whole financial system). The Task Force noted that because systemic risk is often present where derivative transactions are concerned, parties to derivatives disputes may wish to avoid the consequential effects on financial markets that publicity from the dispute could cause.

Sovereign finance

The Task Force examined disputes relating to sovereign finance—ie, sovereign bonds and other capital market instruments that governments use to raise capital.

The Task Force examined bonds issued by 92 sovereigns (most issued between 2010 and 2015), and found that arbitration was provided for in 18 of those bonds (approximately 20%). Of the approximately 50 financial institutions interviewed, 22 out of 33 (approximately 67%) indicated that they would be more inclined to choose arbitration over litigation in a contract with a sovereign, five (approximately 15%) indicated that they would be less inclined to select arbitration, and the remaining six (approximately 18%) indicated that they would be equally inclined or that their choice would depend on the specific circumstances.

In addition to other commonly cited advantages of arbitration, the most important factor identified for choosing arbitration in contracts with sovereigns was neutrality—ie, the ability to avoid resolving disputes in the sovereign's national courts. The Task Force noted that the most common cause of sovereign finance disputes is non-payment, and in such disputes the duration of the proceeding is likely to be of greatest concern to financial institutions. In addition, the Task Force mentioned that investor-state arbitration may be beneficial in resolving complex foreign finance disputes (for example, those involving the restructuring of sovereign debt).

Investor-state arbitration

The Task Force addressed the protections that international investment agreements (IIAs)—ie, bilateral, multilateral, and some free trade agreements with investment provisions—offer to the banking and finance sector. In particular, the Task Force considered how the procedural and substantive protections established in IIAs could be relevant to financial institutions, and whether investor-state arbitration is an adequate forum to resolve disputes involving financial institutions, their shareholders and financial instruments. The Task Force noted that IIAs provide financial institutions with procedural and substantive protections for their investments in a particular host state.

The Task Force reviewed investor-state arbitration awards involving financial institutions, a number of which had arisen out of various financial crises and state measures in response to those crises.

First, it looked at jurisdictional issues that had arisen in such cases, as well as the substantive protections that investors had sought to invoke when bringing claims based on allegations of state interference in the operations of financial institutions.

Second, the Task Force considered the definition of 'investment' under the treaties at issue in those cases, and concluded that there is a measure of unpredictability regarding whether financial institutions and their products are protected. For example, the Task Force found five awards in which sovereign debt products were found to be a qualifying 'investment' protected under the applicable treaties. However, these awards have been subject to debate, and questions have been raised about whether dematerialised financial instruments (ie, financial instruments with only electronic records of title), particularly when acquired on the secondary market, can fall within the meaning of 'investment' as defined in the relevant treaties, and whether they can or should satisfy an objective test for what constitutes an 'investment.'

The Task Force also looked at instances in which regulatory activity might have given rise to investor-state arbitration claims, and found that, in cases involving financial institutions, their shareholders and financial instruments, tribunals have generally shown deference to what is on balance viewed as legitimate regulatory activity, in light of the public interest served by the regulation.

Finally, the Task Force noted that states have become increasingly sceptical of allowing claims concerning sovereign debt restructuring to be made in arbitration. This is reflected in the exclusion of financial instruments from protection under some recently drafted IIAs.

Regulatory Matters

The Task Force analysed the potential for arbitration to be used in dealing with 'regulatory matters.' In its definition of regulatory matters, the Task Force included the application and enforcement of business conduct rules, the regulation of financial products and markets, and prudential supervision.

The Task Force found that few financial institutions had any experience arbitrating regulatory matters, and considered that this could be because such matters concern questions of public policy, and are therefore addressed directly by regulators themselves or by national courts, rather than through arbitration.

The Task Force found, however, that financial institutions were willing to consider arbitration in connection with disputes arising from the civil and financial consequences of regulatory breaches. The Task Force suggested that such disputes should, in principle, be arbitrable. It noted, however, that if a dispute involves public interest concerns or touches on interests of third parties (such as those involving securities laws), it may not be arbitrable. The Task Force found that the trend is to view the financial consequences of a dispute based upon a regulatory breach as arbitrable, although this varies from jurisdiction to jurisdiction. The Task Force considered arbitration particularly beneficial where private claims arising out of regulatory breaches are concerned, and referred to FINRA in the US and the FDRC in Hong Kong, specialised institutions that already administer such disputes through arbitration.

International Financing

The Task Force also addressed international financing, which it characterised as cross-border loans, facility agreements and unfunded guarantee facilities, including secured and unsecured lending, bilateral and syndicated lending, project finance, and trade finance.

The Task Force observed that financial institutions have been reluctant to rely on arbitration to resolve disputes involving international financing, as they prefer instead to litigate such disputes, particularly for syndicated lending or asset financing disputes. However, it noted that there have been some signs of shifting attitudes. For example, arbitration is often used in project finance disputes, especially when parties or assets are located in a developing country.

The Task Force also noted that financial institutions prefer arbitration in jurisdictions where domestic courts are perceived as being unreliable or lacking independence. In trade finance disputes, although the historical trend was to favour litigation, there is growing acceptance of arbitration. In contrast, in secured transactions, parties are often more reticent about using arbitration, on the assumption that court intervention is necessary to enforce security rights, because such matters tend to arise in the context of insolvency proceedings and are traditionally within the exclusive jurisdiction of an insolvency court. However, the Task Force observed that such limitations do not apply to self-enforcing securities—namely, where the law provides a means for the secured creditor to enforce its right over collateral out of court, such as in a private enforcement agreement.

Islamic Finance

The Task Force also looked at financial transactions carried out in accordance with sharia or Islamic law. The Task Force noted that, although the use of Islamic finance has grown significantly in recent years, there has not been a parallel growth in the use of arbitration relating to these transactions.

Islamic finance often requires financial transactions to comply with two sets of rules: those established in sharia and those established under the applicable national law. This can lead to choice of law issues, particularly when the contract specifies that national law applies *unless* it contradicts sharia. The Task Force found that some courts (for example, in the United Kingdom, *see Beximco Pharmaceuticals Ltd. v. Shamil Bank of Bahrain*, [2004] EWCA Civ 19) are reluctant or at least ambivalent about either applying sharia or refusing to apply national law based on a purported contradiction with sharia. The Task Force considered that this reluctance might make arbitration more attractive where the contract provides for the application of both a national law and sharia, because there have been arbitral awards that gave effect to such a choice by the parties that have been upheld and enforced *(Sanghi Polyesters Ltd (India) v. The International Investor* KCSC (Kuwait), Sanghi Polyesters Ltd (India) v International Investor KCSC (Kuwait) [2000] Lexis Citation 2632).

Additionally, the Task Force concluded that, although two arbitral institutions have already attempted to develop specific procedures for Islamic finance disputes—the International International Islamic Centre for Reconciliation and Mediation (IICRA), based in Dubai, and the Kula Lumpur Regional Centre for Arbitration (KLRCA)—these efforts have had limited success, as important Islamic banks have not embraced arbitration.

International Financial Institutions, Development Finance Institutions, and Export Credit Agencies

The Task Force also addressed the approach that international financial institutions (IFIs) (ie, financial institutions established or chartered by more than one state, whose shareholders or owners are generally sovereigns), development finance institutions (DFIs) and export credit agencies (ECAs) take towards arbitration. The Task Force found that these institutions are aware of the potential advantages posed by different features of arbitration that they may choose (such as institutional versus ad hoc arbitration or three arbitrators opposed to one), usually have no firm policies regarding the use of either arbitration or litigation, and exercise significant influence over documentation related to international financing agreements (including the choice of dispute resolution mechanism).

The Task Force suggested that, in some cases, these institutions may find arbitration to be advantageous because:

- They tend to have large operations in emerging countries that do not recognise foreign judgments or subject them to extensive review
- They tend to be concerned about the neutrality of the forum, particularly when the counterparty is a state or a state-owned entity, and
- Some IFIs enjoy privileges and immunities in their host states, and arbitration allows them to safeguard those immunities by avoiding subjecting themselves to national courts and potentially waiving their immunity

The Task Force found that IFIs, DFIs and ECAs do not have many disputes, but are more open to arbitration than other types of financial institutions. Finally, the Task Force noted that disputes in international lending usually involve monetary claims arising out of the borrower's default on its payment obligations. These kinds of disputes usually do not involve complicated points of law, which may be a reason for the practice of choosing to litigate in English or New York courts.

Advisory Matters

The Task Force also covered advisory matters, focusing on disputes concerning the advice that investment banks provide to their clients in mergers and acquisitions (whether in the form of a straight sale or purchase, a merger, an asset swap, a public tender offer or a privatisation) and equity capital markets (including initial public offerings (IPOs) or the issuance of debt or equity securities). Contracts for these services usually include dispute resolution clauses. The Task Force noted that arbitration may be preferable for disputes arising out of these services, as they tend to involve complex and sensitive issues and the parties may value confidentiality. Nevertheless, the Task Force found that financial institutions often do not include arbitration agreements in contracts for advisory services, which may be due to lack of experience or familiarity with the arbitration process or perceived cost issues.

Asset Management

Finally, the Task Force looked at asset management, defined as the management of portfolio investments or the provision of investment advisory services. The Task Force noted that a wide range of entities rely on asset managers, but that these types of services are often required by individuals, small and medium enterprises, and non-profit organisations.

The Task Force found that arbitration is seldom used in asset management disputes. In some cases, the asset management companies interviewed by the Task Force were completely unaware of the existence of arbitration. Other interviewees were unaware of the potential advantages arbitration could have for resolving asset management disputes.

The Task Force noted that two factors may contribute to make arbitration attractive for asset management disputes. First, asset management disputes can involve complex issues in a niche area, and that arbitration may provide a level of specialised technical competence not found in courts. Second, confidentiality may be desirable for both parties to asset management disputes: asset management providers may not wish to have their identities revealed, particularly in cases involving allegations that they have breached their obligations, and private clients usually want to keep sensitive financial information confidential.

What did the task force recommend?

The Task Force made a number of recommendations based on financial institutions' current experiences with arbitration. These include:

- Methods for reducing time and costs through effective case management
- Using bifurcation and other techniques where it would result in a more efficient resolution of a case
- Providing for a duty of confidentiality
- Making express provision for the availability of summary disposition, and
- Specifying cost shifting rules in arbitration agreements

The Task Force also recommended that parties assess potential avenues of recourse under investment treaties as they plan their investments.

The Task Force considered that Islamic finance and derivatives were potential growth areas for arbitration and financial institutions, and suggested several ways to further facilitate use of arbitration by financial institutions. It recommended that financial institutions develop their own set of internal policies regarding the use of international arbitration and preferences for particular terms for arbitration agreements tailored to their particular business. Finally, the Task Force recommended that financial institutions assess how to make better use of arbitration through dialogue with trade associations, universities, law firms and arbitral institutions.

What conclusions may be drawn?

The findings of the Task Force confirm a widely held perception in the arbitration community that the arbitration of financial services disputes has been a real growth area in recent years. However, they also suggest that there are several types of banking and financial activities that have not seen as much of an increase in the use of arbitration as one might expect—such as derivatives, advisory services and asset management—despite the advantages that arbitration offers as compared to litigation. These might be areas of potentially significant growth for the use of arbitration in the future.

To the extent the issue holding back an increased use of arbitration in these types of banking and financial activities is one of perception and a lack of understanding by financial institutions, the report is an important first step in addressing some of these concerns. However, it is not yet clear how effective the report will be in increasing awareness and understanding outside of the arbitration community. To succeed, there would likely need to be sustained efforts at dialogue with financial institutions of all types, as well as the banking and finance counsel that advise them on transactions. To this end, the ICC is planning a worldwide series of events to launch the report that are targeted at financial professionals and their legal counsel, which began with a global launch in Rome on 8 November 2016. Further events are scheduled for 2017 in Panama, Frankfurt, London, New York, The Hague, Hong Kong, Paris and Singapore. The goal of these efforts is to spur greater understanding and use of arbitration by financial institutions, although it remains to be seen whether the habit of litigation can be kicked.

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