Introduction

Arbitration, a method of dispute resolution conducted through a privately constituted tribunal, has long been preferred over court litigation in many types of financial transactions. In the insurance sector and some areas of the banking sector, the standard method of dispute resolution has for some time been international arbitration. However, until recently, there have been limitations to the use of arbitration for disputes arising in respect of over-the-counter ("OTC") derivatives. OTC derivatives form the largest market for derivatives; as of December 2012, the notional value of the global OTC derivatives market stood at a staggering US$633 trillion.¹

OTC derivatives explained

OTC derivatives are financial products, the value of which derives from an underlying asset or variable. They are not traded on regulated exchanges (hence “over-the-counter”) and consequently are subject to increasingly stringent regulation. Some of the most common OTC derivatives are interest rates swaps, credit default swaps and options. Their commercial and, to some extent, legal terms are based on negotiations between the parties involved.

Almost all OTC derivatives are documented using either the 1992 or the 2002 version of the standard form master agreement ("ISDA Master Agreement") developed and published by the International Swaps and Derivatives Association, Inc. ("ISDA"). ISDA is a trade organisation operating on behalf of participants in the market for OTC derivatives. The main body of the ISDA Master Agreement is a pro-forma agreement containing industry standard provisions. These provisions can be amended and/or supplemented through the Schedule to the ISDA Master Agreement ("Schedule"), which is often heavily negotiated.

In a typical transaction involving an OTC derivative, the standard practice is to execute the ISDA Master Agreement as the central document which sets forth the general terms and conditions necessary to allocate risk and regulate the relationship between the parties. Once that legal framework is in place, the parties enter into one or more derivative transactions thereunder by agreeing on the material commercial terms.

The current dispute resolution provision in the ISDA Master Agreement (2002 version)

In its current incarnation, the dispute resolution provision in the ISDA Master Agreement (2002 version) provides for disputes between the parties to be resolved by the English or New York courts, depending on whether the parties have opted for English or New York law as the governing law in the Schedule. However, the increasing involvement in international finance of end users based in emerging market jurisdictions has led to the publication by ISDA and P.R.I.M.E. Finance (an organisation catering for the resolution of disputes on complex financial transactions) of model arbitration clauses for the resolution of disputes involving OTC derivatives. Whilst in the past financial institutions may have developed and incorporated arbitration clauses by way of amendment of the ISDA Master Agreement for

use with certain counterparties, the recent developments are significant because, in practice, counterparties are often unwilling to accept amendments to the ISDA Master Agreement that are neither market standard nor recommended by ISDA.

The desirability of arbitration for OTC derivatives transactions

The push towards arbitration is driven largely by the unattractiveness of court litigation as a method of dispute resolution in financial transactions. In some jurisdictions, court proceedings are associated with excessive delays, which can drive up the cost of litigation. An additional hurdle may be the lack of local counsel with expertise in OTC derivatives. The movement towards arbitration is driven by strong forces, such as the ease of enforcement and finality of an arbitral award, the private and confidential nature of arbitration, the procedural flexibility that it offers and the neutrality (whether actual or perceived) of arbitral proceedings.

(i) Ease of enforcement

As discussed above, the OTC derivatives market has grown to include end users which are based in emerging market jurisdictions, in which it is often difficult to enforce a foreign court judgment. The most effective way to mitigate this risk is for the parties to agree to arbitration as the mode of dispute resolution. The advantages in relation to enforcement flow from the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards (“New York Convention”) to which 149 states are signatories. Under the New York Convention, contracting states are required to recognise and enforce foreign arbitral awards, subject only to limited exceptions set out in Article V of the New York Convention.

(ii) Finality

Arbitral awards are final and binding on the parties once the award is rendered by the arbitral tribunal. Unlike a court judgment, arbitral awards are not subject to appeal on the merits. Under the New York Convention, recognition and enforcement of foreign arbitral awards may only be refused on the grounds set out in Article V (for example, if the tribunal has no jurisdiction to determine the dispute or certain requirements of due process are not met). Although enforcement of foreign arbitral awards is, in practice, not straightforward in some jurisdictions, the victorious party would still be in a better position than if it had a court judgment in its favour. This is particularly the case in jurisdictions where there is a lengthy appeal process for court judgments; in many instances, a success in court in one of these jurisdictions represents a pyrrhic victory.

(iii) Private and confidential nature of arbitration

One of the key features of arbitration that parties find attractive is the privacy of arbitral proceedings (the hearing is conducted behind closed doors) and the potential confidentiality offered by arbitration (subject to the agreement of the parties and/or the law of the place of arbitration). The obligation of confidentiality requires the parties to refrain from disclosing all matters relating to the proceedings and the award. This advantage would be commercially significant to large financial institutions with an interest in protecting their international reputations and preserving existing banking relationships.

(iv) Procedural flexibility

The inherent procedural flexibility of arbitration allows parties to tailor the manner in which proceedings are run to suit the requirements of the case at hand. For instance, as expert
witnesses are likely to be called, the tribunal may employ the use of witness conferencing or “hot tubbing”. This is a procedure in which expert witnesses of the same discipline appointed by the parties give their evidence at the same time, allowing each the opportunity to respond to statements and question assumptions made by the other. If executed properly, this is often a highly effective and efficient way for expert witnesses to give evidence. Also fundamental to arbitration is the right of the parties to select the arbitrator(s) to determine the dispute. In cases which are fact-intensive, it may be essential to have arbitrators who possess a sound working knowledge and familiarity with the derivatives market as these may not be readily grasped by outsiders to this sector. In this regard, one noted commentator has observed that “[t]he decision-making dynamic for resolving disputes about swaps and other derivatives is quite different from the environment surrounding credit agreements”.2

(v) Neutrality

Counterparties in emerging market jurisdictions are increasingly reluctant to accept that disputes will be resolved in the English or New York courts, and arbitration is often a more acceptable alternative.3 By the same token, financial institutions benefit from arbitration by having the dispute heard in a neutral forum instead of the national courts of a counterparty. This is especially the case where one of the parties is a national government. For example, in a recent case between Deutsche Bank and Sri Lanka’s national petroleum corporation, Ceylon Petroleum Corporation (“CPC”), the parties entered into an oil hedging agreement on 8 July 2008 (“Hedging Agreement”) to protect Sri Lanka against the impact of rising oil prices. The Hedging Agreement comprised, among other things, a term sheet containing the key terms and an unsigned and undated ISDA Master Agreement (1992 version). The term sheet provided that CPC’s failure to enter into the ISDA Master Agreement within 90 days would amount to a termination event. Due to a sharp fall in oil prices in July and August 2008, CPC was required to make payments under the Hedging Agreement to Deutsche Bank. On 3 December 2008, Deutsche Bank terminated the Hedging Agreement as a result of CPC’s failure to execute the ISDA Master Agreement within 90 days, and calculated the close-out amount payable by CPC as US$60 million. Deutsche Bank subsequently commenced arbitration against Sri Lanka under the bilateral investment treaty between Sri Lanka and Germany4 to recover this sum. These proceedings were administered by the International Centre for Settlement of Investment Disputes (ICSID).5 The case was eventually resolved in favour of Deutsche Bank, with the arbitral tribunal ordering Sri Lanka to make payment of the sum of $60 million plus interest to Deutsche Bank.

Model arbitration clauses for use in OTC derivatives transactions

The value proposition of arbitration in the resolution of derivatives-specific disputes has started to receive market recognition. Specifically, as mentioned above, ISDA has recently published model arbitration clauses, which can be incorporated into the ISDA Master Agreement should the parties wish to select arbitration as their dispute resolution mechanism. In addition, P.R.I.M.E. Finance has published several model amendment agreements to the ISDA Master Agreement, each of which amends the ISDA Master Agreement so that arbitration is the agreed method of dispute resolution.

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3 See ISDA’s Memorandum on “The use of arbitration under an ISDA Master Agreement” dated 19 January 2011, ¶4.2.
5 Deutsche Bank AG v Democratic Socialist Republic of Sri Lanka, ICSID Case No. ARB/09/02. This decision is now the subject of annulment proceedings filed by Sri Lanka on 8 March 2013.
The 2013 ISDA Arbitration Guide containing the ISDA model arbitration clauses ("ISDA Model Clauses") is drafted on the basis that the ISDA Model Clauses will be incorporated into the Schedule to the applicable ISDA Master Agreement. Various different combinations of governing law, seat of arbitration and institutional rules are provided for in the ISDA Model Clauses. They include a choice of English or New York law as the governing law of the underlying agreement, with options for the seat of arbitration to be London, Paris, The Hague, Geneva, Zurich, New York, Hong Kong, or Singapore. The choice of institutional rules allows for ICC Rules, LCIA Rules, AAA-ICDR Rules, HKIAC Rules, SIAC Rules, Swiss Rules of International Arbitration and P.R.I.M.E. Finance Rules (the last of which is likely to be attractive since P.R.I.M.E. Finance boasts a panel of recognised international market experts in finance).

The 2013 ISDA Arbitration Guide was issued following a lengthy consultation with ISDA’s members starting on 19 January 2011, and was developed with members’ input. The consultation revealed that ISDA’s members were very interested in using arbitration for disputes arising in connection with derivatives transactions documented under the ISDA Master Agreement. On this basis, the ISDA Model Clauses are likely to be a welcome development for market participants. For one, they will help to solve the oft-encountered problem of defective arbitration clauses, which are usually the consequence of poor drafting or the parties not turning their attention to the arbitration clause during negotiations until the last minute (it is hence referred to as the "midnight clause"). However, as the ISDA Model Clauses are new, it remains to be seen how frequently they will be used. In particular, financial institutions which have already invested resources in developing their own arbitration clauses may prefer to continue to use these (to the extent that they are accepted by counterparties) rather than amend their ISDA Master Agreements further to incorporate the new ISDA Model Clauses.

It is noteworthy that the ISDA Model Clauses make no attempt to provide for a "unilateral split" arbitration clause. These are arbitration clauses which are often favoured by banks for their flexibility, and provide for the obligation to resolve disputes through arbitration; however, one of the parties to the contract (usually the bank) has the additional option of bringing a claim in the courts of a specified jurisdiction. Although such arbitration clauses have been written into contracts in many instances in the past, recent decisions of the French and Russian courts have thrown their enforceability into question.

**Conclusion**

For the reasons outlined above, it is apparent that the arbitral process is well-suited to the resolution of disputes involving OTC derivatives. Indeed, one can go further to say that the arbitral process facilitates "the development and maintenance of an efficient and productive worldwide market in derivatives and swaps", as the English High Court suggested in a decision in 1999. What is clear is that the introduction of the model arbitration clauses by ISDA and P.R.I.M.E. Finance has given commercial parties additional options for dispute resolution. As this is a recent development, it remains to be seen whether, and to what extent, these model arbitration clauses will be adopted by the market.

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6 Published on 9 September 2013.
8 See the decision of the French Cour de Cassation (Cass Civ. 1ere, 26 September 2012), n° 11-26.022.
9 See the decision of the Presidium of the Supreme Arbitration Court of the Russian Federation No. 183/12 dated 19 June 2012 (Russian Telephone Company v Sony Ericsson Mobile Communications Rus).
10 Bankers Trust Co v PT Jakarta International Hotels and Development [1991] 1 All ER (Comm) 785.