Arbitrating financial "star wars"

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This article considers the use of arbitration as a way of resolving financial disputes involving "over-the-counter" (OTC) derivatives. Understanding these derivatives is vital to avoiding systemic risk in the global financial economy. OTC derivative disputes involve important challenges, not only because of their complexity, especially in the case of non-centrally cleared derivatives, but also because of their unfamiliarity among commercial arbitrators who are likely to be pressed by the parties for a speedy delivery of an award.

INTRODUCTION

> There is no sphere of human thought in which it is easier for a man to show superficial cleverness and the appearance of superior wisdom than in discussing questions of currency and exchange.
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> WS Churchill[1]

> The study of money, above all fields in economics, is the one in which complexity is used to disguise truth or to evade truth, not to reveal it.
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> JK Galbraith[2]

> Derivatives are financial weapons of mass destruction.
>
> WE Buffet[3]

The phenomenon of "over-the-counter" (OTC) derivative contracts has been likened to a shadow over the banking system. Acronyms, such as "CDOs" for collateralised debt obligations and "CDSs" for credit default swaps, abound. It would be easy to mix them up with C3PO and R2D2, the robots in George Lucas's "Star Wars". Synthetic CDOs and CDOs[2] (ie CDOs squared) are simply artificial contracts by another name.

Explosive worldwide growth in OTC derivative trading has been seen since the mid-1980s – most of which is speculation. Hedging against financial risk, whilst important, has been less of a cause. The "notional" outstanding amount of OTC derivative contracts at the time of the global financial crisis in 2008 was US$673 trillion[4] or US$673,000,000,000,000.[5]

As at 31 December 2012, the notional value of derivative contracts outstanding was US$633 trillion with a market value of US$25 trillion of which interest rate swaps represented about 76%.[6] By comparison, the World Bank put the global GDP for 2012 at US$72 trillion.[7]

This article explores the use of arbitration as a way of resolving OTC derivative disputes. First, it is considered whether derivatives serve a useful purpose. Secondly, the peculiar characteristics of different types of derivatives are discussed. Thirdly, some background is given as to the legal character of derivatives. Fourthly, consideration is given to the introduction of central clearing parties and the

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[1] Churchill WS, *Hansard*, Vol 468, col 160 (28 September 1949).

[2] Galbraith JK, *Money: Whence it Came Where it Went* (Houghton Mifflin, 1975) p 5.

[3] Buffet WE, *2002 Annual Report* (Berkshire Hathaway Inc, 2003) – "Chairman's Letter", p 15, http://www.berkshirehathaway.com/2002ar/2002ar.pdf.

[4] The Financial Crisis Inquiry Commission, *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* (US Printing Office, 2011) p xxiv.

[5] The "milky way", which contains our solar system, has a mere 200-400 billion stars. Numerically 673 trillion corresponds to 67 light years; 10 trillion km = 1 light year with light travelling at 300,000 km per second; a trillion is 10^{12}.

[6] Bank for International Settlements, *Table 19: Amounts Outstanding of Over-the-counter (OTC) Derivatives* (Quarterly Review, May 2013), http://www.bis.org/statistics/dt1920a.pdf.

[7] World Bank, *Total World GDP* (2012), http://search.worldbank.org/data?qterm=total+world+gdp&language=EN&format=&os=40.

likely effect this will have on arbitrating disputes. Fifthly, some of the issues concerning non-centrally cleared derivatives are canvassed. Sixthly, the types of disputes that might arise are identified with respect to traditional OTC derivative transactions and centrally cleared derivatives. Seventhly, the practice and procedure of arbitrating derivative disputes involving the originating parties and a central counterparty (CCP) is discussed. Finally, the role for existing arbitral bodies is considered, especially as to the quick determination of disputes.

DO DERIVATIVES SERVE A USEFUL PURPOSE?

Whether derivatives serve a useful purpose is a vexing question. It is contended that they act as price insurance or hedge, especially with respect to interest rates, currency rates, agricultural products, metals and shipping freight rates. As to synthetic CDOs and CDSs, it is contended that they are instruments of speculation. American International Group's losses on CDSs (partially recouped against an $80 billion "bail out" from the American government), vividly illustrated the cavalier way in which risk was assessed. Sed quis custodiet ipsos custodies (who guards the guards), seems to be apposite.[8] In other words, who insures the insurer?

> The challenge faced by the credit default swap market is that it has transitioned from a buyer's and seller's market of protection, where the first party would take a bond or loan to protect against a default and the second party would be willing to provide the protection because he or she had the opposite position or because he or she felt that the rewards were worth it, into a pure speculator's market where neither party possesses any assets. Instead they bet on whether or not a default or "credit event" will happen to a certain loan or bond. This market has nothing to do with a traditional insurance market because the seller of protection has no capital requirement as insurers do, and the buyer of protection cannot easily determine the counterparty risk of the protection seller, as in the case of an insurer that is regulated.[9]

Warren Buffet hit the mark when he said:

> I know of no reporting mechanism that would come close to describing and measuring the risks in a huge and complex portfolio of derivatives. *Auditors can't audit these contracts, and regulators can't regulate them*. When I read the pages of "disclosure" in 10-Ks of companies that are entangled with these instruments, all I end up knowing is that I don't know what is going on in their portfolios (and then I reach for some aspirin).[10] [emphasis added]

CREDIT DEFAULT SWAPS AND COLLATERALISED DEBT OBLIGATIONS

CDSs as at 30 June 2012 had a market value of US$0.848 trillion, which was 3.4% of the outstanding market value of OTC derivatives of US$24.7 trillion.[11]

By their very nature CDSs and synthetic CDOs are likely give to rise to disputes when a counterparty defaults. CDSs are bets that there will be default on the repayment of a debt instrument issued by a corporation or a country. The risk is whether the insurer will be able to pay the difference between the debts face value and its market value when the default event occurs. The insured has no insurable interest to protect, but is willing to pay premiums to the so-called insurer. Posner described the usefulness of speculation in this way:

> Like other speculators, short sellers and buyers of credit default swaps that insure strangers' debt are unpopular because they are trading on and therefore hoping for a future calamity. When the price of an asset falls as a result of speculative activity, the speculators are blamed. That's like blaming a thermometer for a fall in temperature. Provided the speculators do not spread false rumors about the

[8] Juvenal, *Satire VI*, line 347.

[9] de la Dehesa G, *Twelve Market and Government Failures Leading to the 2008-09 Financial Crisis* (Occasional Paper 80, Group of Thirty, 2010) pp 37-38, http://www.group30.org/images/PDF/ReportPDFs/OP80.pdf.

[10] Buffet WE, *2008 Annual Report* (Berkshire Hathaway Inc, 2009) – "Chairman's Letter", p 17, http://www.berkshirehathaway.com/2008ar/2008ar.pdf.

[11] See Bank for International Settlements, n 6.

> assets they're hoping to see fall in price, or engage in other fraud, their activity is socially beneficial. It adds to the information in the market and by doing so tends to bring about a more rapid and complete alignment between prices and underlying values.[12]

THE LEGAL CHARACTER OF DERIVATIVES

The English Court of Appeal in *Lomas v AFB Firth Rixson* [2012] EWCA Civ 419 at [2] adopted the following definition of derivatives:

> A transaction under which the future obligations of one or more parties are linked in some specified way to another asset or index, whether involving the delivery of the asset or the payment of an amount calculated by reference to its value or the value of the index. The transaction is therefore treated as having a value which is a separate (although derived) from the values of the underlying asset or index. As a result the parties' rights and obligations under the transaction can be treated as if they constituted a separate asset and are typically traded accordingly.[13]

OTC derivative trades are contracts for differences. In law they are properly characterised as wagering contracts. Except for currency swaps, the settlement amount of these wagers is a small proportion of their notional value. In the case of interest rate swaps, the settlement of differences is roughly 3-5% of the notional amount.[14]

With financial derivatives, such as interest rate swaps, the amount of the bet is calculated by reference to a hypothetical or notional loan. Its only purpose is to act as an integer in fixing the amount of the bet. They are fictional loans free of any transaction costs (such as legal fees and taxes).

Historically, in most jurisdictions betting or wagering contracts were held to be unenforceable contracts. Whether OTC and exchange-traded derivatives contracts are wagers needs to be determined for each jurisdiction.[15]

In *Carlill v Carbolic Smoke Ball Company* [1892] 2 QB 484 at 490-491, Hawkins J defined a wagering contract as follows:

> It is not easy to define with precision what amounts to a wagering contract, nor the narrow line of demarcation which separates a wagering contract from an ordinary contract; but, according to my view, a wagering contract is one by which two persons professing to hold opposite views touch the issue of a future uncertain event, mutually agree that, dependent upon the determination of that event, one shall win from the other, and the other shall hand over or pay to him, a sum of money or other stake; neither of the contracting parties having any other interest in that contract than the sum or stake he will so win or lose, there being no other real consideration for the making of such contract by either of the parties. It is essential to a wagering contract that each party may under it either win or lose, whether he will win or lose being dependent on the issue of the event, and therefore, remaining uncertain until that issue is known. If either of the parties may win but cannot lose, or may lose but cannot win, it is not a wagering contract. It is also essential that there should be mutuality in the contract.

OTC derivative contracts are in truth what have been described as "difference contracts" or "time bargains". Windeyer noted:

> If a contract is a mere "difference" bargain, which the so-called buyer and seller both intend shall not operate as a genuine sale and delivery under any circumstances, but shall be settled merely by the payment of differences in accordance with the variation between the market price of the shares on the date of the contract and the price at a later date – then the contract is by way of gaming and wagering. For a contract to amount to a wager, however there must be a mutual intention to wager.[16]

The OTC derivative contract itself needs to be examined as to whether it answers the description

[12] Posner RA, "Did Speculation Make the Economic Crisis Deeper or Shallower?", *The Becker-Posner Blog* (2 May 2010).

[13] Cited in Firth S, *Derivatives Law and Practice* (Sweet & Maxwell, 2009) at [1-004].

[14] Wood PR, *Set Off and Netting, Derivatives, Clearing Systems* (2nd ed, Sweet & Maxwell, 2007) at [10-004].

[15] Global Derivatives Study Group, *Derivatives: Practice and Principles Appendix II: Legal Enforceability: Survey of Nine Jurisdictions* (Group of Thirty, 1993).

[16] Windeyer WJV, *The Law of Wagers, Gaming and Lotteries in the Commonwealth of Australia* (1929) p 86. See also *Universal Stock Exchange Ltd v David Strachan* [1896] AC 166 (HL); *City Index Ltd v Leslie* [1992] QB 98 (CA).

of a wagering contract. As Isaacs J said in *See v Cohen* (1923) 33 CLR 174 at 182:

> It must, however, be made clear that speculation does not necessarily involve a contract by way of wager, and to constitute such a contract a common intention to wager is essential. A contract may be speculative and yet a perfectly good commercial contract. It would be disastrous to hold otherwise.

When the Sydney Futures Exchange was established in the late 1970s, s 16 of the *Gaming and Wagering Act 1912* (NSW) provided that such wagering contracts were null and void.[17] This section was virtually identical to s 18 of the English *Gaming Act 1845*, 8 & 9 Vict, c 109. Section 7 of the *Futures Markets Act 1979* (NSW) provided that "for the purposes of any Act or law, a futures contract made at a futures market maintained by a futures exchange is not a contract by way of gaming or wagering". Of course, this did not apply to OTC contracts but in 1979 there were few, if any, such contracts.

On 1 March 1999, the *Unlawful Gambling Act 1998* (NSW) repealed the *Gaming and Wagering Act*, thereby ending the idea that OTC derivative contracts were null and void under the law of New South Wales.[18]

In Australia, the commencement on 11 March 2002 of s 1101I of the *Corporations Act 2001* (Cth) was wider than the repealed ss 778 and 1141. OTC derivatives answering the description of financial products were made valid and enforceable despite what any State or Territory law provides with respect to gaming or wagering. For example, in Western Australia OTC derivatives would otherwise be unenforceable by reason of s 4(1)(a) of the *Gaming and Betting (Contracts and Securities) Act 1985* (WA).[19]

Unsurprisingly, the United States' *Commodities Futures Modernization Act* of 2000 (CFMA) appears to have been a signal for the *Financial Services Reform Act 2001* (Cth) to pass s 1101I to the *Corporations Act*.

In England, OTC derivatives answering the description of contracts for differences appear to be classified as investments under s 412 of the *Financial Services and Markets Act 2000* (UK).[20] Hence s 18 of the *Gaming Act*, which would classify them as wagering contracts, has no application.

Stout argues:

> [The] traditional legal restraints on OTC speculation were systematically dismantled during the 1980s and 1990s, culminating in 2000 with the enactment of the [CFMA], to amend the Commodity Exchange Act 7 USC 1. This amending legislation set the stage for the 2008 crises by legalizing for the first time in US history speculative OTC trading in derivatives.[21]

Stout dismissed the price–discovery argument for OTC derivatives speculation when she said:

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[17] *Gaming and Wagering Act 1912* (NSW), s 16: "All contracts or agreements, whether by parole or in writing, by way of gaming or wagering shall be null and void, and no suit shall be brought or maintained in any court of law or equity to recover any sum of money or valuable thing alleged to be won upon any wager or which has been placed in the hands of any person to abide the event on which any wager has been made…"

[18] *Unlawful Gambling Act 1998* (NSW), s 56 provides: "(1) Any agreement, whether oral or in writing, that relates to any form of gambling that is prohibited under this Act has no effect, and no action may be brought or maintained in any court to recover any money alleged to have been won from, or any money paid in connection with, any such form of gambling. (2) Nothing in subsection (1) applies to or in respect of any form of gambling that is otherwise lawful."

[19] *Gaming and Betting (Contracts and Securities) Act 1985* (WA), s 4(1)(a): "Except in so far as they relate to, or arise out of a contract or agreement relating to, prescribed gaming or prescribed betting – (a) All contracts or agreements, whether in writing or otherwise, by way of gaming or betting are null and void, and no proceedings shall be brought or maintained in any court for recovering any money or other valuable thing alleged to be won at gaming or upon a bet, or deposited with any person to abide the event on which a bet is made…"

[20] *Financial Services and Markets Act 2000* (UK), s 412: "(1) No contract to which this section applies is void or unenforceable because of - (a) section 18 of the [1845 c. 109.] Gaming Act 1845, section 1 of the [1892 c. 9.] Gaming Act 1892 or Article 170 of the [S.I. 1985/1204 (N.I. 11).] Betting, Gaming, Lotteries and Amusements (Northern Ireland) Order 1985; or (b) any rule of the law of Scotland under which a contract by way of gaming or wagering is not legally enforceable. (2) This section applies to a contract if – (a) it is entered into by either or each party by way of business; (b) the entering into or performance of it by either party constitutes an activity of a specified kind or one which falls within a specified class of activity; and (c) it relates to an investment of a specified kind or one which falls within a specified class of investment."

[21] Stout LA, "Derivatives and the Legal Origin of the 2008 Credit Crisis" (2011) 1 *Harvard Business Law Review* 1.

> Exchange-based trading in which multiple buyers and sellers post their bid and ask prices produces price quotations that can be made publicly available. In contrast, OTC trading involves private, bilateral agreements entered between parties with no obligation to report either the fact of their transaction, or their transaction terms, to the outside world. Thus, OTC derivatives trading typically does not provide price discovery benefits. Indeed, a standard criticism of the OTC market is that it lacks "transparency".[22]

CENTRAL CLEARING OF OTC DERIVATIVES CONTRACTS

At the Pittsburgh Summit in September 2009, the G20 members agreed inter alia that standardised OTC derivative contracts should be cleared by the end of 2012 through CCPs. Australia's response has been to insert Pt 7.5A into the *Corporations Act* (by the *Corporations Legislation Amendment (Derivative Transactions) Act 2012* (Cth)) to provide for the regulation of derivative transactions and derivative trade repositories. Relevant rules were made under ss 901A and 903A of the *Corporations Act*, with the first mandatory reporting phase commencing on 1 October 2013.[23]

Title VII of the 2010 *Dodd–Frank Wall Street Reform and Consumer Protection Act* (Pub L 111-203, HR 4173) deals with "Wall Street Transparency and Accountability". Section 723 amends the *Commodity Exchange Act* (7 USC 2) by inserting s 2(h) to generally require that "cleared swaps must be executed electronically on an exchange or a swap execution facility".[24]

What is now important is the creation of the new vehicle of CCPs in clearing standard OTC derivative contracts, especially interest rate and currency swaps. "By becoming the buyer to every seller and the seller to every buyer, the CCP assures completion of the trade if a trading partner defaults."[25] Essentially the original contract between the parties is novated to the CCP so that it acts as both a buyer and seller. The premise on which it works is the requirement for the posting of an initial margin call and further calls against unfavourable price changes or offsets for favourable price changes. They take on the role of buyer to every seller and seller to every buyer. By splitting the OTC contracts, their number is doubled.

Whether CCPs are capable of dealing with CDSs, "which are much more complex, illiquid and risky, than other cleared products has as yet not been tested".[26]

The novation with CCPs is likely to limit the need to include arbitration of dispute clauses in International Swaps and Derivatives Association (ISDA) contracts. However, under the rules of the CCP it could be expected that there would be provision for arbitration. There will of course continue to be non-standardised OTC derivative contracts, especially CDSs, where the inclusion of arbitration clauses would be wise.

"In December 2012 the Australian Stock Exchange (ASX) announced that seven domestic and international banks had joined a foundation programme to work with ASX to develop an OTC Clearing Service for $A interest rate swaps by mid-2013."[27] There are now nine banks involved.[28] On 2 July 2013, the Australian government also approved the granting of a clearing and settlement licence to LCH Clearnet Ltd.

As to the effectiveness of these changes, Riles astutely contends that:

[22] Stout, n 21 at 31.

[23] ASIC Derivative Transaction Rules (Reporting) 2013; ASIC Derivative Trade Repository Rules 2013. See also the Regulation Impact Statement – G20 OTC Derivatives Transaction Reporting Regime (2013).

[24] Norman P, *The Risk Controllers – Central Counterparty Clearing in Globalised Financial Markets* (John Wiley & Sons Ltd, 2011) p 335.

[25] Norman, n 24, p 7.

[26] Gregory J, *Counterparty Credit Risk and Credit Value Adjustment* (2nd ed, Wiley, 2012) p 18.

[27] ASX, *ASX Extends OTC Derivatives Clearing Solution to Include Client Clearing for Australian Investors* (media release, 30 April 2013).

[28] ANZ, CBA, Citibank, Deutsche Bank, JP Morgan, Macquarie Bank, NAB, UBS and Westpac.

> Simply put, new architectures historically have never worked at the level of design. Where regulatory reforms have succeeded, it has been because, in one way or another, they enroll the targets or clients of regulation in the regulatory mission and encourage them to take responsibility for the regulatory problem. Architectures do not build themselves.[29]

MARGIN REQUIREMENTS FOR NON-CENTRALLY CLEARED DERIVATIVES

The International Monetary Fund has estimated that 25% of the interest rate swap market and one third of the credit default swap market will remain uncleared.[30]

Recognising that there will remain a significant market for derivatives not settled through CCPs, the G20 Leaders Statement at the 2009 Pittsburgh Summit stated that "non-centrally cleared OTC derivative contracts should be subject to higher capital requirements".[31]

Five Australian banks have submitted to the Bank for International Settlements and the International Organization of Securities Commissions that the initial margin requirement for a worst-case scenario would require them to post US$250-300 billion – most of which would be referable to cross-currency swaps. The banks contend that the quantum of the margins required would have significant systemic implications for the Australian banking system and complain the cost is unjustified when assessed against the risk of future losses and past history of losses on cross-currency swap transactions.[32]

TYPES OF DISPUTES THAT MIGHT ARISE

Most derivative disputes are likely to be arbitrable, including:

a) default events under paragraph 5 of the ISDA 2002 Master Agreement;
b) the valuation of the non-defaulting counterparties interests;[33]
c) the fixing of credit value adjustments;
d) the interpretation of the ISDA 2002 Master Agreement; and
e) margin call issues.

However, issues dealing with conflicts of law particularly with respect to the enforceability of wagering contracts or whether an insurable interest[34] is required with respect to credit default swaps may be more appropriately decided by a court. Likewise, remedies such as anti-suit injunctions are only available from the courts, as in *Bankers Trust Co v PT Jakarta International Hotels and Developments* [1999] 1 All ER (Comm) 785.[35] In this case an injunction was issued to restrain legal proceedings from being commenced in Indonesia when arbitration proceedings under the dispute clause were to be commenced in London in respect of a failure of the Indonesian respondent to make payments under a cross-currency swap transaction.

Cross-border insolvency issues are unlikely to be arbitrable unless falling within the jurisdiction of an international treaty that provides for arbitration – eg a challenge to the validity of a "flip clause" where priority given to the swap counterparty in synthetic CDOs (which invested in CDSs) shifted to

[29] Riles A, *Collateral Knowledge – Legal Reasoning in the Global Financial Markets* (The University of Chicago Press, 2011) p 227.

[30] International Swaps and Derivatives Association, *Non-Cleared OTC Derivatives: Their Importance to the Local Economy* (2013) p 10.

[31] *The Pittsburgh Summit* (24-25 September 2009) – "G20 Leaders Statement".

[32] Australian Banks Letter to the Bank for International Settlements and the International Organization of Securities Commissions dated 15 March 2013, http://www.bis.org/publ/bcbs242/australianbanks.pdf.

[33] Grove R, "Valuation in the Context of Derivatives Litigation" (2011) 6(2) CMLJ 149.

[34] Eg s 16 of the *Insurance Contracts Act 1984* (Cth) does not require an insurable interest: "A contract of general insurance is not void by reason only that the insured did not have, at the time the contract was entered into, an interest in the subject-matter of the contract." ISDA has apparently relied upon the 1997 opinion of Mr Robin Potts QC of Erskine Chambers, London that credit default swaps do not answer the description of insurance contracts under English law. See also Juurikkala O, "Credit Default Swaps and Insurance: Against the Potts Opinion" (2011) 26(3) *Journal of International Banking Law and Regulation* 128.

[35] See Hudson A, *The Law on Financial Derivatives* (5th ed, Sweet & Maxwell, 2012) at [10-75].

the note-holders before the counterparty received any termination amount.[36] In this case, the proper law of the relevant trust deed was the law of England with the Supreme Court of the United Kingdom upholding the Court of Appeal's ruling that the anti-deprivation rule was not violated.

PRACTICE AND PROCEDURE

In an era of the central clearing of OTC derivatives contracts, the speed in producing an award seems to be of crucial importance. A possible dispute between the CCP and a party is the quantum of the margin call that is being asked to be deposited. The arbitration proceedings could be heard by video conferencing between the parties and the arbitrator, with an ex tempore award being given. Essentially a "very fast track" procedure could be adopted, if it were agreed by the parties. A panel of arbitrators with relevant expertise from which a single arbitrator could be appointed at short notice to hear the dispute could also be established. Alternatively, this work might be done by experienced and independent persons acting as assessors.

Where disputes arise from the clearing of standardised OTC contracts, they are most likely to be resolved in accordance with the rules of the clearing house. A convenient illustration is given by the treatment of non-OTC derivatives in Singapore. There the Singapore International Arbitration Centre (SIAC) is the appointing authority with respect to the Derivative Clearing Rules and the Derivative Trading Rules of the Singapore Stock Exchange.

The SIAC Rules (5th ed of 1 April 2013) also provide for an expedited procedure, if the parties agree (s 5.1(b)). In the case of exceptional urgency (5.1(c)), the amount in dispute is unlimited; otherwise it is limited to S$5 million. If the President of SIAC determines that the proceedings shall be expedited then: the Registrar can shorten the time limits under the rules; it will be determined by a sole arbitrator; unless the parties agree to the dispute being decided on the basis of documentary evidence only, there will be hearing for the examination of witnesses; and the award shall be made within six months from when the tribunal was constituted. The reasons for the award are to be stated in summary form unless the parties agree that no reasons are to be given.

The Expedited Arbitration Rules of the Australian Centre for International Commercial Arbitration (ACICA) could also be used[37] in implementing a fast track procedure.

ROLE OF ARBITRAL BODIES

Presently the ISDA Master Agreement makes no reference to arbitration in resolving disputes. It is an issue that is still under consideration by ISDA, although there have been in circulation suggested draft arbitration clauses. Notwithstanding that no such arbitration clause has as yet been finalised, s 13(c) of the ISDA/International Islamic Financial Market Tahawwut Master Agreement for Islamic derivative transactions provides for arbitration under the rules of the Court of International Arbitration of the International Chamber of Commerce, unless other arbitration rules are nominated by the parties. The London Court of International Arbitration is another respected body that can assist in appointing arbitrators to resolve disputes in accordance with its rules.

In Australia, the rules of the ACICA could be adopted, including its Emergency Arbitration Rules.

A specialist body known as the Panel of Recognised International Market Experts in Finance (PRIME Finance) has been established under the auspices of the Netherlands government to facilitate the determination of international financial disputes. It is headquartered at The Hague. On 16 January 2012, the PRIME Finance Arbitration Rules were published; they are a modified version of the United

[36] Goode R, "Flip Clauses: The End of the Affair?" (2012) 128 LQR 171.United Kingdom – *Belmont Park Investments Pty Ltd v BNY Corporate Trustee Services Ltd and Lehman Brothers Special Financing Inc* [2011] UKSC 38. United States – *In Re Lehman Bros Inc v BNY Corporate Trustee Services Ltd*, 422 BR 407 (Bankr SDNY 2010); the US Bankruptcy Court took a contrary view and denied the validity of the "flip clause"; an appeal was lodged to the US District Court for the Southern District Court of New York but was apparently settled. See also the discussion on the anti-deprivation rule in Ross J, "The Case for P.R.I.M.E. Finance" (2012) 7(3) CMLJ 221 at 259-264.

[37] *ACICA Expedited Arbitration Rules* (1 August 2011), http://acica.org.au/assets/media/ACICA-Appointment-of-Arbitrators-Rules.pdf.

Nations Commission on International Trade Law Arbitration Rules as revised in 2010. Under Art 2(a), the proceeding can be expedited "if the parties agree upon shortened time lines", which are effective if approved by the arbitral tribunal. There is an approved list of arbitrators.

In the United States, the Financial Industry Regulatory Authority Inc (FINRA) is a body that provides arbitration and services with respect to derivative disputes among others. FINRA has launched a voluntary pilot program for large cases involving damages claims of at least US$10 million. In 2009, FINRA arbitrated 607 derivative security cases but since then the number of disputes has plummeted to eight for 2012.[38]

CONCLUSION

OTC derivatives continue to serve a useful purpose, particularly with respect to interest rate and currency swaps, as they offer the prospect of reduced costs due to the identification and use of the technique of comparative advantage.

The clearing of derivatives through CCPs should reduce the likelihood of disputes. Nevertheless it would be prudent for the rules of a central clearing party to provide for the expeditious determination of disputes by arbitration. Here the Expedited Arbitration Rules of arbitral bodies such as ACICA or SIAC may be helpful. In the case of non-cleared OTC derivatives it would also be wise for an arbitration clause to be included in the derivatives contract. The ISDA 2002 agreement could be amended to include such a clause.

If arbitration is to become the generally accepted way of resolving disputes in this new CCP era then the traditional arbitration procedure will need to be modified to produce "fast track" awards.

It is more likely that disputes will arise with respect to bespoke non-centrally cleared OTC derivatives than in the case of CCP-settled derivatives. Because of the complexity of the bespoke derivative contracts[39] there are few arbitrators with the relevant experience and qualifications to satisfactorily resolve these disputes.[40]

Arbitration has the attributes needed to determine most derivative disputes in a just, quick and economical way, particularly where cross-border disputes arise. It should not be overlooked that there are 150 countries that are signatories to the 1958 *New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards*. This ought to give a successful party a greater measure of success internationally in having the award enforced than in seeking to have a court judgment enforced.

The reasons for an award suitably masked or redacted to preserve confidentiality could also be published for the benefit of capital markets. By way of analogy, the decisions of the Taxation Boards of Review in Australia and the decisions of the Special Commissioners for Income Tax in the United Kingdom, which were heard in private, were published without the parties being identified. Hopefully this might work to promote consistency in arbitrators' awards.

OTC derivative disputes involve important challenges, not only because of their complexity, especially in the case of non-centrally cleared derivatives, but also because of their unfamiliarity among commercial arbitrators who are likely to be pressed by the parties for a speedy delivery of an award.

[38] FINRA, *Dispute Resolution Statistics – Security Types Involved in Arbitration Cases* (2013), http://www.finra.org/ArbitrationAndMediation/FINRADisputeResolution/AdditionalResources/Statistics.

[39] Eg Constant Proportion Debt Obligations in *Bathurst Regional Council v ABN AMRO Bank NV* [2012] FCA 1200.

[40] Berger KP, "The Aftermath of the Financial Crisis: Why Arbitration Rules Make Sense for Banks and Financial Institutions" (2009) 20(1) *Law and Financial Markets Review* 54.