ENFORCEMENTS IN FINANCIAL DISPUTES: A CASE FOR AN INTERBANK AWARD CLEARING FRAMEWORK

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Abstract

Resolving disputes resulting from high speed and fast-moving financial transactions has become an essential requirement for the stability of global financial markets as proven by previous crises. In the 2007 crisis, millions of investors ended with worthless investment agreements. The public did not believe they could pursue claims in state courts and had no faith in the operating regulatory systems.

Delays in the enforcement of compensatory awards drained the concept of justice of its meaning. Bankers were bailed out instead of being made to pay for acts of recklessness, information asymmetry and mis-selling. The result was panic and a run on investment banks and the financial crisis ensued.

The question is whether an arbitration process that guarantees immediate payment of arbitral awards can accelerate recovery from a crisis and alleviate the burden on state bailouts using taxpayers' money?

Empirical research show that enforceable and swift dispute resolution for financial disputes can establish certainty in the financial markets and assist in deterring imbedded acts of moral hazard within the financial sector. This in turn will impede the main ingredient for financial crises generated within the financial institutions sector and reduce the possibility of recurrences of financial crises such as that of 2007/2008.

It is against this background that this thesis is proposing the instant monetizing mechanism of arbitral awards that result from banking disputes. The purpose behind the choice of the financial sector as a pilot for such a proposal is the ready availability of interbank clearing networks. Such networks can play an important role re-injecting funds back into the market through the ease of monetizing the awards and instantly transferring funds to claimant investors.

Applying this concept particularly in the financial sector will clear backlogs of investors' funds that will unfailingly find their way back into the financial markets through the banks. Recycling the funds back into the markets will instantly speed the markets' recovering cycle and avert deep crises.

This thesis acknowledges the role of arbitration in the settlement of financial disputes and the integral role that the enforcement of financial dispute can have in facilitating financial stability in a crisis. It recognises that an arbitration process is as effective as the swiftness by which its awards are enforced. It, as such, argues that a framework that can use existing interbank clearing networks to enforce and clear arbitral awards will efficiently address investors' disputes. In turn it will help stabilize financial markets by removing uncertainty.

The proposed framework will identify possibilities of clearing, trading and discounting arbitral awards while guaranteeing the maintenance of liquidity within the financial markets. Once implemented, the framework will remain innovative as it will operate through already functioning networks using up-to-date clearing technology such as blockchain. As the clearing networks continue to develop in to match the speed by which financial markets progress, the award clearing framework will remain as fast and innovative.

List of Abbreviations

AAA - American Arbitration Association
ADR - alternative dispute resolution
BaFin - Federal Supervisory Authority (Germany)
BoE - Bank of England
BIT - bilateral investment treaty
CDP - City Dispute Panel (UK)
CFDs – Complex Financial Disputes
CFTs – Complex Financial Transactions
CIETAC - China International Economic and Trade Arbitration Commission
DIAC - Dubai International Arbitration Centre
DOCDEX - Documentary Credit Dispute Resolution Expertise
EC - European Community
ECB - European Central Bank
ECT - Energy Charter Treaty
EEA - European Economic Area
EFTA - European Free Trade Association
EU - European Union
FCA - Financial Conduct Authority
FET - fair and equitable treatment
FPC - Financial Policy Committee
FRB - Federal Reserve Board
FOS - Financial Ombudsman Services
FSA - Financial Services Authority
FSMA - Financial Services and Markets Act
HKIAC - Hong Kong International Arbitration Centre
ICC - International Chamber of Commerce
ICDR - International Centre of Dispute Resolution
ICLCA - International Centre for Letters of Credit Arbitration
ISDA - International Swaps and Derivatives Association
ICSID - International Centre for Settlement of Investment Disputes
IMF - International Monetary Fund
IP - intellectual property
IPB - international private banking
IPR - intellectual property rights
ISDA - International Swaps and Derivatives Association
LCIA - London Court of International Arbitration
L/C - letter of credit
LIBOR - London Interbank Offered Rate
LLC - limited liability company/corporation
MFN - most favoured nation
MIT - multilateral investment treaty
NAFTA - North American Free Trade Agreement

NYC Convention - United Nations Convention on the Recognition and Enforcement of International Arbitration Awards 1958
OECD - Organisation for Economic Co-operation and Development
OTC - over the counter secrities
PRA - Prudential Regulation Authority
P.R.I.M.E. Finance - Panel of Recognised International Market Experts in Finance
RBS - Royal Bank of Scotland
REPO - Repurchase Agreement
SIAC - Singapore International Arbitration Centre
TBTF - too big to fail
UCP - Uniform Customs and Practice for Documentary Credit
UCTA - Unfair Contract Terms Act 1997 (UK)
UK - United Kingdom
UN - United Nations
UNCITRAL - United Nations Commission on International Trade Law
US - United States
UTCC - Consumer Contracts Regulations 1999 (UK)
WIPO - World Intellectual Property Organization

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Acknowledgement

This is the moment I have been rehearsing the most during the past years while writing my thesis. It is an overwhelming task involving a great deal of emotional research. It requires me to review all these moments that my initial excitement about one of my ideas or my arguments was quickly replaced by an erosive feeling of doubt. However, there was not a single instance that I thought of quitting. It is when I focus on the persons that helped and supported me through the years that I know why.

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Mohamed Raffa
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08.08.2020

CHAPTER ONE

A FRAMEWORK FOR FINANCIAL DISPUTES

Financial and Bank disputes are defined in terms of the participants, claims, situations, strategies, social objectives and outcomes. For the sake of clarity, bank disputes can be stripped down to their components of interbank disputes where at least one party of the disputants is a bank. For that purpose, it is essential to determine who should be represented in banking and financial dispute resolution processes and whose interests should be considered.

Chapter Two clearly identifies the nature and anatomy of financial disputes and their disputants. The core of those disputes usually represents itself in the form of financial misbehaviour where investors claiming that their monies were lost because of misleading statements on the part of the banker.

Financial misbehaviour includes actions such as mis-selling, unauthorised trading, misrepresentation and misappropriation. The latter is a euphemism for theft.[1] The socioeconomic outcome of such behaviours has a profound effect on social development, economic reconstruction and improvement.[2]

This statist perspective is, however, overly narrow and selective. Private and public banks committing international offenses, their victims can range from other state owned banks to domestic and international financial institutions. Individuals and corporate, national and multinational organizations, governmental and non-governmental authorities, global and regional organizations are all possible victims to misguided investment advice from bankers.[3]

The international financial crisis of 2007-08 has shown that the importance of interconnected and complex financial institutions is far reaching, in the sense that their failure could endanger the stability of the entire global financial system. The financial crisis made it clear that we should not only focus on ‘too big to fail’ organizations. The need is to understand the needs of financial investors who drive the markets that are systemically predisposed to moral hazard and geared for panic runs. So, what is a Financial Crisis?

Anatomy of Financial Crisis: There are many forms of investment transactions with some bearing higher risk than others. Placing a deposit with a bank or a Money Market Fund are form of investments. However, other forms of complex investment contracts such as futures

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[1] D.E. Robins, *Seven Deadly Sins that Lead to Arbitration Disaster*, 820 PLI/Corp 489, Practising Law Institute, Corporate Law and Practice Course Handbook Series (July-August 1993).

[2] The term “socioeconomics” refers broadly to the "use of economics in the study of society". Contemporary practice considers behavioural interactions of individuals and groups through social capital and social "markets" and the formation of social norms. In the latter, it studies the relation of economics to social values and legislations imposed by the society's lawmakers.
Socioeconomic is a distinct supplemental usage that describes social economics as "a discipline studying the reciprocal relation between social legal ethics and economic development leading toward social reconstruction and improvement.

[3] Charles W. Calomiris & Stephen H. Haber, *Fragile by Design: The Political Origins of Banking Crises and Scarce Credit , (2nd ed., Princeton University Press (2015)*

currency exchange markets, derivatives, securitised and non-securitised financial market products are also classified as investments, albeit they bear higher risk. The quality of risk those investments carry, should be identified by bankers to their clients.

Financial markets and institutions are much more interconnected and characterized by 'herd behaviour' than any of the other sectors of the economy.[4] When a bank or **a financial institution faces** trouble because the investments they hold on their balance sheet has worsened, the effect is not isolated to that specific bank. There are deposits within that bank that belong to other banks as well as the individual depositors. Moreover, the deposits belonging to other banks also belong to the depositors of those other banks.

The chain reaction of one bank's failure is endless and it has a negative repercussion on the entire financial market as well as on the social structure within a state and globally. Financial linkages between countries, in the form of interbank activities, have been singled out as a key channel of international crisis transmission. According to an International Monetary Fund study by Lindgren, *Garcia and Saal (1996),* statistics show that since 1980 about 133 IMF member countries have experienced significant banking sector problems.[5]

On the other hand, empirical evidence**s show** that different forms of moral hazard in the financial sector are customary and prevalent. It oc**curs with individual clients as well as in** transactions **within the banks themselves**. It takes various forms of information-asymmetry, mis-selling and adverse-selection in almost every depository or investment contractual agreement.[6] These empirical results have important assertions on how some large banks and financial firms transacted with the outside world prior to 2008 financial crisis. It shows that certain firms and banks attempted to avoid their own bankruptcy by unloading bad assets onto other banks and financial institutions without clearly explaining the bad nature of such assets to the buyers.

The adverse selection caused by such information asymmetry created an imbalance in world investment decisions taken by governments, central banks and financial institutions. In turn, this caused a chain reaction of financial failures leading to a kind of a global financial market failure. Bankruptcy of financial institutions spilled over to others in different countries and endangered the entire world financial system. The unmonitored presence of mis-selling and information asymmetry has proven to lead to almost total shut down of global financial markets as seen in the 2007/2008 crisis.

The events of the recent financial crisis have signalled the importance of having a micro-prudential[7] view of the financial system instead of the earlier focus by policy makers and regulators on the entire financial and banking sectors.

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[4] Schnabl, P. (2011), *Financial Globalization and The Transmission of Bank Liquidity Shocks: Evidence From an Emerging Market*, Journal of Finance, Volume 67, Issue 3, June 2012, p. 897–932

[5] Lindgren et al (1996); (Frydl, 1999)

[6] Alberto Martin, *Adverse Selection, Credit and Efficiency: The Case of the Missing Market*, JEL Classification D82, G20, D62 (2010) http://www.econ.upf.edu/~martin/missingmarket.pdf

[7] Microprudential regulation or microprudential supervision is firm-level oversight or financial regulation by regulators of financial institutions, "ensuring the balance sheets of individual institutions are robust to shocks".

The research in Chapter One takes a micro-perspective of individual investors and their capabilities to raise issues with the banks when needed. It introduces the interconnectedness of banks and financial institutions with the tendency for problems to be hidden during boom and exposed during crisis.

Such an approach proposes an effective system of dispute resolution through instant enforcement of arbitral awards. The mechanism will help to identify those financial institutions with large capacity to create high risk operations with financial market instruments and the ability to breakdown the entire financial system.

A workable framework for identifying such institutions involves the use of a clearing mechanism that can grant international marketability (coinage) to arbitral awards. In banking disputes, the process can alert financial regulatory authorities to high risk activities taking place in the market. It also will have the effect of retribution to moral hazard and high-risk activities within certain financial institutions when investors are granted compensations that are instantly imposed.

1. SETTING OUT THE FRAME OF THE DISCUSSION

Arbitration in financial disputes is one of the most pervasive topics in arbitration law and practice. Despite extensive efforts and relevant literature, the issue is far from settled when it comes to the speed and enforcement of arbitration awards resulting from financial disputes. Normally such disputes involve large amounts of money where time and enforceability are indispensable for the world's financial markets.

The thesis examines the challenges prevalent to bank disputes and the current systemic processes available for disputants in the financial markets. There are numerous arbitral institutions specialised in financial disputes such as ICC and P.R.I.M.E. that are still unable accommodate the issues relating to the enforcement arbitral awards. The challenges are specifically focused on the enforceability of arbitral awards in bank and financial disputes. Those challenges arise when national courts overlook the differences in the nature and purpose of international awards' enforceability and the application of public policies within their national laws.

Issuing the award should indicate the finalisation of the arbitral process. However, the finalisation of the process does not necessarily mean the "finality" of the dispute resolution. In fact, the enforcement and payment of the award is the true final step in resolving an arbitral dispute. Clearly, finality is of the utmost importance to the parties on both sides of a dispute and more so for the successful party.

The recognition and enforcement of arbitral awards is of fundamental importance in the arbitral process. Proper recognition followed by effective enforcement serves both as a means of ensuring the effectiveness of the arbitral process and serve as a key factor favouring the use of arbitration.[8]

There are theoretically legal differences between the recognition of an award and the enforcement of an award. The generally accepted principle in international arbitration is that recognition of an award in certain jurisdictions is an essential step that is required prior to the enforcement of international arbitral awards.[9]

There are also theoretical differences between the *"*enforcement of an award" and "payment of an award*"*. Such differences consist in that the enforcement of an award is a pre-requisite legal requirement to the payment of awards. Any potential problems faced in the enforcement of arbitral awards can entail problems in the payment of awards. However, it is not the other way around.

Unless parties can be relatively certain that the award will be paid at the end of arbitral proceedings, an award will be a mere peripheral process to litigation. To expect the award to be paid without undue delay is what the intention of the parties were when they agreed to go to arbitration at the outset of their trading agreement.

Participants to financial markets look carefully at the process of resolving disputes and acquire confidence (or anxiety) from how consistent their disputes are resolved. The generally accepted rules underlying the enforcement of awards in international arbitration apply equally to the encashment (enforcement and payment) of awards. Put another way, there is no point in having arbitration friendly laws, well drafted arbitration rules and competent arbitrators if no effective mechanism of enforcement is available.[10]

As defined in a World Bank study[11], certainty in acquiring justifiable legal compensation can avert panic and bank runs amongst populations of investors on national and global scales. On the other hand, as bankers start to believe they cannot avert retribution under a speedy arbitration process, moral hazard, actions of risk-taking and mis-selling will begin to decline.

The thesis argues for a mechanism of encashment of arbitral awards specially designed for the needs of banks and financial disputes. The case is made for the application of an arbitral award clearing mechanism different both in terms of process and in terms of payment, but nevertheless conclusive.

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[8] Lord Mustill, *"The History of International Commercial Arbitration"* in Newman and Hill (Ed.), *The Arbitrators' Guide to International Arbitration* (New York: Juris Publishing, 2004) at 12

[9] N. Blackaby, C. Partasides, A. Redfern & M. Hunteredfern and Hunter, *"Law and Practice of International Commercial Arbitration"*, 4th Ed. (London: Sweet & Maxwell, 2004)

[10] Gabrielle Kaufmann-Kohler, *"Enforcement of Awards -A Few Introduction Thoughts"* in Albert Jan van den Berg (Gen Ed.), ICCA Congress Series No 12 Beijing, May 2004: New Horizons in International Commercial Arbitration and Beyond (The Hague: Kluwer Law International, 2004) 287 at 287.

[11] Limao, Nuno; Saggi, Kamal. 2006. *Tariff Retaliation Versus Financial Compensation in the Enforcement of International Trade Agreements*. Policy, Research working paper series; no. WPS 3873. Washington, DC: World Bank. http://documents.worldbank.org/curated/en/153561468315288

Finality in arbitration is key to confidence in the markets. A creditor of an award, in this case the winning party in a dispute who is holding an award in his favour, requires a speedy process to be able to cash his award and carry on with his business. The debtor of an award on the other hand may not be happy with the tribunal decision but will also prefer to see the dispute finalised and continue the commercial activity with the other party.

It is also known that on-looking third party participants of the financial markets are interested in the outcome of banking disputes. Third parties are interested to observe that the process works and that disputes with banks are eventually finalised in a speedy manner. As a result, wider arbitral enforceability would compensate for the lack of certainty in financial markets at an earlier stage of a crisis.

The emphasis here is dedicated to the subject of encashment of arbitral awards resulting from banking and financial agreement disputes. Such disputes and the effectiveness of how they are resolved, exemplifies restitution to claimants in bank disputes. The same effectiveness also can be effective as a tool of retribution to wrongdoers. The discussion pertains to three relative areas:

- The effectiveness of the NY Convention on the Recognition and Enforcement of Foreign Arbitral Awards

- The notion of the interference of national courts in the enforcement of international arbitral awards,

- The impact of instant enforceability (or non-enforceability) of financial arbitral awards upon the markets and the moral behaviour of financial institutions.

Empirical research shows that an enforceable and swift dispute resolution mechanism for banks and financial disputes can establish certainty and assist in combating imbedded acts of moral hazard within the financial sector. It can accelerate recovery from a financial crisis and alleviate the burden on state bailouts using taxpayers' money.

Investors are interested in outcomes of disputes involving financial services providers such as banks and stock market brokers. Investors are largely influenced in their reactions to the enforceability of compensations disputants succeed in getting against banks. It constitutes a form of restitution for their possible losses should they face the same dispute.

Simply, restitution for one investor represents retribution against bankers as they are ordered to pay compensation to investors for their losses. The focus here is on the process of paying-out the resulting arbitral awards and the speed by which claimants are paid and remedied. Similarly, efficacy and speed in paying investors will represent the swiftness by which faulting banks are penalised by suffering financial retribution.

The study of the interrelation between arbitration awards and penalisation of financial services providers is an integral part of any discussion touching upon elements of financial arbitration. This has to do with the fact that any turbulences occurring in a financial sector of one state can develop into a global economic crisis touching on other nations' economies. The 2008 Financial Crisis is a proof to that.

1.1. RESEARCH METHODOLOGY

The basic methods employed are comparative research and qualitative analysis of academic papers, primary and secondary legal sources, including *lex financiera,* national and international laws and regulations, case law of national courts and arbitral tribunals. More specifically, as far as financial arbitration procedural rules are concerned, financial arbitration institutions with specific banking and finance arbitration mandates are examined.

Attention, of course, is particularly focused on the United Nations Convention on Recognition and Enforcement of Foreign Arbitral Awards of 1958 (The New York Convention)[12]. The international arbitration treaty has been enjoying an unprecedented success and has been immensely influential to the development of arbitration doctrines and procedural rules.

In terms of national jurisdictions, the research takes an international comparative viewpoint. The legislation and case law of different countries are reviewed, although emphasis is especially placed on England, the USA, France, and to a lesser extent on Switzerland, Germany and the European Union rules on enforcement of arbitral awards and bank regulations.

The selection of the above jurisdictions was mainly made for two reasons. First, it provides equilibrium between common and civil law legal traditions. Second, it covers almost all the major arbitration centres with advanced arbitration laws and procedural systems.

1.2. NOTES IN REGARD TO METHODOLOGICAL APPROACH

First, as already indicated, even though the literature on the financial crisis, moral hazard and retribution against banks is extensive, the discussions are still largely open ended. Additionally, regulations on the topic are lacking at national, regional and international levels. Accordingly, the analysis performed here is policy orientated, whereas the final suggestions go beyond black letter law. That also raises questions about the practice of compensation claims in courts when it comes to disputes against banks.

Second, the analysis on arbitration agreements draws to some extent on material regarding award enforcement and jurisdiction agreements. Arbitration agreements and choices of jurisdiction agreements are considered identical in nature and with the same objective. Both are of contractual nature and both serve the procedural party's autonomy of choice of process and enforceability.

Procedural party autonomy provides the parties with the ability to choose in advance the forum that suits them best, instead of having their disputes resolved by legislation or a default forum. This, in many cases has proven to be difficult to predict if substantive and procedural

[12] *Convention on the Recognition and Enforcement of Foreign Arbitral Awards* – aka The "New York" Convention
The original convention in PDF http://www.newyorkconvention.org/11165/web/files/original/1/5/15432.pdf

legislations were not agreed upon at the outset. Arbitration and jurisdiction agreements give effect to procedural party autonomy, and thus constitute a fundamental legal tool for the payment of arbitral awards.

Case law on jurisdictions and enforceability is used in this thesis to support suggestions regarding payment of arbitral awards through a banking network. Similarly, part of the research focuses on national and regional civil procedural systems. It is true that arbitration in many aspects is a different adjudicatory system from litigation.

However, both arbitral tribunals and national courts are, in principal, equal adjudicatory fora vested with the same power: jurisdiction to determine the dispute. Both are empowered to issue an authoritative binding decision with substantive enforceability.[13]

Therefore, in jurisdictional terms, national courts and arbitral tribunals perform a very similar function. Accordingly, the thesis makes an in-depth comparative analysis of national litigation systems about the participation of third parties being allocated the power to pay out the award.

The aim of this comparative study is to reveal the rationale behind third-party award payment mechanisms in banking and finance disputes. The outcome of this analysis is used as a policy guideline for the thesis to determine the right impact of an award clearing system agreed upon in the arbitration agreement and set in the procedural rules of financial arbitration tribunals.

1.3. STRUCTURE OF THE THESIS

- Chapter One starts by tracing the development of banking and financial arbitration from its early foundations to the well-established dispute resolution mechanism that it has become today. Emphasis is placed on the tumultuous relationship that has existed between national courts and the enforcement of arbitral awards under the auspices of the NY Convention.

An arbitration process for financial disputes needs to remain innovative, as it is obliged to match the speed by which financial markets operate and structure their products. By the same token, the enforceability of awards acquires its strength from the NYC which is the most widely ratified treaty the world has come to agree upon today.

The ratification of the NY Convention was intended to be fundamental to the workings of the international arbitration systems around the world regardless of jurisdictions or domestic litigation processes. However, certainty in the enforceability of awards under the auspices of the NY Convention has encountered some substantive procedural challenges in recent years.

The Chapter includes analysis of reports on those challenges, which includes studies of the UNCITRAL "Guide to the New York Convention 2016". Moreover, attention is drawn to the allegations against the banking sector, the aftermath of the financial crisis and the possible consequences of resolving banking disputes through arbitration versus litigation.

[13] S Sattar, *'National Courts and International Arbitration: A Double-Edged Sword?'* Journal of International Arbitration, (2010) Vol. 27(1) 51.

Analysis is made of the extent to which arbitration can be assessed as a deterrent to embedded moral hazard within the banking sector. The term "moral hazard" here, refers in its wider meaning to undeterred practices in the banking world by bankers and their institutions. It refers to acts of mis-selling, misrepresentation, information asymmetry, excessive risk taking and misappropriation of funds.

Chapter One then introduces the suggestion of an Award Clearing Forum formed by banks such as *SWIFT* or *TARGET*. The purpose is to achieve a speedy award payment mechanism in face of the procedural challenges facing the implementation of the NYC in front of national courts.

- In Chapter Two, the thesis turns to moral hazard and financial regulations. First, it looks at the statutory history of financial regulations and the substantive changes that prompted new regulatory laws in certain countries or complete overhaul of substantive governance of financial institutions. The chapter includes explanations why financial rules and regulations are not enough alone to deter bankers and financial services firms from embedded moral hazard activities. Through the course of this comparison, a defined methodology is adopted with the following stages:

1. A critical comparative analysis as to where the regulatory authorities may have erred. Next, a concluding analysis of the ineptness of imposing more financial and monitoring regulations as opposed to an effective and swiftly enforced arbitral process. The research initially provides an overview of the guiding philosophy of international regulatory governance of financial institutions.
2. Tenets combining theoretical perspectives with international case law observations are presented to arrive at solutions to regulatory governance in the financial sector. The solutions demand special consideration geared towards a fast-retributive method against banks and their corporate executives. Remedies compensating investors for losses in the form of direct clients' compensation and damages for the loss of income are individually explored
3. The adequacy, flexibility and speed of resolving financial disputes in arbitration tribunals are presented as a solution, which offers individual investors the chance to govern their banks through a speedy process of an arbitration process with instant payment of arbitral awards

It is worth mentioning here that orders of punitive damages in arbitration are touched upon briefly in Chapter Two. The reason being is that in most countries, such relief may only be granted in tort claims involving 'exceptionally objectionable conduct' on the part of the defendant. In those countries, punitive damages may not be awarded in arbitrated contract claims.[14]

In the UK, for example, the unavailability of punitive damages in breach of contract actions was affirmed by the House of Lords as early as 1909 and was recently reiterated in a report of

[14] *US Restatement (Second) on Contract*, § 355 provides: 'Punitive damages are not recoverable for a breach of contract unless the conduct constituting the breach is also a tort for which punitive damages are recoverable.'

the English Law Commission. The courts in Australia and New Zealand have followed the English example.

- In Chapter Three, an objective and comparative analysis is conducted in respect of certain allegations and legal actions against financial institutions and inducements to actions of moral hazard. Financial regulatory provisions and the effectiveness of international regulatory authorities' cooperation are examined, as actions of moral hazard continue to occur to this date.

Accordingly, the chapter starts with an anatomy of financial disputes, going through financial transaction agreements including standardised arbitration clauses included in standardised generic agreements such as in the ISDA and ICC universal agreements. The agreements themselves are critically analysed in view of available remedies for investors and the legal restitution processes.

Key areas in legal claims and case laws have been identified as offering the most substantial differences between legislative frameworks even within the same jurisdiction. Case studies of separate jurisdictions throughout the chapter lead the final part of the conclusions: a speedy arbitration process encompassing a mechanism for instant payment of awards can bring the same retribution effects of punitive damages in combating moral hazard.

- *Chapter Four* contains an empirical inquiry into recent trends in international financial clearing systems. Reference is made to several international financial clearing systems using comparison assessments with the operating systems in the United States, UK and Japan.

Of the empirical data cited, an analysis in terms of the thesis' parameters is given as to the need and reasons for an Award Clearing Forum. Attention is drawn to the need for a swift process to pay arbitral awards for banking and financial sector disputes. The method does not require any changes in standard arbitration processes or agreements to operate. The criterion is that the process can be instantly applied through current interbank security clearing procedures where an award against a bank can be set-off against their assets within the banking network system similar to securities or financial notes.

- Chapter Five is the conclusion of the thesis and draws these various strands together in the attempt to prove that in order to preserve financial institutions' social role, a dispute resolution process is an appropriate solution. Financial arbitration in its current form may face special challenges, which go beyond mere contractual disputes.

There is foremost the possibility of asset backed transactions which may raise important issues of award enforcement in terms of the nature, structure and operations of the banks involved, particularly when these charges concern assets in different countries and funds that are moving from one country to another.

In certain jurisdictions, there may be complications in terms of the determination of the applicable domestic laws and the full trans-national status in international finance such as foreign currency controls and the export of capital.

In view of the above, the final chapter leads to the recognition and development of a banking proprietary structure for the set-off and pay-out of financial awards where the enforcement of banking awards in different jurisdictions and transnational financial legal orders may have differing domestic public policy considerations.

Finally, an objective analysis is conducted in respect of the proposed Award Clearing Forum and rapid payment of arbitral awards as a proposed process within the UNCITRAL Model Law and as a gauge for a generic legal process.

1.4. SCOPE AND PURPOSE OF THE THESIS – A SPEEDY COMPENSATION PROCESS RESULTS IN SWIFT PECUNIARY RETRIBUTION

As typically described by analyses of tort damages, compensatory legal remedies are remedies designed to make victims whole.[15] The goal of remedy is to rectify, as far as possible, the harmful consequences of legal wrongs. Ideally, victims of a financial wrong, when rectified, are supposed to be restored to their "rightful position," which they would have been in if no wrong had occurred.[16]

Compensation protects entitlements, expresses society's respect for the victim and provides aid to those who have suffered harm. From an instrumental point of view, compensatory remedies provide incentives for efficient behaviour by forcing injurers to bear the costs of their activities and reducing future wasteful precautions by potential victims.[17]

Compensatory remedies provide satisfaction to the victims of wrongs. Part of this satisfaction comes from a payment that makes up for measurable losses. Yet satisfaction also comes from retaliation against the injurer. In other words, the object of compensatory remedies is not simply to adjust the absolute position of the claimant, but also to adjust an outcome in which the relative positions of other possible claimants against a generic wrongdoer such as banks is clear with predictable results.

This is theoretically a presupposition of any dispute resolution process even though the claimants may belong to the same sector by being a bank themselves. The element of compensation, which seeks to counterbalance the wrong done to the claimant, has a close affinity to revenge in societies and populations of similar affinities such as in cases of investors' claims against banks.[18]

According to theories of corrective justice and tort damages, compensation also enforces moral duty. Those who commit wrongs incur a moral obligation to alleviate the losses they

[15] I DAN B. DOBBS, DOBBS LAW OF REMEDIES: DAMAGES-EQUITY RESTITUTION § 1.1, at 3 (2d ed. 1993) ("The damages remedy is a money aimed at making well the plaintiffs losses.").

[16] DOUGLAS LAYCOCK, MODERN AMERICAN REMEDIES: CASES AND MATERIALS 15-16 (2d ed. 1994) (explaining that restoring the plaintiff to his "rightful position" is "the essence of compensatory damages").

[17] RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW § 6.10, at 192 (6th ed. 2003) (discussing the incentive effects of tort damages).

[18] The term "compensation" is not necessarily limited to loss adjustment. To compensate means not only to "make amends for," but also to "counterbalance." 3 THE OXFORD ENGLISH DICTIONARY 601 (J.A. Simpson & E.S.C. Weiner eds., 2d ed. 1989). "Compensate" is derived from the Latin word "compensate," meaning "to weigh one thing against another." Id

have caused to others.[19] Of course, some inaccuracy is to be expected in litigated compensations where Courts are restricted as to the amounts granted for compensations. Such amounts are circumscribed to schedules and depositions by which arbitration tribunals are not bound. Contrary to arbitration however, legal remedies sought in courts may have multiple functions, of which one is punitive damages.[20]

2. AWARDS – ENFORCEABILITY AND PRESENTMENT

The efficacy of financial or banking arbitration is determined, undermined or strengthened by the enforceability of its award. In fact, the real determination relies on which local courts grants leave to challenge arbitral awards and on what grounds.

It is therefore important to note the extent to which national courts and legislations in certain jurisdictions may allow challenges to arbitral awards. Along with that, there are jurisdictions that facilitate affirmative attacks by losing parties through the expansion of judicial review over final awards, including through full-scale appeal of the facts or law of the award.[21]

Unless parties can relatively ascertain that they will be able to enforce the award at the end of the arbitral proceedings, an award in their favour will be only a marginal victory. Such acts in certain jurisdictions would render the arbitral process largely meaningless.[22]

The relative extensiveness and ease of enforceability of the arbitral award compared to foreign court judgments is a principal advantage of arbitration over litigation. This advantage of arbitration arises because of the success of treaties such as the NY Convention. The network of international and regional treaties providing for the recognition and enforcement of foreign awards is more widespread and developed than any provisions relating to enforcement of foreign court judgments".[23]

In particular, the United Nation's Convention on the Recognition and Enforcement of Foreign Arbitration Awards 1958 has been adopted by more than 159 countries worldwide. It has been described as "the single most important pillar on which the edifice of international arbitration rests".

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[19] JULES L. COLEMAN, *RISKS AND WRONGS* 374-75 (1992); Stephen R. Perry, *Loss, Agency, and Responsibility for Outcomes: Three Conceptions of Corrective Justice, in TORT THEORY* 24, 25-26, 38-47 (Ken Cooper-Stephenson & Elaine Gibson eds., 1993); Ernest J. Weinrib, *Corrective Justice*, 77 IOWA L. REV. 403, 421-24 (1992).

[20] I DAN & B. DOBBS, *DOBBS LAW OF REMEDIES: DAMAGES-EQUITY RESTITUTION*. At 286-87 (identifying "[t]he role of compensation in damage remedies" as an important issue of remedies doctrine).

[21] *Goldman Sachs v. Unsecured Creditors Committee of Bayou Group, Nos. 10-5049-cv (Lead), 11-2446-cv (XAP), 2012 WL 2548927, at *1 (2d Cir. July 3, 2012); Merrill Lynch, Pierce, Fenner & Smith Inc. v. Bobker*, 808 F.2d 930, 933 (2d Cir. 1986) (manifest disregard of law —clearly means more than error or misunderstanding with respect to law).

[22] Ibid in. 3

[23] Redfern and Hunter with Blackaby and Partasides, Law and Practice of International Commercial Arbitration, 4th Ed. (London: Sweet & Maxwell, 2004) ("Redfern and Hunter') at434- 435.

Treaties and conventions as such, form part of the legal framework for recognition and enforcement of arbitral awards which ensures effective and reliable enforcement. A sound legal framework is indispensable in ensuring the recognition and enforcement of awards.

A meaningful arbitral award is conditional upon an effective and reliable enforcement mechanism.[24] The "legal framework" of enforcement should include the black-letter law encapsulated in these treaties and various national laws.

More importantly, it should encompass the underlying scheme and principles of the arbitration treaties, particularly the New York Convention. However, judicial understanding of such principles and the judicial attitude towards the enforcement and payment of arbitral awards are necessary ingredients for an effective procedural process.[25]

Even so, while there is an international policy favouring the enforcement of international arbitral awards, exceptions will persist. In Asia, for example, there have been cases recently of non-enforcement that were regarded to be contrary to international standards and practices.[26]

2.1. PAYMENT OF AWARDS – PRESENTMENT AND PAYMENT

1- Arbitration awards are not self-executing. If the losing party does not pay voluntarily, the award must be judicially enforced. In other words, the award must be converted into a court judgment and then the judgment is enforced, just like any other court judgment. [27]

2- Third party funding companies have become more active recently in the judgment enforcement space. They offer many varied forms of financing, from funding the legal fees of enforcement proceedings to outright purchase of the Award. Furthermore, the third-party funding business has grown to the point that it is no longer used only by entities that cannot otherwise fund the payment of legal fees for their claims or their enforcement efforts. Especially in those situations in which significant sums will have to be spent on enforcement and the possibilities of collection are far from certain, it is an option worth considering.

3- The NY Convention covers awards rendered in a New York Convention signatory state and its application does not depend on the nationality of the parties. National arbitration laws govern the procedure for recognition and execution of New York Convention awards.[28] For example, in the Common Law of the U.S., the Convention is codified in the Federal

[24] Tao Jingzhou*, Arbitration Law and Practice* (The Hague: Kluwer Law International, 2004) at 131.

[25] Albert Jan van den Berg, *"Why Are Some Awards Not Enforceable?*" in Albert Jan van den Berg (Gen Ed.), ICCA Congress Series No. 12, Beijing, May 2004: Neiv Horizons in International Commercial Arbitration and Bryond (The Hague: Kluwer Law International, 2004) 291 at 291.

[26] This issue was addressed recently in Wicor Holding AG v Taizhou Haopu Investment Co., Ltd (Taizhou IPC Commercial and Arbitration Review No. 00004, 2 June 2016). In spite of the fact that China ratified the New York Convention in 1987, the Taizhou Intermediate People's Court of Jiang Province refused to recognise and enforce an ICC award as it determined that to do so would be contrary to the public interest.

[27] Wetter, "The Present Status of the International Court of Arbitration of the ICC: An Appraisal", (1990) 1 American Review of International Arbitration 91

[28] Lucy Reed, *"Experience of Practical Problems of Enforcement"* Albert Jan van den Berg (Gen Ed.), ICCA Congress Series No. 9, Paris, May 1998: Improving the Efficiency of Arbitration Agreements and Awards: 40 Years of Application of the New York Convention (The Hague: Kluwer Law International) 557

Arbitration Act. The Act provides for recognition and enforcement of foreign arbitral awards as well as awards made in the U.S. relating to arbitrations between foreign parties.

In France, enforcement of international arbitral awards is integrated in the French Law, *"Code de Procédure Civile"* (French Code of Civil procedures) Article 1504. The confirmation proceedings in most jurisdictions are based on a petition to a national court to confirm the award.

The U.S. and several other countries apply the New York Convention only for those awards rendered in the territory of another signatory state based on bilateral reciprocity, recognition, enforcement and payment. Due to the political nature of reciprocity, uncertainty can reign especially when it comes to certain countries and changes in the US leadership.

4- The ability to initiate enforcement proceedings in various jurisdictions under the New York Convention matters greatly in cases against a sovereign state. This is because any attachable assets of the sovereign may be in jurisdictions other than the country of the arbitration.

It is worth noting here that while most countries are supportive of international arbitration and provide for expeditious adjudication of enforcement proceedings, award confirmation and subsequent execution with pay-out are two different stages. Efforts for payment of awards against a local bank can have a few avenues to resist enforcement and can prove to be long, tedious and expensive.

2.2. TRADING OF AWARDS

A party winning an award (award creditor) against a bank faces the prospect of enforcing it at the place where the bank assets are located. The bank (award debtor) could be a sovereign state bank that refuses to pay for political or public policy reasons. As a result, winning parties may need to spend large sums of money and time on attempts to enforce their awards. The risk is that some of those attempts can potentially be without success.

It is at this point that some award creditors would start to consider cutting their losses and "selling" their awards, even at a discount. [29]

The market for "trading" awards seems to exist in a limited number of cases and to some extent in pure commercial arbitration. In recent years, a handful of examples of assigned (traded) awards appear to have come to light, all of which concerned investment arbitration awards. For example, in *FG Hemisphere v Democratic Republic of Congo* two International Chamber of Commerce (ICC) awards were assigned (traded) by the award Creditor (Energo Invest, a Bosnian state company) to FG Hemisphere (a US Investment Fund). FG as the new holder then sought to enforce the awards in a few jurisdictions where it finally acquired court approval in Hong Kong.

[29] *Democratic Republic of the Congo and Others v FG Hemisphere Associates LLC* (Final appeal no. 5, 6 and 7 OF 2010 (Civil) (8 June 2011)

It is interesting to note however, that in Hong Kong, the judge was initially "concerned" about "the assignment/trading of the awards". However, the court subsequently accepted the enforcement of the assigned awards.[30]

In *Euler Hermes v PJSC Odessa Fat and Oil Plant*,[31] Euler Hermes (the assignee) sought to enforce a Federation of Oils, Seeds and Fats Associations (FOSFA) award in Ukraine. The application was refused on the basis that only the original party to the arbitration had the standing to seek enforcement of the award. Whilst the Ukrainian Cassation Court set aside the lower courts' decisions, the case illustrates a potential hurdle in enforcing an award in certain jurisdictions.

A similar point was raised, unsuccessfully, by Argentina before the US court in *Blue Ridge Investments v Argentina*[32]. That case concerned enforcement in the US of an International Centre for the Settlement of Investment Disputes (ICSID) award in the *CMS Gas v Argentina*[33] case. The benefit of the award had been assigned to Blue Ridge, the petitioner in the case.

Argentina argued, amongst other things, that "as an assignee, Petitioner lacks authority to seek recognition and enforcement of the Award", and "only a party to the underlying arbitration can seek recognition or enforcement of the award under Article 54(2) [of the ICSID Convention], a transferee or assignee cannot."

The judge carried out a detailed textual analysis of the use of the term "party" in the ICSID Convention and concluded that it "[did] not always refer to a 'party to the arbitration'". As New York law recognised assignment of judgments, the court found that "nothing in the ICSID Convention, in Congress's legislation implementing ICSID, or in New York law prevents an assignee from seeking recognition and enforcement of an ICSID Convention award."

A further result of the *Blue Ridge* case is that Blue Ridge used non-judicial avenues to force Argentina to honour the award. Blue Ridge successfully petitioned the US Trade Representative to suspend Argentina from the US Generalized System of Preferences and lobbied the US government to block World Bank loans to Argentina.

The *CMS Gas/Blue Ridge* award was eventually settled by Argentina in 2013, along with four other awards: *Vivendi,* [34] *Azurix,* [35] *National Grid,* [36] *and Continental Casualty.*[37] The latter

[30] *FG Hemisphere Associates LLC v Democratic Republic of Congo & Ors*. The citation for the decisions are: [2009] 1 HKLRD 410 (Court of First Instance), [2010] 2 HKLRD 66 (Court of Appeal) and FACV 5-7/2010 (Court of Final Appeal).

[31] *Euler Hermes Services Schweiz (Switzerland) AG v OJSC Odessa Fat and Oil Plant (Ukraine)*, on April 8 2015 the High Specialised Court of Ukraine

[32] *Blue Ridge Investments, LLC v Republic of Argentina*, No. 10 Civ. 153 (S.D.N.Y. Sept. 30, 2012)

[33] *CMS Gas Transmission Co. v. Republic of Argentina*, ICSID Case No. ARB/01/8

[34] *Compañía de Aguas Del Aconquija S.A. & Vivendi Universal S.A. v. Republic of Argentina*, ICSID Case No. ARB/97/3

[35] Argentina in its protracted dispute with US-based water services firm *Azurix Corp*, on 1 September 2009 an ad hoc arbitration committee denied Argentina's application to annul an ICSID tribunal's previous decision

two awards had also been assigned, reportedly to the US fund *Gramercy*. The assignment of those awards was part of a settlement structure.

In October 2016, further ICSID awards against Argentina were settled: *BG Group* and *El Paso*. The awards were assigned to special purpose discounting entities. It is worth noting that the Argentine assignment value of the awards in 2013 and 2016 was reported to have had over a 25% discount to the nominal value of the awards.[38]

This review gives an indication that the market for arbitral awards seems to be limited, with most of the publicly available information relating to ICSID investment arbitration awards. It also suggests the likely level of discount that the award party agreed with the assignees (buyers of the awards). Such deep discount is due to the fact that the awards were placed on the open market with no regulated mechanism, such as the one this thesis proposes for the banking and financial sector, in operation.

Finally, it seems that the success in enforcing an assigned award may depend to a significant extent on the political leverage and financial clout of the assignees, as the Argentine settlements acutely demonstrated. This naturally limits the number of parties potentially interested in purchasing awards.

In short, whilst the idea of selling an award might sound appealing in principle, it seems that in practice the opportunities to do so might be limited. Such a process can be expanded if related to a specific sector mechanism that can clear and pay awards at nominal discounts or none at all. This would be mainly a mechanism run by banks for the clearing of disputes relating to banks.

3. SUGGESTIONS OF THE THESIS - THEORETICAL BACKGROUND ON BANKS, MORAL HAZARD AND ARBITRATION

Two recurrent aspects of banking and finance sector disputes are the subject matter of the dispute and the time constraint required to resolve the dispute entirely up to the payment of the award. Those are highly complex features of the financial sector. They represent a challenge for an efficient resolution of disputes in the banking and finance industry all over the world.

The sanctity of contracts and redress for disputing investors are essential components of a financial system. Redress of grievances in banking disputes also encourages ethical behaviour in participants. This requires speedy judicial decisions on alleged breaches and for claimants to be able to assert their rights for redress of grievances. Financial compensation

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awarding Azurix approximately US$165 Million for breach of Argentina's obligations under the US-Argentina Bilateral Agreement.

[36] *National Grid plc v The Argentine Republic*, http://ita.law.uvic.ca/documents/NGvArgentina.pdf

[37] *Continental Casualty Co. v. Republic of Argentina*, ICSID Case No. ARB/03/9 (Originally published in 2011 in International Investment Law and Sustainable Development)

[38] The awards were "sold" at a deep discount. As noted above, the Argentina awards settled at over 25% to the nominal value, implying an even deeper discount on assignment. Thus, in *FG Hemisphere*, the underlying award for US $11.7 million was reportedly sold for US $2.6 million.

effectiveness is not just in the speed of the judicial decision. It lies more importantly in the dispensation of the value of the award and how fast the award holder is paid.

To further study the nature of financial disputes, it is important to point out the core rule of financial arbitration where at least one party is a financial institution. The legal concept of binding compensation through arbitration is very much in the definition of arbitration as a consensual dispute resolution mechanism. It is in the binding contractual agreement of those persons who have consented to arbitration and agreed to be bound by its award. Those are the only parties who will be affected by the tribunal decision and upon whom the award for compensation will be enforced.

The scope of the thesis is particularly focused on the process of enforcement and payment of international arbitral awards in financial disputes. The emphasis is on a mechanism of instantaneous payment of awards designed specifically for inter-bank and inter-financial institutions disputes. The mechanism proposed is to pay out awards through existing networks of international banking clearing systems such as SWIFT, European Standard Bank (ESB), or TARGET.

The principal in this proposal is that an arbitration process is finalised only when the award is settled. The NY Convention is a treaty ratified by 159 to ensure that the finality of international arbitration is effectively finalised through the enforcement of the resulting awards. The need for this treaty illustrates that an arbitration process is only as effective as the swiftness by which its awards are paid.

Empirical research demonstrates that a swift and effective dispute resolution mechanism can impede investors' mass panics. It has shown that a consistent framework of dispute resolution that includes bankers facing the right framework of retribution is a missing key in financial institutions dispute resolution methods.

Studies also demonstrate that expeditious dispute resolution processes in the banking sector can assist in deterring imbedded acts of moral hazard within the financial sector. They can also accelerate recovery from a crisis by alleviating the burden on states using their public funds to bail out banks.

As mentioned earlier, the nature of bank disputes and the structure of financial securities are generic to the financial sector. Financial securities, regardless of their issuers or their geographical location, are formed of the same economic elements and structured within the same financial sector. The global population of investors will be interested in factual legal determinations in arbitral proceedings involving banks as it eventually touches on similarities in their legal position with their own banks. At the end of the day, they all are clients of the same "sector".

Hence, other investors and third parties who are not bound by a specific dispute may not be total strangers to arbitration proceedings and the outcome that follows.[39] Gauging how

[39] Bimal Jalan, Emerging India: Economics, Politics, and Reforms, Penguin Books India, (2012)

readily the award may be paid or enforced, investors' fears would be calmed when they see that they or other investors were granted instant restitution for their claims against banks.

Classic psychology and economics studies argue that people who have been cheated view justice through a personal lens. Victims of mis-selling have been found to value prompt compensation over vengeance. They would rather be repaid for their losses than see their bankers punished.[40]

What makes restitution a complex matter is the diversity of financial products and the banking corporate structures. Nowadays a typical form for a large bank organisation is that of a large corporation carrying out its affairs through overseas subsidiaries. Several company affiliates and subsidiaries with officers, directors, stockholders and members of that legal entity can be fully owned by the same group yet operate as two different legal persons.

Transactions will often take form in the execution of a contract concluded by one branch of the group with another branch of other subsidiaries from another third-party group and often from another jurisdiction. Thus, cross-jurisdictional arbitration has become more frequented by banks and financial institutions than in previous years.[41]

Accordingly, several bilateral substantive contracts between several parties will usually provide for bilateral dispute resolution arrangements. Some of the contracts might include a jurisdiction clause, certain others might provide for arbitration, while there are others which may not include any dispute resolution provisions.

Even those contracts that include jurisdiction or arbitration clauses will usually fail to provide for the same national court or the same type of arbitration when it comes to the enforcement of the arbitral award.

Thus, it often happens that several parties would make jurisdictional arrangements on a bilateral basis, against the backdrop of a multiparty financial product. In other words, the parties will opt for a scheme of several bilateral proceedings rather than a single set of multiparty proceedings.

This practice leads to what is called "jurisdictional fragmentation of multiparty financial transactions" which leads the final party to be cut-off from the initiating parties in the transaction. This occurs when several parties get involved in the development of certain derivatives or the creation of specific securities in one jurisdiction. The securities are then bundled, marketed and sold to investors in other jurisdictions who are subject to different adjudicatory fora.

[40] Janne van Doorn, Marcel Zeelenberg & Seger M. Breugelmans Theory and Decision (2018) (An exploration of third parties' preference for compensation over punishment: six experimental demonstrations) https://link.springer.com/article/10.1007%2Fs11238-018-9665-9

[41] Special Supplement 2008: Guide to National Rules of Procedure for Recognition and Enforcement of New York Convention Awards - https://library.iccwbo.org/content/dr/COMMISSION_REPORTS/CR_ALL_0037.htm?l1=Commission+Reports

Thus, a dispute arising between a bank and its client involving a cross-jurisdictional arbitration agreement will have to be resolved entirely by the provisions of the existing arbitration agreement. The arbitration procedure will take place only between the disputing parties even if the dispute is in connection with a multiparty financial transaction.

The process will be limited to the disputed transaction between those two parties and upon whom falls the genuine intention of the original arbitration agreement. More importantly, the enforceability and payment of the resulting award will be determined by the national courts of the jurisdiction where the assets of the losing party are bsed.

3.1. ENFORCEABILITY OF BANKING DISPUTE AWARDS UNDER THE AUSPICES OF THE NY CONVENTION – PROCEDURAL ISSUES IN ENFORCING CROSS-JURISDICTION ARBITRAL AWARDS

The contractual foundations of arbitration constitute the fundamental difference between arbitration and litigation. In litigation, the capacity to become a party to court proceedings is determined based on interest(s). If it is subject to the territorial jurisdiction of the particular national court, a legal or a natural person is entitled to commence court proceedings, whenever it needs to protect its legal or financial interest.

In the context of arbitration, it is generally accepted that the capacity to take part in proceedings is exclusively determined on a contractual basis. Entering into an arbitration agreement is the indispensable requirement for a party to participate in the arbitration proceedings and be bound by the resulting arbitral award.

The focus here is on the wide group of investors with an interest in the enforceability of arbitral awards resulting from a failed financial agreement between a bank and its client. The assumed efficacy of arbitration is in resolving financial disputes efficiently and being able to globally enforce its awards. The speed and certainty by which a party in a financial dispute is able to enforce an arbitral award is of utmost priority due to the large amounts that may be involved as well as the sensitivity of the financial sector to results arising from bank disputes.

The reality in bank disputes is often complex, so it sometimes can be difficult for a claimant to proceed in a claim of fraud or negligence against the bank. Regardless of the situations which may cause disputed transactions to arise, what may be derived from the evidence and research on banking disputes is that the population of investors will be watching in anticipation to see whether the client will be compensated.

The principal is that an arbitration process is as effective as the swiftness by which its awards get paid. An arbitration process for financial disputes needs to remain innovative, as it is obliged to match the speed by which financial markets operate and structure their products. By the same token, the enforceability of awards acquires its strength from the New York Convention which is the most widely ratified treaty the world has come to agree upon today.

The ratification of the NY Convention was intended to be fundamental to the workings of the international arbitration systems around the world regardless of jurisdictions or domestic litigation processes. It is meant to ensure that international arbitral awards are readily recognizable and enforceable in all jurisdictions including the state in which the award was rendered.[42]

However, certainty of the enforceability of awards under the auspices of the NY Convention seems to encounter some challenges. In a report prepared in 2016 by UNCITRAL, *Guide to the New York Convention*[43], some uncertainties surround the NY Convention articles. To begin with, uncertainty surfaces in Article II and Article III of the NY Convention, which requires enforcement of arbitration agreements unless they are found to be "null, void, inoperative and incapable of being performed."

National reports in the UNCITRAL guide, express doubts surrounding the meaning of that phrase and determination of the law applicable to that issue, but also over doubts concerning the respective roles of courts and arbitrators in making the validity determination that Articles II and III contemplate.[44] The guide confirmed that ambiguity exists for disputants of international arbitration in some of the NY Convention's recognition and enforcement articles.

By way of example, the Korean report[45] among others, finds the public policy exception in Article V of the NY Convention related to recognition and enforcement to be particularly ill defined when it comes to the definition and understanding of what qualifies as public policy. For that, the report enquires as to what constitutes a sufficiently serious violation to justify a denial of recognition or enforcement by the national courts under Article II.

The UNCITRAL guide refers to instances of "overuse" of public policy as grounds for refusal of enforcement at the national level. Other country reports claim inconsistency and lack of clarity in the definition of *"*public policy*"*.[46]

3.2. ISSUES WITH THE WORDING OF THE ARTICLES IN THE NY CONVENTION ON THE ENFORCEMENT OF FOREIGN AWARDS

The NY Convention does not provide guidance in any of its articles as to what kinds of norms may be placed within the "procedural" category for national courts to follow nor for the awarded party to pursue to attain enforceability. The "UNCITRAL Guide to the New York Convention" (2016) has shed light on the differences in the practice of national courts

[42] http://www.newyorkconvention.org

[43] *UNCITRAL Guide to the New York Convention – The countries represented in the report are: Argentina, Australia, Austria, Brazil, Canada, China, Croatia, the Czech Republic, France, Germany, Greece, Hong Kong, Hungary, India, Indonesia, Israel, Italy, Japan, Korea, Macau, Malaysia, the Netherlands, Norway, Paraguay, Peru, Portugal, Romania, Russia, Singapore, Sweden, Switzerland, Taiwan, Turkey, United Kingdom, United States, Uruguay, Venezuela, and Vietnam.*
https://www.uncitral.org/pdf/english/texts/arbitration/NYconv/2016_Guide_on_the_Convention.pdf

[44] Article II of the New York Convention provides for the enforcement of agreements to arbitrate. (The New York Convention on the Recognition and Enforcement of Arbitral Awards, June 10, 1958, 21 U.S.T. 2517, T.I.A.S. No. 6997, 330 U.N.T.S. 38 [hereinafter cited as New York Convention].

[45] Korean, German, Indian and Israeli reports of the UNCITRAL Guide on the NY Convention

[46] *NY Convention Article V(2)(b)* is the so-called "public policy" question, justifying non-recognition or non enforcement of a foreign award if "recognition or enforcement of the award would be contrary to the public policy of [the] country where it is sought."

of the New York Convention in many jurisdictions and on the wide difference in interpretation of its process.

According to the UNCITRAL report[47], the Convention does not clearly address the context of enforcing foreign arbitration agreements and does not clearly identify the universe of arbitration agreements covered by Articles II and III. Article III authorizes national courts to follow local rules of procedure in connection with proceedings for the recognition and enforcement of awards.

Article III of the New York Convention provides that:

> *"Each Contracting State shall recognize arbitral awards as binding and enforce them in accordance with the rules of procedure of the territory where the award is relied upon, under the conditions laid down in the following articles. There shall not be imposed substantially more onerous conditions or higher fees or charges on the recognition or enforcement of arbitral awards to which this Convention applies than are imposed on the recognition and enforcement of domestic arbitral awards."*[48]

The first sentence of Article III provides that each Contracting State shall recognize and enforce foreign awards in accordance with its own national rules of procedure. However, Article III also contains two limitations on the application of national rules of procedure.

First*,* Article III requires Contracting States to recognize and enforce foreign awards under the conditions set forth in the New York Convention.

Second*,* Article III stipulates that Contracting States shall not impose substantially more onerous conditions or higher fees or charges for the recognition or enforcement of foreign awards than are imposed on the recognition and enforcement of domestic awards.

3.3. LIMITATIONS AS TO THE APPLICABILITY OF THE NY CONVENTION

Notwithstanding these limitations, the New York Convention still leaves broad scope for the application of each Contracting State's own national rules of procedure for the recognition and enforcement of foreign awards. The central concern here is that Article III left the enforceability of the award, which is an integral procedural step, entirely to the convenience of national courts and their applicable domestic procedural laws. [49]

It is questionable, however, whether staying or dismissing enforcement actions on discretionary grounds with rooted notions of convenience is consistent with a State's obligation under the NY Convention. After all, the purpose of the NY Convention is

[47] ibid

[48] *Article III of the New York Convention*: The Article provides for the enforcement of arbitration awards. The provisions of the convention are beyond the scope of this thesis, however, Article II & Article III are brought into the discussion to demonstrate a point of view.

[49] *FG HEMISPHERE v. Democratic Republic of Congo, 637 F.3d 373 (D.C. Cir. 2011)* - Court of Appeals for the D.C. Circuit

essentially to ensure that national courts entertain the proper actions for the enforcement of foreign awards.

Nevertheless, ambiguity in Articles II & III has given rise to risks that can in certain cases undermine the efficacy of the NY Convention itself.[50]

Some national reports in the UNCITRAL guide suggest that the contours of Article III are quite broad and vague. It includes not only personal jurisdiction and statutes of limitation, but also potential immunity to sovereign and semi-governmental entities.

Possible immunities to government entities can cause deep uncertainty surrounding financial disputes specifically. For it is worth noting that 80% of the entire number of banks of the world are "publicly owned banks" that are fully or partially owned by their states.[51] This means that for financial disputes, the enforcement of cross-jurisdiction arbitral awards can prove problematic when faced with public policy or immunity for state owned banks.

In cases such as the Chinese decision denying recognition and enforcement on public policy grounds, the court ruled that to enforce an award against a public entity that contradicted an earlier Chinese court decision would "amount to a violation of public interests and violates the judicial sovereignty of China."[52] Other Turkish cases have suggested that violations of mandatory rules governing public institutions necessarily constitute offenses to public policy.[53]

Turning to the grounds for denying recognition and enforcement, the very use of the word "may", for example in the introductory language to Articles V(1) and (2) of the NY Convention, has been criticized as ambiguous, leaving unclear just how permissive or mandatory are the defences to recognition and enforcement.

Discussions of Articles II, III and V bring to mind a further question of whether reform to the NY Convention Articles should take place at the international level through consent of the entire 159 states. Another possibility is reform at the national level through domestic modifications of national legislations on a state by state basis.[54]

The answer depends at least in part on the importance of the particular issue, its amenability to an international solution and the degree to which the issue touches closely on core aspects of national legal systems. It properly depends on whether the concern is viewed chiefly as one of random uncertainties, in which case clarification at the national level would suffice. However, if the case is of uniformity of specific concerns, then reforms to the NY Convention may be required.[55]

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[50] *Figueiredo v. Republic of Peru, 665 F.3d 384 (2d Cir. 2011)*

[51] *European Central Bank* – Consolidated Banking Data (2018)

[52] *Hemofarm DD v. Yongning Pharmaceutical Co., Ltd*., http://www.fsou.com/html/text/chl/1327/132739.html

[53] Decision E 997/9703 and K 998/978 (13th Civil Chamber of the Court of Cassation, Feb. 5, 1998).

[54] Dr. Loïc Cadiet/. Prof. Dr. Dr. H.C. Burkhard Hess. Prof. Dr. Marta Requejo Isidro (eds.) *Procedural Science at the Crossroads of Different Generations*. Nomos (2015).

[55] Renaud Sorieul, The Secretary, UNCITRAL (13 July 2015) - *Speech to the EU Parliament (INTA-EP)*

The Convention serves well the area of international trade law and represents the cornerstone of international arbitration processes across the world. The success of the New York convention since its adoption is renowned worldwide. [56] The UNCITRAL report and most other studies conclude that it is not realistic to attempt or suppose that the NY Convention could be reformed. That is probably as far as discussions could go on "NY Convention Reforms" and the possibility of getting the Articles of the Convention changed or amended to meet the enforcement needs of specific economic sectors.[57]

However, it should be highlighted at this point that the analysis presented so far merely seeks guidance as to litigation procedural systems introduced by the NY Convention. The focus so far is on where the Convention might have fallen short to serve the needs of the financial sector. The intention primarily is to point the fundamental requirements for the financial sector to seek a swift payment process of awards arising from disputes involving banks and financial services providers. The emphasis of this thesis is not to criticize, amend or focus on the NY Convention.[58]

3.4. ANCILLARY ENFORCEMENT IN VIEW OF NY CONVENTION LIMITATIONS

The focus of this research is the concerns related to bank disputes and the enforcement of the resulting cross-jurisdictional arbitral awards. It is essential to point out that the NY Convention in its current form does not guarantee clarity and predictability for the financial sector disputes. In the absence of certainty in restitution, stability in financial markets will remain unstable at every sign of a crisis, unless there is a process, where successful claimants are seen to receive their rights promptly.

The scheme of the research here is to study the possibility of an ancillary mechanism for the immediate payment of arbitral awards explicitly for bank disputes. The legality and judicial validity of enforcement of this mechanism will still derive its admissibility under the auspices of the NY Convention.

The conceptualisation is on the contractual foundations of arbitration and the issue of enforcement in arbitration. This can be better addressed if the focus is shifted from the contractual nature of arbitration agreements under the NY Convention to the jurisdictional effect of enforcement of arbitral awards.

The focus is shifted to whether arbitration agreements as ordinary contracts may allow nominated third party forums to enforce awards on contracted parties. Beneficiaries under the granted award may seek enforcement with ancillary forums other than judicial ones. In the jurisdictional context, the arbitration contract for the dispute pending before the tribunal and

[56] Francisco Orrego Vicuna, *Arbitration in a New International Alternative Dispute Resolution System*, International Centre for Settlement of Investment Disputes ICSID *(Vol 18. Nr2) 2001*

[57] Francisco Orrego Vicuiia, *"Arbitration and ADR: Partners or Adversaries"* at the Eighteenth ICC International Court of Arbitration, American Arbitration Association, ICSID Joint Colloquium on International Arbitration - Paris, November 16, 2001.

[58] Shen Wei, *RETHINKING THE NEW YORK CONVENTION*, Eurt Hamburg May 2013

the resulting award are the key factors to determine the boundaries of the ancillary enforcement.

In light of this jurisdictional approach, the thesis focuses on financial disputes and the implications this enforcement process may have for disputants, rather than on the requirements of enforcement under the articles of the NY Convention alone. On this premise, the thesis examines whether bank clearing networks may assume the power to enforce or pay out arbitral awards for parties who are pre-bound by an arbitration agreement for the encashment of the resulting award. [59]

More specifically, the concept of effective arbitral award enforcement comes as a necessary corollary of the NY Convention enforcement perspective. According to the fundamental concept of the NY Convention, an effective ancillary third party may be able to assume procedural enforceability should the parties agree to such mechanism.

Such a concept is valid provided such enforcement is to ultimately achieve the main contracted determination of the parties, which is to effectively resolve a pending dispute within the premise of the industry practice. In *Lehman Bros. (Europe) 2018,* the court based its decision on industry practice. In reaching its decision, the court first found that industry practice can be utilized in the execution of a financial contract.[60]

On this premise, the forum may assume that enforcement will result in the paying out of awards by parties bound by the arbitration agreement. It is discussed here that for an ancillary forum to assert this jurisdiction, it should not only be able to examine the contractual scope of an arbitration agreement but it should also take into account the full implications of the pending dispute. The reactions of financial markets and the general public will depend upon the result of the dispute.

The cornerstone here pivots on the legal concept that extra-contractual jurisdiction[61] can be applied in bank disputes by allowing a third party clearing network to be assigned the power to enforce and pay out awards using its custodial authority over the assets of the debtor parties.

One such valid example currently in practice is third party finance and the assignment of awards to third party beneficiaries.[62] Award assignment represents a typical procedural means for an external party to assume rights over an arbitral award without the need to being in joinder, interpleading, or consolidation.

[59] P.R.I.M.E. Finance Case Summary: *Lehman Bros Intl. (Europe) v. AG Fin. Prods., Inc., 2018*

[60] An authority or an autonomous organisation is characterised in the substantive sense of the term by its judicial or enforcing function. That is to say, determining or processing matters within its competence based on procedures established and conducted as prescribed by rules of law. (*Belilos v. Switzerland, 1988*)

[61] Steel Co. v. Citizens for a Better Env't, 523 U.S. 83, 90 (1998) (quoting United States v. Vanness, 85 F.3d 661, 663 n.2 (D.C. Cir. 1996))
"The Supreme Court defined jurisdiction by three different identities: jurisdiction as power jurisdiction as defined effects, and jurisdiction as positive law."

[62] *Euler Hermes Services Schweiz AG v OJSC Odessa Fat and Oil Plant*, The Higher Specialised Court of Ukraine, 8 April 2015, case No. 6-3583св15.

More recently, in October 2016, two claimants, *BG Group* [63]and *El Paso*[64], were awarded by ICSID against Argentina. Both claimants agreed not to seek enforcement of their awards through the courts. The awards were assigned to special purpose vehicles for pay-out at a discount.

This gives an indication as to the possibility for assignors agreeing to present their awards for pay-out rather than going through the complexity of attempting enforcement through national courts.

4. RESEARCH QUESTION

The research question is whether an arbitration process deploying a mechanism that guarantees the immediate payment of arbitral awards can accelerate recovery from a crisis and alleviate the burden on state bailouts using taxpayers' money?

Empirical research show that enforceable and swift dispute resolution for financial disputes can establish certainty in the financial markets and assist in deterring imbedded acts of moral hazard within the financial sector.[65] This in turn will impede the main ingredient for financial crises which is generated through high risk transacting within the financial sector.[66]

It is against this background that this thesis is proposing the instant monetizing mechanism of arbitral awards that result from banking disputes. The purpose behind the choice of the financial sector as a pilot for such a proposal is the ready availability of interbank clearing networks. Such networks can play an important role re-injecting funds back into the market through the ease of monetizing the awards and instantly transferring funds to claimant investors.

Applying this concept particularly in the financial sector will clear backlogs of investors' funds that will unfailingly find their way back into the financial markets through the banks. Recycling the funds back into the markets will instantly speed the markets' recovering cycle and avert deep crises.

4.1. NOTION OF AWARD ENFORCEMENT PROCESSES IN *LEX FINANCIERA*

In the field of international banking and finance, domestic laws are frequently inapt to provide workable and operable solutions for disputes arising in cross-jurisdictional transactions. Consequently, these areas are dominated by uniform "private" rules drafted by industry experts rather than domestic legislatures. Prominent examples are the *Uniform Customs and Practices (UCP) for Documentary Credits* published by the International

[63] *BG Group PLC. V. Republic of Argentina,* [CASE NO. U.S. 12-138 (2014) – U.S. SUPREME COURT]
[64] *El Paso Energy International Company v. Argentine Republic (2003)*, (ICSID Case No. ARB/03/15)
[65] Mark R. Reiff, *Punishment in the executive suite: Moral responsibility, causal responsibility, and financial crime* (L. Herzog (ed), *Just Financial Markets? Finance in a Just Society*), OUP 2017
[66] See: Ricardo Bebczuk, *Asymmetric Information in Financial Markets*, Cambridge University Press, Cambridge University Press (2003), Mehrteab, see also H. T. , *Adverse selection and moral hazard in group-based lending*, University of Groningen (2005) , NL

Chamber of Commerce (ICC) or the *ISDA Master Agreement* drafted by the International Swaps & Derivatives Association.

These agreements establish the rights and obligations between the parties in a comprehensive and exclusive manner. Even though they contain choices of law clauses, these master agreements are, as detached as possible from domestic laws. By using these standard contract documentations, the parties create their own rules to govern these complex and highly sophisticated financial transactions.

It is not surprising, therefore, that particularly in the field of international banking and finance there exist private financial transnational legal rules and principles of *("lex financiera")* that are frequently claimed and practiced.[67] In fact, the Canton Court of Zurich, Switzerland, has qualified the *lex financiera* rules regarding the enforcement of bank guarantees on first demand as an institution subdivision of 'the transnational Lex Mercatoria'.[68]

Lex financiera, refers to a body of oral, customary financial rules and regulations which has been developed in the financial sector over many years. It has been administered quite uniformly across the world by merchant banks and court judges, adjudicating disputes between banks and their clients and between banks and each other.

In addition, *lex financiera* extends to certain international conventions and even national laws pertaining to international economic relations. International commercial arbitration is frequently cited as a field in which the modern *lex financiera* is operative.[69]

Within the same token, devising ancillary mechanisms as procedural tools for the enforcement and payment of arbitral awards within the international financial community can be associated to the substantive contractual permissive nature of interbank relations in *lex financiera*. The availability of clearing networks and exchange of funds on a daily basis makes such a process substantively feasible.

The exploration of such a process takes place in the following chapters against a comparative background of several national litigation substantive and procedural systems. Again, here, it is emphasized that the arbitration agreement that exists between the disputant parties is the key element for an enforcement mechanism operated by an ancillary third party.

In particular, the extent to which that third party may participate in the enforcement proceedings between two original parties is key. This is directly relevant to the degree of association between the third party and at least one of the original parties, in terms of the holding of assets or being members of the same bank clearing networks.

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[67] Professor Rosa M. Lastra, *The Quest for International Financial Regulation*, Inaugural Lecture, Charterhouse Square – 23rd March 2011

[68] Lex financiera is a sub-category of transnational commercial law, the new lex mercatoria. The Trans Lex-web platform, which is operated by the Centre for Transnational Law (CENTRAL) at Cologne University, Germany, provides a compilation of over 130 principles and rules of transnational commercial law ("Trans Lex-Principles") together with thousands of comparative law references as well as detailed information on the historic origins and status of the new lex financiera. Bl. Zuerch. Rspr. 1986, No. 23, at 44

[69] ibid

In legal terms, the enforcement of the award may be strongly associated in substantive terms with *lex financiera* and the NY Convention. It may also rely on permissive contractually interrelated agreements for the procedural mechanism of payment of funds out of a party's account even in situations when consent to enforcement proceedings is not disputed.[70] This is the case with banks and financial institutions associated in contractually interrelated clearing networks.

However, the issues of *lex financiera* and substantive laws are in the periphery of the conceptual boundaries of this work, and therefore, they will only be briefly mentioned.

4.2. CONCEPT OF A SWIFT MECHANISM FOR BANK DISPUTES

For many decades, the worldwide trade of over-the-counter *(OTC)* derivatives and structured finance agreements have been contracted upon in standard master agreements such as that used by the International Swaps and Derivatives Association (ISDA). In cases of syndicated loans, there are the master agreements of the London-based Loan Market Association (LMA) and the Loan Syndications and Trading Association (LSTA) based in New York.[71]

In those contracts, in light of the complexity and political considerations such as issues of state sovereignty, the parties would not submit themselves to the jurisdiction of foreign courts of the transacting banks. On the other hand, the transacting banks would also not subject themselves to the jurisdiction of other party's national courts. Instead, the parties would agree to submit their disputes to international arbitral tribunals sitting in a neutral country. As a result, arbitral proceedings through those standardised contracts have played and will play an important role in the renegotiation of financial instruments and financing sovereign debt.[72]

However, recourse to arbitration was not limited to financial loan contracts with local and international parties. In derivatives and structured financing transactions, and other financial agreements with commercial parties from "emerging markets", e.g. Africa or Asia, parties would also agree on arbitration instead of litigation before domestic courts. One reason for pursuing this approach is the interest of those parties to shield themselves from existing legal uncertainties in those countries and problems with the reliability, expertise and efficiency of the local courts there.

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[70] Serrano, A.S., (2018). *The Reform of International Economic Governance*. (1st Ed.). NY: Routledge

[71] Even the *EEFT Master Agreements* of the European Federation of Energy Traders for the delivery and acceptance of gas and electricity were highly influenced by the *ISDA Master Agreement*. They refer to the arbitration rules of the London Court of International Arbitration (LCIA) or to the DIS, depending on whether the parties have selected English or German substantive law to govern their contract. If neither parties have made a choice for either option, then the option in the Framework Agreement stands for the use of arbitration as a means of resolving the dispute. The arbitration tribunal will then be selected depending on the parties' choice of the jurisdiction whether it is for the London High Court or an ad-hoc arbitral tribunal in England pursuant to the Arbitration Act of 1996 (Section 20.1 of the Master Agreement).

[72] *Cour de Cassation, Première Chambre Civile, Nr. 983, Decision from 26.9.2012, Banque Privée Edmond de Rothschild;* Resolution of the Presidium of the *Supreme Arbitration Court of the Russian Federation No. 183/12 dated 19 June 2012* in relation to a dispute between *Russian Telephone Company as plaintiff v. Sony Ericsson Mobile Communications (Russia)*.

Another reason for resorting to international arbitration agreements is to benefit from the worldwide and highly efficient enforcement regime of the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards, especially in scenarios when awards rendered in favour of an overseas claimant need to be enforced against assets in cross-jurisdictional processes.

As mentioned earlier, this may be the case when those parties have concluded a contract with a counterparty that has assets in multiple jurisdictions or a contract with multiple counterparties having assets in a variety of jurisdictions, e.g. in project finance scenarios. For the judgement of domestic courts only bilateral and regional enforcement systems exist, but no such worldwide system.

4.3. FINANCIAL MARKET DISPUTES REQUIRE FINANCIAL EXPERT JUDGES

The chapters that follow will demonstrate that it is possible for arbitration to interact with investors as a method of administering their bankers. At the same time, they will outline the main theoretical economic effects of a speedy process and enforcement of financial disputes with suggestions of a mechanism for immediate payment of financial awards. The mechanism is presented in analytical detail in the main part of the thesis with tests of the concurring boundaries of arbitration awards as assented to in the NY Convention.

Examples from recent practice, both in commercial and investment banks' arbitration show that there is no reason for banks and other financial institutions to avoid arbitration in favour of state court jurisdiction. In many instances, arbitration has shown itself as a superior method of dispute resolution in its speed and the expertise of the judicial panel. One of the many advantages of arbitration is the ability of parties to select an arbitrator with specialized legal know-how and market proficiency.

Arbitrators with expert knowledge are fundamental to the efficient process of arbitration. The choice of specialized financial arbitrators in banking disputes will ensure that the documentations of complex financial transactions like the ISDA and LMA/LSTA master agreements are not interpreted the same way as in any other commercial disputes. A judicial decision from an arbitrator with thorough understanding of the banking and finance industry will strengthen the public confidence in the process and quell possible turmoil.

This classical advantage of expertise in arbitration in financial disputes has become more evident after the 2008 crisis than at any other time. This is because it can be hardly possible to explain to most national court judges in a short time the market understanding and functioning of terms like "backstop facility", "convertible preferred equity certificates", "collateralized debt obligation", "MAC-clause", "parallel debt", "senior facilities agreement", "*pari-passu clause*", "gun jumping" or "contractual subordination.[73]

[73] University of Cologne, Faculty of Law- Arbitration in Banking and Finance - The same applies to the need for expert knowledge to interpret standardized contract documentation for complex financial transactions such as the ISDA Master Agreement:
"Complex financial transactions agreements place a premium on the knowledge and expertise of those using them. They are, literally and by definition, complex. They are also full of what might be called 'code'-words,

The financial crisis and its aftermath have helped the financial sector to better understand the benefits which arbitration has to offer, rather than reflexively resorting to the decades-long established practice of dispute resolution by state courts, without considering alternatives and associated efficiency gains. Already today, a considerable percentage of the case load administered by some arbitral institutions involves international banking and finance disputes or disputes where such issues are in the background. It is not surprising that this increased acceptance of arbitration in the financial industry goes along with the increased complexity of disputes involving financial products.

Three major reasons account for this increased use of arbitration in finance:

1. Access to the legal and financial market expertise of highly qualified arbitrators selected by the parties;
2. Confidentiality of the arbitral procedure, at least in commercial as opposed to investment arbitrations; and
3. Worldwide enforceability of arbitral awards under the 1958 New York Convention.

These, as well as other advantages of arbitration in finance are listed in the *2013 ISDA Arbitration Guide* and have led ISDA to recommend to its members the use of arbitration clauses in the 2002 and *1992 ISDA Master Agreement*. However, the significance of arbitration goes well beyond the area of derivatives transactions. It may even be relevant in cases that involve straightforward and undisputed claims for the payment of a sum of money, e.g. for the repayment of a loan. For such disputes, the parties may benefit from the rules for expedited proceedings ("fast track rules") which have been issued in recent years by a variety of arbitral institutions and which allow for a speedy resolution of disputes through arbitration.

Some of these developments have been evaluated at the German Institute of Arbitration (GAR Live Frankfurt in 2018).[74] Arbitrators and bankers came together to discuss the current state of arbitration in finance and pointed to areas and means of improvement. Amongst these, concerns about the delays facing the enforcement of arbitral awards surfaced as a serious worry for banks and investors alike.

5. THE NECESSITY OF ARBITRATION – CASE LAW

The financial crisis resulted in an increase of interbank disputes as well as between banks and their international correspondent banks. The following are some examples of case law to illustrate how arbitration has proven to be a necessary instrument in financial disputes. It may

expressions and usages, as well as legal underpinnings, known and understood [only] by those who use them. To some extent, the difficulties [in interpreting and understanding the ISDA Master Agreement] also arise from the fact that the ISDA Master Agreement is necessarily a compromise between brevity and the requirement for an agreement that is effective and enforceable under at least two governing laws, as well as under other laws that may be chosen as its governing law." (Capital Markets Law Journal (2012)) http://www.jura.uni-koeln.de/

[74] Fifth Annual German Institute of Arbitration (GAR Live) – June 2018 http://gar.live/frankfurt2018

also prove to be an indispensable instrument in resolving complicated bank disputes in the near future.[75]

1- Disputes over derivative contracts that had been concluded between the bankrupt investment bank, Lehman Brothers, and their investors were resolved through a multi-step arbitration procedure. The process was ordered by the Bankruptcy Court for the Southern District of New York under Section 105 (a) of the U.S. Bankruptcy Code.

2- In Hong Kong, thousands of claims from investors who had purchased bonds of Lehman Brothers investment banks were resolved through arbitration under the rules of the Hong Kong International Arbitration Centre (HKIAC). Pursuant to the "Lehman Brothers-Related Products Dispute Mediation and Arbitration Scheme Agreements", the decision was taken accordingly that those disputes are to be decided by arbitration tribunal and not by state courts.

3- Disputes related to the corporate debt restructuring of the Dubai World Group (DWG), a restructuring made necessary by the financial crisis, were discretely removed from the state courts by decree of the ruler of Dubai and were instead decided by a special tribunal (Dubai World Tribunal) of the Dubai International Financial Centre (DIFC).

4- In 2009, an arbitral tribunal in New York ordered the Swiss bank, Credit Suisse, to pay damages for the purchase of worthless securities. Pursuant to the arbitral award, it had to pay over USD $400 million (310 million euros) to the semi-conductor manufacturer ST Microelectronics in Geneva.

5- On March 1, 2010 ISDA published a modified version of the Islamic Finance-Version of its 2002 Master Agreement ("ISDA/IIFM *Tahawwut Master Agreement*"), which was jointly developed by ISDA and the global standard organization of Islamic money and financial market operations "International Islamic Financial Market" (IIFM).

Section 13 (c) of the Master Agreement now offers parties the opportunity to have disputes arising out of this Tahawwut Master Agreement be decided not by a state court, but rather by a tribunal that operates under the ICC or any other arbitration rules agreed by the parties.

6- In an award dated August 4, 2011, an arbitral tribunal constituted under the rules of the International Centre for Settlement of Investment Disputes (ICSID) declared itself competent to rule on the claims of nearly 60,000 Italian bondholders against the Argentinean Republic. The claims were brought in connection with Argentina's default and the related partial rescheduling of its debt in the context of the international financial crisis.

7- *Solymar Investments, Ltd. v. Santander*, was a case regarding the improper direction of customer funds into the fund of convicted fraudster Bernard L. Madoff. In its decision, the U.S. Court of Appeals for the 11th Circuit in its decision on 28th Feb. 2012, referred the damages claim against the Spanish bank, Santander, to an arbitral tribunal constituted under

[75] Rose, Clayton S., and Aldo Sesia. *"Barclays and the LIBOR Scandal."* Harvard Business School Case 313-075, January 2013. (Revised October 2014.)

the Rules of the ICC. The reason for the US Court of Appeals' decision was that the parties had agreed to ICC arbitration at the outset of their contractual agreement.

8- *Ping An Life Insurance Company v Kingdom of Belgium (2012)* - In September 2012, *Ping An,* sued before an *ICSID* tribunal for damages in the amount of USD $2.28 billion. The case began in 2007 when *Ping An* had acquired an interest in the Belgian bank, Fortis. The bank was subsequently nationalized by the Belgian Government due to the difficulties it faced during the financial crisis. *Ping An* was forced to discontinue with the plans to acquire Fortis Bank and had to write off its investment in the amount of the claim.[76]

9- In October 2012, an ICSID Tribunal ruled on Deutsche Bank's claim against the Republic of Sri Lanka. The claim concerned the possible violation of an investment treaty between Germany and Sri Lanka. The dispute involved a "Hedging Agreement" regarding oil transactions between Deutsche Bank and the state oil company. The tribunal found a violation of the investment treaty and awarded Deutsche Bank damages amounting to approximately USD $60 million, plus interest and attorney's fees. [77]

10- In an award dated February 8, 2013, an arbitral tribunal constituted under the rules of the *International Centre for Settlement of Investment Disputes (ICSID)* declared itself competent to rule on the claims of 74 Italian bondholders against the Argentinean Republic. The claims were brought in connection with Argentina's default and the related partial rescheduling of its debt in the context of the international financial crisis.

11- On May 20, 2013 the Slovak banks *Postova Banka a.s*. and its shareholder *Istrokapital S.E.* filed a claim for damages against the *Hellenic Republic* in relation to Greece's sovereign debt restructuring. *Postova* argued that it purchased Greek Government Bonds in 2010. *Postova* and *Istrokapital* alleged that Greece unilaterally amended the terms of the outstanding bonds by inserting a "collective action clause through the Greek Bondholder Act in 2012.

Postova claimed that being a holder of the Greek Government Bonds when they were forcibly restructured by Greece caused them and *Istrokapital* significant losses. The claimants alleged that Greece destroyed their investment by taking measures that were never taken before in debt restructuring. Those extreme measures included the Greek legislation to retroactively and unilaterally amend the terms of the bonds.

However, the tribunal dismissed all of *Istrokapital's* claims for lack of jurisdiction considering that the claimant had sought jurisdiction on its indirect investment, but failed to establish that it had any rights to Poštová bank assets that were protected by the *BIT*.[78] The point is that the claimant may have had a better chance claiming directly in a commercial arbitration dispute.

[76] *Ping An Life Ins. Co. of China Ltd & Ping An Ins Group of China Ltd v. Kingdom of Belgium*, ICSID Case No. ARB/12/29 https://www.iisd.org

[77] *Deutsche Bank AG v. Democratic Socialist Republic of Sri Lanka 2009* (ICSID Case No. ARB/09/2) https://investmentpolicy.unctad.org/investment-dispute-settlement/cases/337/deutsche-bank-v-sri-lanka

[78] *Poštová Banka, A.S. and Istrokapital SE v. The Hellenic Republic*, ICSID Case No. ARB/13/8

12- In August 2013, the *Iranian Bank Mellat* looked at settling a 780 million USD claim against the *Government of Great Britain* before an ad hoc arbitral tribunal instead of domestic courts. This was after the UK Supreme Court had ruled in a judgement of June 19, 2013 that the decision of the British Treasury of October 2009 to ban the bank from business in the British financial markets was unlawful. The decision by The UK Treasury Secretary was taken for alleged connections of the *Mellat Bank* with the Iranian nuclear programme.

13- *Marfin*, an Athens-based Investment Group and twenty other Greek investors filed a claim on September 6th, 2013 against Cyprus.[79] The collective action was for claims for damages in the amount of 1.05 billion Euros. These claims arose out of the issuance of a decree that increased the Cypriot Government's participation in the Cyprus Popular Bank in which the claimants had invested. Allegedly then, the Cypriot Government take-over of the bank's management control and the subsequent insolvency of the bank was caused by the financial crisis. The Tribunal dismissed all claims against the Cypriot Government including expropriation, and arbitrary and discriminatory measures, including denial of justice claims [80]

14- On September 9, 2013, the International Swaps & Derivatives Association (ISDA) published its "2013 ISDA Arbitration Guide" in which it recommended the use of a number of alternative model arbitration clauses for its 2002 and 1992 ISDA Master Agreements for OTC derivatives in lieu of the choice of forum clause, which was used exclusively in these Agreements.

15- In April 2015, *Capital Financial Holdings Luxembourg (CFHL)* filed a claim for damages of over €100 million against *Cameroon* under the *Luxembourg-Cameroon* Bilateral Investment Treaty. The claim was based on an alleged expropriation of its *47%* stake in the *Commercial Bank of Cameroon* following a state-imposed capital restructuring of the bank. *CFHL* claimed that such a restructure was against their will and that of other shareholders. *CFHL* then argued that because the bank was placed under a regime of "provisional administration" in 2009, *CFHL* and other shareholders lost control over the management of the bank, with a provisional administrator exercising executive powers instead of the bank's CEO and board of directors. *CFHL* maintained that the imposition of the provisional administration regime amounted to an expropriation leading to the loss of its shares in the bank. [81]

It is worth noting that almost all of the above cases involved a standardised ISDA Master Agreement.

6. CHALLENGES TO INTERNATIONAL AWARDS

No harmonisation of state law exists so far on challenging international arbitral awards in general. It is thus difficult to gauge how certain jurisdictions will proceed in any given case as to a challenge to a bank dispute arbitral award. Legal practitioners and parties engaged in

[79] *Marfin Investment Group Holdings S.A., Alexandros Bakatselos and others v. Republic of Cyprus (2013)* (ICSID Case No. ARB/13/27)

[80] https://icsid.worldbank.org/en/Pages/cases/casedetail.aspx?CaseNo=ARB/13/27

[81] *Capital Financial Holdings Luxembourg S.A. v. Republic of Cameroon* 2015 (ICSID Case No. ARB/15/18)

banking transactions in particular countries or regions frequently assess possible jurisdictions in order to determine which jurisdiction is most appropriate as a seat for their arbitration.

This determination is not based upon the ratification of the NY Convention. Unfortunately it is based in large part on the attitude of local courts towards set aside proceedings. Apart from the ICSID Convention, no multilateral convention provides uniformity as to challenges.

That is to say, that while the enforcement of international arbitral awards is governed by international conventions (The NY Convention), the extent of a state's exercise of judicial control over the challenge to awards of arbitral tribunals is not. The result is wide variations of standards, and the extent to which judicial control is permissible thus varies from state to state.

In the absence of treaty-induced harmonisation of approaches, it is believed that in certain jurisdictions, it is incumbent on the parties to go through cumbersome processes that may still end fruitlessly. Arbitration practitioners appreciate how and when transnational issues may influence enforceability especially when it comes to Article V of the NY Convention. National courts usually use the public policy issue to deny enforceability.[82]

It can be argued however, that an award can be challenged in courts to hinder the process of the proposed mechanism of instant payment. The general rule is that award challenges do not automatically suspend enforcement. For example in France, award challenges do not suspend enforcement proceedings (Article 1526 section 1)[83].

The courts can exceptionally suspend enforcement proceedings, in cases where the rights of any of the parties can be seriously jeopardized (Article 1526 section 2). The applied rule in other jurisdictions is that an award challenge shall not hinder the prevailing party from seeking enforcement of the award. It is understood that the automatic suspension resulting from the initiation of an action to set aside the award in the court of the originating jurisdiction does not meet the requirement of the NY Convention Article V(1) (e).[84]

Abstracts of empirical and academic research point out that if the term “suspension” were to refer to the automatic suspension of an award pending an action to set aside, this would

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[82] George A. Bermann / Recognition and Enforcement of Foreign Arbitral Awards: The Interpretation and Application of the New York Convention by National Courts / Springer, 2017 - 2017

[83] Article 1 – Articles 1508 through 1519 of the Code of the *French Civil Procedure*

[84] NY Convention Article V(1)(e)- 1. Recognition and enforcement of the award may be refused, at the request of the party against whom it is invoked, only if that party furnishes to the competent authority where the recognition and enforcement is sought, proof that:(e) The award has not yet become binding on the parties, or has been set aside or suspended by a competent authority of the country in which, or under the law of which, that award was made. In the case of *The Republic of Gabon v. Swiss Oil Corporation*, Grand Court, Cayman Islands, 17.06.1988, XIV Y. B. COM. ARB. (1989) at 621-626 stating that “(the automatic suspension of the effect of the award due to the initiation of a recourse to set aside the award under French law does not amount to “a competent authority acting consciously to stay the award and therefore is not a ground to refuse enforcement under Art. V(1) (e)); S.A. Recam Sonofadex v. S.N.C. Cantieri Rizzardi de Gianfranco Rizzardi, Court of Appeal of Orleans, France, 5 October 2000 (stating that the suspensive effect of setting aside proceedings initiated at the seat of the arbitration, namely Italy, does not amount to an effective suspension required by Article V(1) (e) and cannot serve as a valid ground to reject the recognition and enforcement of the Award).

defeat the whole system of the NY Convention.[85] In the case of *Company X SA v. Y Federation*, in Switzerland, a party challenged the enforcement of an award pursuant to article V(1)(e) of the *NY Convention*. The *Swiss Federal Tribunal* held that the correct interpretation of the *Convention* should be that the suspension of the award in the originating jurisdiction would only constitute a ground for challenge if it were granted by a judicial decision. It would not however, constitute such grounds when it simply arose from an action brought against the award.[86]

In *AB Götaverken*, the Swedish Supreme Court confirmed that the reference to a "suspended" award under article V(1) (e) refers to *"*a situation where, after specific consideration of the matter, the foreign authority orders the setting aside of a binding and enforceable award or the suspension of its enforcement". [87]

As a result, the court rejected the respondent's contention that enforcement should be denied on the ground that recourse to set aside had been initiated in France, the country where the award was issued. The same principle led a US court to deny the enforcement of an award. The court affirmed the rule that "article V(1) (e) of the Convention require[s] a 'competent authority' to suspend the award, not just a statutory stay".

The court held that the stay ordered by the Argentinean courts was not merely an "automatic" stay resulting from the initiation of setting aside proceedings or a "pre-ordered" formality. On that basis the US Court dismissed exceptionally the request to enforce the award.[88]

7. CONCLUSION

The case for a specialized award paying mechanism on an international basis in the banking world is a compelling and a sound one. Such a process will be well positioned to address many issues that arise in financial disputes and to fill the international void of delayed settlement of enormous inter-bank disputes.

However, national courts still have an important role to play in arbitration procedures, mostly in the enforcement process of the awards. Nevertheless, inconsistent interpretation of the NY Convention by national courts has resulted in conflicting decisions in recent years on the

[85] Albert Jan van den Berg, The NY Arbitration Convention 1958: *Towards a Uniform Judicial Interpretation (*1981). Also- Nadia Darwazeh, Article V(1) (e), in *RECOGNITION AND ENFORCEMENT OF FOREIGN ARBITRAL AWARDS: A Global Commentary on THE NEW YORK CONVENTION* (H. Kronke, P. Nacimiento et al. ed., 2010); Fouchard, Gaillard, Goldman *on INTERNATIONAL COMMERCIAL ARBITRATION* (E. Gaillard, J. Savage eds., 1999); Christoph Liebscher, Article V, on NEW YORK CONVENTION ON *THE RECOGNITION AND ENFORCEMENT OF FOREIGN ARBITRAL AWARDS – COMMENTARY* (R. Wolff ed., 2012).

[86] *Company X SA v. Y Federation*, Swiss Federal Tribunal, Switzerland, 9 December 2008, 4A_403/2008.

[87] AB Götaverken v. General National Maritime Transport Company (GMTC), Libya and others, Supreme Court, Sweden, 13 August 1979, SO 1462.

[88] *EDF International S.A. v. YPF S.A.*, District Court for the District of Delaware, United States of America, 20 November 2008, Civil Action No. 08-167-JJF. Also in- S.A*. Recam Sonofadex v. S.N.C. Cantieri Rizzardi de Gianfranco Rizzardi,* the Court of Appeal of Orleans, France, 5 October 2000 ruled that "the suspensive effect of setting aside proceedings initiated at the seat of the arbitration, namely Italy, does not amount to an effective suspension required by Article V(1) (e) and cannot serve as a valid ground to reject the recognition and enforcement of the Award".

enforcement of arbitral awards in different jurisdictions. This was witnessed by the UNCITRAL Report[89] which stands as good example of the difficulties and complexities that exist globally today in the resolution of banking and financial sector disputes.

These cases are also examples of how courts can struggle with the complex issues that financial market participants have as normal operative rules of their daily transactions from a legal as well as a practical market perspective. Banking and finance disputes face two recurrent challenges: highly complex transactions and time constraints for resolving the dispute.

The arbitration process can be and has been proven to be expeditious in certain dedicated arbitral institutions. However, when it comes to payment of the award with respect to asserted gaps in the NY Convention, time constraints may well vary as numerous factors come into play when seeking enforcement through national courts.

Markets and market participants acknowledge that banking disputes will continue to occur if not increase. Markets and market participants need legal clarity, certainty and predictability that their disputes will be concluded in a definitive manner. Regardless of who loses or wins, financial markets require certainties in outcomes in order to be able to plan for the following day.

They also need confidence in the outcomes of the resolutions of their disputes, as well as in the disputes in other markets and of other market participants. Financial markets participants operate on indications and predictabilities. If markets are deprived of investors' confidence, panic waves and bank runs are the eminent result.

The questions that may arise if arbitration is a confidential process are how the public will and regulatory authorities become aware of the outcome? In answer to the confidentiality of arbitration and its procedures, banks are required by standard accountancy rules to form a provision on their balance sheet for every dispute they are involved in.

Arbitration processes and cases may be confidential from the public but it will not be hidden from the banking regulatory authorities.[90] Should a certain bank be disputed by a number of its clients, it is easy for the regulatory authorities to look into the pattern of those disputes and intervene should there be an indication of high risk transactions. The resulting awards will also have to be included in the banks' financial statements, which investors follow on regular basis.[91]

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[89] UNCITRAL Secretariat, *"Guide on the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York, 1958)"*, 2016 Edition

[90] Financial Reporting Standards (FRS12) applicable in the UK: *"The objective of FRS 12 is to ensure that appropriate recognition criteria and measurement bases are applied to provisions, contingent liabilities and contingent assets. Also to ensure that sufficient information is disclosed in the notes to the financial statements for users to understand their nature, timing and amount."*

[91] International Accounting Standards (*IAS 37 Provisions*), *"Contingent Liabilities and Contingent Assets outlines the accounting for provisions (liabilities of uncertain timing or amount), together with contingent assets (possible assets) and contingent liabilities (possible obligations and present obligations that are not probable or not reliably measurable). Provisions are measured at the best estimate (including risks and uncertainties) of the*

A mechanism that guarantees instant payment of dispute awards would be well positioned to assist in the provision of that confidence. That said, the case for such a process would need a banks forum similar to the funds clearing forums SWIFT or TARGET. Consent by members for awards to be debited to their accounts is provided *quid pro quo*. On the other hand, consent by non-members can provide their consent at the outset of an arbitral agreement with a clause providing for awards to be *debited* directly to the account of the losing party through the Award Clearing Forum. This is not necessarily a new practice in the financial sector. Large volumes of derivatives and complicated financial transactions (CFT's) are habitually documented under standardised contractual agreement forms with a standard arbitration clause.

The amenability of an international uniform solution for the expeditious enforceability of arbitral awards in banking disputes will depend initially on the degree to which the issue of enforceability touches core aspects of the financial world and the willingness of banks to resort to arbitration. Market sponsor entities which have sponsored and published several forms of financial dispute agreements such as the European Master Agreements by ISDA for OTC derivatives have shown flexibility in endorsing new clauses in their standard forms. That was also seen with P.R.I.M.E. Finance and the local language ISDA master agreements by the French and German banking associations.

In the international trade and finance arena, as mentioned earlier, the speed by which financial disputes are completely settled has serious effects on world economies and the stability of financial markets. This does not necessarily mean that disputants in banking and financial agreements should limit themselves to the detriments of national legal systems with uncertainty as to the New York Convention's interpretation.

Although disputed for some time, it is generally accepted that arbitration awards can be transferred by way of assignment.[92] Thus, after the assignment of the main contract including the arbitration agreement is completed, the assignee is entitled to enforce the arbitration agreement on its own name and in its own right.

This is the view taken by the courts in several countries. Under the English Arbitration Act, (s. 82(2) the assignee is considered a person "claiming under or through the assignor to the agreement". In essence, the assignee claims instead of the party.[93] Similar cases in the USA include *Asset Allocation and Management v Western Employer,*[94] *Banque Worms v Bellot* in France[95], *Clear Star v Centromor, (1991)* in Switzerland.[96]

Such flexibility will allow financial dispute awards drawn on banks to be traded and discounted freely on the open market which will grant liquidity to the award debtor as well as

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expenditure required to settle the present obligation, and reflects the present value of expenditures required to settle the obligation where the time value of money is material."

[92] D. Girsberger & C. Hausmaninger, *"Assignment of Rights and Agreement to Arbitrate"* (1992) 8 Arb Int'l 121

[93] *Schiffahrtsgesellschaft Dedlev Von Appen v Voest Apline Trading*, [1997] 2Lloyd's Rep 279

[94] *Asset Allocation and Management v Western Employer*, 892 F. 2d 566 (7th Cir. 1989)

[95] *Banque Worms v Bellot*, (2000) Rev. Arb. 85

[96] *Clear Star v Centromor*, (1991) 8(2) J Int'l. Arb 21.

the markets. However, unlike with the assignment of the arbitration agreement, the assignee remains a genuine party to the arbitration agreement after the assignment of the arbitration award agreement is completed. In the case of *American Renaissance Lines v Saxis* [97] in the US, it was held that the assignor can still enforce the arbitration agreement against the other party with the assignee remaining to be entitled to the rights arising out of the award.

In fact, it could be argued that the extent to which the assignor remains bound by the arbitration agreement or its award is primarily an issue of interpretation of the substantive contract containing the arbitration agreement.

With such a view, the same can apply to award clearing forums. In an award assignment agreement, the clearing network becomes an assignee. According to the prevailing view, the network is considered as a custodian agent of the party holding the award.[98] Accordingly, the assignee by holding the award becomes a party to the award agreement incorporated thereto in the original arbitration agreement. [99]

This brief overview suggests a few conclusions. First, global financial organisations seem to be yearning for an expeditious process relating to instant encashment of arbitration awards and consistent with the fundamental policies upon which the NY Convention was established.[100]

Secondly, it seems that the success in enforcing an assigned award may depend to a significant extent on the political leverage and financial strength of the clearing network. For that purpose, the proposal is for a mechanism that operates from within an existing and globally recognised operating network such as TARGET, European Settlement Bank, SWIFT. This is further researched and analysed in Chapter Five of this thesis.

[97] *American Renaissance Lines v Saxis*, 502 F2d 674 (CA2 1974). Cf

[98] C. R. Goode, *Commercial Law*, 2nd ed. (Penguin 1995), p. 1075

[99] R. Merkin*, Arbitration Law, (Lloyd's London 1991)*, para. l. 37 and 2.33

[100] KP Berger, 'The Aftermath of the Financial Crisis: Why Arbitration Makes Sense for Banks And Financial Institutions' (2009) 3(1) Law and Financial Markets Review 54–63; and the ISDA January 2011 Arbitration Memorandum. Also, PR Wood, International Loans, Bonds and Securities Regulation (Sweet & Maxwell 1995) at paras 5–57; G Kauffman-Kohler and V Frossard (eds), Arbitration in Banking and Financial Matters (Kluwer Law International 2003).

CHAPTER TWO

ARBITRATION IN BANKING DISPUTES

Chapter Two includes predominantly the view on the mobility and enforceability of arbitral awards. The New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards, commonly known as the *New York Convention* is recognized as the foundation of international commercial arbitration. It imposes on local courts in the ratifying states a Public International Law obligation to recognize and enforce awards issued in other States.

However, subject to specific limited exceptions such as public policy issues, courts in such states can render an international award non-enforceable in their jurisdiction. In industries such as the financial sector, it is of great importance that arbitral awards be acknowledged as an instrument capable of immediate recognition and enforcement. Currently, the arbitrating parties and the tribunal may regard the award as nothing but an instrument recording a tribunal's decision provisionally or finally determining claims of the parties.

An award deals with legal or factual differences between the parties; it will involve interpretations of the contract terms and finally determine the respective rights and obligations of the parties under the contract. Ultimately, it is the finality and indeed the enforcement of the award that gives credence to the entire arbitration process and justifies the cost and time that the parties to a dispute have invested in the resolution process.

The pressures of high-speed development in the financial markets and the effect of rapid globalization have increased the need for more than purely national systems of law and dispute resolution techniques to apply to complicated financial disputes. Societies are primarily reacting to what occurs in the financial sector between bankers and business professionals. The problems that may arise between banks amongst themselves and/or other financial institutions touch instantly onto the public and social welfare. The Chapter provides that a conclusive arbitration process with expeditious award payment that speedily redress interbank disputes will in turn curb public panic and encourage ethical morals within the financial sector.

1. SECURITIES TRADING, DEALING AND ORIGINATION

The financial crisis in 2007 occurred from within the securities market makers such as banks and non-bank financial brokers. Securities investment and trading were and still are among the most publicized activities in the financial services industry. In line with earlier discussion of the financial system, securities are not only a means of transferring savings to investors. It is essential for the day-to-day financing of international global trade. Third world countries as much as large economies rely on the financial markets in order to secure liquidity for running their economy.

Banks have developed today into financial institutions with newly sophisticated forms of activities amongst which can be banking. Creation and trading of securities and their derivatives stemming from macroeconomic and social needs have placed banks and financial institutions in a category of importance that is "too big to fail".[101]

The emphasis is on the value added by securities trading, market making, and securities origination to the economy and the society. These basic financial services of securities markets have grown in importance as the world economies have grown.

The extent of such growth has been fueled by the rapid increase in technology sophistication and institutional complexity. Securities markets represent a development agent in world economies far beyond the simple operations of raising funds in the form of credit, and are expected to grow ever more around the world.

1.1. FIRMS ACTIVE IN SECURITIES MARKETS

Brokerage and investment-banking firms like Merrill Lynch and Goldman Sachs represent the traditional concept of a securities firm. These and other firms involved in securities markets perform the established functions of brokerage, which are buying and selling securities as well as advising clients on how to originate new securities through investment banking to raise funds.

Traditional firms can be providers of the full range of securities markets services or can be more specialized. "Full line" firms like Merrill Lynch offer retail brokerage services and corporate securities advice. On the other hand, narrowly focused firms like Jeffries Securities concentrate on trading for institutional clients.

In recent years, non-financial firms tried providing securities market services: Sears Roebuck, the retail giant and owner of Allstate Insurance, acquired the full-line broker Dean Witter, and then spun it off in 1993. General Electric, maker of refrigerators and jet engines, bought the investment banking concern Kidder-Peabody, and sold it to PaineWebber in 1995.

A development of even broader potential significance has been the entrance of non-securities related financial service firms, such as commercial banks and thrift institutions, into securities businesses through expansion of their authorized powers. Other financial service firms have entered securities business through acquisitions. For example, Travelers Insurance (Primerica) bought Smith-Barney and Prudential Insurance acquired Bache.

There are four key factors influencing the future of the industry:

(1) possible synergies realized within financial markets between large banks and non-securities financial service firms (non-regulated) offering securities market services;

(2) market share gained by non-financial firms from offering securities market services;

(3) technological change; and

(4) structural changes in the flow of savings into investment.

[101] Larsen, P. T. (2007) "Goldman Pays the Price of Being Big. "Financial Times (13 August 13).

Non-securities financial firms, principally commercial banks, have a number of synergistic connections to securities market services. Banks are portfolio lenders to non-financial firms and are involved in open-market short-term financing to global markets.

Banks increasingly arrange credit for their customers. On the other hand, banks will trade those assets back in the market through non-financial firms and make markets in a variety of money market securities. This is a natural process for banks to expand their working capital through the corporate securities markets.

Therefore, historically it seemed a natural extension of bank functions to arrange funding in the form of public securities issues. Banks in Germany and Japan already have these authorities. Even non-bank, large manufacturing corporations such as General Motors and General Electric have already entered the financial services industry through their finance company subsidiaries. The principal, other than profitability, was to offer securities to the public at a lower cost of funds.

The enormous size of those corporations, their equity capital and top credit ratings, meant that they could commit large amounts of capital to securities business. Their reputation could be of enormous value in competition for securities market services. Furthermore, non-banks were not hampered by the regulations limiting traditional securities and deposit-taking financial institutions such as capital-to-assets ratios.

The vast development in the IT technology and speed processing of data information allowed access to the applying of complex analytical tools. Banks were not the only market participants able to plug into related financial service functions.

Services such as clearing networks, securities issues and technical information meant that many smaller boiler room firms and new entrants can quickly enter as participant to the securities markets. These firms are now able to compete on a relatively even footing with established banks and firms for the securities business.

Finally, the institutional changes in the flow of funds have dramatically altered the markets within which securities markets service firms operate. Globalization integrates world capital markets. American securities firms are active around the world but must compete in the United States with securities firms from Europe and Asia.

Political and demographic trends fostered the emergence of locally important securities markets. Investment opportunities in these markets attracted investors' funds from around the world. On the other hand, as the world's aging population has continued to accumulate savings in institutional investors such as pension funds and money management firms, the market for trading securities and target markets for new securities issues has become more sophisticated.

To appreciate developments in the securities related financial services industry, it is essential to understand the role of securities markets and the economic functions performed by financial services firms. Resolving disputes within this vital sector amounts to resolving global economic crises.

1.2. TRADING OF SECURITIES AND POSSIBLE MORAL HAZARD

Securities are standardized financial claims that can be readily transferred between parties and therefore traded on securities markets. Typical individuals acquire or dispose of securities in the retail markets for securities services. Although this thesis is fundamentally concerned with disputes arising out of transactions involving trading between banks, various types of large firms and investors operate in the market for institutional securities market services may be classified as contributing parties to financial disputes.

Closed and open-ended funds transactions are limited to tailored contractual provisions that may be designed for each fund on its own. There are many reasons why individual and institutional investors prefer securities to portfolio investments:

- Securities have desirable attributes relative to portfolio investments. They are liquid, meaning they can be exchanged for cash easily because there are markets where the securities are traded.
- Securities markets produce technical information including prices for the same or similar investments, unlike portfolio investments which are often difficult to price. Trading volume reflects the depth of the market for securities and investors' ability to convert investments into cash at predictable transaction prices.
- Securities of large corporations can be publicly traded in many countries and are accompanied by a wealth of information in the form of disclosures. The investment community provides ongoing analysis of securities when they are issued or as they subsequently trade.
- Securities markets offer timely information as well as established firms and institutions with reputations for providing technical data on the quality and ratings of traded papers. Rules and regulations govern securities issuance and trading which can be a source of confidence or basis for litigation for investors investing in securities.

The fundamental reason why investors give their money to financial service providers is because of the trust in the information provided by those intermediaries. Should the published information on prices and returns associated with such investments suffer from asymmetry, investors will fall into adverse selection.

That is to say, if an investor is provided with asymmetric information about a product, their choice of investment will be distorted. It is of utmost importance for the public’s confidence to provide the markets with accurate feedback on associated risk to their investments. This includes opportunity costs, ratings and possible decline in future return on funds to investors.

As an example, a trader knows something that the rest of the markets do not know. This information may be that a lawsuit has been filed against an issuer of certain securities or that a bankruptcy could be imminent. Without disclosing this knowledge, the trader will attempt to convince other investors to buy the stock of securities off his hands. The trader will shift the risk to his clients by withholding essential information from them.

Information traders expect to profit because they buy securities at prices which are low relative to their possible future values. Later, they will sell those securities at prices which are high relative to what they will sell for when the advert information the trader possesses becomes available to the market.

Some of the principal problems between investors and bankers may be less severe if firms are willing to disclose information not necessary required by law but morally necessary. Firms issuing publicly traded securities can take advantage of competition in securities markets to reduce issue costs relative to costs implicit in negotiated deals with portfolio investors.

In the case of some large firms, like Enron, open market auctions of securities issues may eliminate the need for financial intermediaries and their fees altogether. These considerations can also lead investors to prefer investing in securities with well reputable banks.

1.3. FUNCTIONS OF SECURITIES FIRMS AND TRADERS

A securities broker finds a buyer for a seller. Because most securities traders are not continuously buying and selling securities, they turn to professional brokerage firms to complete their trades. Often, a buyer or seller wants to trade sooner than would be required by waiting for a counterpart seller or buyer to show up in the market.

Financial institutions, which trade by buying or selling securities on their own accounts, are called "market makers". When offering new securities to investors, firms raising funds require guidance as how to design and price newly issued securities in order to make them attractive to investors. This guidance is one of the functions performed by financial service firms assisting borrowing entities with securities origination.

Brokers and dealers of securities buy and sell a wide range of financial instruments to offer flexibility for investors or issuers in the composition of their portfolios. The variety of securities makes it possible to fine-tune investments or fund raising to particular investor or borrower needs.

Stocks represent ownership in the capital of firms. On the other hand, bonds are debt claims against the earnings or underlying income of a borrower. These traditional securities are the lifeblood of world economies and represent a significant part of trading volume in the financial markets.

Stocks and bonds in their simple forms are important but relatively simple securities. To achieve an optimal combination of risks and returns against a variety of future economic scenarios, investment banks and traders often look for innovative re-designed securities. Marketability and profit are the main drive for the creation of such derived securities.

Bankers found that if derivative securities achieve a combination of much better return but with higher risk in terms of possible future values then they will be more marketable. Classic examples were convertible bonds, preferred stocks, and warrants. Nowadays, examples include collateralized mortgage obligations and index options.

The vital role of banks in keeping the flow of converting securities to liquidity and vice versa is immeasurable. The banks buy simple securities from the market thus furnishing the market with liquidity. They then batch the same securities in marketable derivatives with attractive returns and re-sell them on the international markets.

There is unlimited number of possible risks investors or borrowers may be concerned about. For example, a financial instrument which pays higher returns with higher inflation would offer protection against inflation risks. A security which pays off more if automobile demand drops might be useful to some particular investors.

Conceptually there are an infinite number of possible future outcomes, which could be of concern to individual investors and borrowers. Creating financial instruments that pay future cash flows under specific economic conditions can offer protection to market participants who have certain views towards the market.

With aggressive brokers and traders active in selling securities, there are always opportunities for inventing new high income securities for which sufficient demand exists. All customers are attracted by the security high yield payoffs. But not all customers, if informed, will be willing to accept the risk associated with such high yield.[102] The list of features is endless and growing with innovations in securities becoming more complex.

In legal claims, securities are classified by type of issuer: sovereign governments, foreign or domestic corporations. The categorization follows the nature of the claim. Bonds provide the buyer a fixed claim on the income and assets of the issuer. Equity represents a residual claim against income and assets of the firm after other claims are met.

1.4. RULES AND REGULATIONS GOVERNING SECURITIES TRADING

Securities markets around the world take wide and varied forms. There are two dimensions to describing market structures. The first is the physical and institutional organization of the market, determining whether trading occurs in one place and how exclusive it is for those who wish to trade. The second dimension concerns the rules by which the prices at which trades occur.

The physical and institutional aspects of markets' concerns are whether trading locations or systems are exclusive or open. One structure is for trading to take place in a single location where access is limited to members such as the stock exchange. A famous example is the New York Stock Exchange (NYSE).

A second market structure is that traders are connected by communication links like telephones and wire systems. These are often with computer screens or other display devices with the system allowing open communication to all buyers and sellers. These markets are called over-the-counter-markets, since anyone who is authorized, inscribed or allowed to plug into the information network can buy or sell securities.

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[102] J. Kimball Dietrich, Financial Services and Financial Institutions: Value Creation in Theory and Practice, Upper Saddle River, N.J. : Prentice Hall, c1996 [11/3/1995]

The second dimension of securities markets concerns are the rules governing trading activities. The most important rules govern how prices for traded securities are established. Brokers and other market makers trading in markets with frequent activity agree on rules in order to prevent chaotic trading and disagreements. Those rules *"Lex Financiera"* are industry implemented akin to *lex mercatoria* and intended to ensure that possible disputes about transactions are minimized and orderly settled usually in arbitral processes.

Trading rules establishing prices can be described in terms of *"Members"* of organized markets agreeing on rules covering members. Rules in over-the-counter markets can be bank trading conventions, regulations, or laws. The two attributes of trading rules concern mainly trading, commitment, settlement and the nature of the traders, whether they are, for example, banks, individuals or corporations.

Another aspect of price setting rules concerns the way trades are conducted and how traders close transactions. Traders or their broker representatives find out what prices are being offered and conclude transactions with any other traders or brokers on the other end of the line. In dealer markets, brokers or traders contact securities market participants who specialize or who are designated to quote prices for the immediate purchase or sale of the securities.

1.5. BROKERAGE AND BANKING SERVICES

Brokerage firms offering trading services and advice are called full-line brokers. They typically price their services on a per transaction basis and price their services to cover costs and earn a reasonable risk-adjusted return. Costs mostly consist of the operating expenses and the locating of buyers or sellers in the market.

Services offered by brokers in addition to finding buyers for sellers include:

1. information services in the form of securities research or advising;
2. market making services which we discuss in the following section
3. safekeeping and clearing services, which we discuss in the next chapter.

The point here is that pricing in the brokerage business is bundled with prices for other services.

Many brokerage firms, like **Merrill Lynch, Goldman Sachs** and **Smith Barney**, double as investment banks and brokers. They have research departments, which make "buy" or "sell," recommendations to their clients. This stock and bond research constitutes information and advisory services investment banks offer their clients, and is open to the public in general. When Merrill Lynch recommends buying certain securities, they base their recommendation on the quality of the security, the expected return and risk associated with it.

It is also essential to point out here that, being an investment bank, Merrill Lynch also deals as a market maker. Being a market maker means that they can own and create securities on their books and sell them to their clients. In essence, there is nothing to stop a broker bank from offloading certain securities onto their clients should it start to decline in value or the market shifts unfavorably.[103]

That represents clear conflict of interest, and asymmetric information was an important factor in the wide spread of the crisis in 2008. Asymmetric information is a type of moral hazard that leads to adverse selection by investors. In fact this is what happened in 2008. Banks in the US started to free their balance sheets from bad assets by selling them to clients and other banks in the US and worldwide. This action turned a classic credit crisis into a financial and banking crisis of vast proportions, reaching a global systemic dimension. [104]

Trading rules dictate that the best possible prices should be reasonably assured by brokers.[105] However, the term "reasonably" is found to be quite flexible. Violations of the rules are punishable by sanctions including expulsion from the exchange or broker organization.

Even so, it does not mandate compensation or damages to mislead clients. Most securities trade agreements, however, allow customers to seek relief through litigation or arbitration. Twelve years after the outburst of the crisis, it is still impossible to measure the losses and damage distribution of the banks' actions. To date, that lack of clarity is aggravating the lack of confidence that fueled the spread of the crisis in the first place.[106]

2. LITIGATION AND ADVANTAGES OF ARBITRATION

2.1. LEGAL RISK

When it comes to litigating complex financial disputes, the banking and financial sector world is subject to an immense black hole of legal uncertainty.[107] Legal risk in complex financial transactions (CFT's) has lingered over the financial markets since the Great Depression.[108] Legal uncertainty is partly due to a lack of case law and concerns over the quality of what case law there is. On the other hand, while arbitration is increasingly gaining ground in financial arbitration, there is the major concern by financial market participants about the ability of state and national courts to render decisive enforceability on complex arbitration awards under the auspices of the NY Convention. The award should in theory be easily enforced by the national courts in any of the ratifying states. However, some states have a better reputation than others for complying with the NY Convention. In essence, as long as the NY Convention remains the sole authority for the international enforcement of

[103] Craig Torres, *"How The Street Turns Your Stock Trades to Gold,"* Wall Street Journal, February 16, 1993.
[104] Merrill Lynch, Pierce, Fenner & Smith Inc. v. Bobker, 808 F.2d 930
[105] *Financial Conduct Authority Handbook*, BIPRU Prudential sourcebook for Banks, Building Societies and Investment Firms (2009).
[106] M. FARHI & M. ANTONIO MACEDO CINTRA, "*The Financial Crisis and the Global Shadow Banking System"*, Revue de la régulation, Maison des Sciences de l'Homme - Paris Nord, 5 | 1er semestre /Spring 2009, Dossier: *Crise du Capitalisme Financier*. https://journals.openedition.org/regulation/7473#ftn2
[107] W.D. Baragwanath, *'How should we resolve disputes in complex international financing transactions?'* paper delivered at the opening of P.R.I.M.E. Finance in the Peace Palace in The Hague on 16 January 2012.
[108] SK Henderson, *Henderson on Derivatives* (2nd ed., LexisNexis 2010) at para 10.1

arbitral awards[109], the disquieting matter for financial markets will mostly be the efficacy of enforcing arbitral awards.

2.2. STANDARDISED AGREEMENTS NOT SYSTEMISED DISPUTES

A generation of standardized agreements, largely sponsored by financial market organisations, were systematically developed internationally and in multiple languages to cover a range of global financial markets. Many CFTs are documented by way of these standardized agreements with the most prominent being the International Swaps and Derivatives Association. ISDA has sponsored a wide range of documents for over-the counter (OTC) derivatives, including various editions of its master agreements (the ISDA Master Agreement). The ISDA Master Agreement is 'one of the most accepted and widely used forms of agreement and is considered the most important standard market agreement used in the global financial market.[110]

As mentioned earlier in Ch1. (ss7.1), the ISDA Master Agreement is not the only standard agreement. However, standardisation of contractual agreements has led to a 'form of globalisation by contract' but not a 'global law of contract'.[111] In other words, so far there has not been a unified law dealing with the most essential ingredient of any financial arbitration process which is the contractual agreement. Nevertheless, what this thesis propose is that the unifying of the process of settlement of financial awards can bring the world of financial disputes closer at the final step when the award is due for payment.

The resolution of disputes arising out of these standardized agreements is neither standardized nor globalized. Market participants rely on state and national dispute resolution fora. Because so many CFTs agreements are entered into on standardized or at least market understood terms, a 'wrong' decision in one state or national court may and likely will have systemic consequences somewhere else in the world. Some judicial decisions are uncertain, some are unpredictable, many are not reached in a timely manner but instead only after a too lengthy adjudication process. Many others are too needlessly costly in terms of resources, time and expense. Parties typically and largely want straightforward, cost-effective and timely resolution of their disputes.[112]

2.3. DEVIOUSNESS IN CFT LEGAL STRUCTURE

Legal uncertainty is also a result of the complex nature of many CFTs and of the mathematical innovation that is so much a feature of CFTs. Results of investigating what happened in the crisis of 2007 show that some CFTs were sufficiently complex that only a limited few in the bank or other financial institutions that structured the CFT in the first place understood how it functioned and the true financial risk involved. When disputes arose, those

[109] The Hague Convention on Choice of Court Agreements of 2005 is the litigation equivalent of the New York Convention. It came into force on 1 October 2015. However, to date only Mexico, the EU and Singapore have ratified it. The US has signed but not yet ratified it. It will be a while before it has the impact of the New York Convention.

[110] JB Golden, *'The courts, the financial crisis and systemic risk'* (2009) Capital Markets LJ 4, S141–S149.

[111] UNIDROIT, 2010, Principles of International Commercial Contracts.

[112] *Lomas and others v JFB Firth Rixson, Inc. and others* [2010] EWHC 3372 (Ch) at para 53

responsible for the structuring of many CFTs were no longer available and the bank or financial intermediary did not possess the background or the knowledge to deal with the financial calamity.[113]

It is not just courts or the investors who may not understand the technical structure of those transactions and products or the legal issues involved in dealing with them. Collateralised debt obligations (CDOs), for example, were marketed and sold to investors on the basis of the credit rating assigned by a reputable credit rating agency such as Moody or Standard & POOR. Some of those ratings were found to be influenced or badly misguided by the issuers and, in some cases, those rating agencies themselves did not fully understand what they were rating.[114]

2.4. DISPUTES FOLLOW TRANSACTIONS IN LEGAL COMPLEXITY

The judges in *Hazell v Hammersmith and Fulham*[115] pointed that it was considered that *'*one or more of the parties lacked a fuller appreciation of the products or the nature of the markets involved in the transaction*'*. Such a remark may also indicate the legal fact that the nature of the judicial function is that judges in courts are necessarily generalists, as are the courts.[116] It is easy to be critical of judges in the often difficult circumstances they find themselves in when faced with a complex case beyond their experience. [117]

Just as CFT's and markets have become more complex, so have the disputes. CFT disputes today raise a range of issues, such as the effect and consequence of complex financial and valuation models, not to mention the complexity of CFT documentation and the consequent jargon. Although concern is often expressed that CFT disputes take too long to come before the courts, the opposite can be true: some CFT disputes are brought too quickly before a court because the parties think that the issues require urgent resolution.

In these circumstances, courts are rushed into decisions on the likely basis the issues will only be properly examined on appeal, or in subsequent cases dealing with the same issue. This view was taken in *Marine Trade SA v Pioneer Freight Futures Co Ltd* [2009] EWHC 2656 (Comm). The more subtle and sophisticated, or wider, 'commercial' context and arguments, as well as a more sophisticated analysis of the ISDA Master Agreement itself, were considered in the ensuing S 2(a) (iii) ISDA Master Agreement cases.[118] This is hardly satisfactory as CFT disputes are global, multi-jurisdictional, common and civil law and language issues.[119]

[113] LB Re Financing No 3 (in administration) v Excalibur Funding No. 1 PLC and others [2011] EWHC 2111 (Comm)

[114] *Anthracite Rated Investments (Jersey) Limited and others v Lehman Brothers Finance SA in liquidation* [2011] EWHC 1822 CH

[115] Hazell v Hammersmith and Fulham London Borough Council [1992] AC 1

[116] Diane P. Wood, *Generalist Judges in a Specialized World*, 50 SMU L. REV. 1755, 1767 (1997).

[117] *Hazell v Hammersmith & Fulham London Borough Council* [1992] AC 1

[118] *Marine Trade SA v Pioneer Freight Futures Co Ltd [2009] EWHC 2656 (Comm)*. The S 2(a) (iii) ISDA Master Agreement cases', were not all put to Flaux J in the Marine Trade case.

[119] S. Firth, Derivatives Law and Practice (Sweet & Maxwell 2011 reprint) (Firth) at para 11–012.

The great majority of CFT cases presented for disputes have their documentation in English. Moreover, because English and New York law are frequently the governing law, many CFTs are subject to common law court practice. However, many parties to CFT documentation are domiciled in jurisdictions where English is not the common language and where the common law is not the law of that jurisdiction. So, while many CFTs are documented in English and governed by English written laws, there are others that are documented in English but are to be heard before courts whose first language is not English.

Some state and national courts are perceived to show a local bias towards parties and/or applicable laws. Even if they do not in fact suffer from local bias, courts in different jurisdictions can be expected to prefer different interpretations of the same CFT agreements. This is something which has no place in the banking world, where markets, regulatory authorities and institutions are interconnected and interdependent. Disputes in front of courts in such circumstances are not likely to lead to a settled, global, body of law.

In a global financial marketplace, therefore, the significance of disputes that arise beyond the traditional London and New York axis cannot be underestimated. Local and national disputes, courts and decisions beyond that axis cannot be ignored. The wider market has an interest in the outcome of many cases, possibly more so than the actual parties involved. Resolution of a dispute that has an international consequence or effect requires a judge to focus on more than his or her own narrow domestic focus.[120]

Standardisation may be cost- and time-effective, but it carries its own systemic risks[121], including greater vulnerability to financial markets. Standardisation also carries possible systemic legal shocks, as a mistake in or a mistaken judgment involving the interpretation of standardised agreements will have far reaching implications in case law.

2.5. SPECIALISED PARTIES RATHER THAN SPECIALISED JUDGES

Banks and financial institutions have become rapidly more adverse in complicated financial products, and transactions in those products have become more legally complex. However, judges involved in the resolution of CFT disputes are not specialized financials or mathematicians. To some extent, judges must necessarily educate themselves while on the case. However, many judges cannot be expected to understand fully the formulation of complex products let alone the contractual agreement the transaction is built upon.

Judges with the necessary commercial or financial background are available, particularly in emerging markets. That said, the English, EU and New York courts generally inspire a relatively impressive level of confidence in their ability to resolve CFT disputes adequately in comparison to other state and national courts in the wider world. This wider world does not

[120] Ibid. Baragwanath (n 3) para 9.

[121] The definition of systemic risk is consistent with the one used by the Bank for International Settlements (BIS) (1994: 177): Systemic risk is the risk that the failure of a participant bank to meet its contractual obligations may in turn cause other participants to default, with the chain reaction leading to broader financial difficulties. Robert Parry (1996: 2), President of the Federal Reserve Bank of San Francisco defines Systemic Risk as the risk that one bank's default may cause a chain reaction of...failures and even threaten the solvency of institutions.

have the benefit nor the resources to acquire deeper experience in complex legal issues related to financial CFTs.

2.6. ENFORCEABILITY IN LITIGATED DISPUTES

In London and New York, law firms have lawyers and departments specialised in complex financial legal issues and knowledge of CFTs. Financial institutions and dealers have those firms and counsels acting for them and against other large financial institutions and individual clients on a consent basis. This means that large law firms will not or cannot obtain consent to act against a bank or a financial institution in CFTs litigation. There are issues of conflict of interest as well as matters of revenue at stake for a law firm to sacrifice.

A consequence of this is that some parties, particularly individual clients and customers of banks and financial institutions are not adequately represented in courts, even in jurisdictions where major CFTs specialised law firms exist such as in England and New York. Another issue that adds to dilemmas in financial disputes litigation is the matter of expert witnesses. In some jurisdictions, a suitable expert witness can be hard to find, for the same broad conflict of interest reasons.

As well as proper representation, parties also want effective enforceability of judgments and awards against banks. However, enforceability of foreign judgments in a range of jurisdictions remains difficult if not impossible.[122] Case law and evidence suggests that increased arbitration of financial disputes is inevitable, as banks and financial institutions increasingly begin to realise the benefits of international arbitration and the enforceability of foreign awards.[123]

3. FINANCIAL ARBITRATION

What is arbitration? At its simplest, international arbitration is an alternative to national court litigation as a means of resolving disputes; in choosing arbitration parties are opting to have their dispute resolved privately instead of going to a national court.

Key characteristics of international arbitration include:

- It is consensual. In some circumstances national courts may assert jurisdiction over a dispute even in the absence of an agreement between the parties to this effect. By contrast, an arbitration tribunal only has jurisdiction if all parties have agreed to submit their dispute to arbitration. This is commonly dealt with by inserting an arbitration clause in the relevant contract. Once agreed to, a party cannot unilaterally withdraw from arbitration.

[122] Reinmar Wolff, 'Article V(2)(b)' in Reinmar Wolff (ed), New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards of 10 June 1958 Commentary (CH Beck Hart Nomos 2012) 412 suggests that such international best practices have already been formed, although they are not precise.

[123] 'The use of arbitration under an ISDA Master Agreement; feedback to members and policy options', a memorandum dated 10 November 2011 prepared by ISDA and addressed to the ISDA Financial Law Reform Committee and to members of ISDA (the ISDA November 2011 Arbitration Memorandum).

- It is neutral. Hearings can take place in a neutral country where none of the parties is based, and the parties can agree the procedural rules that govern the arbitration, rather than being bound to follow a national court procedure. Usually they choose the procedural rules of one of the well-known international arbitral institutions such as the ICC, LCIA or SIAC. They can also choose the language that the arbitration will be conducted in, rather than being bound to use the language of the national court.
- The process is less formal than national court litigation. For example, arbitration can take place in a meeting room, which could be anywhere, rather than a court-room. Typically, hearings will be held in a conference room at a hotel, a law firm's meeting-room or a specialist suite of rooms run by an arbitration institution.
- Instead of a judge, the decision-making is by arbitrators who are usually appointed by the parties. Typically, a sole arbitrator or a panel of three arbitrators is appointed, referred to as the "tribunal".
- Decisions of an arbitral tribunal, the arbitration award, are usually final and subject to limited rights of challenge, unlike the judgments of national courts, which typically can be appealed through several further rounds of litigation.

3.1. ARBITRABILITY

Non-performance of contracts by certain banks and fund managers in some countries such as Russia, and in Africa and the Far East, is one of the most worrisome problems at the moment. This is true especially after the 2007/2008 crisis and the responsibility the world places on US banks for being the sole culprit behind the largest financial crash in history.

Other banks around the world are allowing themselves flexibilities when it comes to moral commitments as a follow-up to US financial firms. This renders the enforceability of arbitral awards against some banks and fund managers a central issue even in the western hemisphere.[124]

Another issue for financial arbitration is in the fact that few judges in state and national courts are familiar with the complicated nature of financial transactions[125] let alone public confidence in their knowledge and trust in their resolution of complicated banking disputes. In broad terms, there are many jurisdictions that have several specialized courts and tribunals for commercial disputes in general. However, banking financial disputes are cases that can only be settled efficiently in specialised tribunals.

3.2. ARBITRATION TRIBUNALS' FAMILIARITY WITH CFTS

[124] N. Horn and J.J. Norton (eds.), Non-Judicial Dispute Settlement in International Financial Transactions 135-166. 2000 Kluwer Law Int'l. UK

[125] Complicated Financial Transactions are a broad range of complex and structured transactions and products, including over-the-counter (OTC) derivatives (all manner of them, swaps, forwards and options), repos and stock lending transactions, securitization transactions, commercialized and residential mortgage-backed securities, collateralized debt obligations (CDOs), structured investment vehicles, and so on.

Complicated financial transactions (CFTs) are documented by way of familiar market standard agreements, in which a large number of provisions are considered "boilerplate".[126] It is inevitable in these situations that a broad market understanding or consensus can be built regarding the meaning or interpretation of these agreements and these provisions. This understanding or consensus is partly a result of repeated familiarity and usage in a large number of transactions and context.

It is also partly a matter of drafting and refinement by many hands, over a considerable period of time. Documents and individual provisions were analysed in detail by specialist lawyers, leading counsel and market experts in many jurisdictions. However, those documents and provisions have not been substantially tested in state or national courts.[127]

Furthermore, in spite of the lack of testing, standard agreements were entered into by parties in a wide range of jurisdictions and markets without even being modified or adapted from one transaction to another. This is due to common practices occurring in financial institutions where agreements for financial transactions are compiled from relatively standardized agreements with almost identical provisions and documentary building blocks.

In further investigations and disputes, it was found that there are numerous CFTs documented on standardised generic agreements which caused the parties not to appreciate as to what terms they are to adhere to.[128] Agreements and provisions used in one CFT in one jurisdiction are commonly borrowed for use in other CFTs structured in another jurisdiction. It is found that a suite of securitization agreements in New South Wales is not thoroughly different from those used in Hong Kong or New York.[129]

Much of the legal work is often done by teams of in-house lawyers at banks and financial institutions who were told to do what they are told. Moreover, many CFTs are entered into by parties who did not seek to have any input into the drafting or negotiation of any of the market agreements.

This may be understandable from the profitability point of view. When a premium is placed on efficient and cost-effective completion of transactions, those responsible for completing the transaction are naturally looking to the nearest or latest legal precedent. Bankers may be responsible for considerable innovation in CFTs, but it is the lawyers working for those institutions who reach for the legality and precedent. This occurs to the extent that it does not matter whether those lawyers are familiar with the complexity of the transaction or not. Naturally, this creates further complications when disputes arise and someone has to argue for or against the transaction.

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[126] *Boilerplate* is a description of uniform language used normally in legal documents that has a definite, unvarying meaning in the same context. It denotes that the words have not been individually fashioned to address the legal issue presented.

[127] Jonathan Ross, *The case for P.R.I.M.E. Finance, Capital Markets Law Journal*, 2012, Vol. 7, No. 3 Downloaded from http://cmlj.oxfordjournals.org/ on July 14, 2013

[128] *Anthracite Rated Investments v Lehman Brothers Finance S.A*. [2011] EWHC 1822 (Ch).

[129] Perillo, J.M. (1994), *"UNIDROIT Principles of International Commercial Contracts: The Black Letter Text and a Review"*, in 43 Fordham Law Review, 281 et seq.

Those transactions included counter-parties who may not speak English, being the language in which the CFTs are documented. Such asymmetry of knowledge of the true risk, the sophistication of the transaction and language has meant that there is no real negotiation of risk on the part of at least one of the parties to the agreement. In *State Street Bank v Sompo Japan Ins.*[130], 'something had gone wrong with the language' and it was clear that a mistake had been made in an applicable definition and a correction required to give effect to the parties' intention was also not clear. The court in this case made a declaration regarding the true interpretation of the relevant provisions.

For all of the above reasons, Financial Arbitration Tribunals that are familiar with the complexity of financial transactions can surpass such non-clarities in order to arrive to a speedy and efficient decision (award).

4. PARTIES TO FINANCIAL TRANSACTIONS

In view of the discussion in section 1.2, this section will examine the interests of parties to arbitration proceedings regardless of the substantive status of the individual parties. Financial transactions entail the involvement of various parties from multiple jurisdictions in multi-cross-border string-trade transactions. Some parties in such complex financial transactions (CFTs) may benefit from the presence of a third-party claimant in the arbitration procedures.

A bank or a person in Pakistan, for example in the case of a dispute will be interested in having the seller (a bank) of a mortgage backed bond from the UK join the procedures against the securitising bank in US. That person will establish the case against the securitising firm as well as binding the seller in the UK by the determination of the final award.

The essential point here is whether arbitration laws and regulations will allow multiparty proceedings without the consent of all the relevant main parties to the agreement. The arbitrability of multiparty disputes in certain jurisdictions restricts the material scope of arbitration and may render the whole system ineffective.

An example is highlighted in *Belmont Investments v BNY & Lehman*. The paradox in this case lies within the context that the claimants acted on the basis that the Lehman Brothers entity was subject to insolvency proceedings in England, when in fact it was not. In this case, The Supreme Court handed down its judgment on 29 February 2012 in relation to the clients' money application relating to *Lehman Brothers International (Europe)*.

The judgment had several implications for firms and banks which hold clients' money. The majority of the Lords dismissed the appeal and held that:

"Clients' money is held on "statutory trust" by the receiving firm or bank. The statutory status is imposed by the FSA's Client Assets Sourcebook ("CASS") from the time of receipt of funds by a bank and not upon segregation of clients' money internally. Provided it is identifiable, clients' money which yet is not segregated by the

[130] *State Street Bank & Trust Co v Sompo Japan Insurance Inc & others* [2010] EWHC 1461 (Ch)

firm from its own accounts will nonetheless form part of the clients' money pool available for distribution to clients on insolvency." [131]

It is worth noting, however, that the insolvency of Lehman would not, as a rule, have intervened with any arbitration procedures if the arbitral procedures would have already started. The emphasis is on the status of the parties where a direct relevance can exist between jurisdictional and substantive standing of several 'persons' in a multiparty commercial transaction. The closer the association between the parties in substantive terms, the less likely it is for them to be separated in terms of jurisdiction. Whenever several persons constitute a substantive unit, they also are regarded as a unit jurisdictionally and as such are subject to the jurisdiction of a single adjudicatory medium.

The findings on this point, and the association of officers, directors and SPVs[132] of banks, provide the conceptual base for regarding the rights of savers and investors in arbitration action against banks and financial institutions: this depends on how closely officers and directors are associated with the bank and the SPV. The association is focused specifically on the terms of benefits, interests and liabilities. Depositors and investors will have concurrent rights in a pending dispute in terms of contractual arbitration agreements. Officers and directors of financial institutions and SPVs will usually be co-liable or co-holders of duties in community of rights and liability.

There are cases where banks claimed confidentiality of such association. However, in *Solomon v Solomon*[133] parliament intervened to enable courts to pierce the "corporate veil". Such authority allowed the courts to look at the incorporation of subordinate companies in order to decide whether to hold directors personally liable.[134]

Although contractually associated, the degree of association in terms of liability is relevant to arbitration laws. That may be a consequence of the fact that financial disputes are little more than just the collection of a debt where summary proceedings in a state or national court can be effective and straightforward.

Examples include international treaties such as the United Nations Convention on Contracts for the International Sale of Goods, where common obligations are given effect by state laws, and the World Trade Organization agreements, imposing common obligations to subjects in common dispute resolution systems. Very often, parties in their financial transactions arrange for the security of the performance or the expected cash flow for the transaction in hand. The security traded may have originated in a separate agreement with a third party that may be a bank, an insurance company or SPV for a completely different financial institution.

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[131] *Belmont Park Investments Pty Limited v BNY Corporate Trustee Services Limited & Lehman Brothers Special Financing Inc.* [2011] UKSC 38

[132] SPV - *Special Purpose Vehicle*, also called a *Special Purpose Entity* (SPE), is a subsidiary created by a parent financial institution/bank to isolate the financial risk on their financial statements. The legal status of SPV's as a separate company makes its obligations secure even if the parent company goes bankrupt.

[133] Solomon v A Solomon & Co. Ltd (1897) AC 22

[134] Insolvency Act 1986 s.767 and the Companies Act 2006

Naturally here, the arrangement leads to a multiparty situation and interwoven contractual agreements.

The intertwined nature of financial contracts may hold no substantive relationship to certain investors who may be considered as third parties. Courts in general have tendencies to protect the interests of third parties in disputes going to arbitration.

On several occasions courts extended the scope of arbitration agreements to include third parties and non-signatories based upon doctrines such as the doctrine of group-of-companies and incorporation by reference, thus piercing the corporate veil and agency in cases such as banks and their SPVs.

4.1. FINANCIAL TRANSACTION AGREEMENTS

Given the broad nature of the banking and finance sector, there are wide arrays of disputes that may arise out of transactions that cover a large number of underlying asset classes and immense sums of money. Nevertheless, till today large volumes of derivatives and CFTs are habitually documented under standardised contractual agreement forms.

Financial industry associations have systematically developed generic agreement forms. Such was the case in general financial transactions that the majority of the subprime notes and derivatives prior to and during 2007 were documented by way of those agreements.[135]

Various market sponsor entities have sponsored and published several other forms of documentation for OTC derivatives including:

- The European Master Agreement by ISDA
- Local language ISDA master agreements by the French and German banking associations.
- In China, the NAFMII Master Agreement by the National Association of Financial Markets Institutional Investors
- In Australia, the AFMA schedules and documentation by the Australian Financial Markets Association.

In the case of foreign exchange transactions, the New York Federal Reserve, together with the British Bankers' Association, the Canadian Foreign Exchange Committee and the Tokyo Foreign Exchange Markets Committee, have sponsored and published:

- The International Foreign Exchange Markets Agreement,
- The International FX and Currency Option Agreement, the Foreign Exchange and Options Master Agreement and the International Currency Option Master Agreement.

In the case of repos[136] and stock lending transactions, the International Capital Market Association (ICMA) has drafted and sponsored various versions of its global master

[135] SK Henderson, *Henderson on Derivatives,* (2nd ed. Lexis Nexis 2010) 10.1

[136] A REPO is a repurchase agreement (repo). It is a form of short-term financing/borrowing using government securities. In the case of a repo, a dealer in a bank sells government securities to investors, usually on an

repurchase agreements (the GMRA), as has the Securities Industry Financial Markets Association. The International Securities Lending Association (ISLA) has drafted and sponsored various editions of its securities lending agreements and The Futures and Options Association has sponsored and published its FOA master netting agreements.

Many documents in the bond and credit or loan markets are similarly standardized. For example, the Loan Market Association has sponsored and published its Multicurrency Term and Revolving Facilities Agreement. A French translation of this agreement has also been published.

4.1.1.. ISDA MASTER AGREEMENT

The *International Swaps and Derivatives Association* (ISDA) Master Agreement is an agreement form which is designed to govern multiple derivatives transactions. It is in the form of a single agreement consisting of three different components:

1- A printed form for standard provisions

2- A schedule to the agreement in which certain variables and elections are to be agreed upon by the parties

3- Confirmations related to any further individual transactions where financial and economic terms of the transactions are to be set out

The Bank of International Settlement estimates the current size of the derivatives market alone managed solely by ISDA Master Agreements in 2014 to exceed $600 trillion. However, homogeneous forms of agreements are no match to complicated financial disputes that are neither standardised nor uniformed.[137] Contracts as such may lead to forms for a globalised set of procedures, but not of law.[138] Investors in financial transactions and depositors cannot rely only on a one-size-fits-all set of documents when almost all financial transactions are entered into internationally and within a global network of intra-banking.

Consequently, a judicial decision in one state will have worldwide systemic consequences that may be interpreted differently. With the continuous innovative nature of financial products, legal uncertainty will be a natural resultant and uncertainty will dawn on judicial

overnight basis, and buys them back the following day at a slightly higher price. That small difference in price is the implicit overnight interest rate.

[137] Jonathan Ross, **(Ross, 2012)**, Capital Markets Law Journal, Vol.7 no. 3

[138] http://www.bis.org/publ/otc_hy1411.htm .

decisions.[139] English courts for example have taken a sceptical approach, holding investors to their contractual agreement regardless of how aggrieved they might be. [140]

In a case against HSBC, when the client relied on the bank officer's advice about a fund investment, the court ruled that the bank officer's advice may have been negligibly presented to an unsuitable client and the bank was liable in contract and in tort. However, the ensuing client's losses were not recoverable since the loss was not caused by the negligent advice. Moreover, the loss which occurred as a result of the collapse of Lehman Brothers was not reasonably foreseeable in 2005 when the investment was made with HSBC and the client was accordingly entitled only to nominal damages.[141]

This case involved the same and exact sort of standardised uniform contracts sponsored by associations such as ISDA. It is worth noting that as a standard provision in all those standardised contracts, banks' liability for misrepresentation is excluded and banks do not owe advisory duty to their investors. [142] Parties' Autonomy - Despite what may appear in such provision as clear denial of the duty of care owed by banks to their clients, courts have still given priority to commercial reality. Courts have held parties to what they have agreed upon at the outset and banks were able to avoid liability under advisory duty.[143]

However, the importance of maintaining consistent interpretations of the critical terms of the agreements in jurisdictions around the world can save the market participants from conflicting cases with unexpected results. In particular such as:

Investigations led by US Congress and other financial market authorities revealed that very few individuals in banks or financial firms that structure CFTs are able to actually understand how those financial instruments are created or what is the structured risk to be borne by the bank or the investors.[144] In other words, bank executives owe a duty of advice on a product that they do not understand themselves. [145] Bank officers will present to investors standard documentation in conjunction with complicated financial transactions without the full

[139] Standard Chartered Bank v Ceylon Petroleum Corporation [2011] EWHC 1785 (Comm) (claim for damages arising out of an alleged breach of advisory duty, partly based on the asymmetry of sophistication between the parties; it was held that the bank did not in the circumstances hold itself out as an adviser; rather, the bank acted in a sales capacity).

[140] Henderson, "Master Agreements, Bridges and Delays in Enforcement: Part 3", [2005] 1 JIBFL 18 (January) and, for a related Australian case, "Recent Derivatives Litigation, Part 1, Enforcement of the ISDA Master Agreement" [2006] 3 JIBFL 118 (March).

[141] Rubenstein v HSBC Bank plc [2011] EWHC 2304 (QB) ; Soheir Ahmed Zaki and others v Credit Suisse (UK) Limited [2011] EWHC 2422 (Comm) (although notes in which the client invested were unsuitable during the height of the global financial crisis in 2008, the client was found to be a successful businessman who would have invested in them anyway; the bank did not cause his loss); also Camerata Property Inc. v Credit Suisse Securities (Europe) Ltd [2011] EWHC 479 (Comm) (even if the bank had been guilty of negligence or gross negligence, its fault did not cause its client's loss).

[142] *LEHMAN BROTHERS HOLDINGS INC., AND LEHMAN BROTHERS INC., Debtors. 1EE LLC, Plaintiff-Appellant, v. JAMES W. GIDDENS, AS TRUSTEE FOR THE SIPA LIQUIDATION OF LEHMAN BROTHERS INC., Defendant-Appellate.* United States Court of Appeals, Second Circuit (16-2737) 07.27.2017

[143] Jonathan Ross; *ibid* supra note 100

[144] Financial Crisis Inquiry Commission (FCIC); *ibid supra note 20*

[145] *Marine Trade SA v Pioneer Freight Futures Co Ltd [2009] EWHC 2656 (Comm).*

understanding of the financial structure of the instrument or the extent of the underlying legal issues within the documentation.[146]

4.1.2. HYBRID DISPUTE RESOLUTION AGREEMENTS

Asymmetric jurisdiction clauses or hybrid dispute resolution agreements are those which restrict one party to a contract to where it can bring court proceedings, but not the other party. This practice considers complex dispute resolution clauses and examines the different forms that are so called "hybrid" or "carve-out". It focuses on the issues that may arise in using complex clauses, and highlights the potential pitfalls in drafting financial agreements. It offers an avenue of recourse for investors who purchase faulty investment products through a bank or an investment institution.

The agreement permits one party to follow a different dispute resolution procedure from the other party. Naturally, this often results in parties not being of equal bargaining power. The most common agreement in these situations is when the bank can impose its discretion as to the forum and form for which it wishes to bring claims. The enforceability of hybrid arbitration clauses has recently been the subject of much judicial debate worldwide, the result of which varies markedly between jurisdictions. [147]

The English courts have proven more willing to enforce hybrid dispute resolution clauses. For example, in *Mauritius Commercial Bank*, the High Court held that a one-way jurisdiction clause permitting the claimant, a Mauritius-incorporated bank, to litigate wherever it chose, was valid. This is particularly striking considering the factual similarities with the case of *Banque de Rothchild* [148]decided by the French Supreme Court.

In the case of *Mauritius Commercial Bank Ltd v Hestia Holdings*[149], Popplewell J. held that the parties to a loan agreement were able to amend the governing law of an asymmetric jurisdiction clause from Mauritian to English law. Popplewell J. robustly confirmed the enforceability of asymmetric jurisdiction clauses as a matter of English common law.

In doing so, he commented on the controversial decision on the enforceability of such clauses as a matter of EU law handed down by the French Court de Cassation in *Banque Privée Edmond de Rothschild Europe v X.* The decision is a helpful one for parties seeking to rely on such clauses in the future.[150]

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[146] *LB Re Financing No 3 (in administration) v Excalibur Funding No. 1 PLC and others [2011] EWHC 2111 (Comm) and Anthracite Rated Investments (Jersey) Limited and others v Lehman Brothers Finance SA in liquidation [2011] EWHC 1822 (Ch).*

[147] *Lomas et al. v. JFB Firth Rixson Inc. Et al.* (2010) EWHC 3372

[148] *Mme X. v Banque Privée Edmond de Rothschild, French Supreme Court, First Civil Chamber, 26 September 2012, (No 11-26.022)*

[149] In *Mauritius Commercial Bank Ltd v Hestia Holdings Ltd & Sujana Universal Ind* [2013] EWHC 1328 comm.

[150] *Commerzbank Aktiengesellschaft v Liquimar Tankers Management Inc [2017] EWHC 161 (Comm)*, this is a Commercial Court case where Mr Justice Cranston has held that an *asymmetric jurisdiction clause* can confer exclusive jurisdiction on the courts of a Member State.

For such an agreement to take effect, a hybrid clause must be inserted into banks' sales and purchase agreements, which requires the intervention of local monetary and governmental authorities. The focus of such a clause is to target mis-selling and moral hazard techniques employed by banks and investment firms.

4.2. FINANCIAL AGREEMENT INTERPRETATION

Part of the problem in the matter regarding agreements is in the market unfamiliarity and non-understanding of the agreement documentations or the structure of the financial transaction itself. This is quite common in cases involving standard agreements such as the ISDA Master Agreements, whose brevity meant they proved ineffective in a range of jurisdictions.[151]

Financial markets have reached a point where there is great need for a theory and practice of contract interpretation of standard agreements. The best proof of this is the fallout after the financial crisis of 2008. CFTs are complex and require drafting contracts created specifically for financial agreements involving complicated derivatives and multiple mathematical formula transactions. The risk of courts misinterpreting an agreement is quite likely and with it comes everlasting disputable jurisprudence as a result.

A digression into the market usage of preformatted "use-for-all" standard agreements shows that those formats are entered into by parties on a global scale without truly appreciating fully their contents. Standard universal agreements are substantially used across a wide range of jurisdictions without the necessary modifications to adapt to those markets.

Clauses and provisions used in subprime mortgage transactions in the US are copied without adjustments for the use in a Collateralised Debt Obligation (CDO) in Hong Kong or Singapore. A textual interpretation of a financial contract is an orthodox method and is the default position adopted by almost all courts and tribunals in face of the complexity with the transaction itself. [152]

Litigation in courts can be like arbitration tribunals except that arbitrators in arbitration tribunals allow the parties to introduce their understanding at the time they concluded the contract. They require an interpretation of the science behind the words of a transaction in a financial agreement. Parties in arbitrable disputes have the right to make the tribunal reach an understanding of the matter in dispute.[153]

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[151] Lord Clarke, *Rainy Sky S.A. and others v Kookmin Bank [2011] UKSC 50*, par.14: "For the most part, the correct approach to construction of the Bonds, as in the case of any contract, was not in the dispute, but in the agreement."

[152] Pioneer Freight Futures Company Limited (in liquidation) v TMT Asia Limited [2011] EWHC 1888, at paragraph 27 (Gloster J). And notwithstanding that the 'approach to . . . interpretation . . . is not controversial', she disagreed with an interpretation of S 2(a)(iii) of the ISDA Master Agreement by Flaux J in both Marine Trade SA v Pioneer Freight Futures Co Ltd [2009] EWHC 2656 (Comm) and Pioneer Freight Futures Co Ltd v COSCO Bulk Carrier Co Ltd [2011] EWHC 1692 (Comm).

[153] *Allen & Overy note of 16 March 2011* **(Allen & Overy, 2014)***:* In 2010 two German courts, the Higher Regional Court of Frankfurt, 4 August 2010, file No 23 U 230/08 and the Higher Regional Court of Stuttgart, 27 October 2010, file No 9 U 148/08 rendered directly opposed decisions involving swap transactions. The

4.3. MIS-SELLING CLAIMS IN UNIVERSAL AGREEMENTS

Following the financial crisis, investors and clients of banks made claims of mis-selling of financial instruments. Claims were mostly made by institutions or professionals and hence included sophisticated clients, pension funds, municipalities and other banks. Fewer claims were made by retail clients while most of those disputes included a common transactional theme. They almost all included structured financial products and derivatives.

Claims were brought on broad bases alleging mis-selling or solicited trades from the part of the financial services firms. Claims included breach of advisory, negligent or fraudulent misrepresentation, mis-selling and deceit, ultra-vires or lack of capacity on the part of the investor and the most common was contractual terms signed in implied representation.

The banks argued that the investors "their clients" are contractually estopped by reason of applicable disclaimers and non-reliance clauses that exclude all fiduciary or advisory duties on the side of the bank, as clearly agreed upon in the contractual agreement. [154]

Most court decisions took the side of the bank and held the investors to their contractual obligations which release the banks from misrepresentation and mis-selling. Typically, dispute cases as such, involve claims by aggrieved investors who may have placed their grievances in front of courts expecting a completely different result. However, in view of documentation releasing the banks from their liability, the courts were compelled to follow the law. [155]

4.5. EXPLOITATION OF CONTRACTUAL ESTOPPEL

Contractual estoppel has been developed in the context of the exclusion of liability for misrepresentation. It provides a legal explanation for the validity of 'no representation' and 'no reliance' clauses as to advice provided by banks to their clients. This however may contradict the truth where banks approach their clients with investment ideas, yet the estoppel

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Frankfurt court held that a bank had complied with its obligations to a corporate vehicle of a municipality customer, whereas the Stuttgart court held a bank liable for having breached its obligations to a corporate vehicle of a municipality customer. The parties' arguments in both cases were similar. The courts, however, reached contrary conclusions. Interest rates moved against the two customers, which then sought to impugn the swaps on the basis that the banks had not sufficiently informed the customers of the risks. One major argument was that the swaps were incompatible with the municipalities' public purposes. It was both an *ultra vires* case and that the banks breached a duty under a consultancy agreement to advise the banks of the statutory prohibitions and the provisions contained in their constitutions. The Frankfurt court found that there was no breach of duty, whereas for the Stuttgart court there was. Both courts overturned respective first instance decisions.

[154] *Michael Duthie Wilson et al v MF Global UK Limited [2011] EWHC 138 (QB)* (a 'significant part of the strategy Mr Wilson had selected for himself involved frequent day trading of Futures Contracts for difference and futures and options in a very active and aggressive way' (at para 104); and *Camerata Property Inc v Credit Suisse Securities (Europe) Ltd [2011] EWHC 479* (Comm) (in the 'course of the client's dealings with the relevant bank account manager, he increasingly became interested in more adventurous investments'.

[155] Rubenstein v HSBC Bank plc [2011] EWHC 2304 (QB); and *JP Morgan Chase Bank v Springwell Navigation Corporation [2008] EWHC 1186* (Comm) affirmed *Springwell Navigation Corporation v JP Morgan Chase Bank [2010] EWCA 1221* (the documentation contained risk disclosures and disclaimers that excluded and limited the bank's liability, all of which negated the existence of a duty of care, a fiduciary duty and negligent misstatement).

may prevent a claim for misrepresentation or mis-selling. The importance of contractual estoppel does not stop at consumer investors. During the Financial Crisis, banks responsible for issuing and selling subprime notes were mostly transacting with other overseas banks, financial institutions and semi government entities in many countries. [156]

There are however, two central points that courts do not find easy to decide, most commonly when a claim is based upon alleged mis-selling of restructured investment products:

(1) The nature of the contractual estoppel;

(2) No-representation and no-reliance clauses included in the investment agreement subject to the test of reasonableness set out in the Unfair Contract Terms Act 1977, as extended to contractual terms which may exclude liability under the Misrepresentation Act.[157]

For contractual estoppel to arise there is a standard burden of proof that falls on the claimant. Unquestionably, such a burden is now one of the most significant defensive tools for banks and financial institutions in cases of claims of mis-selling and/or misrepresentation. Although the estoppel doctrine is not limited to financial and banking disputes, almost all the leading cases on contractual estoppel have arisen in this sector.[158] This in part may be explained by the widespread use of industry standard documentation, including the ISDA Master Agreement.

As mentioned earlier, those agreements incorporate clauses (such as the "non-reliance", "assessment and understanding" and "status of parties" clauses commonly incorporated into the schedule to, and confirmations under, the ISDA Master Agreement). They set out the basis upon which the parties are dealing and which the courts have found, are capable of giving rise to this type of estoppel. Similar provisions are also commonly found in banks' terms of business.

There are many examples of the complexities that exist in resolving banking and financial disputes. Those cases are an example of how courts can struggle in interpreting conflicting documents and complex transactions. This is illustrated by the decision in *Peekay Intermark v Australia and New Zealand Banking Group,* where the claimant was an investor who had purchased from the defendant bank a structured product linked to Russian Treasury bills.[159] Prior to the purchase, the aggrieved party had signed a "Risk Disclosure Statement" which stated that the bank assumed that investors were aware of the risks involved at the time of the deal and that they had determined for themselves that the product was suitable for them.

[156] Hooley, Richard, Contractual Estoppel and the Misrepresentation Act 1967 (November 26, 2016). "[F2 (1)] If a contract contains a term which would exclude or restrict— (a) any liability to which a party to a contract may be subject by reason of any misrepresentation made by him before the contract was made; or (b) any remedy available to another party to the contract by reason of such a misrepresentation", University of Cambridge Faculty of Law Research Paper No. 57/2016 https://ssrn.com/abstract=2875776

[157] Misrepresentation Act 1967 (S3) (F2) (1)

[158] *Rock Advertising Limited v MWB Business Exchange Centres Limited [2018] UKSC 24*

[159] ibid. S.N 130

Moore-Bick LJ in his ruling in 2006 summarised the essence of contractual estoppel, which he found that it arose from the contract, in the following terms: [160]

- There is no reason in principle why parties to a contract should not agree that a certain estoppel should form the basis for the transaction, where it be the case or not.

- Where parties express an agreement in a contractual document neither can subsequently deny the existence of the facts and matters upon which they have agreed, at least so far as those aspects of their relationship to which the agreement was directed.

- The contract itself will give rise to an estoppel.

Furthermore, in 2010 the Court of Appeal held in *JP Morgan v Springwell*[161] that contractual estoppel was a separate doctrine from estoppel by convention, and that there was no requirement on the part of the bank to show that it would be unconscionable to recoil from the representations made. Financial transaction agreements are complex and there is a premium on the knowledge and expertise of those using them. Those agreements are transaction oriented and worded accordingly. Legally underpinning what may go wrong, or foreseeing upcoming disputes due to non-performance of a mathematical financial formula goes beyond a standard agreement and requires the knowhow of those who use them.

It is not surprising, therefore, that the decision in *Lomas v Firth Rixson (2010)* recognised that the ISDA Master agreement used by the parties left significant matters without clarification concerning parties' commitments and payment obligations. The decision of J Briggs in *Lomas v JFB Firth Rixson* [2010] EWHC 3372 (Ch) gave rise to several important considerations for market participants in relation to the interpretation and construction of Section 2(a)(iii) of the ISDA Master Agreement. It also addresses whether this provision offends the anti-deprivation principle or could be classified as a penalty.

The facts varied between the individual appeals, but the common theme in each of them was that an event of default had occurred under an ISDA Master Agreement, but the defaulting party was "in the money". In the sense that if the open positions were all to be terminated, the non-defaulting party would have had to pay over considerable sums to the defaulting party to close out the various positions.

However, in each case the relevant master agreements had not provided for automatic early termination upon an event of default. Accordingly, each non-defaulting party could simply elect not to terminate based on the event of default and avoid paying the sums otherwise due

[160] Peekay Intermark v Australia and New Zealand Banking Group [2006] EWCA Civ 386
[161] *JP Morgan Chase v Springwell Navigation* [2008] EWHC 1186 (Comm) Gloster J; Court of Appeal ([2010] EWCA Civ 1221): upheld Gloster J's decision, with *Aikens LJ's* analysis proceeding again from first principles: if A and B enter into a contract, they are *prima facie* entitled to agree what they like and this includes agreeing that a certain state of affairs exists at the time of the contract or in the past, even if it is not the case. As such, when Springwell agreed in its contracts with the bank that no representation had been made to it, it was – subject to statutory control by way of (s.3) of the *Misrepresentation Act 1967* and the *Unfair Contracts Term Act 1977* (as to which: – contractually estopped from asserting that it had bought the instruments in question on the basis of an actionable misrepresentation).

to the defaulting party. This problem was then compounded by the drafting of the ISDA Master Agreement which stated that non-occurrence of an event of default was a "condition precedent" to any payment obligation. In the cases before the court the event of default was continuing up until the time when the financial contracts would naturally have come due for payment. The non-defaulting parties argued that they never had to pay the sums due because the condition precedent was not satisfied.

They were entitled to a windfall and could avoid their liabilities under the relevant derivative contracts because of the other party's default.[162] The need for a comprehensive statement of the law by the Court of Appeal had been driven in part by a decision in *Marine Trade v Pioneer Freight*[163] where the court had taken a position contrary to the orthodox market view in relation to the close-out provisions. The different appeals had different derivative contracts under consideration, but most of the legal issues which arose were capable of being dealt with on a conjoined basis.[164].

In *Barclays Bank v Svizera Holdings*, the court held, with regard to the issue of contractual estoppels that are in a bank's standard terms text, the non-reliance and “none acting as advisor" clauses are satisfactory to prevent an aggrieved investor from pursuing a misrepresentation claim. This decision will give some further rise to moral hazard risks and banks will get some comfort from the way that their standard "no reliance" and "no advice" clauses will generally be effective in excluding liability on their parts and counter claims on the part of the clients of misrepresentation and breach of a duty of care.[165]

However, following *Cassa di Risparmio*[166], two potential issues should still be borne in mind. A misrepresentation as to the effect of the contractual documents which are claimed to give rise to the contractual estoppel may prevent the estoppel from arising. In addition, the scope of the estoppel is a matter of construction of the contract so that (in less straightforward circumstances than those in this case) a court will analyse whether the representations made by the bank fall outside the terms of the specific clause which is claimed to give rise to the estoppel.

In *CRSM v Barclays Bank*[167] J. Hamblen found that the standard ISDA “non-reliance clause” does not permit a customer from claiming that they had relied upon communications from the bank as investment advice or as constituting a recommendation. However, the decision did not necessarily preclude the customer from claiming that they had been persuaded by a “mis-description” of the risks of the investment vehicle, or a distinct claim from being advised, or recommended a risky product.

Second, the application of contractual estoppel has been somewhat tentatively described by the Court of Appeal as “arguably misplaced” (and at least unsuitable for summary

[162] Edward Murray. *"Lomas v Firth Rixson: 'As you were!'"*. Capital Markets Law Journal*; 8: 395.*
[163] *Marine Trade SA v Pioneer Freight Futures Co Ltd* [2010] Lloyds Rep 631
[164] *Lomas and Others v JFB Firth Rixson, Inc and others* [2010] EWHC 3372 (Ch) at para 58.
[165] *Barclays Bank plc v Svizera Holdings BV* [2014] EWHC 1020 (Comm), 8 April 2014
[166] *Cassa di Risparmio v Barclays Bank [2011] EWHC 484*
[167] CRSM v Barclays Bank PLC (Commercial Court 2008 F. 757 (2011), EWHC 484, Comm.

determination) where it is claimed that the contracts containing the clauses were induced by fraud.[168]

Contractual estoppels have featured prominently in the current wave of litigation concerning interest rate hedging products and a recent important decision in *Crestsign v NatWest*.[169] *Crestsign* concerned a property development company which had entered into an interest rate swap with the *National Westminster Bank*. The court factually found that the bank had given advice to *Crestsign* during a meeting, followed by various documents, including a risk management paper, two sets of terms of business and a swap confirmation, all of which contained clauses which clearly defined the relationship between the client and the bank as "non-advisory". The documents were presented and signed by *Crestsign*.

The judge found that, although negligent advice had been given, the terms of the contracts were clear and unambiguous and were effective enough to preclude *Crestsign* from claiming that it was being advised and solicited into the transaction. In the opinion of the court, the bank had gone out of its way to bring all facts to the customer's attention during the negotiations phase.

The judge rejected the suggestion that, applying the "re-writing history" test from *Raiffeisen*[170], the clauses operated as exclusion clauses. The case illustrates the power of contractual estoppel. Where a disclaimer is construed as a "basis clause", it may be effective notwithstanding its unreasonableness under UCTA. **(Andrew Mitchell QC, 2015)**.

5. ANATOMY OF FINANCIAL DISPUTES

This section is to construe the many layers and different causes which come together in a financial dispute. It begins by analysing the various international dispute resolution processes that have been attempted in financial arbitration. Financial disputes are examined in terms of the participants, claims, situations, strategies, social objectives and outcomes. For the sake of clarity and fuller analysis disputes are stripped down to separate components bearing in mind the continual intersecting and wider impact of financial banking disputes.

The first task is to determine who should be represented in banking and financial dispute resolution processes and whose interests should be considered. If any participants' interests are ignored or underestimated, the dispute is not likely to be resolved. Securities and financial disputes generally present themselves with investors claiming that their monies were lost because of misleading statements on the part of the financial adviser.

The banker will of course reply that the customer was aware of the risks. The core of those claims is financial misbehaviour. Financial transgressions include actions such as unauthorised trading, unsuitable advice, misrepresentation and misappropriation. The latter is

[168] *Deutsche Bank v Unitech* [2013] EWCA Civ 1372

[169] *Crestsign Limited v NatWest and RBS* [2014] EWHC 3043 (Ch)

[170] *Raiffeisen Zentralbank Osterreich Ag v The Royal Bank of Scotland Plc*; (2010) EWHC1392 (Comm), [2010] 1 Lloyds Rep 123

a euphemism for theft.[171] The socioeconomic outcome of such behaviours has a profound effect on social development, economic reconstruction and improvement.[172]

This statist perspective is, however, overly narrow and selective. Private and public banks committing international offenses and their victims range from state owned banks to domestic and international financial institutions. Individuals and corporate, national and multinational organizations, governmental and non-governmental authorities, global and regional organizations are all possible victims to misguided investment advice from bankers and all could be participants in financial disputes collectively or separately against a bank.[173] Hence, as mentioned in Chapters One and Two above, contractual process and formation of contracts at the outset is of utmost importance. [174]

Looking at the anatomy of financial disputes and the layers of causation including directorship yearn for profit can be the main drive for starting a dispute. In the case of Goldman Sachs which is one of the largest investment banks in the world, it was involved in risky securitisation and whiles the directors saw the subprime bust coming earlier than others, its survival from the crisis had little to do with analytical trading. It specifically had to do with its traders, whom Goldman directors gave direct orders to sell the entire stock of subprime notes to their own clients without informing them of the expected crash in the value of such securities. When the crash ensued, those same banks such as Goldman Sachs, Merrill Lynch, Citi and others were bailed out by the US Federal Government through the “lender-of-last- resort” funds.[175]

Investment Bankers were saved during the bailout of AIG, netting a $16.8 trillion from taxpayers. The Fed guaranteed the senior unsecured debt of banks and bank holding companies by purchasing US$ 1.8 trillion in treasury debt, mortgage-backed securities and other instruments to halt the fall in stock prices of the ailing banks and indirectly help the "too-big to fail" investment bankers from falling. However, investors and other banks around the world who suffered the loss of their capitals did not benefit of such bailout nor did the banks that caused their losses compensate them for it.[176]

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[171] D.E. Robins, *Seven Deadly Sins that Lead to Arbitration Disaster*, 820 PLI/Corp 489, Practising Law Institute, Corporate Law and Practice Course Handbook Series (July-August 1993).

[172] The term “socioeconomics” refers broadly to the "use of economics in the study of society". Contemporary practice considers behavioural interactions of individuals and groups through social capital and social "markets" and the formation of social norms. In the latter, it studies the relation of economics to social values and legislations imposed by the society's lawmakers.
Socioeconomic is a distinct supplemental usage that describes social economics as "a discipline studying the reciprocal relation between social legal ethics and economic development leading toward social reconstruction and improvement.

[173] Charles W. Calomiris & Stephen H. Haber, *Fragile by Design: The Political Origins of Banking Crises and Scarce Credit , (2nd ed., Princeton University Press (2015)*

[174] Ch1 s7.1.1 – 2 & Ch2 s2.1.3.

[175] Jennifer G. Hill & R.S Thomas, *Research Handbook on Shareholder Power* [2015], Edward Elgar Publishing Ltd., 1st Ed., Cheltenham, UK

[176] The Special Inspector General for TARP summary of the bailout said in his July 2015 report that the total commitment to-date of government funds to banks bailout of the 2008 crisis is $16.8 trillion dollars with the $4.6 trillion already paid out. 'Troubled Asset Relief Program - *TARP' The Troubled Asset Relief Program (TARP)*

In April 2010, the Securities and Exchange Commission (SEC) accused Goldman Sachs of fraud.[177] The charge was that, in "certain transactions" the selection of the bonds which formed the asset base of a CDO was influenced by hedge fund managers who correctly bet on the turn in the housing market and profited in a big way as a result. The US financial regulator charged Goldman Sachs in 2010 with securities fraud, accusing them of misleading investors, omitting crucial information and misrepresenting the product.

The lawsuit charged Goldman Sachs' traders with encouraging unwitting investors to buy a product that they knew was eminent to crash. Investors in what is known as the ABACUS 2007-AC1 case lost over $1 billion. By contrast, Goldman was ordered to pay a fine of $20 million by way of retribution and there was no redress ordered for the investors.

However, a distinction must be drawn between the direct protagonist financial institutions playing the central role with their innermost interests in sight and the others who become involved through their peripheral role in attempting to manage other people's funds for the best returns they can achieve. Even participation in a clear-cut international dispute, such as those arising out of the 2008 crisis and the sinking of worldwide financial markets, can be wider than just plain bank-to-bank or investor-to-bank disputes. The main disputants in that crisis were states and central banks struggling to save their national economies and bailout their local banks from bankruptcy.

5.1. ISSUES IN INTERNATIONAL AWARD ENFORCEMENT

5.1.1 Hurdles in front of Domestic Courts

The labelling of various factors as participants in the international financial dispute is relevant to determining the appropriate arena and mechanisms for the payment and settlement of an award. More importantly, it is pertinent to the methods of payment (enforceability) sought. With the usual customary settlement of claims and often partial reparation banks offer to their disputants, the continuing disputes can be narrowed down, leaving the large and complicated bank-to-bank disputes and the peripheral domestic procedures of dispute settlement or restitution.

It may be problematic or inaccurate to define the situation caused by the attempts of seeking payments under litigation for international financial disputes as being similar to getting international awards to be paid instantly under arbitration as proposed by this thesis. There are recurring hurdles facing the enforcement of international arbitration awards.

Domestic courts' responses to enforcing arbitration awards are usually slow, partially because of the possible influence of locally residing financial institutions. The usual protagonist in

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was a group of programs created and run by the U.S. Treasury to stabilize the country's financial system, restore economic growth, and mitigate foreclosures in the wake of the 2008 financial crisis.

[177] Securities and Exchange Commission v. Goldman, Sachs & Co. and Fabrice Tourre, 10 Civ. 3229 (BJ) (S.D.N.Y. filed April 16, 2010)

those disputes is generally governmental or large financial institutions operating within a statist protective jurisdiction.[178]

It is worth noting that statist political intervention in critical financial disputes does not occur only in developing countries or authoritarian jurisdictions. In fact, it occurs in countries such as the US, Canada and Mexico.[179]

5.1.2 Manifest Disregard of the Law

Those concerns were expressed upon the ground that the *"*manifest disregard of the law" doctrine renders international awards especially in financial disputes, vulnerable to being set aside in the US jurisdiction.[180] Given what the International Commercial Disputes Committee recorded in their final report where it likens the "manifest disregard of the law" doctrine to other domestic standards of award reviews in third world countries as well as in Canadian and Mexican courts.[181]

Manifest Disregard of the Law — means an error or misunderstanding with respect to law by the Arbitration tribunal that a court may set aside an arbitral award because of an error of law. The U.S. Supreme Court held that[182] —the interpretations of the law by the arbitrators in contrast to manifest disregard can be subject, in the federal courts, to judicial review for error in interpretation. In the years since the Wilko case in 1953, the federal courts, particularly the Second Circuit in New York, have repeatedly held that awards may be set aside for mere errors of law by the arbitrators.[183] The two statutory grounds for the vacating of an award on the basis of Manifest Disregard of the Law rely on the words contained in the Federal Arbitration Act §§ 10(a)(3) (the arbitrators were guilty of misconduct) and 10(a)(4) (the arbitrators exceeded their powers).

While neither of these grounds appears as such in the *New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards* as a basis for refusing to recognise or enforce a foreign award, the NY Convention does not purport to impose restrictions on signatories with respect to the grounds on which awards rendered within their territory may be set aside. The New York Convention's drafters elected to address only the minimum permissible grounds for refusing enforcement or recognition of a foreign arbitral award, and

[178] David Gliksberg, *The Effect of the Statist-Political Approach to International Jurisdiction* [1994] V15 (2) https://www.law.ox.ac.uk/sites/files/oxlaw/oscola4thednhart2012.pdf - accessed 10.10.2016

[179] *The US, Canada and Mexico are the forming members of the NAFTA* (North America Free Trade Agreement 01.01.1994)https://ustr.gov/trade-agreements/free-trade-agreements/united-states-mexico-canada-agreement/united-states-mexico

[180] *Citizens Bank v. Alafabco*, 539 U.S. 52, 56 (2003)

[181] New York City Bar, *The "Manifest Disregard of Law" Doctrine and International Arbitration in New York*, (Report by the Committee on International Commercial Disputes [Aug 2012]).

[182] *Wilko v. Swan, 346 U.S. 427, 437 (1953).*

[183] *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bobker*, 808 F.2d 930, 933 (2d Cir. 1986) *(manifest disregard —clearly means more than error or misunderstanding with respect to law||)*

did not seek to establish a uniform international standard for setting aside awards in the jurisdiction where the arbitration occurred. [184]

In *Schwartz v. Merrill Lynch,*[185] the NY 2nd Circle Court did not confirm awards due to serious reservations about the soundness of the arbitrator‘s reading of the financial transaction contract while in *Goldman Sachs v. Unsecured Creditors Committee*,[186] an award was not enforced despite a court‘s disagreement with the tribunal on the merits of the case.

The *International Commercial Disputes Committee* expressed their concern that those decisions create uncertainty with awards' enforceability which will compromise the finality and viability of the international arbitration process.[187] Local courts should ignore the explicit statist restrictions within their own jurisdictions and give wider interpretations to the statutory standards for the enforceability of international arbitral awards.

Taken together, these decisions limit the courts' usefulness as an enforceable authority forum for financial arbitration awards when participants are not exclusively states; however they may have exceeding powers over the governments that run the state.[188] The situation that arguably exercises the greatest impact upon the development and resolution of financial disputes is the interdependence between financial institutions in interbank deposits relations.

5.2. ISSUES IN FINANCIAL ARBITRATION AWARD ENFORCEMENT

Consideration regarding whether the disputants are private or public banks and ties between states usually are a major factor to consider in a financial dispute. Another factor that cannot be ignored, but is difficult to weigh, is the sociological one. One aspect of this sociological factor is the type of people normally involved in disputes on behalf of their banks: traders, fund managers, brokers, and lawyers. Most of these tend to be relatively senior and stand to lose a good deal of money should they lose the case. Their behaviour is moulded by their

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[184] *ST Microelectronics, N.V. v. Credit Suisse Secs. (USA) LLC, 648 F.3d 68 (2d Cir. 2011); Merrill Lynch, Pierce, Fenner & Smith Inc. v. Bobker*, 808 F.2d 930, 933 (2d Cir. 1986) (manifest disregard of law —clearly means more than error or misunderstanding with respect to law); *STMicroelectronics, N.V. v. Credit Suisse Secs.* (USA) LLC, 648 F.3d 68 (2d Cir. 2011); *Schwartz v. Merrill Lynch & Co, Inc*., No. 10-0826, (2011) WL 5966616 (2d Cir. Nov. 30, 2011); *Wallace v. Buttar*, 378 F.3d 182, 190 (2d Cir. 2004) (an award should be enforced, despite a court‘s disagreement with it on the merits, if there is a barely colourable justification for the outcome reached); *Westerbeke Corp. v. Daihatsu Motor Co., Ltd*., 304 F.3d 200, 216 n.10 (2d Cir. 2002) (court is required to confirm awards despite —serious reservations about the soundness of the arbitrator‘s reading of the contract); *Starborg v. National Metal Converters, Inc.,* 500 F.2d 424, 432 (2d Cir. 1974) (misinterpretation of contract is not a mistake of law that may be corrected); *Yusuf Ahmed Alghanim & Sons, W.L.L. v. Toys "R" US, Inc.,* 126 F.3d 15 (2d Cir. 1997), cert. denied, 522 U.S. 1111 (1998).

[185] *Schwartz v. Merrill Lynch & Co, Inc., No. 10-826 (2d Cir. 2011)*

[186] *Goldman Sachs v. Unsecured Creditors Committee of Bayou Group, Nos. 10-5049-cv (Lead), 11-2446-cv (XAP), 2012 WL 2548927, at *1 (2d Cir. July 3, 2012)*

[187] The Third Restatement on International Commercial Arbitration conducts an analysis of the manifest disregard doctrine that leads its drafters to suggest that the U.S. courts should no longer apply the doctrine. Restatement (Third) U.S. Law of International Commercial Arbitration § 5.15, Reporter's Note a (Tentative Draft No. 1).

[188] Marta Varela, *Arbitration and the Doctrine of Manifest Disregard*, 49 DISP. RES. J. 64, 65 (June 1994) (Manifest disregard has become a repository for all sorts of outlandish theories of arbitral misconduct devised with but one aim in mind: the application of standards of appellate review to the arbitration process and ultimately to vacate a particular arbitral award within a particular political aim.)

profession and greed. They pay no attention to any social expectations of their roles as bankers. This steers them toward certain established patterns of conduct.

At this professional level, institutional decision-making tends to be interconnected and personalised. However, the importance of financial reward and profitability is especially visible in contemporary financial disputes. It is merely a continuation of a more general trend spanning the centuries. International financial institutions have always pursued access to wealth and profitability. In a world of shrinking borders and expanding communications, corporate and private wealth and disputes about their allocation and distribution will continue to increase and in a faster and more complicated manner. This historical trend explains the importance of the attempted prescriptive processes for the resolution of disputes between banks that are renowned as the holders of the world's wealth. Pre-empting disputes and providing legal basis for timely resolutions to financial disputes is as essential as the timely allocation of the disputed funds to the winning party (Swift Clearance of Financial Arbitral Awards).

It is worth noting that financial arbitration awards currently may face special challenges which go beyond mere contractual disputes even outside financial crises. There are, above all, the possibility of important issues of property law in terms of the nature, structure and operation of disputed investment tools and floating charges (in respect of placed deposits and liquid assets), particularly when these charges concern assets in different countries and assets that are moving from country to country.

Also, when assets must be re-delivered to other countries, there may be further complications in terms of the determination of the applicable property laws in those jurisdictions short of their full transnational status in international finance. More problems may arise if there is a declared bankruptcy and the relevant assets are or may have to be surrendered to or retained by bankruptcy trustees.

Those cases are common especially if bankruptcy is intentionally declared in a country of their choice where international recognition of arbitral awards affecting the bankrupt estate may even be less probable. Practically, those circumstances can limit substantially the power of award enforceability in certain countries. However, the real concern is in the disturbances the legal powers of domestic courts can impose on the enforcement of arbitral awards as per the NY Convention.

It may in practical process concern in particular the arbitral institutional status and powers of international arbitration tribunals. In property matters within a pending dispute there are deeper questions in arbitration concerning the effect *erga omnes* (the effect on third parties).

It was already mentioned that in the nature of property rights protection, third parties who are affected as much as the losing party may wish to challenge the award. Their rights to do so may be pre-empted when an *Officially Designated Award Clearing Forum* can be formed and security interests are reaffirmed.

5.3. AWARD CLEARING FORUM

An award of an international arbitration tribunal is binding on all parties to the proceeding and each party must comply with it pursuant to the terms of their contracts. If a party fails to comply with the award, the other party can seek to have the pecuniary obligations recognized and enforced in the courts of any NY Convention member state as though it were a final judgment of that state's courts. The same fundamental policies motivating courts in a certain jurisdiction to enforce arbitral awards also motivate courts to recognize and enforce domestic and foreign arbitral awards in another jurisdiction. For example, adoption and implementation of the New York Convention by the United States is found at 9 U.S.C. § 201 (1982). [189]

A party seeking recognition or enforcement must provide a certified copy of the award to the competent domestic court (or other authority which the state has designated for the purpose of enforcement of foreign awards within its jurisdictions). However, although member states of the NY Convention are required to recognize and enforce the award, each state's laws relating to enforceability of international awards differ in the process upon which an award may be enforced.

An essential element in a successful international or national system of effective commercial arbitration is the ease and efficiency with which awards are enforced and paid out. The thesis proposes the Award Clearance Forum whose role will be in the settling and paying-out of recognized and enforceable awards against banks and financial institutions. That is to say, a party holding an award against a bank that is enforceable and satisfies all requirements of the place of recognition will provide the *Forum* with the award. Upon presentation, the award will be paid out immediately just like a cheque or a payment order and the proceeds will be cleared (setoff) against the other party's (the bank's) assets held within the banking network of which the *Forum* is composed.

In practicality, the majority of arbitral awards are satisfied through the voluntary compliance of the parties involved. However, on some occasions the winning party finds itself obliged to resort to an external authority to enforce the award on the losing party and collect the damages awarded. Such external authority to enforce an arbitral award can be in the form of national courts located where the losing party resides. This usually leads to enormous delays especially if the losing party is a local bank or large financial institution with vested interests in the region. In this case of non-compliance or refusal to pay, the party holding the award can inform the *Forum* of the other party's non-compliance. It is then, the *Forum's* role to contact the non-complying bank to inform it of the steps that will be taken to progress the payment of the award and set-off the monies paid against their assets held within the inter-banking network.

5.4. RETRIBUTION *v.* RESTITUTION

[189] Article II of the New York Convention also provides for the enforcement of agreements to arbitrate. Convention on the Recognition and Enforcement of Arbitral Awards, June 10, 1958, 21 U.S.T. 2517, T.I.A.S. No. 6997, 330 U.N.T.S. 38 [hereinafter cited as New York Convention]. Those provisions, however, are beyond the scope of this thesis.

Investors normally seek restitution for their losses rather than retribution for bankers' reckless behaviour. Nevertheless, the imposition of retribution and restitution in a legal process such as arbitration should help pre-empt actions in financial moral hazard such as recklessness and mis-selling. Arbitration processes can only impose monetary awards on the defendant. Retribution will be in the quantum and speed of the enforcement of such award. Arbitration in financial matters delineates characteristics such as speed, confidentiality, expert handling and enforceability. The understanding of the socioeconomic effects of a swift acting process in financial disputes is that it will reinforce social confidence in the banking system as much as it is in the resolution process itself.

For regulatory authorities, individual arbitration cases will function as early collective micro-warning systems useful for prudential regulatory intervention. In spite of the fact that arbitration proceedings are confidential, regulatory authorities in different jurisdictions can still identify banks with troubled liquidity and inadequate capital buffers through monitoring the results of arbitration awards that will be enforced publicly. Arbitration can also act as a complement to the judiciary by filling in for some of the recognized jurisdictional shortcomings. Judicial organizations in the majority of countries in the world today that deal with financial cases experience lack of knowhow and training, time limitations, contradictive domestic legislations and challenging choices of law.[190]

Arbitration, with its rich and almost unlimited resources can offer public confidence by providing answers (resolutions) in almost any dispute comprising complicated financial transactions. [191] Those are essential minimal qualifications to address the social needs of the world's societies in the face of gigantic investment banking conglomerates. The requirements of resolving international financial trade disputes, investment and finance are not satisfied in a very large number of countries around the world due to the delaying techniques devised by those same financial conglomerates that are standing defiant even against states and governments.

Reinstating and reinforcing personal and professional responsibility in the financial sector will require a blend of different strategies. For instance, the promotion of retribution through the medium of alternative dispute resolution (ADR) can be a cost-effective way to push for more responsibility in decision-making. But the key focus of this part falls upon the examination of two types of personal liability: monetary and non-monetary, including disqualification, wrongful trading and criminal strict liability, which can only be applied through the medium of regulatory authority.

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[190] At a meeting of the Law Asia Conference in Manila in 1997, one of the vice-presidents of the People's Supreme Court in China reported that China has around 360 million cases pending in the courts. In India, the number of cases pending is estimated at around forty-five million. And in other countries, even though with not such impressive numbers in the whole system, the backlog is concentrated in some particular courts, which damages the performance of the overall system. So, the first role for arbitration in society is to act as an auxiliary to judicial systems to help them to deal with heavy loads of cases.

[191] David Baragwanath, How should we resolve disputes in complex international financing transactions?; Capital Markets Law Journal, Volume 7, Issue 3, July 2012

Those types of retribution are considered as means to better the current accountability system in financial institutions. The monetary liability of executives was promoted through the wrongful trading provisions of the Insolvency Act 1986, as well as the role the Banking Act 2009 can play in the sharpening of bankers' accountability. Refining this area will enable the closure of the loophole that existed and may still exist in law, where almost all directors of nearly all failed banks were able to escape not paying for their actions.[192]

In relation to non-monetary liability, the effectiveness of disqualification (promoted through the Company Directors Disqualification Act 1986), as well as the new criminal sanctions proposed by the government to tackle the managerial misconduct witnessed during the past few years, do not seem to have been effective to a notable degree. [193] In fact, directors have continued to reward themselves rather excessively and the public keep questioning the current levels of bank executives pay. The earlier comparative analyses are especially useful; particularly regarding the issue of corrective measures adopted hitherto dealing with monetary remuneration in the financial sector. So far, conclusions show that those measures are not strong enough to deal with the complicated aspects of monetary incentives for traders and executives. It may be also concluded that those corrective methods are not sufficiently corrective. This is clearly identified through controversies surrounding *"remunerations for risk"* structure in financial institutions and current laws related to executives' remuneration.

6. IMPACT OF FINANCIAL DISPUTES ON SOCIETIES

Societies are primarily reacting to what occurs in the financial sector between bankers and business professionals. The problems that may arise between banks amongst themselves or other local and overseas financial institutions touch instantly onto the public and social welfare. Consequently, financial arbitration increasingly began to play an active role in resolving cross borders bank disputes, as a mean for establishing confidence in the financial sectors in many countries around the world.[194] The demand for further efficiency in financial dispute resolutions developed as the pressures of high speed interbank transactions gained higher volumes and societies came to rely fully on high speed financial trading. The effect of such rapid globalization has increased a further need for more than purely national systems of law and standard dispute resolution techniques.

Many questions arise regarding the role of arbitration in society and the importance of arbitration beyond individual cases. That is also the effect of set-off and netting within the interbank-payment system. The question already raised before is in how far an arbitral award that in principle can have no third party effect, may nevertheless still have a social effect. At the most fundamental level, arbitration is an important relief from the gigantic pressures of backlogs of cases in the great majority of courts all over the world. In many developing

[192] T. Cole (ed.), The Roles of Psychology in International Arbitration (Series: International Arbitration Library) (Kluwer 2016)

[193] Financial Conduct Authority, Risks to Customers from Financial Incentives, (30.11.2015) TR14/4, www.fca.org.uk/firms/risks-customers-financial-incentives

[194] J. H. Dalhuisen, *Legal Orders and Their Manifestation: The Operation of the International Commercial and Financial Legal Order and Its Lex Mercatoria*, 24 Berkeley J. Int'l Law. 129 (2006)

countries, even if there is a functioning and reputable judicial branch, courts may experience significant backlogs, which can add to lengthy delays in resolving disputes. For example, one commentator has noted that there are “habitual delays of up to 15 years” in litigating commercial disputes in India.[195]

At a meeting of The Law Asia Conference in Manila in 1997, one of the vice-presidents of the People's Supreme Court in China reported that China had around 360 million cases pending in the courts.[196] In India, the number of cases pending is estimated at around forty-five million. And in other countries, even though the numbers in the whole system are not so impressive, the backlog is concentrated in some particular courts, which damages the performance of the overall system. So, the first role for arbitration in society is to act as an auxiliary to judicial systems to help them to deal with heavy loads of cases.[197]

Subject-matter diversification has already been an effective strategy for institutions. Banking and financial arbitration remain the archetype of successful specialized centres such as P.R.I.M.E. Finance in the Netherland. Investment arbitration, on the other hand, started earlier due to the increasing volume of bilateral investment agreements and began with the creation of The International Centre for Settlement of Investment Disputes (ICSID) in 1965. The market nowadays is being dominated by two major international organisations, mostly ICSID and the Permanent Court of Arbitration (PCA). The Court of Arbitration for Sport (CAS) and the World Intellectual Property Organization (WIPO) provide other successful examples of such strategy. ICSID and the PCA exemplify the fact that, in certain of their functions, international organizations themselves can act as service providers with respect to international arbitration.

The third and most important role and impact of arbitration in society is not as a nemesis of judicial systems. To the contrary, the true value of arbitration is its role as a complementing process serving within the judicial system. Lest we forget, current international commercial arbitration cannot function without the assistance of national courts. The New York Convention is built upon this principle. It can even be said that the New York Convention effectively derives its authority from the national courts. The manner in which they interpret and apply the Convention is the main source of its effectiveness. In almost all legislations, arbitration relies on the judiciary for enforceability and assistance.

The emergence, however, of arbitration in the field of conflict resolution responds to the shortcomings of judges’ lack of time and specialised field of experience in some complicated cases. Progress and the increase in demand for arbitration, highlights the fact that case processing is being done too slowly in the judicial systems due to the increase in demand for litigation related to demographical variation rather than the lack of competence in judiciary circles. The situation is similar to how courts of equity developed during the Middle Ages in

[195] Ramon Gosh, *Commercial Disputes in India*, Vol 9, Issue 3. *Investigative Intelligence* (2011), available at http://www.kroll.com/ media/pdf/articles/Asian Mena_Counsel_Ramon_Ghosh_May2011.pdf

[196] G. MacLean, *The Social Efficiency of Laws as an Element of Political and Economic Development*, 4 NAFTA: L. & Bus. Rev. AM. 6 (Spring 1998).

[197] Richard A. Bales, Compulsory Arbitration: The Grand Experiment in employment (1997).

England except that in this case, the response has not come from another office of the kingdom, but from ordinary citizens in the form of merchants, bankers, scientists, professional businessmen, etc.

Arbitral institutions have also grown exponentially, both in numbers of players and in size. They have embraced diversified strategies to differentiate themselves. While some actors have positioned themselves as global such as the International Chamber of Commerce (ICC), The London Court of International Arbitration (LCIA), The International Centre for Dispute Resolution (ICDR), Stockholm Chamber of Commerce (SCC), . . .), others have promoted themselves as regional players, notably The China International Economic and Trade Arbitration Commission (CIETAC), The Singapore International Arbitration Centre (SIAC), The Dubai International Arbitration Centre (DIAC), and the Cairo Regional Centre for International Commercial Arbitration (CRCICA), among many others).

There are also other national, more specialized types of institutions in the United States that sponsor arbitration in more circumscribed fields, such as the National Association of Securities Dealers, the New York Stock Exchange, the American Stock Exchange, the Municipal Securities Rulemaking Board, and the Securities Industry Conference on Arbitration. Other institutions deal with arbitration not in one particular country or in a particular field like commerce, securities or investments, but can cover all type of cases: examples include the American Arbitration Association (AAA), the Centre for Public Resources (CPR), the Institute for Dispute Resolution, the London Court of International Arbitration, and the Hong Kong International Arbitration Centre. Arbitration can also be sponsored by individual corporations or entities that carry on business with large numbers of persons, like banks, insurance companies or energy and oil companies, which can include in their contracts an arbitration clause.

6.1. NATURE OF ARBITRATION AND ITS EFFECT ON SOCIETY

Arbitration helps parties avoid many of the problems that have to do with procedural matters in international commercial and financial disputes which may otherwise be faced in a court of law:

1. The malady of "forum shopping" is eliminated if the jurisdiction is established by mutual agreement, as is usually the case in arbitration.
2. The problem of assignment of cases to a particular judge, the source of many irregularities, is also eliminated.
3. Arbitrators are more "service conscious" toward the parties than judges are, simply because the jurisdiction of arbitrators is not compulsory like that of litigation and is only the result of the agreement of the parties. As Judge Roger Warren, President of the National Centre for State Courts in the United States, said once, "[H]e[would like to infuse in every judge the idea that there is a court a hundred yards away offering exactly the same service that the judge offers".[198]

[198] Roger K. Warren, *Evidence-Based Practice to Reduce Recidivism: Implications for State Judiciaries*, The Crime and Justice Institute and the National Institute of Corrections, Community Corrections Division, US Department of Justice 8/30/2007

4. Submission and assessment of evidence does not take as long in arbitrations as in courts of law.
5. Arbitrators can be much less formalistic than judges in the procedure, with the result that in many cases it is easier to reach a settlement in arbitration than in a court of law, especially in countries without discovery.
6. As decisions of arbitrators are not binding on future cases, there is more flexibility for arbitrators than for judges if circumstances change, especially in common-law countries.
7. And most importantly, International Arbitration awards are final and enforceable, deriving their potency from the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards 1958.

Arbitration is a process that cannot be indifferent to the environment in which it operates and this applies even more in cases of international disputes. Arbitration tribunals will make adjustments when issuing awards to be in line with the social structure and public policy measures that remain in essence subject to the domestic laws of the seat chosen by the parties.[199]

6.2. INTERNATIONAL ARBITRATION IN LOCAL SOCIETIES

International arbitration structures the manner in which social actors are expected to behave in the field of international disputes. It has evolved into being a cohesive dispute resolution process in which a variety of actors share different sets of social values and beliefs.

In the process of evolution, a number of social agents and academic institutions developed the ambition to provide guidance as to the way international financial arbitration should progress and how arbitral social actors should behave when resolving banking disputes. Having the ability to develop socially over time, rules of law susceptible of being applied by arbitrators at various degrees of legitimacy are recognized as having the social ability to provide future guidance to legislators and state courts.

States also have both the legitimacy and the ability to influence the manner in which arbitration develops. They do so directly within the limits of their territory by legislating arbitration laws and regulating hearing processes taking place in that jurisdiction. However, what counts mostly is the recognizing of awards which satisfy territorial social tradition and meet public policy requirements.

By including state influence and social disposition, arbitration has and can be a tool of reducing public anxiety about resolving banking disputes, and avoiding runs on banks. This can only occur if a mechanism of arbitrating and swiftly paying arbitral awards is in place.[200]

Academic institutions are also becoming more specialized in international arbitration and generally focusing on international arbitration research and teaching, such as in Queen Mary

[199] Gabrielle Kaufmann-Kohler, *Identifying and Applying the Law Governing the Arbitration Procedure—The Role of the Law of the Place of Arbitration in ICCA*, Congress Series Volume 9 (n 1) 336.
[200] N. Horn and J.J. Norton (eds.), Non-Judicial Dispute Settlement in International Financial Transactions 135-166. 2000 Kluwer Law Int'l. UK

School of International Arbitration (UK), the Geneva MIDS Programme (Switzerland) and The International Academy for Arbitration Law. Those institutions are also social value providers as they shape the manner in which arbitration is perceived by the public through scholarly articles, conferences and teaching.

6.3. IMPLICATIONS OF FINANCIAL CRISES ON SOCIETIES

The centre of attention so far in most studies on the 2008 Financial Crisis has focused on the impact of investment banks that have failed to meet investors' financial expectations, rather than those that have failed to meet investors' social expectations. The social financial performance of a financial enterprise is to attract investors' funds for the purpose of creating social benefits. Nevertheless, investment disputes will arise when certain financial institutions "over perform". That occurs when monetary rewards can overwhelm or "distract" managers of those institutions from achieving their designated social task. The crisis that started in the summer of 2007 exposed the individual ignorance and ultimately the weaknesses of executives to properly calculate and stick to a degree of risk suitable to the circumstances of their institutions.

When a bank or a financial institution faces trouble, the effect is not isolated within that specific bank. There are deposits within that bank that belong to individual depositors. Moreover, there are deposits of other banks that belong to the depositors of those other banks. The social chain reaction of one bank's failure is endless and it has a negative repercussion on the entire social structure within a state.

The social impact of the "subprime notes" started on a positive note with The Community Reinvestment Act (1997). It had a clear and noble objective of using the provision of cheap credit as a cure for growing income inequality. Such a deal had the apparent advantage of helping to offset the stagnation of median incomes and growing inequality in American society as the earnings gap got wider. Instead of taxes and subsidies to redistribute income, the idea was that those on lower incomes (subprime borrowers) would be able to acquire mortgages to get on the housing ladder so that with time and house price appreciation, they could extract equity to increase consumption.

Banks appeared to be truly involved in a socially beneficial product and shadow banks 'joined the party' with sophisticated products such as CDOs and MBSs that would help re-create liquidity in the market and keep the lending machine working. Under the Clinton and Bush administrations, the mandate on government sponsored enterprises (GSEs) for low income housing steadily increased, from 42% of assets in 1995 to 56% in 2004. Indeed, it has been estimated that: by 2008, the mortgage giants, the FHA and various other government programs were exposed to about $2.7 trillion in subprime and Alt-A loans, approximately 59% of total loans in these categories. As money from the government-sponsored agencies flooded into financing or supporting low income housing, the private sector joined the party.

Unfortunately, the private sector, aided and abetted by agency money, converted the good intentions behind the affordable housing mandate into a financial disaster.[201]

Subprime mortgages bundles were converted into high yield security papers and sold by US investment bankers to worldwide institutions and banks such as Deutche Bank, BNP Paribas, National Bank of Egypt and to charity and Pension Funds such as the Salvation Army and the Indian Pension Retirement Fund. They were ALL sold as lucrative low risk investment vehicles to governmental and semi-governmental institutions worldwide. The risk was truly converted into a universal financial epidemic. This crisis is indicative of how the involvement of banks and financial intermediaries to socially alleviate the burden of financing new home buyers within a specific sector of the society became greedy and offered too much money to feed the demand for Mortgage-Backed-Securities rather than to feed the demand for housing.

Crucially, this reinforces the need to have appropriate monetary behavioural retribution in place that can potentially diminish cognitive social perception limitations towards disputing bankers' actions. People still regard "banks" as unapproachable and the current law has not proven to be an effective constraint against banks' recklessness. For example, in the US, there is no general federal law which provides for the common law grounds of contractual recoverability.[202]

6.4. DIFFERENT CONCEPTS OF JUSTICE, IN DISPUTES

The easy flow of efficient facilitation of international finance in a global society requires the social efficiency of both the legal and the judicial systems to be a reality-not only in certain parts of the globe but in substantial parts of it. In Egypt, the battle to obtain payment does not end with the receipt of court's "final" judgment. It takes months of chasing and pursuing debtors in order to get them to pay. In Indonesia, the reduced percentage of debts that can be effectively collected after a court judgment is a mere small percentage of the original amount. In Poland, the debt collection process is so long, costly, and cumbersome that the government has had to exonerate banks from the need to resort to a judge to collect privileged debts. In order to prevent the collapse of its banking system, banks demand directly from the debtor through the sheriff of the court.

In Russia, a number of bank insolvencies during the early nineties created chaos in the courts with long lines of complainants waiting all night for several weeks to present their complaints. In some cases, mobsters and gangsters were used to act as debt collectors and court enforcers on behalf of the winning party. In Albania, the collapse of the pyramid system in some financial institutions created havoc that required intervention from abroad to calm the riots that followed. In all such instances the societies and the public in general looked for *alternatives* to settling financial disputes promptly.

[201] Bordo, Michael D. *"An historical Perspective on the Crisis of 2007-2008"*. No. w14569. National Bureau of Economic Research, 2008.

[202] *Erie R.R. v Tompkins, 304 US 64 (1938)*

6.5. SOCIAL EFFICIENCY IN RESORTING TO ARBITRATION

The social efficiency of international arbitration in solving financial disputes depends on more than just good laws. Of course, laws provide the adequate social and legal framework within which a dispute is legally resolved. Laws are necessary but not sufficient alone because arbitration requires other external elements in order to fulfil its true role in society. Countries as diverse as Russia, Egypt, Indonesia, Guatemala, or Peru have reasonably good arbitration laws and institutions, yet they are far from successful. While it may be true that a good arbitration can take place in those countries, arbitration is not socially, politically, or economically significant there.

Arbitration cannot fulfil its important social role for the citizens of those countries partly due to the current stereotype of arbitration, especially those sponsored by business associations such as banks and insurances. The ombudsman type of dispute resolutions processes are perceived by the public, even in the Western Hemisphere as biased against customers, and arbitration awards tend to be nominal and slow to realise.[203]

Thus, the need to look for alternatives remains. In many countries the general public distrusts the judicial system when looking for justice in their legal claims. But in most of these countries, there is more a culture of authority than a culture of service. Instinctively, when people look for an alternative they look for an option with authority and power. In Guatemala, for example, many farmers would resort to the mayor of the town, or even to the military head of the local regiment instead of local courts.[204]

In Albania, the elders of the towns in the mountains exercise a natural and effective authority in their communities. But that is of little consequence as far as financial disputes are concerned. As a result, the public lacked a valid alternative for justice when faced with a financial crisis that the courts were not able to handle, and the outcome was an eruption of violence. Panic erupted as people found no alternative to resort to when seeking recuperation of their rights.[205] In Peru, Indonesia, Egypt, and the Philippines, large sectors of the population trust neither the official system nor the ombudsman style offered by other local institutions.

Other alternatives include compulsory arbitration by law. This can take place by forcing parties to submit to arbitration or conciliation before going to court, so that actually going to court would be the last resort when all other venues are exhausted. However this enforceable step however, could, if applied well, be converted into a mere formality rather than an alternative to an official proceeding. This happened earlier this century in Latin America when new procedural codes were enacted that called for a conciliatory hearing at the

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[203] Roberto G. MacLean, *The Social Efficiency of Laws as an Element of Political and Economic Development*, 4 NAFTA: L. & Bus. REv. AM. 6 (Spring 1998).
[204] Hernando De Soto, *Other Path: The Invisible Revolution in the 3rd World* (June Abbot trans., 1989)
[205] MEKA, E., *"In Brick & Mortar We Trust!"* BANKIERI Magazine (3), AAB, April 2012, p.5.

beginning of the procedure. A legal culture of lawyers and judges converted it, in a few years, into one more step in a procedure already too long.[206]

6.6. PARTICIPATION OF THE COMMUNITY.

One of the features of conflict resolution systems, especially arbitration, is the involvement of the community in the solution process. Arbitration systems have neither their own economic sources nor their own armed forces. Their true authority resides in the backing they receive from the community and public opinion. The true force of alternative resolution systems is in the power of persuasion and in moving public opinion.[207] In Peru, in a survey made under the auspices of the United Nations Development Program, three out of four crime victims thought that the system was corrupt. The general perception in Jakarta, Indonesia, is that "justice" belongs to the highest bidder, and the system in Russia is run by politicians. In all of these countries, participation by the community is almost non-existent.[208]

The difference with arbitration is that it is based on voluntary participation and cannot exist without public participation. The growing importance of arbitration in international finance, and its shortcomings have to be measured mainly by the participation of the community. This is an aspect in which arbitration could be more successful with a much larger capacity to grow. However, for all of its impressive achievements, arbitration remains elitist to a certain group of the society. There is a whole new field to cultivate and there the need to be more approachable in developing new methods to gain social approval in a complicated market such as banking and finance.[209]

7. ANTICIPATED SOCIAL EFFECT OF PROPOSAL IN THESIS

As described in Chapter One, compensatory legal remedies are remedies designed to make victims whole.[210] According to theories of corrective justice, compensation also enforces moral duty. Those who commit wrongs incur a moral obligation to alleviate the losses they have caused.[211] The goal of remedies in law is to rectify, as far as possible, the harmful consequences of legal wrongs. Ideally, victims are restored to their "rightful position," meaning the position they would have been in if no mistake had been made by another party.[212]

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[206] Roberto G. MacLean, *The Culture of Service in the Administration of Justice*, 6 TRANSNAT'L L. & CONTEMP. PROBS. 139 (Spring 1996).

[207] Sergio Puig, *'Social Capital in the Arbitration Market'* (2014) 25 European Journal of International Law

[208] Ibid. s.n. 304

[209] Global Arbitration Review, GAR 100 – 7th edition (2014), including the 'GAR 30 – commentary and analysis', available online: http://globalarbitrationreview.com/gar100/ accessed 11 February 2018.

[210] I. E.g., I DAN B. DOBBS, *DOBBS LAW OF REMEDIES: DAMAGES-EQUITY RESTITUTION* § 1.1, at 3 (2d ed. 1993) ("*The damages remedy is a money remedy aimed at making well the plaintiffs losses.").*

[211] JULES L. COLEMAN, *RISKS AND WRONGS* 374-75 (1992) (*describing a "mixed" conception of corrective justice*); Stephen R. Perry, Loss, *Agency, and Responsibility for Outcomes: Three Conceptions of Corrective Justice, in TORT THEORY* 24, 25-26, 38-47 (Ken Cooper-Stephenson & Elaine Gibson eds., 1993) (describing a "comparative" conception of corrective justice); cf Ernest J. Weinrib, Corrective Justice, 77 IOWA L. REV. 403,421-24 (1992) (tracing a connection between corrective justice and Kantian natural right).

[212] DOUGLAS LAYCOCK, *MODERN AMERICAN REMEDIES: CASES AND MATERIALS* 15-16 (2d ed. 1994) (explaining that restoring the plaintiff to his "rightful position" is "the essence of compensatory damages").

Nevertheless, there is a problem of fit between the stated goal of compensation and the details of compensatory remedies that raises questions about the practice of compensation in courts.[213] The results of this limited focus in courts are often at odds with the stated goal of an equitable ruling in arbitration. That is reconstructing the position of the claimant as it would have been if no breach had occurred.

It is hard to object to compensation, so described. Compensation protects entitlements, expresses society's respect for the victim, and provides aid to those who have suffered harm. From an instrumental point of view, compensatory remedies provide incentives for efficient behaviour by forcing injurers to internalize the costs of their activities and by reducing the need for potential victims to take wasteful precautions. [214]

There are parallels here to Émile Durkheim's argument that compensation should be considered as punishment which in turn should be considered a moral phenomenon. While crime violates the moral order in society, compensation serves an expressive role of reaffirming social bonds and defining the boundaries of social groups against those who break their moral commitments.[215]

According to theories of corrective justice, compensation also enforces moral duty. Those who commit wrongs incur a moral obligation to alleviate the losses they have caused. Banks and financial intermediaries play important roles in bridging information asymmetries and monitoring entrepreneurs on behalf of their investors. When an investor raises doubts about the authenticity of a transaction, a large corporation or bank initially challenges that claim. It makes the task heavy for the investor to litigate their claim in the local courts where that corporation resides. An effective dispute resolution system is therefore imperative in the financial services industry if social rights are to be upheld and public order to be maintained. However, the question of enforceability of the award (paying out the winning party) remains the ultimate objective of an effectual arbitration process.

The social effect of the proposed instantaneous payment of awards mechanism materialises in the perception of security the public will acquire towards their banks and financial institutions. The public and tax payers will be spared the anxiety of seeing these financial titans disputing while their own monies held by those institutions are at stake depending on the outcome of those disputes. An arbitration process with a model method of settling awards through the proposed "bank network clearing forum" will keep matters between banks.

Moreover, a mechanism that allows holders of awards to receive their money instantly within the same network of banks will give an added value to markets' liquidity. If a bank is facing difficulties to pay-out the awards due to liquidity squeeze, it can have the awards against

[213] I DOBBS, supra note 183, at 286-87 (*identifying "[t]he role of compensation in damage remedies" as an important issue of remedies doctrine*); LAYCOCK, infra note 186, at 16 (*noting the impossibility of complete restoration*).

[214] Richard A. Posner, *ECONOMIC ANALYSIS OF LAW* § 6.10, at 192 (6th ed. 2003) (discussing the incentive effects of tort damages).

[215] Portis Larry. Les fondements politico-idéologiques de la Sociologie Durkheimienne . In: L'Homme et la société, N. 84, 1987. Éthique et science sociale. pp. 95-110.

them discounted through the "clearing forum" network. Public confidence in the bank will remain, which in turn can relieve public tension and avoid panic runs. Social and institutional confidence in a mechanism that delivers instant justice can have a deterring effect on the risk taking factor which is the main cause of financial crises.

7.1. CONFIDENCE IN BANKS DERIVED FROM RESOLVING THEIR INNER DISPUTES

Financial arbitration has frequently dealt with disputes involving special complicated transactions or interbank contractual problems. Nevertheless, recognition and pay-out of arbitral awards remain two separate stages. Local courts under the rules of the NY Convention can still deny enforcement, vacate or refuse validation of international awards subject to public policy or domestic procedural laws. Such authority of domestic courts still causes uncertainty in the financial markets which reflects on social scepticism.

This thesis is proposing, a forum of banking and financial institutions for award settlement, developed within the already existing network of the security and fund clearing international financial market place. This can be a solution to hurdles facing the recognition, enforcement and pay-out of financial awards. [216]

Financial arbitration has frequently dealt with disputes involving special problems, perhaps more visible if there is an intervening bankruptcy which could have been the case, as with Lehman Bros. In a research led by The American Economic Association and European Monetary Union *(EMU)*, it was found that EU banks' default rates on subordinated bond spreads and market fluctuations have proven to be true indicators as to the fragility of a bank. Both indicators were demonstrated to be complete indicators of bank fragility. [217]

The research used two different econometric models on EU Banks. The findings supported the view that both the distance-to-default and spread are leading indicators of bank fragility, regardless of econometric indicators. In other words, the research found that in cases where investors claiming earlier disputes, they presented earlier signals as to the possible default events of the disputant bank. The research shows that such disputes significantly improve the analysis and expectations of public bailout. [218]

In essence, what this empirical research confirms is that a dispute resolution method that encourages investors to come forward at the first sign of banks faulting, can serve as a significant indicator for a regulatory authority and the state to investigate. Actions of moral hazard and risk taking can be deterred early and crises resulting from failing banks circumvented.[219]

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[216] Emmanuel Gaillard, *Transnational Law: A Legal System or a Method of Decision Making?* 17 ARB. INT'L 59 (2001).

[217] Vulpes, Giuseppe & Gropp, Reint & M. Vesala, Jukka. (2002). *Equity and Bond Market Signals as Leading Indicators of Bank Fragility*. SSRN Electronic Journal. 10.2139/ssrn.318359.

[218] American Economic Association JEL Classification: G21; G12.

[219] Javier Bianchi, *Efficient Bailouts?,* American Economic Review, December 2016 www.aeaweb.org/articles?id=10.1257/aer.20121524

7.2. THE CONCEPT OF SPEEDY DISPUTE RESOLUTION

The term “moral hazard” within the financial sector refers to undeterred practices of reckless misconduct, mis-selling and sequestration of depositors’ funds. It refers to actions in the wake of the 2008 bank bailouts after the global financial crisis. Scandals were showing in different countries such as the “Libor” rigging scandal and mis-selling of protection insurances, such as Payment Protection Insurance (PPI) in the UK, and the Mortgage Financial Protection Policy in France. [220]

Financial institutions’ actions of mis-selling, misrepresentation, information asymmetry and excessive risk taking created international public demand for alternatives to powerless financial regulatory authorities. A study by the IMF[221] on 687 banks and corporations from eight crisis countries has empirically shown that a consistent framework of dispute resolution that includes bankers facing the right framework of retribution is a missing key in financial institutions dispute resolution methods.

It is, therefore, deemed necessary to examine trends in disputes in financial transaction structures and the agreements upon which dispute resolution is decided. The following step is to then distinguish financial disputes from other forms of commercial disputes. From this point, challenges that arise in disputes on failing investments can, in view of economic and social effects, be segregated and examined to find the suitable method of resolving them.[222]

In the process, consideration is given here as to how investors reacted to dispute problems raised during and after the 2008 global financial crisis. This relates to the types of disputes in investment transactions solicited by banks and investment brokers. Disputes mostly relate to investments in securitised notes with contracted predefined dispute resolution processes regarding agreed promised income and allocated risk rating.

On the other hand, as this thesis is proposing, a patented clearing and award clearing framework developed within a network in the international financial market can be another solution to hurdles facing the enforcement and pay-out of financial awards. An instant financial dispute resolution process can help accelerate the recovery from a crisis and reduce acts of systematic moral hazard actions. An arbitration process is as efficient as the enforceability of its awards can be. The instantaneous payment element can therefore begin to function through any of the existing payment clearing systems used currently by banks in daily transactions such as SWIFT, European Standard Bank (ESB), TARGET, etc. The

[220] The Financial Conduct Authority (FCA) has fined three former senior executives of Swinton Group Limited (Swinton) £928,000. The FCA’s action follows previous enforcement action taken against Swinton: in 2013 it was fined £7.4m after it adopted an aggressive sales strategy that resulted in mis-sales of monthly add-on insurance policies; and in 2009 the firm was fined £770,000 for failures in its sales of PPI. www.fca.org.uk/news/former-swinton-executives-fined-and-banned-misselling

[221] *Real Effects of the Subprime Mortgage Crisis; Is it a Demand or a Finance Shock?* 2008 IMF Working Papers Volume: 8, Issue: 186, pp 1

[222] Claus D. Zimmermann, *A Contemporary Concept of Monetary Sovereignty*, Oxford University Press (2013)

enforceability of such mechanism will derive its substantive enforceability from the New York Convention 1958.[223]

Another aspect of this framework is that instantaneous clearance of arbitral awards will allow awards to be traded as short-term debt securities. It will present *ex ante* burden sharing arrangements within financial institutions in a crisis, without placing stress on the state in bail-out efforts. Banks having liquidity problems will have available funds to pay the awards. The mechanism will aid in liquidity creation in the financial markets. This will permit banks to use the awards as short term financing tools to support each other without deleterious impact on their balance sheets.

8. CONCLUSION

Moral hazard in the financial sector was one of the major contributors to the global financial crisis of 2007-2008. However, moral hazard within the financial services and financial intermediaries sector is not an issue relevant only to the design features of deposit insurance schemes.

A foundational premise of market discipline is that investors, individually or collectively will signal elevated bank risk through some sort of disputing action. Investors and creditors can efficiently overlook their banks' risk taking individually through self-interest actions. In total, individual surveillance can represent collective public supervision.[224] This has been a central pillar of banking regulation since the late 1980s. However, during the 2007/2008 financial crisis, millions of investors ended with worthless securities and investment agreements.

The initial units of analysis are the contractual rights of the parties in asset management agreements. The notion of forging financial agreements with a financial service provider such as a bank or stockbroker is the basic point of an investor's right to dispute the actions of the service provider. On the other hand, the consent of the financial institution to be bound by an arbitration process that will expedite compensations to disputing clients into instant payments, will have a positive effect on combating moral hazard activities in the banking and financial sectors.[225]

At that point, the intention of the parties at the outset is what gives the parties the right of instigating the dispute process. The analysis here is built upon the premise that:

(i) should award enforcement become an instant process in financial disputes, investors will be motivated to survey their bankers closely and report unaccepted actions through dispute;

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[223] *The Convention on the Recognition and Enforcement of Foreign Arbitral Awards*

[224] T. Cole (ed.), *The Roles of Psychology in International Arbitration* (Series: International Arbitration Library) (Kluwer 2016)

[225] *Damages in International Arbitration under Complex Long-term Contracts*, by Herfried Wöss, Adriana San Román Rivera, Pablo T. Spiller, Santiago Dellepiane, edited by Loukas Mistelis, Oxford International Arbitration Series, 2014.

(ii) as was witnessed in the 2007/2008 crisis, standard financial rules and regulations currently in place are constricted when it comes to granting immediate remedy to investors; and

(iii) Bankers will be discouraged from acting in hazardous and immoral ways as they see that penalisation is instantaneous and will affect them personally as well as their institutions.

The framework will be comparable to clearing of payment orders. Such a process can start operating immediately because interbank payment networks are in place and functioning.

The *award debtor party* such as a bank or financial services provider that attempts to avoid payment under an award can face immediate capture of its funds held with other correspondent banks within the global banking network. The enforceability of such capture will derive its legality from the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards.

CHAPTER THREE

MORAL HAZARD IN FINANCIAL DISPUTES

Moral hazard in its multi-faceted forms within the financial sector does not owe its existence to deposit insurance schemes only. It has developed due to none existence of clear retributive forums in face of fraud, mis-selling, `self-dealings, information asymmetry, irregularities in business cycle fluctuations, and insufficient asset diversification.[226]

This chapter explores moral hazard in general and determines which dispute resolution method can act as a punitive mechanism for acts of moral hazard especially in relation to the Financial Crisis. It explores the views on acts of recklessness and mis-selling in the banking and financial sector. Analysis is made of the moral hazard actions leading to the crisis of 2007/2008 and building upon the way in which the financial authorities reacted to signs of high-risk transactions at the onset of the financial crisis.

In earlier chapters, we considered the different approaches to understanding financial and banking disputes and to come to the reality that although the damage done during the financial crisis 2007/2008 cannot be overturned, the sharpening of bankers' accountability can make it less likely for the recurrence of similar calamities. Chapter Three leads to the conclusion that an arbitration process with expeditious award payment will impede moral hazard in banks and speedily redress interbank disputes which can curb public panic and encourage ethical morals within the financial sector.

1. THE NATURE OF MORAL HAZARD AND THE FINANCIAL CRISIS

It can be observed all over the world that more attention is being given for the financial sector than any other sector in the economic systems in all countries around the world.[227] There are two main reasons for this:

- **First:** it is held by almost every country that special depository protection has to be provided to their citizens due to the fiduciary nature of financial institutions receiving, accepting and managing public wealth in the form of deposits, loans, mortgages and various forms of investment contracts.

Fluctuations and instability in financial markets, however, have proven historically that the public have to be protected from high risk transactions that financial institutions may get into with the possibility of any opportunistic behaviour.

[226] Kevin Dowd, "*MORAL HAZARD AND THE FINANCIAL CRISIS: Lessons from the Subprime Crisis*", Cato Institute, Washington DC, November 19, 2008
[227] Ibid. *supra note* 2

1.1 REGULATORY AUTHORITIES

There are many forms of investment transactions with some bearing higher risk than others. Placing a deposit with a bank is a form of investment. However, other forms of complex investment contracts such as futures currency exchange markets, derivatives, and securitised and non-securitised financial market products are also classified as investments, albeit high risk investments.

To be able to perform their supervisory role, complex systems of regulatory interventions are being set up by financial regulatory authorities specifically to supervise banks and financial institutions for the protection of investors including depositors. In short, governments believe that they should protect the economy from financial institutions and protect financial institutions from themselves.

- Second: money and liquidity constitute the core of a country's financial system. With transactions involving corporate and individual investors, the protection of investors, whether individual or corporate, is instrumental in the containment of and recovery from a crisis.[228]

Financial markets and institutions are much more interconnected and characterized by 'herd behaviour' than any of the other sectors of the economy.[229] Financial linkages between countries, in the form of interbank activities, have been singled out as a key channel of international crisis transmission. According to an International Monetary Fund study by Lindgren, Garcia and Saal (1996), statistics show that since 1980 about 133 IMF member countries have experienced significant banking sector problems.[230]

On the other hand, empirical evidence shows that different forms of moral hazard in the financial sector are customary and prevalent. It occurs with individual clients and within interbank transactions. It takes various forms of information-asymmetry, mis-selling and adverse-selection in almost every depository or investment contractual agreement.[231]

These empirical results have important particulars of how some large banks and financial firms transacted with the outside world prior to 2008 financial crisis. They show that certain firms and banks attempted to avoid their own bankruptcy by unloading bad assets onto other banks and financial institutions without clearly explaining the bad nature of such assets to the buyers.

The adverse selection caused by such information asymmetry created an imbalance in investment decisions taken by governments as well as financial institutions. In turn, this caused a chain reaction of financial failures leading to a kind of a global financial market failure.

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[228] International Monetary Fund, IMF (2010), *The Fund's Role Regarding Cross-Border Capital Flows*, Report prepared by the Strategy, Policy, and Review Department and the Legal Department, November 15th.

[229] Schnabl, P. (2011), *Financial Globalization and The Transmission of Bank Liquidity Shocks: Evidence From an Emerging Market*, Journal of Finance, Volume 67, Issue 3, June 2012, p. 897–932

[230] Lindgren et al (1996); **(Frydl, 1999)**

[231] Alberto Martin, *Adverse Selection, Credit and Efficiency: The Case of the Missing Market*, JEL Classification D82, G20, D62 (2010) http://www.econ.upf.edu/~martin/missingmarket.pdf

Bankruptcy of financial institutions spilled over to others in different countries and endangered the entire world financial system. The unmonitored presence of mis-selling and information asymmetry has proven to lead in certain cases to almost total shut down of financial markets, as happened in 2008.

1.2. MORAL SENTIMENT AND THE FINANCIAL SECTOR

Much of the focus of the resulting moral outrage has been on the remuneration of bankers. Regulators' focus was on the structure of remuneration which incentivised undue risk-taking and the general public's focus has been on the pay-offs to senior executives of failed banks. Large bonuses were paid to bankers whose activities were most closely involved in the run-up to the crisis. Much of the concern was about the perversity of apparent rewards for a highly imposed cost on society. This outcome seems to fly in the face of the principle of natural justice that society expects.

The mainstream analysis of moral hazard assumes behaviour to be rational with respect to opportunistic self-interest. It is opportunistic in the sense that a party takes advantage of an opportunity for "personal benefit" even if it is at the expense of others. The term "personal"' here refers to a more general meaning of the word, where the opportunistic party can be an individual or an entity.[232]

Moral hazard in the financial sector has been analysed in relation both to investment contracts and to state support for banks in the form of deposit insurance schemes. As far as investment contracts are concerned, it relates to the relationship between an investor trusting in a product sold to them by a financial service provider.

Opportunistic behaviour on the part of the service provider in this case can be the act of concealing the actual risk exposure the investor will be taking. Banks were able to stipulate contracts to cover all the risk behaviours so they could increase their sales and true interest in rewards.

The presumption that risk was knowable to both parties continues to underlie analyses of the crisis as resulting from information asymmetry.[233] Understanding moral hazard is fundamental to understanding how the economy works. Moral hazard can be defined in incidents when one party is responsible for the interests of others but has an incentive to put their own interests first.

Moral hazard actions such as these are pervasive and inevitable features of the banking industry and of the financial sector in general terms. Dealing with them by keeping them under reasonable control is one of the principle tasks of financial regulatory authorities worldwide. The significance of the concept that moral hazard itself exists in so many forms, is not in identifying what actions qualify as morally hazardous. Instead, it is in the identifying

[232] White, M. (2011). Kantian ethics and economics: autonomy, dignity, and character. Stanford University Press.

[233] Calomiris, C. (2009). Banking Crises and the Rules of the Game (No. w15403). National Bureau of Economic Research.

of the undesirable results of such actions on the mass and the ascertainment of delivering the correct process to control the reactions of the mass.[234]

There is no denying that the 2008 financial crisis delivered a major seismic shock to the policy landscape. In country after country, we saw governments panicked into bailouts and nationalizations of banks and large financial corporations on an unprecedented scale. Stories took hold between the public and in societies around the world of the excesses of greedy bankers walking away with hundreds of millions in bonuses whilst taxpayers bail their institutions. Bankers used bailout money to pay excessive bonuses and the moral of risk practices remained.[235]

It is beyond dispute that the 2008 crisis was due to a failure of the financial and economic model of governing financial institutions and banks. The IMF Global Asset Report (2016) estimates the total global size of assets under management at $74 Trillion by the end of 2015, down from $102 Trillion in 2008. [236]

During the crisis, markets witnessed massive unloading of bad assets from failing banks onto other banks and investors through mis-selling. Fundamental concerns about universally embedded moral hazard in the financial sectors were brought to surface. This stimulated further debates that banks were concentrating purely on better financial returns and ignored the societal cost of their flawed investment decisions. [237]

Whether as a cause or an effect, universal moral hazard in the banking and financial corporate sectors is often an element of a major global crisis.[238] The containment of a financial crisis involves many economic strategy choices ranging from macro to micro economic monetary and fiscal policies.[239] However, attempts of containment through legal channels are rarely exercised except in situations of bankruptcy and resolution of struggling banks.[240]

[234] Dowd, K. (2009). Moral hazard and the financial crisis. Cato J., 29, 141

[235] One example story from the UK: Whilst the Northern Rock workforce could anticipate major job losses, the CEO, Mr. Applegarth was able to retire on a generous settlement package. It also transpired that he had been quietly cashing in his own Northern Rock shares – a nice vote of confidence in his own leadership. He managed to get £2m for his shares whilst other shareholders lost everything.

[236] Brunnermeier, Markus K, et al. *The Fundamental Principles of Financial Regulations*, International Center for Monetary and Banking Studies Centre for Economic Policy Research, Geneva 2009.

[237] *IMF Global Asset Allocation Report, Chapter III*

[238] Dow, S. C. (2010, October). Moral hazard and the banking crisis. In FMM Conference, Berlin (pp. 29-30).

[239] Lars P Feld, C.M. Schmidt, I. Schnabel & V. Wieland, *Divergence of Liability and Control as the Source of Over-Indebtedness and Moral Hazard in the EMU (2015)*, German Council of Economic Experts and Centre for Economic Policy Research, CEPR Press 2015

[240] Padma D., *Financial Crisis, Contagion, and Containment: From Asia to Argentina*, Princeton University Press (2014)

2. SYMPTOMATIC MORAL HAZARD

Moral hazard in banking and financial institutions is defined when one party is responsible for the interests of investors' assets but has no deterrent from placing their own financial gain as a priority. [241]

Examples include transactions where:

- Asymmetric information leading to adverse selection **-** Banks sell financial products such as mortgages or loans, knowing that they are not suitable for the investor[242]
- Acquiring large disproportionate bonuses out of managed funds - Executives pay themselves excessive bonuses out of funds that they manage on behalf of their depositors
- Subsidised risk: if clients gain the banker will gain, if the client loses the banker will still gain. Taking unwarranted risks that clients or the state will ultimately bear - Officers and directors knowingly take high-risk decisions, which their clients will have to bear.

2.1. ASYMMETRIC INFORMATION

Information is an imperishable and accumulating tool in the financial world. Entities and investors base their decisions on information gathered from their financial services provider. It is in this sense, as mentioned earlier in Chapter Two, asymmetric information takes the form in acts of mis-selling financial products while hiding the fact that they are not suitable for the buyer.[243]

Information asymmetry in contract theory and economics deals with the study of decisions in transactions where one party has more or better information than the other. This creates an imbalance of power in transactions, which can sometimes cause the transactions to go awry. This creates an imbalance of power and a kind of market failure in the worst case. Results of such practices are adverse selection by the other party in the transaction and information monopoly on the part of the bankers.[244] As discussed earlier, the narrowest definition of asymmetric information is that a financial institution hides the true risk concerning certain securities and will not credibly reveal its intrinsic value to a potential buyer. [245]

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[241] Gary B Gorton, *The Maze of Banking: History, Theory, Crisis*, Oxford University Press (2015), S.17.4.5: *Securitization with Moral Hazard and Strategic Adverse Selection*; p553

[242] *Springwell Navigation Corporation v JP Morgan Chase Bank [2010] EWCA 1221* (the documentation contained risk disclosures and disclaimers that excluded and limited the bank's liability, all of which negated the existence of a duty of care, a fiduciary duty and negligent misstatement).

[243] Hubbard, G. (1990), *Asymmetric Information, Corporate Finance, and Investment*, University of Chicago Press, 1990 http://www.nber.org/books/glen90-1

[244] George A. Akerlof, *The Market For "LEMONS": Quality Uncertainty and the Market Mechanism*, Quarterly Journal of Economics, Vol. 84, No. 3. (Aug. 1970), pp. 488-500

[245] G. Cappelletti, G. Guazzarotti, *"The role of Counterparty Risk and Asymmetric Information in the Interbank Market"*, European Central Bank, ECB Working Paper 2022, February 2007

Asymmetric information problems call for public intervention in financial markets. The errs in regulation and supervision of financial institutions, as well as other instruments such as depositors and investors disputes are fundamental factors in financial market failures. It provides grounds for moral hazard on the part of financial intermediaries and the adverse selection suffered by investors. [246]

2.2. LARGE BONUSES

Profitability and bonuses are endemic moral hazards within banks and financial institutions and lie at the core of institutional functions. Some of these are:

- Self-preservation through corporate capital preserving
- Maximising profits
- Financial compensations and bonuses

However, the mainstay of moral hazard is in the lack of alignment of third party investors' interests with the interests of the financial institution. This occurs even if that third party is another bank or the state itself. There are misalignments of services granted by financial companies and banks, which provide the incentive for such actions.

Fees, incentives and bonuses for traders and financial managers are paid out upfront with no penalties for deferred losses or poor performance. Again, the problem is that agents and traders are working for the creation of profits for their firms and bonuses for themselves and not primarily for the interests of their investors.

3. MORAL HAZARD IN CONTRACTUAL AGREEMENTS

At the core of financial crises lie failed financial contracts. Moral hazard actions such as those mentioned above are persistent practices of the industry as a whole and a customary characteristic of the banking sector. Dealing with them requires fundamental institutional restructuring of the types of contracts used in banking and financial transactions. The aim is to hold financial institutions and their executives as party to the contract and personally responsible.

As mentioned earlier, moral hazard can be defined as when a party responsible for the interests of other parties, decides to put their own interests above those of the others. The significance of the concept itself is not in identifying what may qualify as hazardous actions, but instead it is in the undesirable results of such actions to be controlled.

However, market requirements may require parties to enter into agreements that are more specific. This should, in principal focus on arbitrable issues related to moral hazard disputes rather than contract law. For example, in financial transactions, it is common for parties such

[246] RN Bebczuk, RN Bebczuk, *Asymmetric Information in Financial Markets: Introduction and Applications*. Cambridge University Press, 2003.

as banks and investment firms to insert clauses into contracts, which affirm the restriction of the other parties' right to claim for extra-contractual allegations.

Those contracts are expressly formulated to acknowledge the clients' declaration that they chose to enter the contract out of their own free will and they have not been induced by any representation or solicitation. Such clauses are inserted to eliminate possible future allegations of mis-selling.

However, those contracts are being phased out gradually for two main reasons:

1- Banks began to realise post crisis that they also were victims of mis-selling and were estopped from claiming damages because of those contracts.

2- Should the dispute arrive to arbitration, arbitration tribunals adjudicate on the merits of the dispute and on the interpretation of contracts. The tribunal can use its discretion to look at the nature of the transaction and the possibility of it being transacted without solicitation on the part of the bank.

3- The arbitration tribunals can also look beyond such standardised agreements to reach the parties' intention at the time of entering the agreement. The approach of arbitration tribunals to contract interpretation has important implications for the success of arbitration as a means for the resolution of international financial disputes.

Arbitrators are more likely to apply a more equitable commercial attitude, unlike courts and presiding judges who are bound by governing laws and strictly defined financial rules and regulations within the judicial system.

Substantive contract law and fundamental contractual agreements in dispute resolution systems have developed over time in no small part of the industry. Such developments came in response to global acts of mishandling of savers' funds. In general, contractual provisions determine formal financial transaction agreements and the process of resolving arising disputes.

4. GOVERNANCE OF MORAL HAZARD IN BANKS

As mentioned at the onset of the chapter, the ingredients of moral hazard in the financial industry are not only affiliated to risks taken under deposit insurance schemes. Moral hazard is widely associated with acts of misselling, misrepresentation, self-dealings, information asymmetry, irregularities in business cycle fluctuations, and insufficient asset diversification. However, it is important to evaluate moral hazard in general and determine which dispute resolution method can act as a retributive mechanism for acts of immorality such as information asymmetry and mis-selling.

Traders and executives of a financial institution have an incentive to be engaged in high risk transactions to secure higher compensation and bonus pay-outs. When such institutions start to face trouble because of the actions of their traders, depositors will mistakenly start running on other banks that may have not even been engaged in high risk transactions or moral hazard.

However, questions are raised by the public concerning the support given to financial institutions in trouble. The questioning focuses on the expansion of the financial safety net through extended reliance on government resources and taxpayer's money and it is centred upon the following points:

(I) whether any government finances can be adequate to support the promises of existing insurance schemes in other future crises of stress

(II) how to balance the objectives of preventing bank runs with the potentially negative effects of deposit insurance schemes and other forms of moral hazard

(III) the threat to financial stability from incentives and awards given to traders for aggressive risk-taking

In the opinion of Reinhart and Rogoff,[247] financial institutions' failures involve two interacting factors:

1. The inability of financial authorities to prevent financial service providers from unwise usage of investors' money in excessive risk transactions.
2. How can financial institutions be compelled to repay misled clients the money they have lost through risky transactions, and who can do this?

The argument is that bankers can commit to not engaging in moral hazard if they anticipate that clients can trace unauthorised transactions and successfully force bankers through some sort of judicial process to repay back what they have lost. The thought behind this is that regulators are limited when it comes to compensating injured investors.

This is because the power of the regulatory authority to issue and publish legal rules and put them into practice is always limited by the licensing rule of the law. What regulators can impose on banks and financial sector institutions can either be by a statutory instrument duly passed by the legislature or at ad hoc where the judiciary accept certain regulatory practices as legally enforceable.[248]

Quantitative measures imposed by financial regulators were not able to capture qualitative problems such as poor management even where asset impairment had been properly measured. For example, prudential deficiencies and lack of confidence in the financial conditions of banks had a different impact on financial institutions than it had on securities intermediaries such as brokerage firms, investment banks and insurance companies.

Furthermore, the primary emphasis for financial regulators is on investor protection and market efficiency considerations. They rely on disclosures coming from financial institutions

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[247] Carmen Reinhart and Kenneth Rogoff, *This Time is Different: Eight Centuries of Financial Folly* Princeton University Press, Princeton NJ (2009).
[248] *Bank of Scotland v Investment Management Regulatory Organisation Ltd, [1989] SLT, 432.*

and on assumed market discipline and an effective accounting framework. In the banking and insurance sectors, regulators focused primarily on an institution's ability to meet its obligations to depositors and policyholders, with some attention to systemic stability in banking. So far, none of those legislative authorities has produced the process for compensating investors for losses caused by irresponsible financial services providers. [249]

5. HIDDEN MORAL HAZARD

To fully understand the role of moral hazard in the global financial meltdown of 2008, it is important to understand the subprime mortgage structure. Why was it considered by many experts to be the main reason for the global financial crisis?

There is little doubt that the collapse in the subprime market led to the crippling of key financial institutions in 2007 which in turn led to the crisis.[250] Mammoth firms like AIG, Lehman Brothers, and Bear Stearns collapsed and liquidity around the world was drained. [251] The bonds were assets backed by high risk mortgage loan contracts bundled together with other highly rated securities. They derived their value from high credit ratings by Moody and S&P and the expected elevated cash flows generated by repayments on the bundled mortgages.[252]

However, for diversification purposes, banks which generated such securities simultaneously bought other securitised bonds generated by other banks. This meant that banks selling subprime notes from one end, were buying it back from the other end knowing or unknowing of the true associated risk.

5.1. DERIVATIVES

A derivative is a financial instrument that derives its value from the expected future value of an underlying asset or commodity. In other words, it is an agreement between two speculators that an asset is actually worth something in the future, other than its current market price.

Derivatives are a known tradition in monetary economics and financial markets that go back to the 19th century. They are known as financial market security derivatives". Many of the instruments presented by financial institutions caught up in the crisis were part of the centuries' old phenomenon of financial innovation. New derivative instruments are often devised to avoid regulations.

The rise and fall of financial institutions and instruments occur as part of a long-standing pattern of booms and busts in the securities markets. Securities include equities, land, commodities, foreign exchange and other assets. Those cycles are financed through margin credit to enable speculators to use non existing funds to gamble on the movement of the

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[249] David Marston and Udaibir S. Das, *Financial Sector Regulation: Issues and Gaps*; IMF Working Paper Aug. 4, 2004

[250] Financial Crisis Inquiry Commission (FCIC); *ibid supra note 20*

[251] Davis, Gerald F. "*Managed by the Markets: How Finance Re-Shaped America*". New York: Oxford UP, 2009. Print.

[252] Ashcroft, Adam & Til Schuermann; Understanding the Securitization of Subprime Mortgage Credit. Federal Reserve Bank of New York: Staff Report, 2008.

markets. Booms and busts of credit cycles are also related to the business cycle of the economy.

The underlying assets for those transactions can be virtually anything. Derivatives can be traded on stocks, oil prices, oranges or even the weather. A very important principle and point to make is that derivatives allow speculating investors to make money from assets that they do not actually own.

As such, they also are gambling with money that they do not own. When losses occur, speculators and banks have to cover the cost of the transaction plus the losses attached to it. This is where the true risk of derivatives to the overall financial system lies and this is what happened during the course of 2007-2008 when banks gambled on the property markets boom.

Conversely, by purchasing the debt obligation to the mortgage, investment banks became liable for covering the unpaid debt if the mortgage defaulted. This meant that the sooner they turned around and sold the notes to their investors, the sooner they could realise their profitability and most importantly, reduce the acidity on their balance sheets.

Investors in turn held all the risk. Lenders themselves were able to create subprime mortgages without taking on the risky long-term debt. They were able to do so because they would sell the debt obligations to the investment banks immediately upon inception of the mortgage. This way they passed on the liability to the packaging bank that ultimately passed it to the market.

However, as explained earlier, for a lender who generates a mortgage agreement with a view to passing it on to a third party through securitisation, the incentive to take higher risk and hide the true nature of the credibility of the loan is seriously heightened.[253] In this case, the lender sells on the open market securitised mortgages, bundled with other over-rated loans and has no further concern whether the borrowers default or not.

The only concern for those brokers was to carry on generating loans, regardless of the credit status of the borrower and receiving the loan arrangement fees. The fact that the borrowers were incapable of making payments on the mortgages was priced into the mortgage securitization process. That meant that mortgage brokers were paid overwhelmingly high fees by the financing banks. Those mortgages were then bundled by the banks together with other mortgages originated by a similarly lenient process and sold to unsuspecting investors.

Investors were banks such as the German *Landesbank* or Icelandic *Kaupthing Bank* and many others all over the world who were attracted by the promised high yield but unaware of the hidden risk. That was when mortgage defaults on mortgage repayments became frequent and interest rates were hiked. The system that perpetuated itself began to stall as more and more subprime mortgages began to default and profitability did not last.

[253] Securitisation is the process of taking an illiquid asset, or group of assets, and through financial engineering, transforming them into a marketable security. A typical example of securitization is a Mortgage backed Security (MBS), which is secured by a collection of mortgages. http://www.investopedia.com

5.2. THE CRISIS

In 2006, interest rates began to rise in the US and, as rates began to climb, investors began to turn away from the subprime bonds market. They started to sell back their subprime investment obligations to the investment banks from which they had purchased them. This left lenders and investment banks with unsold securitised notes and a rising debt with a decreasing supply of buyers.

What developed in late 2007 and into 2008 was a series of runs on financial institutions. However, instead of a classic run on banks, it was a run on the shadow banking system. Unlike in a classic bank run when bank depositors run on banks to withdraw their deposits, it is argued that the panic of 2007-2008 was a run on the sale and repurchases market, known as the repo market.[254]

The repo market is a short-term market that provides financing for a wide range of security transactions between financial institutions, securitization of assets and interbank borrowing. Repo transactions are collateralized, back-to-back with securitized bonds. The term securitized banking refers to the combination of securitization plus repo finance.

In the shadow banking system, institutions have short-term liabilities in the form of short-term borrowing. Those short-term liabilities use longer-term assets like mortgage-backed securities as collateral. This means that the due date for repayment of short term debts will fall before the financial institution could have the liquidity to repay it. The only option is to borrow again to repay the older debt and rollover the liability. This is where the repo market comes in to help banks and financial institutions sell and repurchase their debts.

Gary Gorton believes that it was the wholesale run on the repo market during 2008, a run that was not so much on depository institutions, but on the shadow banking system, that caused the crisis.[255]

The problem with bank borrowings was that those collaterals were in the form of mortgage-backed securities. As the value of mortgage-backed securities fell, the collateral became insufficient for the amount already borrowed by the banks. Financial institutions including banks were faced with no choice but to sell their assets (the mortgage backed bonds) at a loss to repay their borrowings. This led to the chain reaction of de-leveraging in which financial institutions had to sell off assets to cover their exposure or go bankrupt.

The central discussion relates to the fact that these activities were at the nexus of the crisis when the bonds used as collateral for securitised repo transactions collapsed. Concerns about the liquidity of markets for the bonds used as collateral led to increases in liquidity collateral margins to cover repo transactions (repo haircuts). Unable to go to borrow on the interbank market, banks and financial institutions began a frenzied sale of their assets to acquire the needed liquidity for their margin calls, causing the value of their assets to decline sharply.

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[254] Gorton, Gary B. and Metrick, Andrew, Securitized Banking and the Run on Repo (August 2009). National Bureau of Economic Research (NBER) Working Paper No. w15223. Yale University - Yale Program on Financial Stability. Available at SSRN: https://ssrn.com/abstract=1454939

[255] Ibid 303

With declining asset values and increasing repo haircuts, the U.S. banking system was effectively insolvent, and other markets, such as commercial paper markets, started to fall in and suffered a "run". The resulting "assets fire sale" mechanism led to an adverse loop which forced financial institutions to deleverage and sell more assets, and the decline in asset values continued further, and so on.[256]

In 2007, dozens of mortgage lenders, who had become very dependent on the subprime market for their profitability, closed their doors. On April 2nd, the U.S.'s largest subprime lender, New Century Financial, which in 2006 made over $60 billion in subprime loans, filed for "Chapter 11" bankruptcy. Bear Stearns and Merrill Lynch both reported losing substantial amounts of money in the subprime market in the first quarter of 2007. In August, there was a run on Countrywide Bank, the largest mortgage holder in the U.S. By this point, it became clear that the subprime collapse would adversely affect every level of the world's financial markets. [257]

The market then crashed in March of 2008 as Bear Stearns announced it was being bought out by JP Morgan Chase with substantial help from the Federal Reserve Bank of New York. Finally, in September 2008, the credit roof caved in. In less than two weeks, the U.S. government de-privatized Fannie Mae and Freddie Mac, Bank of America purchased Merrill Lynch for $50 billion, Lehman Brothers filed for bankruptcy, and AIG applied for a federal bailout.[258]

In early October the crisis spread to Europe and to the emerging countries as the global interbank market ceased functioning. The UK authorities responded by pumping equity into British banks, guaranteeing all interbank deposits and providing massive liquidity. The EU countries responded in kind and on October 13th the US Treasury followed suit with a plan to inject $250 billion into the US banks, to provide insurance of senior interbank debt and unlimited deposit insurance coverage for non-interest bearing deposits. By the end of the month, the effects of the subprime mortgage backed securities crisis were felt throughout the entire financial industry, plunging the world into a global financial crisis.[259]

6. MISREPRESENTATION AND MISSELLING MORAL HAZARD

In the tort setting, the potential claim misrepresentation depends on whether the defendant decided to take the necessary care so as not to cause harm to the other party. In the contract setting, the claim is whether the defendant decided to breach a term of the contract. This rule

[256] Andrei Shleifer and Robert Vishny, *Fire Sales in Finance and Macroeconomics*, Journal of Economic Perspectives, V. 25, Nr 1, 2011, Pp 29-48. http://scholar.harvard.edu/files/shleifer/files/fire_sales_jep_final.pdf

[257] Keoun, Bradley, & Church Steven. "New Century, Biggest Subprime Casualty, Goes Bankrupt." *Bloomberg*. 2 Apr. 2007. 10 Dec. 2010. http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a9e64Mkizp7I

[258] Sorkin, Andrew Ross. "Lehman Files for Bankruptcy; Merrill Is Sold." *The New York Times*. 14 Sept. 2008. Web. 10 Dec. 2010. http://www.nytimes.com/2008/09/15/business/15lehman.html

[259] Moral Hazard and the Financial Crisis, Kevin Dowd; *Cato Journal, Vol. 29, No 1 (Winter 2009).* CATO Institute.

is generally decided upon at the outset of the contract setting when the parties often write the rules that directly regulate the other parties' required conduct.

Moral hazard and adverse selection problems arise from the imposition of liability in financial services products affecting the investors' welfare. However, tort systems provide a general setting for pecuniary compensation to parties suffering losses due to adverse selection and/or misselling. In other words, strict liability implies different types of risk sharing between potential parties to an agreement and third parties. During the past fifty years there have been debates on how risks are shared between banks and their clients.

A prevailing product of liability precedent was established in *MacPherson v. Buick* (1916)[260] where it was held that producers possess informational comparative advantages in designing their products that consumers may not be aware of. Nevertheless, the prevailing doctrine of privity in product liability stipulates that damages may be recovered only from the party with whom a contract exists. Hence, if a party seeks economic damages from a defective product, damages may be recoverable from the firm that sold the product but not from the party that produced it.

However, analyses show how tort liability can provide a setting within an arbitration process.[261] Privity, contributory and comparative negligence may imply different types of risk sharing in strict liability between claimants and respondents. What follows from this analysis is that tort liability may be another way to achieve justice. Nevertheless, compensation and damages in tort have proven to be more elusive than real. Compensation in tort is poorly served because most negligence caused damage does not necessarily result in a claim. However, even if it does succeed, the financial compensation is usually consumed by legal fees and costs.[262]

Similarly, most adverse events are not so much the result of actions by an individual provider. The complex system of financial transactions in banks and other financial institutions is usually way beyond the experience of a court of justice. It may require tribunals with field experience and capabilities that can match the knowhow and size of disputes as well as the speed required to resolve them. In all of the above, a challenge in arbitration may serve as an effective deterrent for executives of financial firms against risky transactions which they then pass over to their clients. [263]

However, in an efficient dispute resolution system as proposed in this thesis, a buyer of mortgage backed securities for example can have recourse against the seller for knowingly passing over to him a bad deal. In fact recourse will not be limited to just the institution that

[260] Buick Motor Co. MacPherson v. Buick Motor Co., 217 N.Y. 382, 111 N.E. 1050 (1916)

[261] *Standard Chartered Bank v Ceylon Petroleum Corporation [2011] EWHC 1785* (Comm) (claim for damages arising out of an alleged breach of advisory duty, partly on the basis of the asymmetry of sophistication between the parties; it was held that the bank did not in the circumstances hold itself out as an adviser; rather, the bank acted in a sales capacity)

[262] *Bank Leumi (UK) plc v Wachner [2011] EWHC 656* (Comm)

[263] Frederic Mishkin (1991) "*Asymmetric Information and Financial Crises; A Historical Perspective*." NBER WP 3400.

securitised the mortgage, but it can go all the way to the risk feasor who granted the loan in the first place, be it a loan broker or building society.

6.1. CONTRACT LAW UNDERLINES FINANCIAL AGREEMENTS

At the bottom of the financial crisis lie failed contracts. Failed contracts are the stuff of contract law.[264] However, most cases following the crisis have settled for allegations of fraud and abusive practices by financial institutions without focusing on the underlying contract law in the disputed financial agreement. Discussions and legal arguments about the crisis paid little attention to the underlying contract law because most legal depositions were based on the assumptions that all contracts at issue would be strictly regarded by courts as enforceable.

On the other hand, those debates omitted to note that contract laws include generally several flexible doctrines that dispute resolution tribunals could use to address problems resulting from the crisis. For example, it is the rule that the capacity to take part in proceedings is exclusively determined upon a contractual agreement. This is an indispensable requirement for a party to participate in arbitration proceedings, whether as claimant or defendant.

Financial institutions generally use wizard-like formulas to change relevant party rights to arbitration in their contractual financial agreements. An integral part of this section is the discussion touching upon the interrelation between parties to a financial transaction and the capacity to become party to arbitration proceedings based on interest as determined in litigation.[265] By reviewing conventional contract law approaches to financial transaction contracts, arbitration tribunals might need to interpret various contract law doctrines to efficiently address financial disputes.

UK and US contract law doctrines include, for example: assignment, modification, restraint of trade, unconscionability, mistake, impracticability, damages and the objective theory of intent.[266] In the combat against moral hazard in the financial industry, the formation of financial contractual agreements determines at the outset the circle of persons that can participate in an arbitrable financial transaction.[267]

Fouchard suggests that those[268] parties may and should include the relevant executives of the institutions involved in the transaction. This is due to the definition and nature of arbitration as a consensual dispute resolution mechanism binding the agreeing parties to an arbitration agreement. Modern international financial transactions have become extremely complicated requiring the participation of several parties. For example, a typical securitised mortgage

[264] John Patrick Hunt, Taking Bubbles Seriously in Contract Law, 61 CASE W RES. L. Rev 681 (2011), which is aimed more broadly at how contract law should deal with financial problems in general. "The role of the judiciary has been noticeably absent from discussions about solutions to the crisis caused primarily by mortgage agreements." Andrew J. Kazakes, Comment, Protecting Absent Stakeholders in Foreclosure Litigation: The Foreclosure Crisis, Mortgage Modification, and State Court Responses, 43 Loy. L.A. L. REv. 1383, 1386 (2010).

[265] US Federal Rules of Civil Procedures R17, *Parties Plaintiff and Defendant Capacity in Interest*. English CPR 19.6 *Representative Parties with Same Interest*.

[266] Sultar v. Merrill Lynch, 2004 Conn. Super. LEXIS 3003 (2004)

[267] English CPR 19.6 *Representative Parties with Same Interest*.

[268] P. Fouchard, E. Gaillard & B. Goldman, *International Commercial Arbitration*, ed. 1999.

bond will involve the mortgagor (the borrower), the mortgagee (the bank or building society), the trader purchasing the mortgage, a futures trader within the bank and an executive affirming the trade, and finally, the investor or depositor who will be the purchaser of the finished product.[269]

It is appropriate to clarify whether a party to a financial transaction may have to pursue their right for arbitration which exists for investors in an investment transaction on the open market. A party to an investment transaction in this case can be a borrower in a securitised loan or a purchaser of such loan whether solicited by a banker or directly by the principal vendor of the securitised paper.[270] However, for financial governance and combating moral hazard, the main challenge is whether an investor can establish the contractual liability of the security initiating parties as in the cases of mortgage backed securities (MBS). If investors, as third parties can claim damages in arbitration, they will then not be bound by the privity doctrine and will not need to rely on one of the original lenders to obtain substantial redress.[271]

The move from privity limitations in terms of how liability is shared *ex-ante* between mortgage lenders and bankers represents an attempt for compensation in tortious liability. However, as mentioned earlier in tort, the scope of redress is ultimately determined ex-post by the legal system and courts. Of course, it would be reasonable to assume that regulators can move to codify existing financial transactions and practices to correlate the risk associated with certain transactions to a tort-related penalisation.[272]

An important issue being debated is whether persons involved in the above situations are sometimes incorrectly disregarded in the financial agreement. However, buyers of investment tools should be measured as parties since they are contractually bound by reference to the provisions of the established contract initiating the transaction and considered in the right to claim compensations on failed securities.

For example, in *Deutsche Bank AG v Tongkah Harbour Public Co Ltd* (2011)[273], issues arose in relation to a series of agreements that provided for optional arbitration and for litigation. In this case, the issue was whether Deutsche Bank, as a party to multiple related agreements

[269] Nassim Taleb, Risks of Financial Modelling VAR and the Economic Meltdown, House Hearing, 111 Congress, Sept. 10, 2009 http://www.gpo.gov/fdsys/pkg/CHRG-111hhrg51925/html/CHRG-111hhrg51925.htm

[270] In *International Research Corp PLC v Lufthansa Systems Asia Pacific Pte Ltd [2012 SGHC 226* (*per* Chan Seng Onn J) ("*International Research*"), the Singapore High Court addressed the issue of whether an arbitration clause contained in one contract between two parties binds a third party who subsequently enters into a supplemental agreement with the original two parties. In finding that the third party was indeed bound by the arbitration agreement, the High Court made important observations concerning the enforceability of multi-tiered dispute resolution clauses requiring parties to negotiate or mediate before resorting to arbitration. Those observations are noteworthy because they reflect the Singapore judiciary's recognition that the promotion of consensus was a cultural value worthy of promulgation. The Singaporean approach can be usefully contrasted against the English approach most recently demonstrated by *Wah (Aka Alan Tang) & Another v Grant Thornton International Ltd & Others [2012] EWHC 3198 (Ch)*.

[271] *Yukos v. Russia (USD50 Billion), Gold Reserve v. Venezuela (USD713Million)*

[272] *David Mayers* and *Smith, Clifford W,* Contractual Provisions, Organizational Structure, and Conflict Control in Insurance Markets; The Journal of Business,1981, vol. 54, issue 3, pages 407-34

[273] *Deutsche Bank AG v Tongkah Harbour Public Co Ltd (2011) EWHC 2251 QB*.

containing arbitration clauses, could choose to litigate under one agreement and simultaneously arbitrate under the other. Deutsche Bank argued that its different divisions in Amsterdam and London were involved in different capacities regarding the relationship with its customers. The court, following the Lords' decision in *Fiona Trust* (2007) UKHL 40, said that Deutsche Bank was one contracting entity and the different divisions were irrelevant.

The legal nature of dispute resolution processes is determined by different doctrines which include the nature of jurisdictional procedures and the premise of contractual consent. There are various motivations behind the parties' choice to depart from the state's court system and enter alternative proceedings for resolving their dispute. However, the most common and important motivation will be the recognition and enforceability of the tribunal decision in their dispute.

Third parties seeking compensation should be able to resolve their disputed rights against highly paid traders and executives as well as the institution.[274] It would be useful at this stage to briefly look into certain parties to a financial agreement whose status to a concluded transaction arbitration agreement may not be clear.[275]

6.2. CURRENT FINANCIAL DISPUTE RESOLUTION PROCESSES

Since before the financial crisis of 2008/2009, the financial markets generally regarded the use of arbitration to resolve financial disputes involving financial securities with indifference if not non-acceptance. This is because of the diverse approach taken by national courts in many jurisdictions. National courts seem to resort to public policy to decline enforcement of financial arbitral awards against their own banks. This is in spite of the enforceability governed by the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards.

The NY Convention Articles are silent on the procedural norms for the enforcement of awards and where Art. III authorizes national courts to follow local rules in connection with proceedings for the recognition and enforcement of foreign awards. In addition, the articles of the NY Convention do not provide for local rules or procedures to be followed or governed by domestic courts when examining the enforcement of awards on their soil.

Uncertainty in the enforceability of arbitral awards has proven the need for deeper structural reforms to the contractual practices currently in place as well as a sustainable dispute resolution mechanism for the financial sector within the confines and parameters of the existing legal systems. [276] In general, arbitration agreements must meet specific requirements of formal and substantive validity.

[274] Jagusch, S. & Sinclair, A., *The Impact of Third Parties on International Arbitration*, (Part 4 Ch. 15) in Loukas Mistelis & Julian Lew (Editors), *Pervasive Problems in Intl. Arbitration*, Kluwer Law Intl. (2006)

[275] *Montedipe v JTP Jugotanker, (1990) Lloyd's Rep 279*. It is the assignee rather than the assignor who will be liable on the original contract after the assignment is concluded.

[276] *Benton State Bank v. Warren, 263 Ark. 1, 562 S.W.2d 74 (1978).*

This is especially apparent in the banking industry which began to see a methodical surge in systematic moral hazard practices.[277] During the financial crisis, millions of bond bearers and security buyers across the world ended with worthless investment securities and rigid court procedures. Those investors indiscriminately included commercial investment banks, retirement funds, governments and semi government institutions.

Arbitration provisions are governed by specific provisions of arbitration such as arbitration laws and international conventions.[278] For example, in the UK, these are the Arbitration Act (1996) England, NI and Wales, (S.5), the United Nations Convention on the Recognition and Enforcement of International Arbitration Awards, NY 1958 (the NY Convention) Art. II (2), the Uniform Law for International Sales under the 1980 United Nations Convention Model Law on International Commercial Arbitration (the UNCITRAL Model Law) Arts 1-13.

The applicability of this argument to arbitration is on whether separate consent to arbitrate is required for all persons bound by the transaction agreement, whether relational or formal.[279] A party's liability in specific circumstances is determined on the basis of either bad faith or on the basis of a duty of care. The investor who needs to have recourse on the SPV that created the faulty security should be able to do so through the indirect contractual relation they have with the sponsor (bank) of the SPV.[280] Such examples exist in the financial sector as there are certain traders and financial directors who abuse and who have the incentive to game the risk and show evidence of only what is in their own interest.[281] The result ultimately transpires in the risk taken by investors being much greater than that which was described or written in the agreement.[282]

According to David Baragwanath,[283] existing financial dispute resolution process so far have proven inadequate because some court decisions may produce an immense black hole of legal uncertainty which crosses state borders. Yet there is no international regime that can substantiate it or was able to fully deal with it. [284] This issue is particularly acute in emerging markets. In those jurisdictions, few judges with a commercial or financial background are appointed. However, many of those judges cannot be expected to understand fully the markets involved let alone the contracted banking and financial transactions disputed.

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[277] B. Hanotiau, *Complex Arbitrations, Multiparty, Multi-contract, Multi-issue and Class Actions*, Ch.III, pp 101-162, Kluwer Law Int'l (2006).

[278] Bacache, Répértoir de Procédure Civile (Dalloz) 2007, Indivisibilité (A.1225)

[279] S. Williston*, Williston on Contracts* 447. (Jaeger 3d ed. 1960.

[280] *Fraser v Compagnie Européene des Pétroles*, 6th Nov. 1990, (1991) Rev. Arb. pp73; Paris Cour de Cassation decided that an arbitration clause included in a chain sale contract could not be enforced on a party that has not clearly accepted the arbitration clause at any point down the selling chain.

[281] Phillip I. Blumberg, *Tort, Contract, and other Common Law Problems in the Substantive Law of Parent and Subsidiary Corporations*, (Little Brown 1987).

[282] *David v. Merrill Lynch, Pierce, Fenner & Smith, 440 N.W. 2d 269 (N.D. 1989)*

[283] David Baragwanath, How should we resolve disputes in complex international financing transactions?; Capital Markets Law Journal, Volume 7, Issue 3, July 2012, Pp 204–220, https://doi.org/10.1093/cmlj/kms027

[284] *Carl and Martha Fisser v Int'l Bank F.2d 231 (2nd Circ. 1960) 233-38*

Also, 'The use of arbitration under an ISDA Master Agreement: feedback to members and policy options', a memorandum dated 10 November 2011 prepared by ISDA[285] and addressed to the ISDA Financial Law Reform Committee and to members of ISDA says that uncertainty is not limited only to third world jurisdictions. For instance, the English and US courts which generally inspire a relative level of confidence in their ability to resolve complicated financial transactions' (CFT's) are not even characterised by uniformity in similar cases.[286]

Not only have different judges interpreted aspects of contract provisions differently, but also several of the parties to some cases have raised a series of different conflicting points and in certain instances have successfully put forward sophisticated arguments for various interpretations of what the courts have decided.[287] The truth is that courts of each state jurisdiction can be of very high quality and yet be affected by social, cultural and historical factors that their decisions may come out conflicting and reflecting uncertainty on the markets.

For example in the case of *DFC* v S*ecurity Pacific Australia Limited (SecPac)*[288]*,* the bank invoked what was then called *"*limited two-way payments*"* (a walkaway clause) in order to book substantial amounts as profits under an out-of-the-money swap transaction. It did so in the face of an express statement by the statutory managers of *DFC*, made with the approval

[285] ISDA November 2011 Arbitration Memorandum.

[286] S.K. Henderson; *Henderson on Derivatives*; (2nd ed., LexisNexis 2010) par. 10.1.

[287] *Lehman Brothers Special Financing Inc v Carlton Communications Ltd* [2011] EWHC 718 (Ch);

[288] Kalogianni, Anna. *"PRIME Finance and the Resolution of Financial Disputes."* (2015). "DFC New Zealand Limited (DFC) was made subject to statutory management in New Zealand (a moratorium regime somewhat akin to ch 11 in the United States) in October 1989, only one of its several counterparties that could have done so, Security Pacific Australia Limited (SecPac), invoked what was then called Limited Two-way Payments (a true walkaway clause) in order to book a substantial windfall gain under its out-of-the-money swap. It did so in the face of an express statement by the statutory managers of DFC, made with the approval of the New Zealand central bank immediately upon DFC being made subject to statutory management, that DFC would meet all of its derivatives obligations. SecPac terminated the swap some weeks after that announcement. It was thought that the gain so booked by SecPac was immediately brought into its profit and loss account for its year-end that ended barely days after the swap was terminated and the Limited Two-Way Payments clause invoked. By terminating the swap, SecPac made a profit for the relevant financial year when it evidently would not, when its financial statements were eventually published, otherwise have done so. DFC sued. Among the allegations made by DFC was that the booking of that windfall gain, and the consequent profit rather than loss for that year, allowed bonuses to be paid that would not otherwise have been payable. Shortly after that allegation was made, the case settled. One of the lessons of the DFC case may be that to understand behaviour in many banking and markets cases, one needs, so to speak, to 'follow the money', to understand the interests that a particular party is protecting (e.g. whose bonus is at risk, by how much it is at risk, and when it is at risk—or perhaps when it is no longer at risk—and who is responsible for decisions made accordingly about the particular transaction). Two further observations may be made about the DFC case. First, SecPac, and in due course its new parent, Bank of America, earned the considerable opprobrium of the wider derivatives world by invoking Limited Two-way Payments. ISDA put some pressure on both parties to settle and indeed sought to mediate a settlement at a meeting to which DFC was called if not summonsed. Secondly, this case, among a limited number of others, convinced ISDA, its members generally, and regulators that what we now know as the Second Method should be mandatory for regulated entities that wish to report their net rather than their gross ISDA Master Agreement exposures for risk capital and other purposes. The 1992 ISDA Master Agreement was amended accordingly."

of the New Zealand central bank upon DFC being made to meet all of its derivatives obligations.

This case, among others convinced *ISDA* and regulators that it should be mandatory for regulated entities to report their net rather than their gross ISDA Master Agreement exposures for risk capital and other purposes. The 1992 ISDA Master Agreement was amended accordingly.[289] What the markets want is a process that applies more widely in view of the expected natural judicial conservatism the uncertainty that may engulf enforcement of interbank financial disputes.[290]

7. FINANCIAL ARBITRATION

Arbitration procedures in their current form may not be able to resolve depositors' and investors' multiparty, multi-claim implications due to their inability to break bilateral restraints. Unlike litigation, arbitration derives its substance from contract law due to its contractual origins. What might seem as a drawback in the arbitration system, namely its inability to resolve all multiparty disputes, including non-signatories to the arbitration agreement, is essentially related to the core nature of arbitration.

Arbitration is a closed dispute resolution system agreed upon by certain parties and for resolving disputes arising out of specified bilateral contractual agreements. Parties in financial transactions often conclude back-to-back bilateral contracts initiated by the financial institution. Further bilateral transactions refer to the same transaction as it develops in its nature and transforms into other types of security or financial instrument.

In fact, these entwined agreements set a network of rights and duties binding parties to each other through a chain of bilateral agreements relating to one initial transaction, for example mortgage derivatives.

7.1. PROCEDURES

Naturally, in situations where consolidation of claims may be relevant, it must be determined whether a course of action in arbitration is feasible as well as permissible under the relevant legal regime. The essential points that arise in these cases are:

i) The circumstances and appropriate measures of consolidation of claims

ii) The legal basis for such consolidations

These issues are normally not present at the outset when parties agree. Such consolidation agreements fall within the doctrine of party autonomy, and courts and tribunals will

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[289] Briggs J in Anthracite Rated Investments (Jersey) Ltd v Lehman Brothers Finance SA (in liquidation) [2011] EWHC 1822 (Ch), said, at para 116, that concessions in a line of earlier cases to the effect that the concepts of Loss and Market Quotation under the ISDA Master Agreement, although different formulae, are aimed at achieving broadly the same result, 'is one of those sensible concessions which has hardened into hornbook law'. The Court of Appeal agreed with this analysis: [2012] EWCA Civ 419, at para 129.

[290] David Shirreff, Dealing with Financial Risk, The Economies in association with Profile Books Ltd., London 2004

ordinarily respect such freedom. Thus, the points that arise above are court or tribunal ordered substantive or procedural consolidations.

In a sense, substantive and procedural laws form a balance. Persons who are not party to one bilateral agreement in the chain of contracts can nevertheless be strongly associated to the transaction one way or another. In principle those parties should be allowed to express their case before being excluded or redirected to a different arbitration procedure. However, once the jurisdiction of arbitration authority has been established contractually, procedural law takes precedence.

The jurisdictional aspect of arbitration will then assume a predominant role once a dispute arises and arbitration procedures begin. Financial disputes will then have a wider jurisdictional sphere of arbitrability and investors with claims of moral hazard and adverse selection will be better positioned on agreements involving multiple producers of the same transaction.

7.2. CASES

Clauses in financial transaction agreements that warrant estoppel on clients are purposely placed to stop them from claiming that the transaction in hand resulted from solicitation on the part of the bank or any of its representatives.[291] The effectiveness of contractual estoppel clauses may be challenged only if the contract can be voided for example through claims of fraud.[292] As an example, US courts have often estopped signatory parties to arbitration agreements from initiating court proceedings against "non-signatory" parties, ordering the signatories to submit their dispute with the "non-signatories" to arbitration".[293]

The impact of such decisions in the financial sector has given no back-up to disappointed investors looking for a method to claim losses resulting from mis-selling by banks and financial institutions even if those claimants were also financial institutions or banks. In *Cassa di Risparmio della Repubblica di San Marino (CRSM) v Barclays Bank,*[294] the decision handed down by the Commercial Court in London, HR Hamblen dismissed a mis-selling claim by *Banca Di San Marino* in relation to the structuring and sale of various structured products by Barclays.

The claim related to a series of CDO-squared notes with a combined par value of EUR 230 million which were structured by Barclays and sold to CRSM, in 2004 and 2005, and to a subsequent restructuring of the transactions. CRSM brought a claim for misrepresentation and, in an amendment shortly before trial, fraud. All its claims were rejected by the court. CRSM's claim was founded on an assertion that Barclays had emphasised the AAA rating awarded to the notes by credit ratings agencies.

[291] Sere *Holdings ltd. v Volkswagen Group UK (2004) EWHC 1551; also Standard Chartered Bank v Ceylon Petroleum Corp. (2011) EWHC 1785.*

[292] *Colchester Borough Council v Smith (1991) 448, affirmed on appeal (1992); Sentinel Int'l Ltd. v Cordes (Bahamas) [2008], UKPC 60*

[293] Brekoulakis, Dr. Stavros, *The Relevance of the Interests of Parties in Arbitration: Taking a Closer Look at the Elephant in the Room*, Penn State Law Review (2009) (v113) (pp1165-1188)

[294] *Cassa di Risparmio della Repubblica di San Marino SPA v Barclays Bank Ltd* [2011] EWHC 484 (Comm)]

Such rating implied a low risk of default on the notes which proved later to be false. It was also found that the true risk was known to the management of Barclays when the notes were solicited to CRSM. Yet, the court held that a statement by the Barclays bank about the AAA rating was not a misrepresentation or general abstract statement about risk or probability of default, but only a statement about the rating agency's opinion.

The court decided not to consider that the representations alleged in relation to default risk were made. Hamblen J. also did not find any inconsistency between a low probability of default for AAA rated products derived from historic default levels by rating cohort and more credit risk. That was implied in Barclays' internal financial modelling of the transactions for hedging and balance sheet dressing purposes which made use of credit default spreads and referred to in the agreement with CRSM.

Credit spreads were found not to give a reliable indication of "real world" probability of default. The judge also dismissed the allegations of fraud, finding that the individuals involved at Barclays had reasonable grounds for believing, and believed, what they said about the products.

It was further held that a contractual term in the sales contracts would in any event have precluded the claim, with no finding of fraud. By the term, similar in substance to a provision commonly found in transactions governed by ISDA documentation, CRSM warranted that it understood and accepted the terms, conditions and risk of purchasing the notes and was thus prevented (estopped) from asserting that it was misled as to the risk of the CDO papers.

Findings of contractual estoppel of this nature were also accepted in the English High Court. For example in *Peekay & Anor v Australia & New Zealand Banking Group* (2006) [295] and *Springwell Navigation v JP Morgan* [2010][296] where an investor could not argue that he had been persuaded into entering a contract to make an investment by a misrepresentation as to the nature of that investment.

In *Springwell*, the claimants provided that when the true nature of the transaction had been communicated in the final terms and signature processes of the contract, they signed without reading. Reasons given by Springwell, which was the investment vehicle for a group of shipping companies owned by Adamandios Polemis, were that the entire family had a long-standing relationship with Chase Manhattan Bank and fully trusted the bank. At first instance, Springwell made two principal claims against Chase in respect of the losses it had incurred, alleging that Chase had breached a general advisory duty to Springwell and that Chase had misrepresented the risks related to the investments.

Following a 68-day trial, Mrs Justice Gloster concluded that Chase did not owe a general advisory duty to Springwell regarding the appropriateness of its investments and that in any event such duty was precluded by the contractual documentation governing their relationship.

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[295] Peekay Intermark Ltd & Anor v Australia & New Zealand Banking Group Ltd (2006)
[296] Springwell Navigation Corporation v JP Morgan Chase Bank [2010] EWCA 1221

It was also held that another contractual term, like "non-reliance" clauses found in ISDA governed transactions, by which CRSM warranted that it was not relying on any communication from Barclays as investment advice or as a recommendation to enter into the transactions, did not mean that CRSM was promising that it was not relying on anything that Barclays said. This means that the court decided that whether a statement amounts to advice or a recommendation depended on the substance of the claim made on a case by case basis.

These cases signify an emerging pattern demonstrating that it is difficult for investors to pursue mis-selling claims against financial institutions in courts especially when parties are of equal bargaining strengths as in actions of banks against each other or of sophisticated investors against financial institution.[297]

There are, however, certain exceptions such as the court's decision in *Cassa Risparmio v. Barclays Bank.*[298] This was an unusual decision in that it concerned allegations that the bank had knowledge of a default risk of a structured product. The bank refrained from informing the investor that the true risk in the structured security was higher than the rating assigned to it by a credit rating agency.

Despite the above arguments, this exploration of an arbitration process for the speedy resolution of banking disputes maintains that a procedural mechanism for efficient and speedy proceedings for depositors, investors, interbank and general creditors should be established.

Although arbitration is a private dispute resolution system, it should not remain a closed system, exclusively reserved for those parties that are contractually associated. No dispute resolution clause will satisfy every segment of the financial services industry. Rather, the interaction of all elements of a given financial transaction will determine when and how arbitration may (or may not) be appropriate for the resolution of banking and securities disputes.

In most cases, arbitration merits special consideration when assets of a defendant party are found in jurisdictions lacking judgment treaties with the probable litigation forum. In other cases, it will be appropriate when securities are subject to exchange controls or when debtors might file punitive damages or lender liability actions. Arbitration may also be appropriate when there may be a need for special expertise, such as in the settlement of documentary credit disputes subject to the Uniform Customs and Practices of the International Chamber of Commerce.

Arbitration is a dispute resolution system which in most circumstances is flexible and able to communicate between disputing parties in an industry that may genuinely have pending interests in the outcome of an ongoing dispute.

[297] Merrill Lynch, Pierce, Fenner & Smith v. Eddings, 838 S.W.2d 874 (Tex. Waco. App. 1992).

[298] *Cassa Di Risparmio Della Republica Di San Marino SpA v Barclays Bank Plc* [2012] EWCA Civ 1073 (25.06.2012)

8. CONTROLLING MORAL HAZARD

De-rooting moral hazard entirely in the financial sector is an ambitious target that is difficult to achieve, at least in the near future and not without major re-structuring to financial markets and regulatory processes. This is due to imbedded practices and implanted profit seeking culture within the financial sector and bank ventures.[299]

Traders and fund managers always have an incentive to "game" the risk management system. They respond intelligently to the system in their own interests. They identify the financial system's errors and use them to their benefit. It is their job that they were hired to do.

For example, financial traders exploit relative pricing imbalances or underestimated risks to grab a deal and make their profitable transactions. The result, almost inevitably, is that a client of the institution is taking the real risks because traders use depositors' money. This occurs especially when the actual risk is likely to be greater than the risk allowed by the regulatory system or internal controls of the institution.

This suggests that no system can be perfect and there are limits to the extent to which any system can feasibly take account of how traders will react to it. These problems point to a curious paradox at the heart of modern financial risk management.

The more sophisticated the system, the more unreliable it might be, as traders invent ways to go around it. Increased sophistication means greater complexity and so greater scope for error. In turn, less transparency will make errors harder to detect leading to greater dependence on assumptions of which any could be wrong.

The primary reason why people give their money to financial service providers and banks is the existing risk arising from information asymmetry. The gap of information between the provider of funds and the receiver of those funds is so wide and fast moving.

A banker is supposed to know more about the sale item than the provider of funds does. The tragedy of the financial crisis was that bankers knew of the risk associated with the mortgage backed securities, but they did not know the nature or the composition of those securities.

Likewise, a borrower knows more about his financial condition and his future prospects than the lender. The lender does not know for sure that the borrower will not simply disappear with the funds. Another possibility is that the borrower will misuse the funds in a high risk venture, by using them differently from what he claimed he would do when he asked for the loan.

A company that sells stock may not put the money to its best use. It might be used to pay extravagant compensation to its CEO or to pay huge bonuses to bankers who practically destroy their company. These examples illustrate the two types of risks that are present when there is information asymmetry:

[299] Sarah Breeden (2016), *Taming international banks: Time for New Tricks*, Speech at Bank of England, International Banks Supervision Directorate, Bank of England, UK.
https://www.bankofengland.co.uk/news/publications

- Adverse selection, which is a risk exposure that exists before the money is lent or invested
- After transaction moral hazard, which is the risk traders take without the clients' knowledge after the financial transaction has been concluded

8.1. ADVERSE SELECTION

Selecting whom to give more of your money is a very important part of controlling risk. If you give it to a crook, you lose your money. If you give it to someone who is not good at handling money, you could also lose it. In fact, without information about those seeking funds, theory goes that you would have to charge an average price for your money or sale item.

But an average price would cause those who are better risks or have better products to shun your offer, while those with higher risks will seek your offer, resulting in adverse selection.

The discussion of moral hazard referring to banks taking higher risk because of protection from failure through depositor protection schemes is of no longer standing. Recent banking literature has identified the activities lying behind banking crises, precisely because of the moral hazard problem.[300]

Moral hazard in this context need not involve active concealment of information. It can be an act of inattention on the part of bank customers or poor monitoring by the central bank. It can also be an inability of the central bank to prevent increased risk taking due to concealed data on the part of the bank.

The 2007 financial crisis involved all of these things. One example is structured products which incorporated securitised loans in an opaque way and concealed the extent of risk attached to them. This concealment now appears to have been deliberate on the part of the bankers.[301]

Yet the products were traded in spite of their make-up, and the lack of clarity as to the likely risk attached to their value. Market sentiment was such as to encourage optimism that downside risks were low and asset prices would continue their long rise.

However, because banks themselves trusted the state to provide support to prevent them from failing, they took on additional risk, which brought about more closely the prospect of failure. Bankers argue that the moral hazard problem can be resolved by removing the state from banking altogether. [302]

In that theory, banks would succeed or not on the strength of their portfolios. Customers would signal their unhappiness to banks with increased exposure to risk by withdrawing

[300] Ibid Dowd (2009)
[301] Griffin, John M., Ten Years of Evidence: Was Fraud a Force in the Financial Crisis? (April 4, 2019). Available at SSRN: https://ssrn.com/abstract=3320979
[302] CLAASSEN, Rutger. *Just Financial Markets, Finance in a Just Society*, 2017, p. 56. 2017 p. 56.

deposits or placing disputes in front of tribunals.[303] The market would thus discipline banks, which did not behave prudently or misguided their investors.[304]

8.2. RESOLVING MORAL HAZARD THROUGH DISPUTES

Once disputed, banks will be obliged to compensate the injured investor and will see their bonuses diminish.[305] This proposal falls squarely within the mainstream approach where it is presumed that there are objective risk measures, to which everyone in principle has access.

It is presumed that banks will risk failure only at the micro level as a result of imprudent individualistic behaviours. However, it has long been recognized that workers whose wages are in the form of bonuses or for whom the pay-out is not linked to the firm's performance may have limited incentive to work diligently, particularly when this performance is not documented conclusively to any third party.[306]

An essential difficulty in controlling such non-diligence is to find a tractable method to deal with the incentive compatibility constraints which can capture the strategic behaviour of the employee who in turn can carry the constraint up the corporate pyramid of the firm.[307]

Incentive compatibility is challenging for at least two reasons:-1- employee's actions are continuous; and 2- assumed constraints turn around directors' decisions for profit optimization problems.[308]

Empirical research provided a general methodical solution to solve moral hazard problems when output (performance) of the feasor is a continuous random variable.[309] That involved solving the original problem using a pattern derived from proposed procedural studies. That is to say, use constraint compensatory values for rewarding performance. [310]

Researchers acknowledge, however, that the procedure may be difficult unless sufficient structural information on the employing firms is known.[311] Nevertheless, as the examples in those studies illustrate, this may not be an issue. The studies show that moral hazard was restrained in cases where compensation was restricted through observation and intervention of third parties.[312]

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303 Wolf, M. (2008) *"Why It Is So Hard to Keep the Financial Sector Caged."* Financial Times (5 February 2008).

304 Jennifer L. Peresie, Reducing the Presumption of Arbitrability, 22 YALE L. & POL'Y REV. 453, 460 (2004)

305 McCaffrey, M. (2017). *The morals of moral hazard: a contracts approach*. Business Ethics: A European Review, 2017, vol. 26, no 1, p. 47-62.

306 Walsh, C. E. (1995). "Optimal Contracts for Bankers". The American Economic Review, 150-167

307 Mirrlees, James A. (1999), *"The Theory of Moral Hazard and Unobservable Behaviour"*: Part I." The Review of Economic Studies, 66, 3–21. [1426, 1427, 1430, 1431, 1439, 1441, 1463]

308 Innes, R. D. (1990). "*Limited Liability and Incentive Contracting with Ex-ante Action Choices*", Journal of economic theory, 52(1), 45-67.

309 Grossman, Sanford J. & Oliver D. Hart (1983), *"An Analysis of the Principal–Agent Problem."* Econometrica, 51, 7–45. [1425, 1426, 1427, 1475]

310 Jewitt, Ian, Ohad Kadan, and Jeroen M. Swinkels (2008), "Moral Hazard with Bounded Payments." Journal of Economic Theory, 143, 59–82. [1443, 1478, 1479]

311 Araujo, Aloisio and HumbertoMoreira (2001), *"A General Lagrangian Approach for Nonconcave Moral Hazard Problems."* Journal of Mathematical Economics, 35, 17–39. [1426, 1456]

312 Hölmstrom, Bengt (1979), *"Moral Hazard and Observability."* Bell Journal of Economics, 10, 74–91.

Such intervention can be applied via successful disputes against the firm (employer). Indeed, the proposition is helpful in regard to this thesis and the efficacy of a speedy arbitration process. The alternate approach is proposed here for an instant payment of arbitral awards in banking disputes, which will bring the required constraint on compensatory rewards.

There will be no risk of systemic crisis, whereby if one bank is in trouble it is reasonable to doubt other banks will follow. This stems from the socioeconomic belief that societies will accept the liabilities of banks if blame is clear and compensation is swift.[313]

8.3. MINIMISING ADVERSE SELECTION

The risks of adverse selection and moral hazard make direct financing expensive, especially for small firms, since people are not willing to lend to or invest in unknown entities. With their expertise in gathering reliable information at reduced cost, financial intermediaries can extend financing to many firms or individuals who would otherwise not get it.

The cure for information asymmetry is in providing accurate and timely information to potential buyers. The best predictor of future creditworthiness is past performance and creditworthiness. Checking the history of the fund receiver reduces adverse selection and moral hazard. Requiring collateral can also reduce information asymmetry risks. Collateral reduces adverse selection by requiring a specific value of collateral, such as a 20% down payment on a house, for instance.

Collateral also lowers moral hazard risk because the borrowers stand to lose their collateral if they do not make the required payments. Requiring a minimum asset net-worth will reduce adverse selection. The reason is that only those individuals or businesses with sufficient assets over liabilities can be considered for a loan. Moral hazard will then be reduced because the borrower can be sued if they fail to make timely payments on their loans.

8.4. PRE-MEDITATED MORAL HAZARD

Banks created and spread credit derivatives such as Credit Default Swaps (CDS), through which they could buy protection against the credit risks of their loan portfolios. They also resorted to so-called “structured products”, instruments which result from the combination of credit bonds, debentures, bonuses, negotiable bonds, mortgages, credit card debts, etc. and the set of financial derivatives, which include futures, swaps, options and credit derivatives.

At a later moment, these banks started issuing “synthetic” versions of these instruments, backed by credit derivatives and not by the loans granted. Unable to raise resources from depositors, financial intermediaries resorted to the capital market, mainly by issuing commercial papers bought by money market mutual funds.

SIVs could not create money by granting credit directly as they were not banks. Therefore, they made use of short-term resources to assume the counterparty of the banks’ operations. Banks began through their fully owned funds selling securities on the derivatives market, and

[313] Wenzel, M., Okimoto, T. G., Feather, N. T., & Platow, M. J. (2008). “*Retributive and Restorative Justice. Law and Human Behaviour”*, 32(5), 375-389.

then selling protection against credit risks through options. They thus came to participate in the credit market by raising short-term resources to fund long-term credit.[314]

Besides the losses in their credit portfolios, new problems arose from the repeated drops in the quotation of papers, bringing to light alleged misdeeds which had remained unnoticed during the banking profits euphoria. At times of low liquidity and high losses, investigations of the SEC made many banks cut deals of dozens of billions of dollars. The case involved papers called auction rate securities (ARS), long-term debt instruments whose interests were established at auction. Banks were accused of luring their clients into selling them as extremely safe assets, even when their market had ceased to exist. Until August 14th, 2008, some banks such as Citigroup, UBS, Merrill Lynch and others, had committed themselves to repurchasing US$ 43 billion in ARSs, whereas others had to follow the same path, laying additional pressure on their capital reserves.[315]

9. CONCLUSION

There is certainly scope for misfeasance in the financial sector, as elsewhere. But the analysis suggests that this goes much further than the conventional understanding of moral hazard. While institutional behaviour should arise from successful social conventions, structured and thus both enabled and constrained, by a sound institutional environment, actions of moral hazard does not depart clearly from the mainstream view of self-interest behaviour.

From the regulatory perspective, full knowledge of risk is impossible for buyers and sellers of securities. Because in an open system objective risk cannot be measured, what bankers are concealing can be legally construed not to be true knowledge of risk. Each party may estimate risk, but each will regard that estimate with some degree of confidence. There is certainly scope for immoral behaviour in the financial sector, as elsewhere. But the analysis suggests that this goes much further than the conventional understanding of moral hazard. Moral behaviour arises from successful social conventions, structured and thus both enabled and constrained, by a sound institutional environment.

This means that the knowledge the banker may be holding back from the buyer falls short of absolute certainty of the true risk. Bankers may conceal information, and depositors may accordingly find it more difficult to assess risk.

Ultimately, since neither party can have full understanding of the future path of the conditions under which the security formula and transaction contracts are made, the investor's reliance on his banker is built on trust. The investor trusts the banker not to intentionally take the investor's money into additional risk, which would break the understanding on which the trust is built.

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[314] Borio C., *"The Financial Turmoil of 2007- A Preliminary Assessment and Some Policy Considerations"*, BIS Working Papers, n. 251, Basle, BIS, March 2008. DOI : 10.2139/ssrn.1132776

[315] Chang, Winston W., *Financial Crisis of 2007-2010* (June 30, 2011). Available at SSRN: https://ssrn.com/abstract=1738486

Mainstream theories analyse trust effectively as the exercise of rational self-interest. The open-systems approach analyses it in terms of conventional understandings about the exercise of agency. Moral hazard is the danger that these understandings break down, eroding trust.[316]

Actions of moral hazard involve increased risk taking: *"if I can take risks that you have to bear, then I may as well take them. However, if I have to bear the consequences of my own risky actions, I will act more responsibly.*"

Thus, inadequate control of moral hazards often leads to socially excessive risk-taking, and excessive risk-taking was certainly a recurring theme in the last financial crisis. No other industry but finance has a compatible talent for privatising gains and socialising losses.[317]

The growth of modern financial instruments such as mortgage backed securities (MBS) and collateralised debt obligations (CDOs), gave lending institutions such as banks and insurance companies the extra incentive to make various types of loans available to borrowers. As the risks associated with those loans (mortgages, credit cards, car loans, etc.) were passed through to the investors via the financial instruments, it became easier for individuals in the society to obtain loans and satisfy their dreams.

The fast expansion and high yield of those instruments in the markets also made it possible for investors all over the world to buy into the US housing and consumer markets. When the housing market collapsed in the US, major financial institutions around the world suffered large losses due to their investments in the subprime MBS.[318] The vicious circle of foreclosures and falling house prices in the US started to spread to other parts of the world economy as the deflationary effect of drying credit began.

Investors were willing to go along with these generous terms because the funds had generated good returns for many years. These remuneration packages prompted an exodus of talent (real or imaginary) from the banks into the funds, and the banks responded by adopting similar practices themselves.

Fund managers and bankers then took much greater risks than they would have had if their own money was at stake. However, with none of their own money on the line and the potential to generate colossal bonuses, many bankers were seemingly seduced by their own propaganda. They believed that structured finance was revolutionary financial technology for transforming poor quality loans into high quality investments.

Bankers in private equity partnerships and hedge funds were induced by their own institutions. They were promised high bonus remuneration systems and no personal risk. Those bonuses once paid, they were not recoverable except through court orders.

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[316] Peter Timothy Hughes, Trust: Economic Notions and its role in Money and Banking, European Journal of Economics and Economic Policies: Intervention, 2012, vol. 9, no 1

[317] Admati, Anat & HELLWIG, Martin. *The Bankers' New Clothes: What's Wrong with Banking and What to Do about It*, Updated Edition. Princeton University Press, 2014.

[318] DELL'ARICCIA, Mr Giovanni, MARQUEZ, Mr Robert, et LAEVEN, Mr Luc. Monetary policy, leverage, and bank risk-taking. International Monetary Fund, 2010.

This absence of any deferred compensation gives fund managers an incentive to focus only on the period to their next bonus. If the fund makes losses later, then that is not their concern (or, of course, their fault). The absence of deferred remuneration thus institutionalises short-termism and undermines the incentive to take a more responsible longer-term view.

Yet the subprime scandal and the greed game are merely illustrative of a much broader and deeper problem. Namely, that moral hazard in the financial sector has simply been out of control.

Creating value is the principal practice of financial institutions, including structured finance, alternative risk transfer etc. However, practices of huge leverages, aggressive accounting and dodgy credit ratings have enabled large banks and financial services providers to extract value from the market on a massive scale. Such actions have occurred while those banks were unconstrained by either risk management ethics or by corporate governance and financial regulations, all of which have proven to be virtually useless.

CHAPTER FOUR

REGULATORY LIMITATIONS IN FINANCIAL GOVERNANCE

The research in Chapter Four follows on from the previous chapters leading to the conclusion that if investors would have at least disputed successfully the methods their funds were directed by bankers, the picture would have been different in 2008.

A debating point is whether mass failures of regulated financial institutions can be construed as a failure of regulations or just a failure in the functioning of regulatory tools. Critics and academics point out the general characterisation of moral hazard in the financial sector. Empirical research shows that moral hazard emerges when regulators err.[319]

In this chapter, the focus is on the development of disciplinary regulations on banks worldwide which was substantially reduced and replaced by poorly designed and mispriced safety nets for depositors. The changes in regulations in favour of financial service providers explains the classical increase in acts of moral hazard behaviour by bankers as public taxpayers' money was used to fend the fall of such banks. [320]

The chapter explores foundational normative questions about how to conceptualize justice in relation to financial markets. The findings are then related to state bias in the legal frameworks of financial markets that produced unjust outcomes post crisis.

Financial markets should function within perspectives of social objectives. Public funds replaced private shareholders' capital as the shield against failure and depositors' panic. In effect, banks were encouraged and found it a chance to increase their profits by getting into excessive risk exposure using depositors' funds. As a result, the assets to liability ratio decreased on banks' balance sheets while they increased their high-risk portfolios reducing with it the banks' capital ratios. Regulatory authorities erred when they decided to ignore the clear signs of high-risk transactions.

1. GOVERNANCE, ARBITRATION AND SOCIAL PERCEPTION

Many official working groups and academic studies have analysed the causes and policy responses to financial crises and banks' failures transversely across mature economy countries.[321]One interesting recent proposal, by Barth, Caprio, and Levine (2012)[322]

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[319] D. Starkman, *The Watchdog That Didn't Bark* (New York: Columbia Journalism Review Books, 2014); The Comptroller and Auditor General, *Regulating Financial Services*, 24/03/2014. (www.nao.org.uk)

[320] Aslı Demirgüç-Kunt & Edward Kane, Deposit Insurance Around the Globe: Where Does It Work, Journal of Economic Perspectives, Volume 16, Number 2, 1 April 2002, pp. 175-195(21) The failure of the late Federal Savings and Loan Insurance Corporation (FSLIC) to promptly resolve insolvent savings and loan associations in the 1980s, led to its own insolvency, the shifting of its approximate $150 billion negative net worth to the U.S. taxpayer, and a record number of thrift failures. (Brinkmann, Horvitz, and Huang 1996; 1995a)

[321] Claessens & Terrones (2011), Reinhart & Rogoff (2009), Borio & Drehmann (2009), Mendoza & Terrones (2008), Collyns & Senhadji (2002); Herbert Baer & D. Klingebiel (1995), G. Caprio & Daniela Klingebiel (1995), Charles Goodhart (1995), Zenta Nakajima & H. Taguchi (1995).

[322] BARTH, James R., CAPRIO JR, Gerard, LEVINE, Ross. "*Guardians of Finance: Making Regulators Work for the People*". Mit Press, 2012.

established a forum of independent experts to identify flaws in banking system regulation and supervision. They then drew their findings on threats to banking stability to the attention of the public and regulatory authorities.

Their approach is to offer, through mutual monitoring by members of society, both individual and corporate, a means of establishing a credible and informed process that can voice concerns for improved regulation and supervision of banks.[323] Well-functioning financial markets are crucial for economic well-being and contemporary justice in societies. The great financial crisis has shown a disappointment perspective of social trust in the self-regulating banking industry and the limitation of financial regulators.[324] This is the trust granted by the public who cannot capture what is at stake in regulating financial markets.

The damage done by the great financial crisis, including its distributive consequences, raises serious questions about the justice of financial markets as we know them.[325] This chapter brings together research on legal theory, law, and economics in order to explore the relation between justice and financial markets, broadening the perspective from a purely economic one to a liberal egalitarian one.

The financial crisis brought about proposals that were introduced in different jurisdictions on how the structures of financial markets could be reformed. However, analysis of why reform is not happening at the speed that would be desirable from a perspective of justice are producing proof that financial regulatory authorities have a lot to answer for.

1.1. INTERNATIONAL FINANCIAL REGULATORY AUTHORITY

The concept of "governance of financial institutions" is often associated inaccurately with "corporate governance".[326] There is a difference between shareholders' privilege to govern their corporate rights and governance of financial institutions to protect investors' rights through the regulating of prudential conduct in banking and financial business.

The clearest example was the failure of Lehman Brothers in the US which in turn was a direct cause of the chain reaction leading to the financial crisis. Shareholders of Lehman Brothers were the first to bear the losses when the bank declared bankruptcy. Reasons leading to such failure may indeed have been due to poor corporate governance on the part of the shareholders of Lehman. Nevertheless, governance of the financial sector or the lack of it has been the major contributor to the contagiousness of failure to other institutions and the resulting global financial crisis.

Regulatory governance of financial institutions should in theory influence the activities and efficiency of institutions at the corporate level. As a result, the effectiveness of a nation's

[323] Claessens, S., & Kose, M. M. A. (2013). *Financial Crises Explanations, Types, and Implications* (No. 13-28). International Monetary Fund.

[324] Helleiner, E. (2014). "*The Status Quo Crisis: Global Financial Governance After the 2008 Meltdown*". Oxford University Press.

[325] Claessens, S., & Kodres, M. L. E. (2014). *The Regulatory Responses to the Global Financial Crisis: Some Uncomfortable Questions* (No. 14-46). International Monetary Fund.

[326] Mayes, D. & Wood, G. ed. (2013), *Reforming the Governance of the Financial Sector*, Routledge, Abingdon-Oxfordshire, pp. 3-19.

financial system further shapes economic performance locally and at the international level. Regulatory governance of banks, financial intermediaries and non-bank financial intermediaries is different from the standard corporate governance.

This chapter will explain the complexity and limitations of international financial regulations versus the adequacy, flexibility and speed arbitration tribunals can offer. It will explain why financial rules and regulations are not sufficient alone to deter bankers and their firms from embedded moral hazard activities. The key lesson is that corporate governance may have been at fault at the time of the crisis and it is essential to point out the deficiencies in the regulatory framework that allowed the pre-failure and pre-crisis activities to exist and continue. Governance of the financial sector bears the major part of the responsibility in regulating the entire industry where failure of self-governing by banks from within follows naturally. Aspects of the limits in supervisory and regulatory networks were apparent in allowing extremely rapid and uncontrolled growth in complicated, overly rated and little understood high risk structured securities.

Despite various theories of the regulatory governance of financial institutions, there are special problems facing actual governance of banks and financial intermediaries. Financial intermediaries and banks in particular have special attributes that intensify those governance problems. Moreover, pervasive government involvement, past and present, can create additional impediments to effective corporate control over the financial sector in general.

This chapter combines theoretical perspectives with international observations to arrive at solutions to regulatory governance problems in the financial sector particularly in banks and financial intermediary industries. Those solutions demand special consideration geared towards retributive methods against banks and their corporate executives in the form of direct clients' compensation and damages for the loss of income.

1.2. GOVERNING THROUGH DISPUTE

"Agency theory" defines corporate governance problems in terms of how the interest of shareholders may conflict with public interest. Equity holders may act passively towards the actions of their directors or positively by influencing them to act in the interests of the owners of capital rather than the general good of the economy. Banks and financial intermediaries may allocate, with the blessing of their shareholders, high stake incentives to induce their own fund managers to behave in ways that favour the profitability of the institution.

At the same time, those managers may behave in a way that hurts the interests of the public and the nation's overall financial system. The shareholders will be satisfied if the profitability of the institution mounts and they will act passively towards the methods the directors use to attain such profits. Consequently, relying on standard corporate governance by shareholders alone may not yield the same effect as the governance through dispute approach. This approach will focus on the mass role of the investor clients' base for every bank to shadow and observe the activities of their bankers.

The actions of bankers will be scrutinised by their clients who will be given the ability to utilise arbitration to claim restitution in a speedy process. Successfully disputed matters can reveal or raise an alarm, bringing the attention of the regulatory authorities to riskier actions that could be happening within the bank that would not have been disclosed until too late.

The chapter examines literature reviews such as Claessens (2001) which were built on empirical analysis with data on 687 corporations from eight crisis countries. Claessens' research investigated regulatory policies including: [327]

1- Liquidity support in cases of a run on financial institutions

2- Liability guarantees to creditors during early phases of a crisis

3- Establishing asset management entities for restructuring or resolving troubled banks

The studies found that a package of these measures can facilitate effective containment and quicker recovery of the corporate sector from a crisis and assist the sustainability of the other sectors in the economy. Nevertheless, the study does not effectively address the core problem which triggers bank runs: namely, panic and fear for loss of funds. Claessens does not address unresolved restitution claims by investor clients.[328]

1.3. PUNITIVE DAMAGES

There are many different types of compensatory damages but, broadly speaking, they are broken down into general or special damages. Compensatory damages seek to reimburse or compensate an injured party for the harm they have suffered, and these kinds of damages are available in almost all injury cases, including auto accident, medical malpractice, and slip and fall cases. Compensatory damages are also awarded in wrongful death cases, but the damages available in these cases are often unique and not typically found elsewhere. Punitive damages, on the other hand, are only awarded in a small number of cases. Punitive reliefs are in no way tied to the type of harm that has been suffered but are awarded to punish the wrongdoer for certain types of behaviour. Both punitive and compensatory damages are awarded directly to the injured party or plaintiff.

In the United States, the Restatement on Contract[329] expressly provides for the availability of punitive damages when the breach of contract also constitutes an 'independent' tort. In addition, under the so-called Indiana decisions, punitive relief may also be awarded where the breach in question does not amount to an independent tort, but was fraudulent, malicious, grossly negligent or oppressive. Punitive damages for breach of contract are also awarded in Canada, though apparently to a more limited extent.

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[327] Claessens, S., Simeon Djankov and Daniela Klingebiel, *Financial Restructuring in Banking and Corporate Sector Crises: What Policies to Pursue?*, Working Paper 8386, National Bureau of Economic Research, Cambridge, MA; July 2001 www.nber.org/papers/w8386

[328] Caprio, Jerry and Daniela Klingebiel, 1999, "Episodes of Systemic and Borderline Financial Crises", Mimeo, World Bank, October, Washington, D.C. Claessens, Stijn and Thomas Glaessner, 1997, "Are Financial Sector Weaknesses Undermining the East Asian Miracle?" Directions in Development, World Bank, September.

[329] US Restatement (Second) on Contract, § 355 provides: '*Punitive damages are not recoverable for a breach of contract unless the conduct constituting the breach is also a tort for which punitive damages are recoverable.*'

Subject to a limited number of exceptions, punitive damages are only recognized in common law countries. They are notably awarded by the courts of the UK, the US, Canada, Australia, and New Zeeland.[330] However, as some comparative studies have pointed out, the circumstances in which punitive relief is available and the magnitude of punitive damages awards vary greatly from one jurisdiction to another. In the UK, the availability of punitive relief is a question of law, while in the US, punitive damages are subject to state laws with a significant majority of states authorizing awards for punitive damages.[331] In civil law jurisdictions, punitive damages are generally not available. Hence, under French and German law, for example, courts do not grant punitive relief.[332]

Arbitration laws on the other hand do not generally address the question of whether arbitrators may award punitive relief. As a general rule, they do not even deal with the more general question of the available remedies. For example, there are no sections on punitive damages or relief contained in the UNCITRAL Model Law, the French Code de Procédure Civile, the US Federal Arbitration Act, the German Arbitration Act and the Swiss Private International Law Statute (PILS). Hence, in general arbitration laws do not specifically contain provisions regarding the arbitrators' ability to order specific performance on punitive relief.

As a general rule, international commercial arbitration involves disputes based on contracts. In fact, the referral of an international commercial dispute to arbitration is based on a contractual clause providing for arbitration of disputes arising in connection with the parties' transactional dispute. Hence, the availability of punitive damages in international commercial arbitration depends on whether, under the applicable law(s), such damages are available for breach of contract cases.[333] Most arbitral tribunals as a result will consider that a punitive arbitral award may contravene the substantive public policy of the seat and thus be annulled by the courts of that seat. As a result, arbitral tribunals may refuse to award punitive relief even though it may be available under the *lex contractus*.[334]

2. LIMITATIONS IN FINANCIAL REGULATORY RULES

Regulations and regulatory authority were able to ban bankers and financial managers for life and fine them penalties that may amount to a fraction of the profits they accumulated through mis-selling and misrepresentation. But in almost all cases researched, none of the institutions found blameable by regulatory authorities were ordered to pay compensation to any of the injured parties. Claimants were left to claim damages before courts for whatever length of

[330] John Y. Gotanda, *Punitive Damages: A Comparative Analysis*, 42 Colum. J. Transnatl. L. 391 (2003).
[331] English Law Commission, *Aggravated, Exemplary and Restitutionary Damages [1997]* EWLC 247, § 5.42.
[332] Volker Behr, *Punitive Damages in American and German Law – Tendencies towards Approximation of Apparently Irreconcilable Concepts*, 78 Chi.-Kent L. Rev. 105 (2003).
[333] John Y. Gotanda, *Awarding Punitive Damages in International Commercial Arbitrations in the Wake of "Mastrobuono v. Shearson Lehman Hutton", Inc.*, 38 Harv. Intl. L. J. 59 (1997).
[334] Final award of 1996 in ICC Case No. 8445 in 26 Yearbook Commercial Arbitration 167 178 (Albert Jan van den Berg ed., 2001).

time and expense it may take. These conduct rules are regulatory requirements which entail fines, disqualifications and criminal liabilities.[335]

Many cases are now still being litigated that may not be directly related to the 'credit-crunch' or the 'global financial crisis', However, those cases may have nevertheless been given added stimulus by the general public demanding that banks are to be held to account in an unprecedented way for their actions. Banks have had to address claims for mis-selling financial products, claims from their own disgruntled employees for unpaid bonuses, and now claims arising from the LIBOR-fixing scandal.

A key development has been a rush by regulators to toughen up enforcement activity, leading to a focus on investigatory work rather than retaliatory monetary compensations. That said, as with what happened in the LIBOR manipulation case, regulatory interference triggered retribution litigation that ended with nominal penalty settlements. Such scandals may yet give rise to further litigation, if regulatory investigations into Barclays' 2008 capital raising prove to be justified; or vice versa in relation to claims brought against Royal Bank of Scotland (RBS) arising from the prospectus for its 2008 rights issue.

2.1. CLAIMS AGAINST DISTRESSED FINANCIAL INSTITUTIONS

An expected upsurge in litigation against directors of loss-making banks has not turned out to be the case. The Court of Appeal's rejection of the Northern Rock shareholders' appeal, grounded in human rights law rather in insolvency law or on company law principles, in *SRM Global Master Fund LP v Commissioners of HM Treasury [2009]* highlighted the weak position of shareholders of banks which failed during the financial crisis.[336]

The current plight of the Co-Operative Bank illustrates that more financial institutions may find themselves in distressed circumstances. How the Co-Operative Bank responds to its problems will be informed by recent cases: in *Assenagon Asset Management v Irish Bank*,[337]a "bail-in" re-structuring was disrupted when the English High Court held that the necessary resolution was not validly passed, as the requirement for the "exit consent" from participating note holders for the exchange of their notes to be replaced with a reduced value note, was unlawful and represented "coercive threat". Following this case it seems highly unlikely that the Co-Op will launch an offer on similarly aggressive terms.

However, *Azevedo v Importacao Exportaacao*,[338] points the way to an alternative approach of incentivising consent to a bail-in. The court found it was lawful for a company to offer the "carrot" of an additional payment to bondholders who vote in favour of an amendment where that additional payment is not made to those who do not vote, or vote against the change.

[335] Iris H-Y Chiu, *"Regulating From the Inside: The Legal Framework for Internal Control in Banks and Financial Institutions"*, (Oxford: Hart Publishing, 2015), 205.
[336] *SRM Global Master Fund LP, RAB Special Situations (Master) Fund Ltd, Dennis Grainger & Others v Commissioners of HM Treasury* [2009] EWCA Civ 788
[337] *Assenagon Asset Management SA v Irish Bank Resolution Corporation* [2012] EWHC 2090 (Ch),
[338] Azevedo v Importacao Exportaacao E Industria De Oleos Ltda [2012] EWHC 1849 (Comm),

2.2. CLAIMS AGAINST BANKS

Typical mis-selling claims involve an unsuitable product recommended by the bank, where risk or break clauses were not adequately explained, or the presentation of the product was misleading. Claims are for breach of statutory duty, negligent advice and misrepresentation. Typical mis-selling defences are that the product was suitable, there were no advisory relationships on the facts, and that there has been a contractual estoppel precluding any claim. Many cases in England concern the validity and scope of clauses in the agreement that protect the banks from claims in tort, especially from misrepresentation. The Court of Appeal in *Springwell Navigation v JP Morgan*[339] upheld and enforced the principle of contractual estoppel arising from exclusion clauses to thwart claims for misrepresentation.

A further blow to investors was struck in *Euroption Strategic Fund v Skandanivaviska Enskilda Banken*.[340] The claimant argued that the bank had negligently delayed the close-out and conducted it incompetently. The court held that the bank had not delayed but in any event it owed no Tortious duty of care to the claimant. Imposing such a duty would expand the law of negligence into a new context, namely, loss of investment opportunities. The claimant also unsuccessfully argued that there was an implied term of the mandate that the bank would conduct the close-out using reasonable care and to a suitably professional standard. The court held that it was not necessary to imply such a term to give business efficacy to the contract. The court also held that although the mandate was a contract for the supply of services with the Supply of Goods and Services Act 1982, the implied term in "s.13" of that Act only applied to services contemplated by the mandate and closing out of the portfolio was not a service that the bank had agreed to carry out under the mandate.

More recently the balance has shifted against the banks: the decision in *Rubenstein v HSBC*[341] suggests that financial advisors will be kept to an increasingly high standard. The Court of Appeal found that it is reasonably foreseeable that if a financial advisor misleads a client as to the nature of its recommended investment and puts its client into an investment which is unsuitable when they could have just as easily put the client into something that was more suitable, then the financial advisor could be liable for loss resulting from the investment. In circumstances where the financial adviser is not only obliged to avoid injuring his client but also to protect him from the particular loss which has come about, the scope of the adviser's duty may extend to even unusual events, which will not be considered too remote.

However, the court's decision in *Camerata Property v Credit Suisse (Europe)* [342] can be contrasted to the decision in *Rubenstein*. In *Camarata,* losses incurred on a Lehman Brothers' note were unrecoverable, as the collapse of Lehman Brothers was held to be unforeseeable. The difference between the cases may, as ever, be on the facts: in *Camerata,* the claimant had invested in increasingly adventurous investments over time and was viewed as a knowledgeable and experienced investor, by contrast to Mr Rubenstein who wasn't and who had asked for specific assurances in relation to the particular risk which led to his loss.

[339] Springwell Navigation v JP Morgan Chase Bank and Others [2010] EWCA Civ 1221
[340] Euroption Strategic Fund Ltd v Skandanivaviska Enskilda Banken AB [2012] EWHC 584 (Comm).
[341] *Rubenstein v HSBC Bank plc [2012]* EWCA Civ 1184
[342] *Camerata Property Inc v Credit Suisse Securities (Europe) Ltd [2012]* EWHC 7 (Comm)

2.3. INTEREST RATE SWAP LITIGATION

One category of investor claims has been in relation to alleged mis-selling of interest rate swap agreements. In *Green v RBS Plc,*[343] the court dismissed a claim for negligent misstatement and breach of duty to give suitable advice, in relation to the sale of an interest rate swap agreement. However, until *Green v RBS* there had been no reported decisions of the English Court on this issue, possibly because cases may have settled before reaching trial. Notwithstanding the court's decision in *Green*, there is likely to be further litigation of interest swap agreements, particularly as the outcome of reviews the FSA (now FCA) has ordered several banks to carry out into their selling of such products becomes clear. This conclusion is reinforced by the fact that the Financial Ombudsman Service noted in their 2012/2013 review that they had received 258 complaints from businesses about interest rate hedging products sold by banks, but could not deal with most of these as they were from non-eligible businesses.

2.4. ALLEGATIONS IN ISDA MASTER AGREEMENT

There have also been a number of cases arising from uncertainty in the correct interpretation of provisions in ISDA Master Agreements, for example, in disputes arising from the unilateral close-out of trading accounts or loan facilities. The current provision in the ISDA Master Agreement for disputes to be dealt with under the jurisdiction of the English courts or the New York Court has given rise to the recent litigation in England. The ISDA Law Reform Committee has discussed the possibility of inserting an arbitration clause into the next iteration of the ISDA Master Agreement.

In *Lehman v Metavante,* for example, it was held that reliance on s. 2(a) (iii) of the ISDA Agreement[344] and failure to terminate within a reasonable period resulted in loss of the safe harbour, which only applies to the right to terminate and close-out.[345]

Whether arbitration will be adopted remains to be seen. The same might also be said about the P.R.I.M.E. finance arbitration initiative in The Hague. As decisions have been made, the scope for disagreement over provisions in the 1992 and 2002 ISDA Master Agreements has been reduced. For example, in *Lomas v JFB [2012]*[346], the conjoined appeal of a number of claims relating to the close-out and valuation provisions in the 1992 ISDA Master Agreement, has provided important clarification for market participants.[347]

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[343] *Green v Royal Bank of Scotland Plc [2012]* EWHC 3661 (QB)

[344] The importance of maintaining consistent interpretations of the critical terms of the agreements in jurisdictions around the world can save the market participants from conflicting cases with unexpected results.

[345] *Lehman Brothers Holdings Inc., et al. [Metavante] 2009* Banker. LEXIS 4349

[346] *Lomas v JFB Firth Rixon Inc [2012]* EWCA Civ 419

[347] *Marine Trade S.A. Claimant and (1) Pioneer Freight Futures Co Ltd BVI (2) Armada (Singapore) Pte Ltd Defendants [2009] EWHC 2656 (Comm), Lomas and others [Lehman] v JFB Firth Rixson Inc and other companies [2010]* EWHC 3372 (Ch) 21 December 2010 and *Pioneer Freight Futures Company Ltd v Cosco Bulk Carrier Company Ltd* [2011] EWHC 1692 (Comm). The Courts in Firth Rixson held that the defaulting party remains liable to make gross payments to the non-defaulting party has been challenged in *Pioneer Freight Futures Company Limited (in liquidation) v TMT Asia Limited* [2011] EWHC 1692. Dening and Parsons, "*Firth Rixson: Why Didn't Mandatory Set-off Apply?" [2011]* 11 JIBFL 663 (December)

2.5. THE LIBOR MANIPULATION CASE

In June 2012 the LIBOR-fixing scandal broke when it was announced that Barclays had agreed to pay around $453 million to regulators in the US and UK to settle charges that its conduct had resulted in the manipulation of LBOR. Subsequently UBS and RBS have had to pay huge fines as well. The fixing of LIBOR, relied on in thousands of contracts for financial products, has raised the prospect of further regulatory action against other banks, in particular *HSBC, Deutsche Bank and Societe Generale*. The charges include criminal prosecutions, class-action suits in the USA and even cartel action by the European and other jurisdictions (for example, in Singapore).

In *Graiseley Properties Ltd v Barclays Bank plc [2012]*[348], the High Court allowed an interim application by the claimant to amend its claim for the mis-selling of interest rate swaps in order to plead alleged implied misrepresentations and breach of implied terms concerning the alleged manipulation of LIBOR in the bank's favour. While the court permitted the amendments on the basis that they were arguable, the claimant will face significant challenges to make good the claim, particularly in proving causation.

The *Graisley Properties Ltd* case can already be contrasted to the court's ruling in *Deutsche Bank v Unitech Global* [349], rejecting the defendant's application to amend their defence and counter-claim to claim that Deutsche Bank had made LIBOR related misrepresentations which had induced the defendant to enter into an interest rate swap agreement and associated credit agreement, and that in making these misrepresentations Deutsche Bank had given an implied warranty that the representations were true, on the basis that the amended claims had no reasonable prospect of success. The court acknowledged that its decision ran counter to that in *Graisley Properties Ltd* but said each case must be decided on its merits.

Permission has been granted for appeals of both decisions, raising the prospect of the Court of Appeal reconciling the position in the two cases and providing a more definitive statement of the position to be adopted by the courts in considering claims arising from LIBOR manipulation. In any event, how the cases develop will continue to be watched closely; whether, or not, other investors launch LIBOR-related claims is likely to be informed by what happens next.

2.6. CASES AND RETALIATION

As provided above, the global financial crisis of 2008 was a crisis largely of human making. It was also a financial institutions governance crisis. Internal imbalances proved just as significant as the other triggers to the financial turmoil and the events that happened sparked a fresh round of deliberation about the most likely deficiencies in governance of financial intermediaries. The roots of the crisis predominantly lay in unsupervised inadequate bank capital, highly leveraged hedge funds, subprime mortgage securities and reckless loans. For years there were low interest rates, weak government enforcement efforts, minimal government interference and deregulations.

[348] *Graiseley Properties Limited (Guardian Care Homes) v Barclays Bank plc [2012]* EWHC 3093 (Comm)
[349] *Deutsche Bank and Others v Unitech Global and Another [2013]* EWHC 471

The collapse of Northern Rock in the UK, Lehman Brothers in the US and other banks occurred because the financial risk generated by the US subprime mortgage lending was being directed and reused across the world through shadow banking structures. With hindsight, the credit-rating agencies failed terribly in the performance of their duties. Financial derivative products were so complex and non-transparent that even those who created them were unable to understand what they meant, and too much legal manipulation was used in order to lay blame on investors' apparent sophistication. There were profound failures of the regulatory policy and inadequate transparency.

These ingredients came together to trigger a financial crisis of global proportions. Certainly, the question of how far poor regulatory governance of financial institutions led to a crisis is still a controversial topic to date. An immeasurable number of 'wrongdoers' have been identified as contributors to the global financial crisis and there are more reasons now to address the key elements which contributed to it.

Those reasons lay mostly in weak regulatory governance, absence of rapid restitution methods against offenders, profit driven executives, greedy and inattentive bank shareholders and unsuitable remuneration structures. Financial intermediaries lacked understanding of the technical strategies of the financial products they were selling and showed no ethical standards when they pushed those products onto their clients.

Shareholders appeared unable to scrutinise and monitor their company boards. They accepted all transactions they believed to be leading to higher profits for their shares and holdings. They gave low priority to governance issues, thereby encouraging the risk-taking that eventually proved fatal for many institutions including their very own.

In addition, there were clear and unquestionable failures of the system of regulatory governance. There were no regulatory rules on the quality and quantity of executive pay. There was no interest in the accountability and personal qualifications of those who managed financial firms when they were hired, for assessment of possible legal liabilities. Mostly, there was no emphasis on recourse methods, particularly on the potential monitoring and supervisory role institutional investors can play or resort to, apart from litigation.

However, if investors can confront the issues through an arbitration process that in theory should not take longer than a few days; this can help redress the balance in governance of financial institutions. At the very least, such individualistic action can identify deficiencies such as those that lead to the crisis. Even if such actions are taken in a pre-calamity epoch of any major crisis, it will constitute an indirect form of collective governance by investors.

With a focus on the position in the United Kingdom and US, the issues underlying governance of moral hazard activities rationalisations and conceptions through individuals disputing actions will contribute productively and effectively to the ongoing worldwide efforts for effective regulatory authority governance of financial institutions.

The following are examples of litigated cases where financial intermediaries were able to get away with penalties. Investors had no recourse other than courts with long delays and expense:

- Swinton Group Ltd director was indicted for predatory mis-selling. The institution and the directors were fined a total of £928,000.[350]

- *Michael Lee Thommes v FSA*[351] is another case involving a small size investment firm with sole directorship carrying on the business of mortgage brokerage. The director was indicted for fraud in accepting and filing incorrect details on mortgage applicants as well as assisting applicants in misleading lending institutions. The firm and its director were fined, and the director was banned for life from "performing a controlled function" in the financial services industry. The FSA issued a decision notice to Mr. Thommes in July 2011, outlining its intention to prohibit him from performing any controlled functions.

  Mr Thommes was the managing director of General Finance Centre Limited and the FSA found that he failed to adequately supervise and oversee the general conduct of the firm. He did not establish and maintain adequate systems and controls to prevent financial crime. He also did not understand his responsibilities associated with regulated mortgage business as an approved executive, especially his responsibilities as a director holding a controlled function. The matter was referred to the Tribunal, which concluded Mr Thommes should be prohibited. The Tribunal decision was issued in December 2012 and the Final Notice was issued by the FSA in January 2013.

- Martin Currie Investment Management Limited and Martin Currie Inc.[352]

  The FSA in May 2012 imposed a financial penalty of £3.5 million on Martin Currie Investment Management Limited and Martin Currie Inc. (together "Martin Currie") for systems and controls failures relating to the identification and handling of conflicts of interest. A parallel action was taken by the US Securities and Exchange Commission ("SEC") in relation to the same conduct which imposed a financial penalty of $8.3 million. Both sets of regulatory actions relate to an investment by one client of approximately £15 million in an unlisted bond issued by an offshore Chinese firm managed by Martin Currie's Shanghai office. The FSA and the SEC found that the investment loss incurred by the client had significant advantages for another client of the same company.

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[350] The Financial Conduct Authority (FCA) has fined three former senior executives of Swinton Group Limited (Swinton) £928,000. The FCA's action follows previous enforcement action taken against Swinton: in 2013 it was fined £7.4m after it adopted an aggressive sales strategy that resulted in mis-sales of monthly add-on insurance policies; and in 2009 the firm was fined £770,000 for failures in its sales of PPI. www.fca.org.uk/news/former-swinton-executives-fined-and-banned-misselling

[351] *Michael Lee Thommes v The Financial Services Authority*, FS/2011/0022, [Tax and Chancery Tribunal Decisions].

[352] *SEC v Martin Currie Inc. & M Currie Inv. Management Ltd (2012)*, Administrative Proceedings, 3-14873

- On 9th February 2012, the FSA fined Donald McKee Morgan £335,204 and banned him from performing any functions in relation to regulated financial activities. The FSA found that fraud had been committed between approximately 2005 and 2010 through the deliberate retention by Mr Morgan of premium payments which should have been paid to insurers by his firm. It was found that his conduct in doing so and falsifying documents breached Principle 1 (integrity) of APER. The financial penalty was composed of a punitive element of £112,700 (reduced by 30 per cent as Mr Morgan agreed to settle at stage one of the FSA's executive settlement procedures) and disgorgement of financial benefit of £222,504.[353]

- Lack of due diligence and skill were used against *Halifax Bank of Scotland* (HBOS) where on 12th September 2012 the FSA fined Halifax and its director Peter Cummings £500,000.

  Mr Cummings was Chief Executive of the Corporate Division of Bank of Scotland plc between January 2006 and January 2009. The FSA took action against him for breaches of Principle 6 of APER (due skill, care and diligence in managing the business of the firm for which he was responsible in his controlled function) and for being knowingly concerned in a breach by the firm of Principle 3 (management and control) of the principles for Businesses ("the Principles") during that time between January 2006 and December 2008.

  Cummings was banned for life from performing any significant influence function in any bank, building society, investment firm or insurer. He was also banned from holding any senior position in any UK authorised firm. However, Mr Cummings is now a senior director of a French Bank operating offshore.

  The FSA based its action on the aggressive growth strategy pursued by the firm under Mr Cummings' direction. In its notes, there was no mention of mis-selling or misleading investor clients. The FSA acknowledged clearly that Cummings did not act deliberately or recklessly and found that he should have been aware of serious deficiencies in Halifax’s systems and assessment controls of internal departments. The FSA found that he should have acted to remediate those deficiencies and pursue a less aggressive strategy. [354]

  It is worth noting that the FSA had previously acted against three individual former executives of Northern Rock (Messrs Baker, Barclay and Jones in 2010). However, this was the first occasion on which it had acted against an individual for conduct directly connected with the financial crisis. That fine in 2012, constituted the highest fine that the FSA had ever imposed on a senior executive for management failings. [355]

[353] *FSA v Donald McKee Morgan & Janet Morgan* (2012), Final Notice DMM00021 February 2012
[354] *FSA v Peter Cummings (Sep. 2012)*, Financial Services Authority Final Notice PJC01301
[355] *FSA v Mortgages UK 1970 (2012), Financial Services Authority Final Notice 300422*

- By the same token in the US, the Securities and Exchange Commission ("SEC") has charged 112 entities and individuals with misconduct relating to the financial crisis. Of those charged, 55 were Chief Executive Officers, Chief Financial Officers and other senior executives of financial institutions. The SEC imposed penalties, disgorgement and other monetary relief of over $2.2 billion.
- Post Crisis, the deterrence objective was clear in a fine of £3.345 million imposed by the FSA on Mitsui Sumitomo Insurance Company (Europe) Limited ("MSIE") for failures in corporate governance between 2009 and March 2011. The FSA fined Mitsui Sumitomo Insurance Company (Europe) Limited ("MSIE") for failures relating to its expansion into non-Japanese markets between October 2009 and March 2011. It also fined its executive chairman Mr Yohichi Kumagai £119,303 and banned him from performing any significant influence-controlled function in the financial industry.

  Both fines were reduced by 30% as MSIE and Mr Kumagai settled at stage one of the FSA's executive settlement procedures. The FSA also imposed a fine of £119,303 on the Executive Chairman of Mitsui Sumitomo and banned him from performing any significant influence or control function.

The APER personal liability for directors and senior management became an effective strategy in regulating directors and senior executives in financial institutions. However, these changes did not take place until 2013 in the wake of public discontent. That's when legislators and regulators felt compelled to introduce enhanced personal liability for bank senior managers with wide-scale enforcements.[356]

The Act (Financial Services Banking Reform 2013) adopted much of the Parliamentary Commission recommendations and provided for senior persons to be subject to enforcement for misconduct in cases where such a person "contravenes" the conduct rules applicable to them or to the financial institution they belong to. Nevertheless, the Act did not specifically define "Senior Persons" to whom specific liabilities would be attached and by whose authority.[357]

In all the above cases and all the regulations, those held responsible were subjected to bigger liabilities as compared with other employees. They were also found liable for the firm's failure in following regulatory requirements in all aspects that may fall within the general activity of the department or area of that person.

However, in all of the above decisions, there is no process for compensation or indemnity for the wronged party. Directors have been banned for life and fined penalties that may amount to a fraction of the profits their firms have gained through misrepresentation. They directors and/or their firms were not ordered to pay back indemnities or damages to investors who lost their fortune. Claimants were left to seek justice in courts and for whatever length of time and expense it may take.

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[356] *Changing Banking for Good* Vol 2 (n2) par 632-634

[357] Demirguc-Kunt, Asli, Edward Kane and Luc Laeven*, World Bank Policy Research Working Paper*, 2014

The best comment here is to use Paula Patrik's quotation: *"What matters if I pay a scrap fine and retire as a millionaire?"*[358]

Collaboration between regulatory authorities and individual actions by investors can achieve the systemic stability yearned for by governments to align financial services and bank executives in line with pre-set rules and regulations.[359] Such collaboration can only occur within a process where investors, whether public or corporate believe that they can dispute the actions of their bankers with success because they know they can rely on an effective process for claims and compensation. Raising disputes will create an independent monitoring tool that will aid regulatory authorities to shorten the gap left by attrition in penalising those who are responsible and equally compensating the aggrieved. [360]

The role of regulators is pivotal in policing financial services firms. Laws and regulations along with the quality of their enforcement by regulators are essential elements of the governance of financial markets. Statutory regulations set bounds on contracts which individuals and organizations may enter into. Rules are needed to enforce the boundaries of performance by different parties to a financial agreement. Tribunals and courts operate within those boundaries. Even if arbitration tribunals may have the right to distance themselves from certain laws, they will still need the boundaries of rules and regulations to decide upon performance and awards.

Rajiv Sethi, Professor of Economics at Columbia University, commented on the book *Bull by the Horns* by Sheila Bair, the former Chairman of the Federal Deposit Insurance Corporation (FDIC) during the 2007 crisis. In his comments on the book, Professor Sethi explains that:

"A fragmented regulatory structure with a variety of norms and standards encourages financial institutions to shop for the weakest regulator".[361]

In the lead up to the 2007 crisis, such regulatory shopping occurred between banks and asset managers. Mortgages and securities brokers such as Merrill Lynch, Goldman Sachs and Lehman got around a strict regulatory jurisdiction by involving insured banks in other less strict jurisdictions in the acquisition and resale of unregulated products. However, Sethi also notes that, in some countries, certain banks never needed to shop for regulatory arbitrage. He points out three of the largest banks in the US who became quite problematic, namely Citigroup, Wachovia, and Washington Mutual Bank (WaMu).

Those were insured banks at the time and had been with the same regulators for decades. They had all the independence to do what they desired and never needed to shop elsewhere. In reality, Sethi is saying the problem was that banks were operating in independence from

[358] Patrik,P. 2009, *Parading as Millionaires: Montana Bankers and the Panic of 1893*. *Enterprise and Society*, 10(4).

[359] FSB DI Peer Review (Financial Stability Board (FSB) *Thematic Review of Deposit Insurance Systems: Peer Review Report*) p.10

[360] Posner, Elliot *"Is a European Approach to Financial Regulation Emerging From The Crisis?"*, in E. Helleiner, E. Pagliari & H. Zimmermann, (eds.), *"Global Finance in Crisis"*, London: Routledge (2010).

[361] Rajiv Sethi (14 October, 2012), *"Of Bulls and Bair: Thoughts on Economics, Finance Crime and Identity"* (Blog Post), Retrieved from http://rajivsethi.blogspot.fr/2012/10/of-bulls-and-bair.html

their regulators, but the regulators were not independent from their banks.[362] To take the point further, Bair in her book explains her theory that, "The financial system is still fragile and vulnerable to the same destructive behaviour that led to the crisis in the first place. We are at risk of other financial crises unless the public engages more actively in influencing the financial services institutions."[363]

In other words, the public needs an incentive and a process to be able to engage in monitoring their financial service providers. This thesis discusses how a process which can effectively impose retaliatory compensations and penalties on financial institutions can provide incentive for the public to be active in monitoring their bankers and help to diminish moral hazard in the process.

2.7. BANK RUNS

A bank run is an event that occurs when large numbers of depositors start withdrawing their deposits in fear that their bank is at risk of failing. A bank panic on the other hand, is when many banks start to suffer from bank runs almost at the same time including banks running onto each other.

It is interesting to point out that a working paper by the IMF on deposit insurance schemes[364] indicated in 2013 that there were no clear widespread bank runs during the first two years of the crisis 2007-2009. The report covered in its analysis 188 countries that were members of the IMF. There were some notable exceptions, nevertheless, such as Northern Rock in the UK, and some expanded withdrawals by uninsured depositors.

However, the report shows clearly that the world did not experience systemic bank runs by insured depositors. It shows that the events that took place in 2007 within the banking system were not retail panics involving individuals running on banks. It was a wholesale panic involving banks and financial institutions running on each other.[365]

The report indicates plainly that moral hazard existed, misrepresentation was fully fledged, banks were suffering from illiquidity, but there was no run on banks by insured depositors. Financial institutions and banks, after realising the true depreciation in the market value of the assets on their balance sheets, commenced a run on selling those assets to the market-makers which were mostly the same institutions which had introduced this kind of securities to the markets in the first place.

Having the securitised banking system around the world running on one another caused a fire sale in securitised assets and the whole financial system became insolvent to the point of

[362] WaMu Inc. Banking subsidiaries were closed by the OTS and placed into the receivership of the FDIC. In September 2008, their assets were sold to *JPMorgan Chase*, which now operates the assets as a part of Chase Bank.

[363] Sheila Bair, "*Bull By The Horns: Fighting to Save Main Street from Wall Street*", N.Y., Simon & Schuster, 2012 (in the Prologue)

[364] A. Demirgüç-Kunt, E. Kane, & L. Laeven, *Deposit Insurance Database*, IMF Working Paper, WP/14/118, 2014

[365] ibid. https://www.imf.org/external/pubs/ft/wp/2014/wp14118.pdf

collapse. Insolvency in the securitised banking system left financial institutions around the world unable to raise the necessary liquidity for their day-to-day activities.

Those activities included straightforward credits and loans which supply the necessary liquidity to allow other sectors of the economy to continue functioning. Most importantly, it also includes repayments of the "on-demand" short-term deposits of banks and financial institutions. Lack of interbank liquidity caused a contagious systemic dryness in the wider and more global economic activities around the world.

Shin argues that the failure in the securitisation banking system was a failure of the major source of liquidity intended to transfer credit risk from financial institutions to the open market.[366] Channelling financial papers through the open market is the ultimate source for funds for banks and financial institutions where securities are absorbed by the large population of multi layered segments of individuals and investors. By failing to repay each other, banks caused a collapse in the liquidity generating machine and the global financial sector ran out of money.

At this point it is essential to differentiate between protecting investors' rights and regulating prudential conduct of banking business. The idea is not to rely entirely on financial regulatory systems to monitor banks and financial institutions. An effective arbitration process can act as a tool of client-bank check process inducing greater monitoring efforts on the part of the public and keeping regulatory authorities aware of serious disputes that may indicate more serious regulatory infringements.

Bank clients must be able to monitor banks *(*dispute monitoring*)*. By monitoring their banks and pricing risk correctly in their agreements, creditors are also effectively influencing banks' behaviour *(*public monitoring*)*. Making public monitoring discipline work calls for more comprehensive supervisory frameworks of which compensation through dispute resolution can be a part of the regulatory monitoring process, even if indirectly. Arbitration processes may ultimately be the banking regulatory supervisor tool in monitoring banks' behaviour on a case by case basis.

Investors are most dependent on the law and regulatory guidelines for protection against bankers' clear misdemeanours. The most manifest of those delinquencies are actions of moral hazard which have no one specific legal form or shape. They exist in reckless and immoral actions that may tread on the borders of illegality but with no attainable evidence of trespassing financial rules or breaking the law. They mutate and adapt to every new rule and regulation. Immorality lies in the fact that, when financial institutions design a new product, they make sure that it is within the frame of the written rules and regulations but will go jurisdiction shopping to arbitrage advantages from the discrepancies between regulations in

[366] Shin, H. S., 2005. *Financial System Liquidity, Asset Prices and Monetary Policy*. s.l., Reserve Bank of Australia.

different jurisdictions.[367] They will then offer securities that are not permitted in one jurisdiction to local financial firms located in an unregulated jurisdiction.

When offering these securities, bankers will not voluntarily disclose to their clients the full details of the regulatory bypass and risk involved in the transaction. In certain cases, bankers themselves do not realise or fully understand the scale of the risk involved or how the security has been formulated.[368] However, regulatory processes are so far not set up for compensating investors or awarding damages. This is left to courts to examine contract performance and adjudicate reparations. Lest we forget, I emphasize once more that at the bottom of the crisis lie failed contracts.[369] Given the ever-increasing financial-engineering capabilities of banks today, economists and regulators expect other future financial crises are still to come with more severe damage to financial markets as moral hazard activities still go on. The search now for preventive measures is thus of critical importance. [370]

3. ARBITRATION AS A TOOL IN GOVERNING BANKS

Regulatory system processes differ from one country to the other and from jurisdiction to jurisdiction and particularly so with regard to financial disagreements. In comparison, international arbitration has standard processes that resemble judiciary hearings while flexible enough to adapt to all parties regardless of ethnicity. In domestic as well as cross border financial disputes, arbitration can play two essential roles:

1- Resolving bank and financial disputes in a speedy and efficient manner

2- By compensating claimants and financially penalising respondents, it can play a valuable role in the governance of the financial sector.

Regulators cannot be everywhere and examine every transaction within the banking system. If investors can use the right to dispute actions of moral hazard, there will be an unlimited number of observers in the form of banks' clients and investors in every bank and in every country of the world. If one investor succeeds in disputing a questionable transaction, that dispute may reveal a series of other dubious activities that financial institutions are engaged in.

Regulators will have a chance to commence investigations for the possibility of suspicious transactions. The bank involved can face retribution and possibly be ordered to refund outstanding transactions to clients. Financial institutions will be forced to repay their bonuses and claimed profits as investors begin to reclaim back their losses plus possible

[367] Michael Taylor, *Twin Peaks: A Regulatory Structure for the New Century*, Centre for the Study of Financial Innovation (1995).
[368] Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, Robert Vishny, *Investor Protection and Corporate Governance*, Journal of Financial Economics 58 (2000) 3-27.
[369] *George M Cohen, The Financial Crisis and the Forgotten Law of Contracts, University of Virginia School of Law, September 13, 2011*
[370] Sir David Walker, *A review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations*, http:/www.hm-treasury.gov.uk/d/walker_review_261109.pdf

compensations. After a point, banks and financial institutions will find that it is better to refrain from excessive risk and mis-selling activities.

Arbitration is voluntary and consensual in origin. It is an extension of the will of the parties in a contract to refer their dispute to one or more persons for a final decision. Arbitration is a process of universal judicial application that has a significant function to adjudicate and not to create rights. That is to say arbitration does not create judicial precedents.[371]

Basic social facts and their implications must be fully realised before the full potentials of an international arbitration process for resolving financial disputes can be achieved. The social potential here relates to the common man, wherever he is and under whatever jurisdiction he may reside.

It is essential for that common man, to have confidence in some kind of a judicial process, a process that the whole of society will come to believe in and have faith that it can bring back their money. Such realisation can repel social unrest and deter the panic of bank-runs.

For those reasons, the thrust of this thesis is based on a swift arbitration mechanism as an adequate deterrence to moral hazard in the financial sector. The principle is built upon equity and justice that Arbitration Tribunals use to build their conclusions on.

Tribunals are entitled to look behind written agreements and read through the intentions of the parties. They can part from statutory rules and strictly worded pre-set contracts to arrive at the merit of the agreement. Arbitrators, as social actors, also express values which may have a broader social destiny.[372] When the French Court of Cassation affirmed that an international award is "[a] decision of international justice", it expressed values as to what arbitration is or should be to a broader international audience.[373]

Awards are expressive decisions that can have influence on more than just the parties concerned in a single dispute or in one legal circle or jurisdiction. Similarly, when the House of Lords recognized the severability of the arbitration agreement in *Fiona Trust*, it set forth an international standard in addition to providing a solution for the case at hand.[374]

3.1. ARBITRATION FOR PUBLIC GOVERNANCE

There may not have been a shattering surge of litigation since the onset of the financial crisis, but there has been a steady increase in financial services litigation. In some cases the courts

[371] Earl S. Wolaver, *"The Historical Background of Commercial Arbitration",* 83 U. Pa. L. Rev. 132 (1934).

[372] E Gaillard at Note 517 (English translation, French International Arbitration Reports 1963–2007)

[373] This statement was made in order to justify the fact that recognition of an award should focus on the award itself, not ancillary decisions pertaining to assess its validity at the place in which the award is rendered. *Cass 1e civ, 29 June 2007*, PT *Putrabali Adyamulia v Rena Holding*, 2007(3) Revue de l'Arbitrage 507, E Gaillard at 517, French International Arbitration Reports 1963–2007, *Case No 62, at 539* (T Clay and P Pinsolle eds, Juris Publishing, 2014)).

[374] House of Lords, *Premium Nafta Products* Limited (20th Defendant*) and others* (*Respondents) v Fili Shipping Company Limited (14th Claimant) and others (Appellants), [2007]* EWCA Civ 20, 32; *Fiona Trust and Holding Corporation and Others v Yuri Privalov and Others*, [2007] EWCA Civ 2 and *Fiona Trust & Holding Corp & others v Yuri Privalov & others,* [2006] EWHC 2583 (Comm).

have provided helpful guidance and certainty to market participants, reducing the scope for further disputes to arise.

However, just as the financial crisis is far from being over, so we can continue to expect plenty of financial services disputes over the years to come. Banks are likely to face future claims from investors arising from causes of action uncovered by more vigorous regulatory enforcement.

The issue this thesis addresses is considered as a pivotal point in regulatory governance of banking and financial intermediary activities. The issue specifically concerns the speed by which dispute resolution methods get processed and the guarantees they offer of finality. That is to say, investors involved in banking disputes do not need to wait longer than a few days in order to reach a final decision and get paid. The speed of granting resolutions will promptly redress clients' claims and quietens possible panic in the future. On the other hand, swift retribution will improve governance of financial institutions as dispute results can raise an alarm for the regulatory authority to analyse causes of the dispute and identify areas of high risk and deficiencies in banks activities. This point is especially important as it evaluates coordinated regulatory developments internationally in a comparative perspective. It also draws out some of the implications for broader global trends in governance of financial institutions as disputes become broader and faster in getting resolved.

In examining the arbitration of regulatory matters involving financial institutions, there are three areas to consider:

(i) The arbitrability of disputes between clients or investors and financial institutions involving misleading transactional agreements and whether they involve regulatory breaches.

(ii) Specialised arbitral institutions that administer dispute resolution proceedings between clients and financial institutions

(iii) The possibility of using arbitration by investors or financial institutions to seek remedies in response to alleged improper actions on the part of regulators.

Investor clients equipped with such an indirect instrument of governance through dispute can provide a thorough critique of at least three fundamental elements:

- Executives' personal and professional accountability;
- Executives' remuneration as an incentive to take high risk; and
- Regulatory Authorities' alerting, engagement and activism.

Prior to 2007, quantitative measures imposed by financial regulators were not able to capture qualitative problems such as poor management, even where asset impairment had been properly measured. In the banking and insurance sectors, regulators focused primarily on an institution's ability to meet its obligations to depositors and policyholders, with some attention to systemic stability in banking.

Their primary emphasis was on investor protection and market efficiency considerations. Regulators relied primarily on disclosure reports coming from the banks and their auditors to ensure market discipline and sound legal and accounting practices.[375]

The term "regulatory" in the context of financial institutions, encompasses a broad range of subjects including prudential supervision, application and enforcement of rules of conduct for doing business, and the regulation of financial products and markets.

For years, the global structure of financial regulations remained roughly the same. Regulatory committees were formed then replaced by others. Forums were held, and regulation practices remained the same. The paradox is that legal and auditing inspections imposed by financial regulators were not able to capture qualitative problems in the banking operations such as poor fund management or asymmetrically formed agreements. In fact, reports revealed no discrepancies or regulatory failures during all the years prior to Lehman's collapse.[376]

Moreover, the report by The Financial Crisis Inquiry Commission (FCIC) on Ben Bernanke's[377] testimony during the crisis quotes him as saying that, "out of thirteen of the most important financial institutions in the United States, twelve of them were at risk of failure within a period of a week or two".[378]

The question that needs to be asked is whether there were any regulatory processes exercised on those institutions and if 'yes' then why did the crisis occur? The FCIC report gives an answer in its conclusion. It says, "In our inquiry, we found dramatic breakdowns of corporate governance, profound lapses in regulatory oversight, and near fatal flaws in the financial regulations systems".[379]

3.2. FINANCIAL REGULATIONS AND ARBITRATION

The difficulty with regulatory authority lies in that regulators cannot shift regulatory rulings instantaneously. Any conduct of moral hazard involving newly invented financial transactions will require new regulations which will need time to be worded and enacted.

Regulators are unable to spontaneously respond to certain actions because of the time lag between when a demeanour occurs, and the time required to produce a rule penalising or prohibiting it. It may take up to a year for the legislation of new financial regulations to pass and be implemented. Alas, even those newly enacted regulations will still not be able to resolve what has already been transacted.

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[375] David Marston and Udaibir S. Das, *Financial Sector Regulation: Issues and Gaps*; IMF Working Paper Aug. 4, 2004

[376] H. Davies & David Green, *Financial Regulation: The Essential Guide*, Polity Press (2009) 2ed.

[377] Ben Shalom Bernanke served two terms as Chairman of The Federal Reserve of the United States from 2006 to 2014. During his tenure, Bernanke oversaw the Federal Reserve and US Government responses and application of policies to the 2007-2008 Financial Crisis.

[378] The Financial Crisis Inquiry Commission Report (2011) - https://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf

[379] *FCIC* - pp 27-28 https://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf

Laws and regulations in principle do not get to be applied retroactively. Thus, investors with bad deals will have no recourse on the financial institution under any newly enacted rules. However, disputes raised by creditors and investors in front of financial arbitration tribunals can theoretically take a fraction of such a period in order to resolve.

Additionally, raising such disputes can help regulators identify unclear or hidden conducts that may be taking place within the financial service sector.[380] Bankers and financial service providers continue to reward high performing traders on the trading floors. This occurs regardless of the level of uncontrolled and excessive risks those traders may engage in while manoeuvring around the existing set of rules and regulations.

Such practices by financial institutions and bankers have allowed a culture of dangerous risk taking, immoral misrepresentation and fraud to develop in the financial sector. It developed into a cultural mode within banks, financial institutions and insurance conglomerates to the extent that it became a feature of the day-to-day conduct of business.[381]

3.3. REGULATORY POLICIES

Creditors are the principal transmitters of contagion for systemic bank failures on a national scale. However, and in contrast to existing perceptions, creditors do not start bank failures. Failures, to a certain extent, are a result of compounded factors of inherent policies and practices in banks and financial institutions.

A collapse of a financial institution is not always a direct result of external factors. Excessive risk taking, and moral hazard actions are accumulative and the economy can endure it for a length of time. However, there comes an instant when the compounded effect of more than one bank taking excessive risk surmounts any regulatory attempts and will then result in uncontrolled contagion failures.[382]

The effectiveness of interference by regulators at this stage is debatable and dependable on politicians and policy makers. Debates on ex-ante versus ex-post interference by regulators,

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[380] P.R.I.M.E. Finance decision by specialist arbitrators resolved a US$1.7 billion credit derivatives dispute in just eight days got the runner-up prize in the category of the most important published decision of the year at the Global Arbitration Review Awards 2016 when these were announced in Shanghai on 2 March 2016. The case was decided under ISDA expedited procedural rules in February 2015, providing a fast and efficient outcome at a cost of less than US$50,000. Arbitral decision by P.R.I.M.E. Finance experts cited at Global Arbitration Review GAR Awards *March 2016,* http://primefinancedisputes.org/news/

[381] Moshinsky, B., *Turner Makes Claims for Bank Culture Reform Sought,* (Bloomberg, 2012); Kantšukov, M. & Medvedskaja, D. From dishonesty to disaster: the reasons and consequences of rogue traders' fraudulent behaviour. Adv. Ser. Manag. 10, 147–165 (2013); also Abrantes-Metz, R. M., Kraten, M., Metz, A. D. & Seow, G. S. Libor manipulation? J. Bank. Finance 36, 136–150 (2012); Hill, C. A. & Painter, R. *"The Personal and Professional Responsibility of Investment Bankers"*. (Univ. of Minnesota Law School, 2012). http://www.bloomberg.com/news/2012-07-24/turner-stakes-claim-for-boe-helm-asbank-culture-reform-sought.html

[382] George Kaufman, Bank Contagion: *A review of the Theory & Evidence, Journal of Financial Services Research* (1994), 123-150, Kluwer Academic Publishers 1994

have traditionally been associated with the question whether the law should be given content before or after harmful conduct has occurred.[383]

A run on one single regional bank can eventually transfer into a large-scale financial malfunction. Such failure can reach into a global financial breakdown due to contagion shortages in liquidity. But, if creditors' claims can be resolved at the early stages of a financial crisis, the entire panic transmission process may be contained ex-ante. Unlike other areas of regulations, financial regulatory authorities operate in the context of complex co-dependent systems.

Financial markets and financial institutions including banks are dependent on legal rules for day-to-day operations. This has implications on regulatory policies, in particular the choice between ex-ante regulations aimed at preventing financial failures and ex-post regulations aimed at responding to a failure.[384]

Regulatory systems should be able to impose order or discipline when it comes to dissolving ailing institutions. The purpose of imposing such discipline is to insure the rights of creditors and investors. Guaranteeing creditors' rights here is of the utmost priority to mitigate panic and contagion failure within the financial markets.

*"*Regulatory Theory*"* is not the focus of this thesis; however, it is worth noting that regulations in the context of financial failures take separate forms. Nevertheless, it is necessary to focus on regulatory-imposing forms. In other words, it is important to examine how policy makers and financial regulators impose forms of rules and regulations on financial institutions. The focus is on what kind of exemptions if any, are granted and to which institutions; and if there are rules aimed at reducing the likely economic effect to a failure of a financial institution.

As Steven Schwarcz[385] explains, there is a dual role for regulatory authorities to play. His study implies that ex-ante and ex-post a crisis, regulations should be balanced throughout by an independent and officially authorized operating system. Its role is to interfere and prevent moral hazard within financial institutions. Executives and traders of banks and financial institutions should be discouraged from engaging into further risky activities before a failure occurs and, moreover, after a crisis materialises. Certain institutions try to use a crisis for their benefit by engaging in risky financial transactions such as shorting the markets or acquiring put options.

At this juncture, I put forward that a dispute resolution system such as arbitration can play ex-ante and ex-post roles. This lends support to the view of this thesis that arbitration as a

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[383] In 1974, central banks governors of the G10 countries decided to establish the *Committee on Banking Regulations and Supervisory Practices* which came to be known as the *Basel Committee on Banking Supervisory*. Established under the supervisory of the G10 countries, the membership was mostly dominated by European central banks and has remained so. (Howard Davies and David Green, *Global Financial Green: The Essential Guide (2008*) ch.7.

[384] Sheng, Andrew: *Bank restructuring: lessons for the 1980s; World Bank: Washington D.C.*

[385] Steven L. Schwarcz, *Regulating Ex Post: How Law Can Address the Inevitability of Financial Failure*, Texas Law Review, (2013) Vol. 92:75

dispute resolution process can be effective in encouraging investors to monitor their banks. The public's monitoring function will act as a complementary compliance method monitoring moral hazard within financial service providers, whether banks or brokerage firms.

A public's role as such will add to the efforts of containment by regulatory authorities prior to a failure of a bank. It will also support efforts to restrain panic runs in a financial crisis through an orderly disputes resolution system for aggrieved parties. Arbitration will provide a time restraint on distressed parties.

While assured that arbitration will grant them their rights effectively, investors will be restrained from running on ailing banks and causing panic. This in turn will contribute to the slowing down of bank failures as regulatory sanctions and the possible shutting down of troubled institutions can be stayed while arbitration procedures are in progress.

Transmission of panic is not exclusive to consumers and individual clients of banks and financial institutions. Banks can also start running on each other, as was evident in 2008. Balance sheets of financial institutions ultimately include liabilities that are assets of other banks. This in turn makes the value of balance sheets of other banks dependent on the behaviour of financial institutions that get into trouble.

Drawing on the same principle of assuring savers and investors, an arbitration framework with effective and speedy payment process will persuade creditors and investors of their rights. Parties to a dispute with a bank will be satisfied to claim compensation in front of a neutral and speedy tribunal. An indication of how the markets are receptive to such a process shows in the post financial crisis dramatic increase in the number of financial disputes referred to arbitration. In the US, for example, slightly more than 3,000 arbitration cases were filed in 2007 with the Financial Industry Regulatory Authority (FINRA). The number of cases filed in January 2009 was 12,000.

An award handed down by a FINRA tribunal in February 2009 arising from transactions in auction rate securities, illustrates the enormous magnitude of disputes arising from the financial crisis and the speed with which they can be resolved through arbitration. The tribunal ordered a brokerage unit of Credit Suisse Securities US, to pay $400 million to its customer ST Microelectronics NV, a European semiconductor maker.

ST Microelectronics[386] claimed it had authorized Credit Suisse to make investments in top-rated securities backed by U.S. Government guaranteed student loans, but instead the funds were invested in collateralized debt obligations some of which were backed by sub-prime mortgages. The entire process, including 28 hearing sessions over two months, took just under a year. Any court proceeding would undoubtedly have taken far longer. Nonetheless, ST Microelectronics, according to the award, incurred more than $4 million in legal fees during that time. It is worth noting that all financial institutions who are FINRA members are compelled to arbitrate customer disputes.

[386] *ST Microelectronics, N.V. v. Credit Suisse Securities* (USA), No. 10-3847 (2d Cir. 2011)

3.4. REGULATORS

Advocates for international financial regulatory systems argue that errors by national regulators were "by no means" at the heart of the 2008 financial crisis. On the other hand, there is unanimous agreement between both sides of the argument on the serious lack of international coordination between regulatory authorities.[387]

What this means is that bankers have an incentive to engage in moral hazard on an international scale to bypass local restrictions. In this case, counter actions need to be coordinated and specifically internationally enforceable so that it can have the desired effect in combating jurisdiction arbitrage. The introduction of government regulations and regulatory institutions in countries such as the United States was intended to provide protection against the fragility of banks. However, it appears to have unintentionally increased both the fragility of the banks and their failure rate.[388]

This illustrates the predictable and classical moral hazard behaviour as public taxpayers' money shielded banks from failure and depositors' panic.[389] In effect, banks were encouraged and found it a chance to increase their profits by getting into excessive risk exposure using depositors' funds while being protected from failure. As a result, assets to liability ratios of large banks decreased while high-risk portfolios multiplied. Regulatory Authorities around the world accordingly could not brace the world economy for the impact of the failure in the mortgage market in one country that spread into a contagion global banks failure.[390]

In the years leading to the crisis, regulators were mainly concerned with the applicable deposit insurance system and potential impact of bank failures within their local jurisdictions. Their outlook neglected that there could be wide macroeconomic ramifications resulting in international contagion financial failures. [391] A breakdown of one bank's liquidity would result in a worldwide failure in the interbank payment systems such as that of Lehman Bros. which led to the 2008 liquidity crisis.[392]

3.5. MORAL HAZARD MISFEASANCE IN BANKS

It is essential to look at how regulatory systems in the US operated and developed through two quotations by two Comptrollers of the currency 100 years apart:

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[387] Arner, Douglas W. and Taylor, Michael, "*The Global Financial Crisis and the Financial Stability Board: Hardening the Soft Law of International Financial Regulation?"* (June 1, 2009). AIIFL Working Paper No. 6.

[388] Demirgüç-Kunt, A., and E. Detragiache, 2002, "Does Deposit Insurance Increase Banking System Stability? An Empirical Investigation," *Journal of Monetary Economics*, Vol. 49, No. 7, pp. 1373-1406.

[389] Aslı Demirgüç-Kunt & Edward Kane, Deposit Insurance Around the Globe: Where Does It Work, Journal of Economic Perspectives, Volume 16, Number 2, 1 April 2002, pp. 175-195(21) The failure of the late Federal Savings and Loan Insurance Corporation (FSLIC) to promptly resolve insolvent savings and loan associations in the 1980s, led to its own insolvency, the shifting of its approximate $150 billion negative net worth to the U.S. taxpayer, and a record number of thrift failures. (Brinkmann, Horvitz, and Huang 1996; 1995a)

[390] Mazar, N., Amir & Ariely, D. *The dishonesty of honest people: a theory of self-concept maintenance*. J. Mark. Res. 45, 633–644 (2008).

[391] Senate Report on the *Credit Rating Agency Reform Act of 2006* - 109-326.

[392] Gerard Caprio Jr. and Ross Levine, 2002, *"Corporate governance in Finance: Concepts and International Observations*", in Liton, Pomerleano and Sundararajan, eds. *Financial Sector Governance: "The Roles of the Public and Private Sectors"*, pp.17-50 (Washington DC, Brookings Institute Press).

[T]'he Comptroller of the Currency in the US Treasury in the 11th Annual Report 1874 on the "Panic of 1873" said that all the bank failures that occurred were due to "[..], criminal mismanagement of the officers of the banks or neglect or violation of the National Banks Act on the part of the directors*"* **(Knox, 1873)**

One hundred years later, Robert Clarke[393], then Comptroller of the Currency, in an evaluation on factors contributing to the 2008 crisis and bank failures reported that:

[I]insider abuse such as self-dealing, inappropriate transactions with purpose built affiliates or fraudulent misrepresentation and unauthorised transactions on behalf of depositors were significant factors leading to failures of 35% of the failed banks.

History could have helped regulatory authorities understand and foresee the situation and guide thoughts about regulatory reforms. One constant factor that remained was that bank failures in almost every developed economy with well-developed markets and functioning banking systems had never stopped since the Great Depression.

However, the speed and complexity of leveraging had grown so much within the banking sector that it had become practically impossible for regulators to monitor any irregularity until a crisis or a failure occurred. In a similar proportion moral hazard and information asymmetry surrounding banking activities grew, and was not properly addressed by the regulators.

Regardless of what regulations are aimed to prevent, correct or deter in the banking world, eradicating immorality seems to be the goal. Mitigation of immoralities cannot, however, be achieved by rules and regulations alone. Wrongdoers can always find a way around rules and regulations.

Deterrence must be of the same kind as that of the action. Bankers' stimulus in performing risky transactions is motivated by profitability and to gain more money.

Thus, a slapping and speedy financial deterrent can discourage hunters of profits from wrong doing. However, not just any deterrent that can work. The deterrence must be of a quantity superior to what has been gained plus compensation to the injured party.

To curb bankers' appetite from risking their clients' funds, there must be a method that can make them instantly refund their investors as well as hefty compensations for costs. The current penal system penalises institutions collectively for misdemeanours but does not reimburse investors individually for their losses.[394]

[393] Gokhan TornaRobert DeYoung, *Non-traditional Banking Activities and Bank Failures During the Financial Crisis*, March 2012Journal of Financial Intermediation 22(3)
[394] Lee Buchheit, *'Did we Make Things too Complicated'*, (2008) International Financial Law Review 24, at 24-26, www.iflr.com

4. PUBLIC MONITORING AND POLICY MAKERS

Caprio and Klingebiel found in a sample of 24 systemic banking crises in emerging-markets and developed countries, that deficient bank management and controls were responsible in all cases. On the microeconomic side, poor supervision, over regulation and deficient bank management were often found to be a significant factor. Since then, there have been numerous reports and articles produced. [395]

The results clarified the causes of the crisis and presented proposals for avoiding a recurrence of another financial crisis. The proposals related to many facets of the banking system such as tougher prudential capital requirements, enhanced liquidity requirements and prohibitions on banks carrying on certain types of business.[396]

They also reflected apparent decline in public confidence which stemmed from the unprecedented increase in the incidences of bank failures before and during the crisis of 2008. [397]Decline in public confidence can also reveal the fact that as the number of banking laws and regulations increased, there was also an increase in the probability of neglecting investors' disputed rights. This normally occurs and becomes more apparent at times of crises.

Authorities became preoccupied more with the political effect of the crisis and the upheaval of failing banks than with the failure of creditors and losses to investors.[398] This is where the challenging and monitoring power of the public can be influential. If investors can be guaranteed an instant and adequate method to recuperate their funds and be compensated for their losses, public confidence will self-mitigate panic bank runs.

The policy response from governments, central banks and regulatory authorities to public reactions took many forms post 2007-2008 crisis:

- Internationally, at the highest level, were the G20 countries, who adopted recommendations of the newly-created Financial Stability Board and the Basel Commission on Banking Supervision, and are now introducing wide-ranging changes to its best practice guidelines
- At national levels, legislations and regulatory reforms were brought forward across the globe to address faults identified in individual banking regulatory systems. There were also searches for effective mechanisms for resolving failed banks internationally and across national boundaries with revised deposit protection schemes.

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[395] Caprio G and D Klingebiel (1996), 'Bank Insolvencies: Cross Country Experience', World Bank Policy and Research WP 1574

[396] Dziobek C and C Pazarbasioglu (1997), 'Lessons from Systemic Bank Restructuring: a Survey of 24 Countries', IMF, WP 97/161.

[397] Bank for International Settlements (BIS), "Bank *Failures in Mature Economies"*, Working Paper Nr.13 (April 2004), (www.bis.org).

[398] Supra (Ch. One)

Accounting and auditing rules for financial instruments were also amended as well as a total re-evaluation of the role of credit rating agencies.[399] Measures of financial institutions' supervisory competence were also enhanced, whether through structural changes or by strengthening regulatory resources and regulators' authority.

Those are all important changes in their own right. However, for the sake of efficacy, most of those supervisory powers will depend upon investors and depositors monitoring their banks for acts of moral hazard. [400]

In their report, "Principles for Enhancing Corporate Governance", The Basel Commission on Banking Supervision argues that effective depositors and investors' monitoring practices are essential to achieving and maintaining public trust and confidence in the banking system. Those are critical components for the proper functioning of the banking sector and the world economy.

Further on, the report reiterates that poor monitoring by the public can contribute to banking failures, which can in turn pose significant public costs and economic consequences. Fundamentally lax public supervision can lead markets to lose confidence in the ability of a bank to properly manage its assets and liabilities, including deposits and investors' funds, which could in turn trigger a bank run. [401]

Combating moral hazard takes both sides of the equation. Depositors can also be accomplices in deeds of moral hazard. They may choose to let their bankers take higher risks with their money but raise disputes of mis-selling or fraud should the investments begin to show losses.

Add to that, if the public know that their banks will not be allowed to fail, depositors and investors can also be engaged in an "offset moral hazard" by neglecting or choosing to disregard risk taken by their bankers.[402] In fact, even if investors choose to monitor and supervise their bankers, they will find that it is extremely difficult in practice for the public to monitor the actual risk profile of a bank.

Bank's assets are hard to evaluate even for specialised regulators, let alone a member of the public. There are general arguments in different countries that accounting standards and methodologies by which assets are measured have failed to make adequate provision for the more complex financial instruments to which banks are party.[403]

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[399] BIS (2013) '*Supervisory Guidance on Dealing with Weak Banks'*, Basel Committee paper no 88, March has also set out guidelines for dealing with weak banks, including early indication of problems and alternative resolution measures.

[400] Claus J. Hopt, Corporate Governance of Banks after the Financial Crisis, European Corporate Governance Institute, Law Working Paper No.181/2011, September 2011, http://ssrn.com/abstract=1918851

[401] Basel Committee for Banking Supervision, "Principles for Enhancing Corporate Governance" 10/ 2010, www.bis.org/publ/bcbs176.htm

[402] Mark V. Pauly, *The Economics of Moral Hazard: Comment*, The American Economic Review; V58, No.3, Part 1 (Jun. 1968), pp. 531-537

[403] Regulation on Banks' Internal Control and Risk Management Systems, Published *in the Official Gazette, issue no. 24312, on 8 February 2001,* Issued by the Turkish Banking Regulation and Supervision Board.

Not only that, but the profile and risk characteristics of assets build-up can change very quickly and defeat the most determined monitoring efforts by the public. Bankers will attempt to elude their clients as well as the supervisory regulations and take excessive risks, betting on winning against the odds by using their clients' money.

For instance, investors who invested their funds with Bernard Madoff lost most of their $65 billion because Madoff was running a "Ponzi Scheme". Rather than investing the money as the investors intended, he was paying initial depositors with money received from newer investors.

Madoff did not actually invest any of his client's money for years. The fraudulent process was exposed during the 2008 credit crisis. That's when more investors began to withdraw funds than those who were placing which caused the pyramiding process to finally collapse.

People who invested in American International Group (AIG) thought that their money was relatively safe because they were investing in an insurance company that had the highest credit rating given by the credit rating agencies. However, AIG was also selling credit default swaps on mortgage-backed securities (MBSs) that started to default in large numbers in 2008 requiring them to post more collateral than they had.

Why did AIG take such risks? Because the traders who sold the credit default swaps (CDSs) to AIG were receiving huge bonuses and they didn't have to bear the risk. But AIG wasn't concerned about risks because it was too big to fail, since they were selling most of these CDSs to banks and other investors.

Hence, if AIG couldn't make the payments on the CDSs or post collateral as the CDS contracts required if AIG's credit rating dropped, then the government would have to bail them out; otherwise, many other banks would collapse if they did not receive the payments on their defaulted MBSs. Indeed, the government did bail them out, wiping out the stockholders of the company.

The risks of adverse selection and moral hazard make direct financing expensive, especially for small firms, since people are not willing to lend or invest money in unknown entities. With their expertise in gathering reliable information at reduced cost, financial intermediaries can extend financing to many firms or individuals who would otherwise not get it.

The cure for information asymmetry is more information about potential fund receivers. The best predictor of future creditworthiness is past performance and creditworthiness. Checking the history of the fund receiver reduces adverse selection and moral hazard.

Requiring collateral can also reduce information asymmetry risks. Collateral reduces adverse selection by requiring a specific value of collateral, such as 20% down payment on a house, for instance. Collateral also lowers moral hazard risk because the borrowers stand to lose their collateral if they do not make the required payments.

Requiring a minimum asset net-worth also reduces adverse selection because only those individuals or businesses with sufficient assets over liabilities can be considered for a loan.

Moral hazard is reduced because the borrower can be sued if they fail to make timely payments on their loans.

There are additional methods of reducing moral hazard. One method for equity finance, which is financing through the issuance of stock, is to require the managers to own a certain percentage of the company, which is often achieved through the granting of stock options as part of the compensation package.

Another method for debt finance through the issuance of bonds is to require restrictive covenants that prevent the bond issuer from taking too many risks, or to restrict the amount of debt that can be added later. By law, all bonds are required to have a 3rd party trustee who ensures that the bond issuer will comply with the terms of the bond.

Smaller firms, who are unable or unwilling to obtain financing through the issuance of stocks or bonds, apply for loans. Lenders can lower their risk of moral hazard lending to these small firms by using the standard debt contract, sometimes referred to as the optimal debt contract. Small firms often borrow money for specific projects, but it is difficult for lenders to determine the profitability of those projects.

Additionally, costs would be incurred by investigating or monitoring the project. So, in addition to the traditional credit screening tools, the lender can stipulate via the contract that monitoring or investigating the project will not be undertaken as long as the borrower repays their debt. If the repayment is insufficient, delayed, or non-existent, then the lender must spend some money for monitoring or investigating, to identify sources of revenue, which the lender can attach or levy to fulfil the repayment of the loan.

Mishkin argues that the role of banks is in directing funds from savers to investors with a certain level of risk. However, a certain impediment to this process is the asymmetric information (non-disclosure) present in standardised financial services providers' contracts.[404]

The dilemma is how to hold corporate executives accountable for the risky decisions they take while still allowing those same executives the autonomy, the motivation and the power they need to maintain profitability for the institutions they are running. The issue here is primarily the personal accountability of financial institution executives through the enforcement of law. The focus is on the failure of bankers rather than the failure of banks.

When investors deposit their money with a financial institution, they face the risk that the returns they were promised on their investments will never materialize. Expropriation, which is another form of moral hazard, is related to the agency problem described by Jensen and Meckling. They focused on the consumption of perquisites by firm executives and directors.[405]

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[404] Mishkin, F.S. 'Prudential Supervision: Why is it Important and What Are the Issues?' **(Mishkin, 2001)**.

[405] Michael Jensen and William H. Meckling, *Theory of the firm: Managerial Behaviour, Agency Costs and Ownership Structure,* Journal of Financial Economics (1976), vol.3, issue 4, pp305-360

This means that the executives and controlling managers of those banks use the profits of the firm to benefit themselves rather than present the returns to the investors and creditors. They expropriate those deposits before the return on the investors' deposits may even materialise.

The point I raise here predominantly takes a view on recklessness rather than fraud. This is because the crisis of 2007/2008 is characterised by lack of understanding of consequences of financial business decisions marred by “immoral” hazards and reckless activities.

Those acts have proven disastrous for the global economy with a consensus that this type of behaviour is precisely what pushed many institutions, particularly investment banks to the brink of collapse. Even though the damage done cannot be overturned, the sharpening of bankers’ accountability can make less likely the occurrence of other episodes that can cause similar serious calamities.[406]

Personal liability is imperative, primarily due to the conflicting enticements promoted through limited liability and the phenomenon of moral hazard. Yet, despite the crisis and the subsequent regulatory response, some of this behaviour remains to the current day. Inconsistencies in law and regulation need to be eradicated.

For instance, at present, it is possible to disqualify the directors of companies for unfitness or make them personally liable. They can even be ordered to personally contribute financially to their institutions’ commercial liabilities. However, a director of a financial institution brought to the brink of insolvency but rescued by a form of government intervention cannot be disqualified or held accountable for the actions that brought about the failure of his bank. This is irrespective of the level of wrongful or reckless trading they have engaged in. Certainly, this is a serious deficiency of the current system of accountability, made worse by the fact that directors are generally confident that the system will not allow large institutions to fail. Moral hazard occurs thereafter when the borrower or deposit taker, in this case the bank, starts to change behaviour and engages in higher-risk activities using investors’ money in a way other than what has been affirmed to the depositor.

In fact, the difficulties are that universally formatted agreements such as the ISDA Master Agreement have to make compromises between the need for brevity in their structure and the need for details such as effective enforceability under jurisdictional conflicts.

Key issues for financial markets and participants are the understanding of the nature of their agreements and the confidence they can have in interpreting a financial transaction dispute clause, as occurred in cases such as *CRSM v Barclays*[407] and *Springwell v JP Morgan.*[408]

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[406] An externality is a consequence of an economic activity experienced by unrelated third party; it can be either positive or negative. Pollution emitted by a factory that spoils the surrounding environment and affects the health of nearby residents is an example of a negative externality. The effect of a well-educated labour force on the productivity of a company is an example of a positive externality.
http://www.investopedia.com/terms/e/externality.asp

[407] CRSM v Barclays Bank PLC (Commercial Court 2008 F. 757 (2011), EWHC 484, Comm.

[408] *Springwell Navigation Corporation v JP Morgan Chase Bank [2010] EWCA 1221*

This comes about when investors are being overawed by authoritatively trained brokers and blinded by a veil of trust in their bankers. It prevents them from challenging an age long established trust in financial institutions and banks which occupy a respected position in the economy. Therefore, as the current regulations have not proven to be an effective constraint against reckless behaviour by bankers and financial intermediaries, it is time to consider a variety of legal strategies that help eradicate the weaknesses. Instating and enforcing personal and professional responsibility in the financial sector will require a blend of different strategies.

The arbitration process proposed by this thesis will act as an assisting tool in the financial governance of financial institutions and banks. It will grant savers and investors the tool to monitor their bankers and file for claims should the need arise. Reinstating and reinforcing savers claims speedily and effectively and holding banks and their directors liable will strongly aid to eradicate acts of moral hazard in all its forms. On the other hand, regulatory authorities such as the Financial Stability Board (FSB) will have the scope over financial irregularities as disputed matters take place.

This will occur primarily as banks publish financial records which will include entries of payments of penal awards. The actual disputed arbitrations are, however, confidential and only regulators will be able to access them. The arbitral process will have greater international enforcement powers granted by the N.Y. Convention.

It will be backed by financial institutions and banks without the need to move to full treaty based or hard law amendments. This mechanism will likely enhance the ongoing supervision of cross border financial markets and lead to higher supervisory standards over international transactions.[409]

5. REGULATORY SCHEMES

Banks and financial institutions are legal entities operating in markets that are essentially legal. Collateral is a form of contractual property such as derivatives which are mere financial commitments under contracts. Money markets and securitisations are creatures of those contractual agreements and are governed by the law. Monitoring of these financial instruments and the institutions that deal in them should not fall far from the supervisory powers of the law. In that sense, financial transactions are fundamentally agreements where parties have the legal right to monitor the performance of one another.

Most regulatory schemes strive to maintain the joint objectives of financial stability and depositors' protection. Since the crash of 2007, the debate has raged on what should have been done differently.

Amendments to debt-to-equity ratios in financial institutions' that was imposed by Basel III are regulated at about 15:1 for banks and 30:1 for securities institutions.

[409] Arner, Douglas W. and Taylor, Michael, *The Global Financial Crisis and the Financial Stability Board: Hardening the Soft Law of International Financial Regulation?* (June 1, 2009). AIIFL Working Paper No. 6; http://dx.doi.org/10.2139/ssrn.1427084

This leverage has some implications. Financial Regulatory Authorities sitting in Basel were right in deciding to distinguish capital liabilities from assets. But in reality, their theory was wrong. Not all assets or liabilities are treated the same and not all institutions declare their assets and liabilities the same way.[410]

This is especially true for large investment banks with substantial contingent liabilities in the form of derivatives contracts. Similarly, a small change in the variance of bank assets can lead to a large change in bank risk. This has some unpleasant implications for governance.

Jensen and Meckling[411] explain that over-leveraged institutions will gamble with their creditors' money by shifting the nature of their assets and liabilities by using derivatives which are supplementary to the credit nature of the bank's assets such as loans, but inbuilt as a main source of liquidity in their risk-shifting manipulations of their balance sheets. Bank deposits are not the only financial liability.

Insurance company policies are another form of liability for financial institutions. For example, if we consider a term policy with an insurer to healthy policyholders, the policy is worth little, because it is easy to replace. But consider a person who purchased the policy at a low cost when healthy, then subsequently develops cancer with right to renew. Derivatives in this case will help the insurance company to hedge the risk against fluctuations in future payments and match their future assets forecasts to present liabilities.

But considering that those derivatives were purchased and placed with an insolvent bank such as Lehman, a quick pro rata redistribution of debt upon the resolution of Lehman will be a disaster for the insurer at today's present value for the derivatives. Add to the situation, the insurer's future obligations without the protection of the derivatives which disappeared with Lehman's failure.

Beck et al.[412] found that legal systems that are adaptable swiftly to changes in the contracting needs of investors in an economy will stimulate speedy financial recovery in a crisis. The legal literature has convincingly made the case that there is often a positive and causal empirical relationship between creditors' rights and financial and economic development, which depends on the quality of the legal environment.

However, the exact ways in which this empirical regularity is shaped at the micro level and the relative importance of legal versus other determinants of financial regulatory development are still largely unexplored.[413] That is because there are inbuilt difficulties that

[410] S. Kalemli-Ozcan, B. Sorensen & S. Yesiltas, *Leverage Across Firms, Banks, and Countries*, 88 J. Int'l Econ. 284 (2012).

[411] Michael Jensen and William H. Meckling, *Theory of the firm: Managerial Behaviour, Agency Costs and Ownership Structure,* Journal of Financial Economics (1976), vol.3, issue 4, pp305-360

[412] Reinmar Wolff, 'Article V(2)(b)' in Reinmar Wolff (ed), New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards of 10 June 1958 Commentary (CH Beck Hart Nomos 2012) 412

[413] Atje and Jovanovic (1993), King and Levine (1993a, 1993b), Demirgi.i9-Kunt and Levine (1996), Levine (1998), and Levine and Zervos (1998) at the country level; Rajan and Zingales (1998), Wurgler (2000), and Fisman and Love (2002) at the industry level; and Demirgi.i9-Kunt and Maksi-Movic (1998, 1999, 2002) at the firm level. The creation of an extensive World Bank database in 1999, as described in Beck et al. (2001), led to

became associated with the introduction of different schemes: those related with moral hazard, asymmetric information and excessive risk taking. [414]

As mentioned earlier, moral hazard in financial institutions currently is not just limited to insurance deposit schemes and excessive risk taking using depositors' funds. There are other facets where moral hazard materialises in extravagant bonuses and rewards paid to executives and traders of such institutions.

Rosa Lastra argues that amongst the numerous explanations given consequence to the 2008 crisis was that moral hazard has swelled in correlation to the swelling of rules and regulations taken by regulators and governments to combat excessive risk taking. The more rules the regulators imposed, the more inventive the bankers became to legally bypass such rules.[415]

Lastra mentions that there are still major challenges and points of debate on relevance, form and scope of regulatory interventions and the efficient method to overhaul the financial regulatory system whether by introducing new regulations or eliminating some altogether.

5.1. FINANCIAL REGULATORY SYSTEMS

Initially, the activities of financial institutions (mostly banks) were regulated by the respective national central banks. The supervisory function in that era did not involve too much supervision of the day-to-day operations of the banks. Such lax supervision was altered drastically following universal banking system and corporate sector crises including the Nordic countries' crises in the early 1990s, the Mexico crisis in 1994/95, and the crises in East Asian countries after 1997.

The challenges facing international financial regulations, however, are mostly in the method of homogeneous application of rules and regulations. Regulators issue uniform directives on diversified sectoral financial institutions with varied financial market activities, expecting those institutions to comply regardless of their asset holdings and fund management methods.

5.2. WHERE REGULATORS MAY HAVE ERRED

With reference to the FCIC report on the crisis[416], the Financial Committee found profound lapses in financial regulatory systems. Regulators cannot supervise and encourage

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additional empirical evidence in Demirgi.i9-Kunt and Levine (1999), Beck et al. (2000), Beck and Levine (2000), Levine et al. (2000), and Leahy et al. (2001). In 2001 the most important results were published in book form (Demirgi.i9 Kunt and Levine (2001)). The main policy implications were described in World Bank Repot (2001).

[414] Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 204 (2008)

[415] Rosa M Lastra & Geoffrey Wood, *The Recent Financial Crisis: Why did it Happen and What Lessons Can it Teach?*; Journal of International Economic Law, Special Issue '*The Quest for International Law in Financial Regulation'*, V. 13(iss3), 9/2010

[416] *Financial Crisis Inquiry Report (FCIC):* The Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States - In the wake of the most significant financial crisis since the Great Depression, President Obama signed into law on May 20, 2009, the Fraud Enforcement and Recovery Act of 2009, creating the ***Financial Crisis Inquiry Commission***. It was established to examine the causes, domestic and global of the financial and economic crisis. During the course of its investigation, the ten person committee reviewed millions of pages of documents, interviewed more than 700 witnesses and held 19 days of public hearings in New York, Washington, D.C., and communities across the country that were hit hard by

compliance with the rules or decide the appropriate mode of enforcement unless they can interpret the requirements of such rules considering each particular case. [417]

In May 2005, two years before the crisis, Prime Minister Tony Blair characterized regulators of the FSA who attempted to regularly supervise and impose straining regulations on banks, as "hugely inhibiting of efficient business by perfectly respectable companies that have never defrauded anyone".[418]

Dorene Isenberg[419] argues that regulators and regulatory authorities go by what politicians aspire to rather than by what markets need. Regulations are imposed in many situations where the regulated population cannot comply with the directives because they do not know or understand the reasoning behind them.

In other instances, the regulated population do not believe in the neutrality of the regulators because they believe regulation may be politically motivated or designed to benefit specific institutions more than others. Isenberg discusses how Hank Paulson, The US Secretary of Treasury was the main engineer behind the sweeping regulatory intervention by the US Government. Nevertheless, Paulson was a former Goldman Sachs Senior Board Executive until 2006. Isenberg in her remark raises a question which ultimately leads to the conclusion that Paulson approved personally almost all trades in subprime notes or at least someone close to him on the board of Goldman Sachs did.

Paulson was one of the executives of an institution that conspired to engineer subprime notes. Should we not ask how other regulated institutions can believe in the neutrality of regulators? By the same token, Elliott and Baily (2009) blame financial institutions and regulators for the crisis, the reckless behaviour inside and outside of the US and disregard of regulations.[420]

In systemic crises, individual corporate fates will depend on the reactions of international financial regulatory authorities in face of the actions of banks and financial institutions. However, during the years prior to the crisis, the pattern of financial crises highlighted the complex coordination problems that had arisen amongst individual financial regulatory authorities around the world.[421]

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the crisis. The final report presents the Commission's 60 days of findings and conclusions in 126 pages of dissenting views. http://www.gpo.gov/fdsys/pkg/GPO-FCIC-INDEX/content-detail.html.

[417] W. Twinning and D. Miers, *How to Do Things With Rules (1982)*, 165 and 170-172

[418] *PM Tony Blair* speech at *Institute of Public Policy Research*, 26/5/2005 www.theguardian.com/politics/2005/may/26/speeches.media

[419] D. Isenberg, "*Paulson Plan Would Be Disaster"*, Institute for Public Accuracy, Sept 22, 2008. *www.accuracy.org*

[420] Douglas J. Elliott and Martin Neil Baily, "*Telling the Narrative of the Financial Crisis: Not Just a Housing Bubble"*, The Initiative on Business and Public Policy, The Brookings Institution (Elliott and Baily 2009)

[421] "The recent crisis 2007-2008 spread between countries whose exchange rates were floating – the USA and the UK, for example and it did not spread as wide across areas of single currency. As for the banking systems of some countries in the Euro zone, it was either unaffected or affected only trivially – for example Finland." Ronald McKinnon (with Huw Pill), '*Exchange-Rate Regimes for Emerging Markets: Moral Hazard and International Over-borrowing*' (1999) 15(3) Oxford Review of Economic Policy 3.

5.3. CHARACTERISTICS OF FINANCIAL CRISES

It is essential to lay out what is meant by a financial crisis and how a dispute resolution mechanism may possibly contain it. Until the 20th century, only problems in the banking system as narrowly defined could be regarded as a crisis.[422] Failures of merchant banks were regarded as a crisis and only when it led to a run on the banks whose liabilities were part of the money stock of merchant banking.

Anna Schwartz[423] described 'real' crises as those which are fuelled by public fear that means of payment and ability to acquire the day-to-day necessity of life will not be available as banks start to close. In a fractional reserve banking system this leads to a rush by the public for a run on banks. Meanwhile, there will be a decline in asset prices, equity stocks will drop and the value of real estate follows. With merchant banks dealing in securities, they start facing substantial liquidity pressure as investors in "silent runs" scramble to liquidate their holdings searching for cash. Central banks do not intervene to relieve merchant banks from such runs.[424]

There are two primary explanations for the main causes of a financial crisis: banking practices of previous years, with banks getting into securities dealings, and the behaviour of the Federal Reserve in the US and actions (or lack of them) by international financial regulatory authorities. The first explanation has been examined by Peach (1941)[425], Benston (1990)[426] and Kroszner and Rajan (1994).

A universal banking system and corporate sector crisis can be characterized as a situation where economies around the world simultaneously, or within a short period of time, start to face large-scale financial and corporate distress. [427]

Likewise, judicial and dispute settlement and retaliatory processes that are exclusively based upon authoritarian international rulings, need to be put to speed and efficiently enforced. The crisis has proven the need for financial and monetary regulatory reform. On the other hand, the fact finding efforts has also proven the need for the appropriate frameworks for settlement of bank disputes of cross-border nature and efficacy in enforcement.[428]

In effect sanctioning procedures regarding cases of securities violations discovered by a central bank (the acting authority as the supervisor on banking financial activities) may not

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[422] Rosa M Lastra & Geoffrey Wood, *The Recent Financial Crisis: Why did it Happen and What Lessons Can it Teach?*; Journal of International Economic Law, Special Issue *'The Quest for International Law in Financial Regulation'*, V. 13(iss3), 9/2010

[423] Anna J Schwartz, '*Real and Pseudo-Financial Crises'*, in Forrest Capie and Geoffrey Wood (eds), *Financial Crises and World Banking Policy* (New York: St. Martin's Press, 1986). R. Lastra & G. Wood; .ibid

[424] Randall S Kroszner and Raghuram G Rajan 'Is the Glass-Steagall Act Justified? A Study of the U.S. Experience with Universal Banking Before 1933' (1994) 84(4) The American Economic Review 810-32

[425] William N Peach, *The Security Affiliates of National Banks* (Baltimore: The Johns Hopkins Press, 1941).

[426] George J Benston, *The Separation of Commercial and Investment Banking: the Glass-Steagall Act Revisited and Reconsidered* (New York: Oxford University Press, 1990).

[427] Supra (173)

428 Christoph v. D Elst and Marijn v. Daelen, *"Risk Management in Europe and American Corporate Law"*, (2009) ECGI Law WP 122/2009 include issuance of fines on violations by banks in financial market activities.[429] This largely means that certain supervisory regulatory "authorities" may be left without "authority". [430]

Handling the aftermath is more important than the technical creation of a crisis management mechanism. Bolstered by support from national public and world population, crisis management becomes a considerably lighter responsibility and a more manageable task.[431]

As discussed in this thesis, this can be initially achieved in an economic sectional system such as the banking and financial sectors. Initially to apply administrative sanctions that are to provide rules for financial transactional activities as well as a certain degree of deterrence that can be independent from the general legal systems. [432] That is to say, it can be applied within dispute settlement environment while financial sanctions can be applied on either party.[433]

6. BAILOUT

Without a credible resolution option, authorities would have only one option for systemically important institutions: a public bailout. However, bailouts often come at huge cost for the taxpayer and with negative consequences for the economy. In addition, bailouts create the wrong incentives for internal risk management and a moral hazard problem, as the cost of failure is not borne by those who have taken the risks but by taxpayers. Bailout mechanisms have also proven to create an uneven playing field among banks as governments are perceived to be more likely to step in and save large and complex banks than smaller banks.

The International Association for Deposit Insurers (IADI) published a set of draft Core Principles for Effective Deposit Insurance Systems (Core Principles)[434] for the benefit of countries considering the adoption or reform of a deposit insurance system (published 29 February 2008). The draft Core Principles include preconditions that should be in-place to support an effective deposit insurance system and are designed to be adaptable to a broad range of countries taking account of circumstances, settings and structures.

[429] L. Garicano & Rosa Lastra, *Towards a New Architecture for Financial Stability: Seven Principles*, Centre for Economic Performance, London School of Economics, CEP Discussion Paper No 990, July 2010 http://cep.lse.ac.uk/pubs/download/dp0990.pdf

[430] Bani, E., "*The Peculiar Administrative Sanctioning System for Financial Markets*", in *"Italian Banking & Financial Law: Crisis Management Procedures, Sanctions, ADR Systems and Tax Rules"*, ed. Domenico Siclari (Palgrave Macmillan 2015), 5.

[431] L. Garicano & Rosa Lastra, *Towards a New Architecture for Financial Stability: Seven Principles*, Centre for Economic Performance, London School of Economics, CEP Discussion Paper No 990, July 2010

[432] "The Post-Crisis EU Financial Regulatory Framework: Do the Pieces Fit?" House of Lords, European Union Committee, 5th Report of Session 2014-15, London: The Stationery Office Ltd. (2nd Feb 2015).

[433] Posner, Elliot *"Is a European Approach to Financial Regulation Emerging From The Crisis?"*, in E. Helleiner, E. Pagliari & H. Zimmermann, (eds.), "*Global Finance in Crisis*", London: Routledge (2010).

[434] International Association for Deposit Insurers (IADI) - On 18 June 2009, the Basel Committee on Banking Supervision (BCBS) and the International Association of Deposit Insurers (IADI) published Core Principles for Effective Deposit Insurance Systems, setting an important benchmark for jurisdictions to use in establishing or reforming deposit insurance systems. https://www.iadi.org/en/core-principles-and-research/core-principles/

In March 2009 the Basel Committee on Banking Supervision (BCBS) and IADI jointly issued a consultative Core Principles for Effective Deposit Insurance Systems (Joint Core Principles). Current guidance on mitigating moral hazard is provided by the BCBS-IADI Joint Core Principles. Principle 2 states that moral hazard should be mitigated by ensuring that the deposit insurance system contains appropriate design features and through other elements of the financial system safety net.

The guidance suggests practices of deposit insurers should follow such as:

- setting limits on the amounts insured

- excluding certain categories of depositors from coverage

- implementing differential or risk-adjusted premium systems

- minimizing the risk of loss through timely intervention

- resolution of troubled and failed institutions by deposit insurers

Depending on their mandates, deposit insurers and other financial safety-net participants can mitigate moral hazard by creating and promoting appropriate incentives for banks and their stakeholders through good corporate governance and effective market and regulatory discipline.

The IMF (2014) finds that implicit bailout funding cost subsidies rose across the board during the crisis 2008-2009. Interestingly, the report shows that these subsidies have declined since the crisis in many countries but remained comparatively elevated in the euro area. However, the study omitted the effect of bailout guarantees on banks' risk taking. Most empirical literature confirms higher risk-taking of institutions classified as too-big-to-fail. [435]

More recently, Black and Hazelwood (2013) showed that large banks rescued under the Troubled Asset Relief Program (TARP) were encouraged to increase their risk-taking. Based on a German bank sample, Dam and Koetter (2012) also find a positive relationship between bailout expectations and moral hazard risk-taking. *Gropp, Hakenes, and Schnabel (2011)* also show that bailout guarantees may also lead to a rise in risk-taking within competitor banks. [436]

6.1. WHY ARBITRATION IF WE HAVE REGULATIONS

The question that may be asked is why we need arbitration to combat acts of moral hazard where there are financial regulators, rules and regulations.

During a crisis, the speed of recovery is a priority. Depending on governmental priorities, the magnitude of fiscal resources available to any government in a crisis is usually directed where it is politically needed. In most countries, governments' main concern in a crisis is to

[435] Fischer, Hainz, Rocholl, and Steffen, 2011; Körner and Schnabel, 2013; however, conflicting evidence in Gropp, Gruendl, and Guettler, 2014

[436] Dam, L., & M. Koetter (2012) *"Bank Bailouts and Moral Hazard: Evidence from Germany,"* Review of Financial Studies, 25(8), 2343-2380.

resolve major corporate insolvencies, and rules and regulations take second priority together with possible long term economic costs to the society as a whole. Government policies usually take the short term view for obvious political reasons while rules and regulations are fundamentally designed for resolving crises in the long run. But in the short run and in spite of much analysis and the large number of rules and regulations, less has been done to resolve the immediate effect on investors, depositors and creditors. Policy makers seem to be oblivious to the fact that investors are the main source of money.

By securing creditors' rights, markets can regain investors' confidence, and liquidity can be maintained on the balance sheet of financial service providers such as banks and insurance and financial firms.[437] Regulators are best positioned to represent and balance the various stakeholders' interests. However, in certain countries the regulators' role can be limited for judicial or public policy reasons. For example, in the UK, corporate governance regulation has traditionally not focused on the special role of banks and financial institutions.

The Financial Services and Markets Act 2000, sought to fill this gap by authorizing the FSA to devise rules and regulations to enhance corporate governance for financial firms. In the US, the regulatory approach has been limited by Federal Court decisions that restrict the role that regulators can play in imposing prudential directives on banks and bank holding companies. Today, high speed dynamic evolutions in financial services are stirring up regulatory debates again. Through the past few years, financial innovations in derivatives by banks and financial firms have been vastly increasing through "off-balance sheet" transactions. The international nature of such undeclared and possibly hidden activities is rendering control by national authorities more and more difficult.[438]

Recent theoretical insights into the role of financial intermediaries and banks shed new light on the role of financial regulations. Researchers as well as parliamentarians in different countries started probing into how ineffective (or effective) those regulations can be. The main concern is whether regulations provide for compensating investors and depositors for their losses in cases of moral hazard, information asymmetry, adverse selection and mis-selling.

[437] Kern Alexander, *CORPORATE GOVERNANCE AND BANKING REGULATION*, Cambridge Endowment for Research in Finance, University of Cambridge.
http://www.cfap.jbs.cam.ac.uk/publications/downloads/wp17.pdf

[438] Off-Balance Sheet items are financial contracts based on a notional principle amount. It represents a contingent liability for the institution which may not have materialized. Financial institutions such as banks, brokerage firms, and insurances should report off-balance sheet items such as SWAPS, forward and futures agreements, securitized loans, operating leases and derivatives. However there is no actual legal liability if an institution fails to show them. These items are harder to track and may become toxic assets before investors come to realize the true exposure of a financial firm. www.fdic.gov/regulations

6.2. PUBLIC MORAL HAZARD

There are two main predicaments with deposit insurance. The first is that by being insured, customers will take little or no interest in the way that the bank lends and takes risks. This is recognized as "passive moral hazard".[439]

In a system without deposit insurance, depositors would have a strong incentive to monitor their bank's behaviour to ensure the bank does not act in a manner that may endanger its own solvency. For example, a depositor would be concerned with the types of loans their bank was making and the amount of capital their bank had (capital acts as a buffer, protecting depositors from losses when loans go bad).

Other things being equal a bank with a higher capital ratio would be considered safer and in consequence could be expected to attract more customers than a bank with a smaller capital base. However, in a system with deposit insurance there is no incentive for customers to monitor their bank's behaviour, as depositors are guaranteed to receive their money back regardless of the level of risk taken by the bank.

This lack of scrutiny from customers (or the financial press) means that banks are not restricted to taking the level of risk that their depositors would be comfortable with. Instead, they are free to lend as much as they like to whomever they like, in the process lowering their capital ratio (increasing their leverage).

Thus, the presence of deposit insurance removes possible risk constraints on the banks' desire to increase "high risk - high return" lending transactions regardless of the unreliability of borrowers. Those banks need such increase in their lending portfolios in order to attract deposits by offering higher rates of return on depositors' funds than their competitors. However, to maintain their profitability margins those banks will have to create high yielding instruments through securitisation. [440]

All being equal those instruments will ultimately yield higher returns, but only whilst banks will knowingly take greater risks that enfold higher possibilities of default by borrowers, and that's when the real crisis unfolds. On the other hand, depositors' moral hazard becomes quite apparent at these instances as depositors and investors become more intrigued by the higher than normal return on their investments instead of caring about their bank's solvency.

The public ceases to monitor the credibility of the financial institutions they are dealing with because they rely on two conceptual principles: the government guarantees household deposits by way of deposit insurance schemes; and, more importantly, the "My Bank is Too-Big-To-Fail" principle.

[439] Brown, David C. and Davies, Shaun William, Moral Hazard in Active Asset Management (January 14, 2016). Paris December 2015 Finance Meeting EUROFIDAI, http://dx.doi.org/10.2139/ssrn.2489113

[440] C. Wyplosz, *"International Financial Stability"*, in *"Global Public Good"*, (eds). Kaul, I., Grunberg, I. & Stern, M. (NY: Oxford University Press) 1999; Cera, M., *"Crisi Finanziara, Interventi Legislativi e Ordinamento Bancario"* in "*Studi In Onore di Francesco Capriglione"* (Padova: Cedam) 2010.

The second problem with deposit insurance regards the insolvency procedure and its costs in the case of a bank failure. In a country with a deposit guarantee scheme, bank insolvency normally means either a government bailout of the bank in question, or the closing of the bank, the sale of its assets, and compensation for deposit holders up to the designated amount.

How likely are governments to take the second option? Dorene Isenberg argues that, "The problem with the bailout is not its size, but its structure". The purchase of the assets of financial institutions with taxpayers' money will not be complemented by an ownership or control structure that reflects public ownership, as proposed for example in certain "bail-in processes".[441]

Within the regulatory rules, the public who became the new owners through nationalisation will have no say about running the bank let alone executive pay-out, bonuses or the disposal of profits. As the bailout now stands, the regulations that allowed this risky behaviour, which is responsible for one of the largest systemic meltdowns in history, are still in place and there are no harmonized international plans for it to change.

7. BAIL-IN

The bail-in tool aims to recapitalise a bank in resolution or to provide capital for a bridge institution in case liquidation of the bank is not possible due to negative externalities. The case of Royal Bank of Scotland (RBS) can serve as an example. When RBS's nearly collapsed in November 2008 during the crisis, the UK government had the option to close the bank and let it fail. However, because of its obligations to depositors, the government would have been obliged to find approximately £800 billion. This is greater than the entire national debt at that time and similar in size to the entire UK's annual tax income. In an ideal world much of this could potentially have been raised by the sale of the bank's assets.

However, the government was constrained in its actions and had to resolve the bank's liquidity quickly to avoid the panic from spreading in a contagion manner to other banks. Finding buyers for £800 billion of assets from a failed bank in the middle of a financial crisis is hard. As a result the government would most likely have to accept a price for the assets far below its market values and make up the shortfall from the taxpayers' money or borrow against its sovereign debt. Invoking bankruptcy procedures against RBS would have therefore been highly costly.[442]

The new bail-in tool in the bank resolution toolkit embeds much strength, notably in relation to mitigating moral hazard and other problems inherent in a strong reliance on bailouts. A credible resolution framework such as the "bail-in tool" was introduced to mitigate these negative externalities. The process is seen primarily to shift costs of bank failures from taxpayers to the shareholders and creditors of the failing bank. Investors, depositors and holders of certificates of deposits (CDs) are all forms of creditors on a bank's balance sheet

[441] *The failure of the Royal Bank of Scotland, Financial Services Authority Board Report*

[442] The legal basis for the bail-in tool is provided by the Single Resolution Mechanism Regulation (SRM) Article 27. Similar provisions can be found for the European Union in the BRRD.

and in total they represent the major bulk of a bank's debt. As such, they rank higher than shareholders' equity and this gives them a better claim to get their money back when a bank faces a bankruptcy situation.

Following the financial crisis, when governments injected hundreds of billions into banks, most creditors of banks were left untouched - even those holding subordinated, or junior, debt, which is theoretically designed to bear losses in times of stress. That was true until the "Bail-In Directive" or as it is known in EU: The Bank Recovery and Resolution Directive.

The legislation is the centrepiece of efforts to avoid a repeat of the €1.6tn of taxpayers' support to banks during the 2008 financial crisis. It empowers regulators to intervene quickly when a bank is weak, avoiding the panic that could arise from a messy and prolonged insolvency procedure. The law took effect in January 2015, but markets were given an extra year to adjust to the application of those measures.

In a sense "bail-in" can be defined as equity write-off and conversion of debt into equity, and it theoretically takes place before a bankruptcy of a bank. Under current proposals, regulators would have the power to impose losses on the shareholders and creditors of a bank. The idea is that by quickly addressing the problems of sickly banks and financial institutions, they would also help stabilize the financial system by removing uncertainty and contagious failures.[443]

Financial institutions' and banks' insolvency is very different in kind than the insolvency of ordinary companies. The key distinction is that financial institutions are dominated by financial liabilities. Those liabilities have a value that is greater than the net present value of the institution's capital and the total income stream. The "bail-in insolvency process" is to convert claims of creditors against a bank into holding equity of the failing institution or ideally a parent company which will be a holder of the failing institution.

The creditors will then be paid out of the return on equity of the holding company. This bail-in process is presumed to impair only the nonfinancial liabilities in the parent company and preserves the financial liabilities in the subsidiary. In an ideal world, it will then preserve the failing institution's liquidity and rearrange creditors' claims, including depositors without disturbing the ongoing operations. This is supposed to allow the institution to survive by continuing its operations and repay its creditors. In short, depositors and creditors of a bank will have their deposits impounded and converted into equity of the failing bank. Any revenue generated after that will be used to repay them what was taken from them.[444]

However, insolvency laws require that operations can continue using separate financing that is detached from claims. In other words, in cases of insolvency, the law forbids borrowing more money to finance previously borrowed money. It is what the law names as "pyramiding". Proposed bail-in processes do this with the automatic stay and post-petition lending. The automatic stay keeps the former creditor away from operations by converting

[443] Directive 2014/59/EU (EBA/RTS/2015/05 dated 3 July 2015

[444] Joseph H. Sommer, *Why Bail-In? And How!,* FRBNY Economic Policy Review / December 2014

their claims into equity. Post-insolvency depositors' and creditors' funds will go on to current operations.[445]

In banking assets calculation, the segregation between older and newer deposits is impossible without the clear distinction between the different types of liabilities (such as long and short term), assets bundles and financing products. Bail-in on the other hand, works by segregating financial assets (loans) from non- financing products. This segregation requires insolvency priorities for the disposal of non-performing financial products.

Such processes in their current form are only designed to contain risk rather than eliminate it. It is recognized that the issuance of bail-in debt instruments or conversion of debt into equity will raise the cost of funding for financial institutions. Nevertheless, the removal of explicit bailout programs is believed to eliminate moral hazard and lead to greater market discipline. Depositors will be converted into shareholders and be more effectual in monitoring the performance and risk-taking activities of their banks.

However, impounding depositors funds and creditors, will not eliminate panic runs on banks. It is necessary to imagine that not all depositors can afford to convert their life savings into equity in financial institutions or banks that are shifty and not of good financial standings. It is also important to assume that some of those depositors rely on their savings for their day-to-day living. It is therefore prudent to assume that should a bank starts to face trouble, they may face the same panic run on them if not more severe in the absence of bailout possibilities.

It should also be noted, that the Capital Requirement Directives and Regulations as well as the Banks Recovery and Resolution Directives (BRRD) are designed to reduce and mitigate the effects of a failure of a financial institution. Whether those directives were efficient but not applied or applied but not efficiently, many within the industry acknowledge that there is a lack of enforcement of rules. In a sector as complicated and sensitive as the financial sector, rules are to be enforced sufficiently and the first thing governments need to do is figure out what it takes to get them enforced.

8. ARBITRATION IN GOVERNING BANKS

In a banking financial dispute, the sums at stake are large and many of the claims are debt or quantum claims. Hence, delays can be advantageous to the defendant and a party's local court is likely to be sympathetic to that party's claim if the dispute is brought in front of them. Parties of the dispute may therefore engage in gaming behaviour for the purpose of changing venues and gaining precious time.

In this multi-party, multi-jurisdictional, cross-border world of bank disputes, disputes regarding jurisdiction of courts and tribunals continue to be prominent, as can be shown in

[445] O. Hart and L. Zingales, 2011, "A New Capital Regulation for Large Financial Institutions", *Journal of Antitrust Enforcement*, V.13, pp. 453-490.

the cases below. For this reason, an ideal arbitration process would contain provisions intended to provide for the better resolution of financial disputes.[446]

Preceding discussions of varying jurisdictional decisions in banking cases are some proof of the propensity for courts to overlook cases where parties seek opportunistic refuge in delaying tactics or seeking a chance to move the case to their own national courts. There will be little confidence in a dispute resolution process that will grant a learned opinion on the matter and resolve the issue in a speedy and efficient manner but nevertheless, the enforcement of its award will remain subject to the same delays. The following cases are an indication.

8.1. CASES

Dallah Real Estate v Pakistan Ministry of Religious Affairs is an interesting case in the context of the arbitration tribunal question of jurisdiction. The case raised issues concerning whether the local courts have the power to decide whether the tribunal has jurisdiction to decide on a case. The case also raised other questions on whether the arbitration tribunal can decide upon its own jurisdiction for an international arbitration. [447]

In this case, Dallah entered into an agreement with a trust established by the Government of Pakistan to build accommodation. The agreement provided for international arbitration in Paris. The trust later ceased to exist. For that reason, Dallah commenced arbitration proceedings against the Government of Pakistan, the Government having promoted the accommodation project in the first place.

The arbitral tribunal determined that it had joinder jurisdiction over the Government of Pakistan even though the Government was not a party to the agreement. The tribunal did so on the basis that the Government of Pakistan was, to all intents and purposes, a party to the agreement with Dallah.

Dallah sought to enforce the award in England. The New York Convention permits an arbitral award to be enforced more easily in countries that are party to the New York Convention than a court judgment. However, the New York Convention contains narrow exceptions that allow a court to refuse to enforce an award.

These exceptions relate to fundamental principles in arbitration: whether the tribunal has jurisdiction, whether the arbitration procedure accords with due process, whether there has been a breach of public policy and whether the arbitration agreement is invalid. It was settled that the tribunal had power to decide whether it has jurisdiction under the globally recognized doctrine called competence-competence (i.e. the tribunal has competence to decide its own competence).

The question was how the case was constructed and how far the court should defer to the tribunal's prior determination that it had jurisdiction or whether it should conduct a full rehearing of the issue. The Supreme Court held that, when a party (here, the Government of

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447 *Dallah Real Estate & Tourism Co v Ministry of Religious Affairs, Government of Pakistan* [2010] UKSC 46

Pakistan) disputes whether it is a party to an arbitration agreement at the enforcement stage, the final word on the issue lies with the court and not with the arbitral tribunal. Moreover, the court must conduct a full rehearing of the tribunal's decision, and not a limited review.[448]

Ever since the *Hazell v Hammersmith and Fulham* [449]swap case, ultra vires issues have been subject to well-established law in transactions by banks, statutory or municipal entities, law firms and legal advisers. Many jurisdictions since the publishing of this case in 1993 were issued enacting laws and regulations to the effect that municipal entities have express capacity to enter into derivatives and complicated financial transactions.

That capacity to enter into such transactions is subjected in most jurisdictions to restrictions such as duly authorised contractual agreements with the bank or financial entity, even where the transaction is of a speculative nature. In *Haugesund & Narvik Kommune v Depfa Bank*[450], a bank proposed to enter into swap transactions with two Norwegian municipal counterparty communities.

The bank asked counsel from a firm of lawyers in Norway on the question of the capacity of the municipalities. This was the only question on which the bank sought legal advice. The lawyers advised in unqualified terms that the municipalities had full capacity. The lawyers also advised the bank that, under Norwegian law, a claim against a Norwegian municipality cannot be enforced and that no execution, bankruptcy or debt proceedings may be initiated against a local council in Norway.

The bank was prepared to take the foreclosure risk, "undoubtedly" taking the view that the municipalities were "honourable, respectable and creditworthy counterparties". It was held that the municipalities lacked the "substantive power" under Norwegian law to enter into the swaps.

This lack of 'substantive power' was characterized in English legal terms as a lack of capacity. Hence, the swaps were void. The bank was nevertheless entitled in restitution to the capital sums advanced together with interest.

The municipalities were not entitled to rely on a defence of change of position. It was also held that the Norwegian lawyers' advice was negligent and that they were liable for damages. It was also held in appeal that the lawyers' firm was not responsible for the bank's losses as the lawyers were not responsible for the loss relating to a bank's enforcement on credit risks. This was a matter that most probably would have been resolved on equitable basis if presented to arbitration. It is also reasonable to point out that the judges in *Haugesund & Narvik Kommune* would not be disposed to let a party such as the municipal entities be opportunistic and escape its contractual commitment where that commitment proved later not to be financially advantageous. Nevertheless, it's needless to say that bankers are opportunistic too.

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[448] *Collins LJ in UBS AG v HSH Nordbank AG* [2009] EWCA Civ 585, at para 95: 'Whether a jurisdiction clause applies to a dispute is a question of construction'.
[449] Ibid. 314
[450] *Haugesund Kommune and Narvik Kommune v Depfa ACS Bank* [2010] EWCA Civ 33

In Berliner (BVG) v JP Morgan Chase the bank *(*JP Morgan Chase*)* claimed $112 million. .[451] BVG alleged that an English-law governed credit default swap to which it and JP Morgan were counterparties was ultra vires, or beyond the power of BVG to enter into.

They argued that based on European Council Judgments Regulation, Articles 22 and 25 of Council Regulation (EC) No 44/2001 the ultra vires issue was to be determined under German law, being the law of incorporation of Berliner BVG. [452]

The Court of Appeal held that while the ultra vires issue was important, because it might be dispositive of the proceeding, the proceedings were not 'principally concerned with' the ultra vires issue, which was the requisite test under Article 25. However, in this case the ultra vires issue could not be isolated from the other issues. For example, BVG alleged mis-selling by JP Morgan and that they were given asymmetric advice at the time the transaction was entered into.

The Court of Appeal characterized the proceedings as being 'principally concerned with' the validity of the credit default swap and whether JP Morgan could enforce its rights under it. Hence, ultra vires was not the focus of the proceedings.

The correct interpretation of Article 22(2) required the Court of Appeal to make an overall judgment under Article 25 on whether the proceedings were 'principally concerned with' one of the matters set out in Article 22(2). The claim was principally concerned with the default of BVG of non-payment of the swap.

The ultra vires argument was one of BVG's possible defences to the claim by JP Morgan. The defence was over-ruled by the Court of Appeal. BVG further appealed to the Supreme Court which in turn referred the issue to the European Court of Justice (ECJ*)*.

BVG had also filed proceedings in Germany which were also referred to the ECJ. In those latter proceedings, the ECJ in effect agreed with the decision in the English Court of Appeal, saying that:

> *[In] a dispute of a contractual nature, questions relating to the contract's validity, interpretation or enforceability are at the heart of the dispute and form its subject-matter. Any question concerning the validity of the decision to conclude the contract, taken previously by the organs of one of the companies' party to it, must be considered ancillary. While it may form part of the analysis*

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[451] *Berliner Verkehrsbetriebe Anstalt Des Offentlichen Rechts v JP Morgan Chase Bank N.A. and JP Securities Ltd,* [2010] EWCA Civ 390 (CA).

[452] Jonathan Ross, *"The case for P.R.I.M.E. Finance: P.R.I.M.E. Finance Cases"* [2012], Capital Markets Law Journal, Vol. 7 (3) pp. 235 "[The] article provides that, if proceedings before a court has their object the validity of decisions of the 'organs' of a company, then, notwithstanding a contractually agreed exclusive jurisdiction clause, the courts of the Member State where the company has its seat *(BVG* has its seat in Germany) have exclusive jurisdiction. *Article 25* provides that, where a court (here, the English court) is seized of a claim that is 'principally concerned with' a matter over which the courts of another Member State (here, Germany) have exclusive jurisdiction, then that court must declare that it has no jurisdiction."

required to be carried out in that regard, it nevertheless does not constitute the sole, or even the principal, subject of the analysis. [453]

Depfa Bank v Provincia di Pisa; Dexia Crediop. v Provincia di Pisa [454] are similar cases. In this case, two banks sought declaratory relief against the *Province of Pisa* under two interest rate swaps. The claims were in particular for the confirmation that the swap transactions issued with the Italian authority were valid and binding.

The swaps were documented under the ISDA Master Agreement 1992, which contained the ISDA-standard English governing law and jurisdiction clauses. The Province of Pisa challenged the swaps when it became apparent, in the case of the final payment, that it was out-of-the-money and hence would need to make a payment to the banks.

As did BVG, the Province of Pisa challenged the jurisdiction of the English courts on the ground that the swaps were allegedly ultra vires and the actions were under Article 22(2) of the Judgments Regulation, 'principally concerned with' matters over which the Italian courts have exclusive jurisdiction.

After the banks issued proceedings in England, the Province of Pisa subsequently issued governance-related executive decisions that purported to revoke certain decisions taken at the time that the swaps were entered into. Public law powers under Italian law purportedly entitled the Province of Pisa to exercise a right of self-redress. It issued proceedings in Italy accordingly.

The banks argued that the court should be aware of the attempts of the defendant, Province of Pisa, to seize jurisdiction away from the English Courts, a contractually chosen forum, in favour of Italian courts, a home court for the defendant. The Province of Pisa sought to characterize the Italian proceedings as only about ultra vires, but appeared in due course also to wish to allege non-disclosure and mis-selling.

The defendant also alleged that the true cost of the swaps had not been disclosed at the time. While the judge accepted that the Province of Pisa had a good arguable case of ultra vires based on it exceeding its powers; he also accepted that the Province of Pisa's case would include those wider issues.

For that reason, the judge held that the proceedings were not likely to be 'principally concerned with' the validity of the decisions of the Province of Pisa and hence ultra vires. While that was an important issue, it was not of itself a decisive issue because of the wider issue of the validity and enforceability of the swaps. The judge accordingly refused to decline English jurisdiction.

In the banking and financial sector parties enter into contracts bilaterally or multilaterally using different forms of standardised agreements such as the ISDA Master Agreements and

[453] Berliner Verkehrsbetriebe (BVG) v JP Morgan Chase Bank NA, [2011] EUECJ C-144/10, 12 May 2011

[454] Depfa Bank PLC v Provincia di Pisa; Dexia Crediop S.p.A. v Provincia di Pisa [2010] EWHC 1148 (Comm).

other forms with different governing law and jurisdiction clauses. Some of the jurisdiction clauses can be exclusive or non-exclusive.

Many transactions, particularly structured finance transactions, involve multiple agreements and multiple parties domiciled in different jurisdictions. A number of the transaction agreements can often be governed by different laws. In such, a single transaction can involve agreements that contain submissions to the exclusive or non-exclusive jurisdiction of different courts. In addition, the parties' contractual relation can be governed by one law or more depending on the structure of the transaction.

This does not, however, preclude them from choosing exclusive jurisdiction clauses. Further, a bank may operate in different markets through one or more branches in those markets. As a result, a customer of the bank can enter into different agreements with different branches in different jurisdictions. Each agreement can contain different choices of law and jurisdiction clauses.

A dispute between the two parties may lead to disputing one or more of these agreements. Needless to say, that customer can be another bank with multiple branches. Therefore, multiple and parallel proceedings are quite likely and the risk of inconsistent decisions occurring in this multi-jurisdictional dispute is eminent.[455]

However, the risk of inconsistent decisions is not always a multi-jurisdictional one: it can happen between judges in the same jurisdiction. In *Rawlinson v Kaupthing Bank* [456] and *Lornamead Acquisitions Limited v Kaupthing Bank HF* [2011] EWHC 2611 (Comm.) [457] the issue was whether claims made in England against *Kaupthing Bank* an Icelandic bank, should be decided in the English courts or in the Icelandic courts. *Kaupthing* was subject to insolvency orders and proceedings in Iceland due to the financial crisis.

In the Rawlinson case, Burton J held that the English courts had jurisdiction on the broad basis that the English proceedings had been commenced prior to the relevant Icelandic insolvency proceedings.

On the other hand, Gloster J in the *Lornamead* case, with what seemed to be the same circumstances and jurisdictional issues, said that: "[I] have concluded that, in the interests of judicial comity, and deployment of judicial resources, the appropriate course is for me to say that, despite my doubts, I am not 'convinced' that Burton J was wrong and that, accordingly, I should follow his decision."

In two other cases, it can be illustrated how jurisdictional issues can arise in a non-ultra vires context. First, in *Deutsche v Sebastian Holdings*[458] the Court of Appeal, following *Fiona Trust Holding Corp v Privalov*,[459] said that jurisdiction clauses must be construed broadly.

[455] *Donoghue v Armco Inc and others* [2001] UKHL 64
[456] *Rawlinson & Hunter Trustees SA v Kaupthing Bank HF* [2011] EWHC 566 (Comm)
[457] *Lornamead Acquisitions Limited v Kaupthing Bank HF* [2011] EWHC 2611 (Comm)
[458] *Deutsche Bank AG v Sebastian Holdings Inc* [2010] EWCA Civ 998. 236 Capital Markets Law Journal, 2012, Vol. 7, No.3
[459] *Corp v Privalov [2007] UKHL 40.*

Parties to multiple agreements do not expect their disputes to be litigated or determined by different tribunals.

However, where there are multiple related agreements, the courts will look into the intention of the parties as revealed by their agreement at the outset of the transaction, against those general principles, for example, if the agreements may have been entered into not as part of one overall transaction but of multiple transactions and over a long period.

In *Deutsche Bank v Tongkah*,[460] similar issues were raised in relation to a series of agreements that provided for optional arbitration and for litigation. The issues concerned Deutsche Bank and whether as a party to multiple related agreements containing optional arbitration clauses it could choose to litigate under one agreement and simultaneously arbitrate under the other.

The claimant, Deutsche Bank, argued that its different divisions in Amsterdam and London were both involved with the same customer Tongkah Harbour Public Co, a Thai corporation, and each branch took a different view of arbitrating in Amsterdam and litigating in London. The court, following *Fiona Trust*[461] said that Deutsche Bank was one contracting entity and the different divisions were irrelevant.

Another case of two banks disputing an issue of securities is *UBS AG v HSH Nordbank* [462], a case involving issuing securities under a CDO transaction[463]. None of the contracts out of which the dispute arose contained a submission to the jurisdiction of the English courts. HSH argued that the English court had no jurisdiction under the Judgments Regulation.

UBS in turn argued that the dispute arose from contracts forming part of an overall transaction. They presented that these contracts contained exclusive English jurisdiction clauses. They also argued further that an exclusive English jurisdiction clause in a dealer's confirmation of the transaction applied to the dispute.

8.2. CASES IN ARBITRATION

The above cases could have been presented to a financial arbitration tribunal for resolving the dispute. The counterparties may be disposed to the possibility of choosing a hearing in their own or neutral jurisdiction. Arbitration also offers those parties the ability to appoint an expert tribunal as opposed to the more random judicial allocation process, over which the parties have no control, with the possibility of a contradicting outcome, as we have seen in the Icelandic Banks cases.

By resorting to financial arbitration, parties to a dispute will find substantial advantages other than deciding on jurisdiction and ultra vires. Parties have their disputes heard, including

[460] *Deutsche Bank AG v Tongkah Harbour Public Co Ltd* [2011] EWHC 2251 (QB).
[461] [2007] UKHL 40
[462] UBS AG and UBS Securities LLC v HSH Nordbank AG [2009] EWCA Civ 585
[463](CDO) is a Collateralized Debt Obligation- it is a type of structured Asset-Backed Security (ABS). Originally it was developed as instruments for the corporate debt markets. After 2002 CDOs became vehicles for refinancing Mortgage-Backed Securities (MBS).

multi-party disputes, and resolved efficiently, cost-effectively and with certainty by arbitrators with expertise drawn from the financial sector and chosen by the parties.

Arbitration, as a process, is not required to resolve any dispute unless the parties to the dispute have agreed, either by way of a pre-existing arbitration clause in an applicable agreement between them, or ex post, that their dispute is to be resolved by an arbitration tribunal.

It may also be that a party that has raised a jurisdictional issue is persuaded by the other party or parties to the dispute to drop that issue on the basis that both or all parties submit to the jurisdiction of a financial tribunal.

8.3 COMPLICATED FINANCIAL DISPUTES

While judges may and do say that 'there is no dispute' about the principles to be used in the interpretation of contracts or that those principles are 'not controversial', the act of interpretation itself is disputed and can be controversial. In *Rainy Sky v Kookmin Bank*[464]*,* Lord Clarke said that the correct approach to construction of the securities in question (bonds) as in the case of any contract, was not in dispute.' Other recent cases in the English courts are good examples of these difficulties facing parties in litigation for financial disputes.

The issue in that matter also lies in market understanding of the documentation and the structure of a complex financial transaction (CFT) and what the public perceive (a) judicial decisions that do not support CFT understanding; (b) in the face of conflicting judicial decisions, confidence in financial institutions is eroded especially in times of crises.

Confidence in the ability and knowledge of state and national courts when faced with a CFT dispute is an essential requisite for market confidence. This concern and lack of confidence today in large measure explain the background to the need for an established theory and practice of an arbitration process capable of contract interpretation, and jurisprudence that best suits the interpretation of market standard agreements, in markets and jurisdictions worldwide.

Part of the answer to that issue further lies in the fact that, in the case of market standard agreements such as the ISDA Master Agreement, the tension between relative brevity and the need to draft an agreement that is effective or 'works' in a range of jurisdictions as well as under two governing laws (e.g. the laws of England and Wales and of the State of New York), means that compromise by the parties is inevitable.

However, in the financial sector where substantial sums are at stake ambiguity may also exist because CFT agreements are complex and specialized. The risk of ambiguity arises, for example, because the commercial terms of the actual transaction need to be drafted, or because that transaction may be unusual or uncommon.

[464] Rainy Sky S.A. and others v Kookmin Bank [2011] UKSC 50, Lord Clarke - para 14

For those reasons, it may be expected that a reasonable number of CFT agreements are poorly or wrongly drafted. When the harsh light of hindsight is thrown on some of the provisions in those agreements, some sense needs to be made of the ambiguities.[465]

8.4. OBSERVATIONS ON CASES

From the perspective of financial arbitration, a number of observations may be made about disputes involving complicated transactions:

(a) A complicated transaction dispute is naturally a case for arbitration comprised of a panel of expert arbitrators to be chosen by the parties. If the court for example in *Anthracite* had had the 'hindsight' to decide for elective early redemption, the arbitrators being experts would have had the knowledge to know how the financial markets operate and that an elective termination is what traders transact upon.

(b) An interpretation case involving the construction of a provision in a market standard CFT agreement is a financial arbitration case. This is true especially when "something has gone wrong with the language" that can raise commercial absurdity arguments in the performance of a financial transaction. It is true to say that financial tribunals would be expected to better understand the wider documentation context and any consequent absurdity better than a court judge and also be alive to potential manipulation of the wording by the parties.

(c) Cases such as *Lehman Brothers* surfaced post 2008 crisis when certain entities became insolvent. The mandatory nature of insolvency law and principals involved can allow financial mediation to hear a dispute that raises insolvency issues.

8.5. MIS-SELLING FROM THE ARBITRATION PERSPECTIVE

Following the global financial crisis in 2008 there was a huge surge of claims from clients and customers of banks and financial institutions who made claims of mis-selling involving CFTs. The claims were made to recover losses and ask for restitution. The claims before courts were raised by institutional and professional clients including banks against banks, sophisticated clients and customers, pension and hedge funds, municipalities, high net worth individuals. Those clients were often trading through investment vehicles fully owned or operated by large investment banks.

Fewer claims were made by retail clients although many of them were settled outside court. In the case of *Bank Leumi v Wachner* the client was a high net worth and extremely successful businesswoman, the CEO of a Fortune 500 company. She traded dozens of complicated reverse knock-in foreign exchange options. The bank sought to recover its margin call from the defendant. She counterclaimed alleging negligence in the sale to her by the claimant of foreign exchange options. Wachner's counterclaim failed.[466]

(a) Typically, these cases have involved claims by aggrieved bank clients and customers who may have been expected to believe that a court will give them a sympathetic hearing. This

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[465] Jonathan Ross, *The case for P.R.I.M.E. Finance*, Capital Markets Law Journal, 2012, Vol. 7, No. 3

[466] *BANK LEUMI (UK) PLC V WACHNER [2011]* EWHC 656 (Comm), [2011] 1 CLC 454

stems from the post financial crisis and the belief on the part of much of the public that banks and bankers deserve some retribution. That being so, it may also be expected that such a claimant has been predisposed to issue judicial proceedings rather than agree *ex post* with the bank to submit their dispute to arbitration. In broad terms courts have not been sympathetic to claimants alleging misrepresentation or mis-selling against banks. It may also be claimed that the reported cases are ones that banks had confidence of winning. Put another way, banks have been settling mis-selling claims where they consider that their prospects of success at trial are not sufficiently strong.

(b) The above cases are in principle arbitration cases but it may be that the parties were not willing to submit to arbitration. Nevertheless, arbitration's neutrality and the expertise of arbitrators will assist the resolution of such disputes in the future with the confidence that the process and settlement of awards will be swift. Prospective defendants to misselling or other financial services claims will welcome the court's finding that the terms of the parties' legal relationship does not change as a result of the defendants providing the claimants with market information and opinions. As with *Springwell*,[467] the decision in *Wilson v MF Global*,[468]demonstrates that the courts are receptive to the argument that financial services cannot be provided without some form of advice or recommendation being given, but that fact alone should not be taken out of all context in order to advance a claim. MF Global Holdings Ltd. was sued by an investor who claims the brokerage caused him to lose about 1 million pounds ($1.55 million) by encouraging him to make short-term, risky trades. It was held that no advisory duty owed by broking house to client trading in high risk securities. However, much will depend on the facts. For example, claimants (*Wilson)* attempted to demonstrate that they had not been properly classified regarding expert trading. This was met with some resistance from the court in circumstances where Wilson himself was responsible for the errors in the information on which his classification was based. More details are to follow on this case in (8.7).

Generally, the English courts have taken a pro-bank and financial institution approach. They have taken a sensible approach tending to refuse assessing risk in relation to CFT agreements following the global financial crisis. Courts have looked closely at the commercial context and the realities of the parties' relationship and have given effect to party autonomy in contract. In particular courts have held the aggrieved investors to their contractual bargain in which they agreed that the banks' liability for misrepresentation was excluded and that the banks owed no advisory duty. Where there is no duty, the investor in effect must rely on misrepresentation, which in turn requires the court to investigate in some detail what was said to the investor and by whom. The claims of regulatory breach tend to be more difficult. Some banks have been found inefficient in terms of the communications made to their investor sales process.

For these reasons, mis-selling cases are fact-specific and much turns on the evidence, which the English courts have not shied away from examining in great detail, in part to uncover

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[467] *JP Morgan Chase Bank v Springwell Navigation Corporation* [2008] EWHC 1186 (Comm) is 278 pages long, the trial having lasted some seven months. Caveat emptor is Latin for "Let the buyer beware"
[468] *Wilson v MF Global UK Ltd [2011] EWHC 138*

opportunistic claims.[469] Where there has been a breach of duty, the courts have tended to find that there was no reliance and no causation and hence no loss.[470] In other words, courts decided in cases of misselling that investors who invested in the wholesale market such as overseas banks and other corporate institutions are supposed to be experts and to be treated as a matter of *caveat emptor* - Buyer be aware.

8.6. CASE FOR ARBITRATION

All that said, it is likely that some claimants regard courts as unsympathetic to misselling claims. It came to be expected also that more jurisdictional issues are raised in claims of this type. The case for a specialized court or tribunal such as P.R.I.M.E. Finance on an international basis in complicated financial transactions is a compelling and a sound one. The case for a swift process of resolving financial disputes with guaranteed award settlement is well positioned to address many issues that arise in financial and banks disputes and to fill the asserted international void. State and national courts will always have their important place. However, conflicting recent cases in courts are good examples of the difficulties and complexities that exist in the resolution of CFT disputes in the international world of banking and finance. These cases are also examples of how judges can struggle with complex issues that market participants would have carefully thought through and understood from a legal as well as a practical perspective.

Markets and market participants can today bank on CFT disputes continuing to occur if not increase. Markets and market participants need legal clarity, certainty and predictability. They also need confidence in the outcomes of the resolution of their disputes, as well as in disputes in other markets and with other market participants. The proposal for a swift clearance of financial awards is well positioned to satisfy the provisions of the required clarity and predictability the markets are seeking.

8.7. DUTHIE WILSON V MF GLOBAL

Duthie Wilson v MF Global is a case involving CFT futures derivatives trading[471] where significant part of the strategy of Wilson which involved frequent day-trading of contracts for futures and options in a very active and aggressive way. Wilson brought these proceedings in his personal capacity as well as being a trustee of a company pension scheme known as Donwin, of which PS Trustees Ltd was the corporate co-trustee.

The defendants were financial intermediaries, brokers and derivative traders, regulated by the FSA, through whom Wilson (on behalf of himself and Donwin) had conducted short-term trades in contracts for differences, futures and options.

Pursuant to the applicable account documentation, trades were conducted on an execution-only basis, Wilson having accepted *"a calculable risk in order to achieve a profit"* with a 12-month investment horizon. The claimants sought to recover losses arising from Wilson'*s*

[469] *JP Morgan Chase Bank v Springwell Navigation Corporation* [2008] EWHC 1186 (Comm)
[470] *Rubenstein v HSBC Bank plc* [2011] EWHC 2304 (QB)
[471] *Michael Duthie Wilson & another v MF Global UK Limited & another* [2011] EWHC 138 (QB) (para 104)

trading activity, alleging: breach of statutory duty under *s150 FSMA 2000*[472] and breach of contract. In respect of all but one account, the claimants had been classified *as "intermediate customers"* pursuant to Code of Business Rules (COB) Rule 4.1R, which was part of the *FSA Handbook.*

The claimants alleged that they should have been classified by the defendants as "private customers" instead. Had they been so classified, they would have obtained the protections granted to private customers then available under COB. These included the obligation to take reasonable steps to ensure that:

- Any personal recommendation to buy or sell a designated investment was suitable (COB rule 5.3.5R)
- When making a personal recommendation, the private customer understood the nature of the risks involved in its trading activity (COB rule 5.4.3R).

Accordingly, the defendants should have explained to the claimants at the beginning that engaging in short-term trading was inappropriate, highly risky and likely to lead to losses due to the commission and financing charges payable. As such, their trading losses would have been avoided.

However, the claimants alleged that regardless of classification and notwithstanding the execution-only basis of the contractual relationship, the defendants had in fact conducted their relationship with the claimants on an advisory basis. They also claimed the defendants had made personal recommendations. The claimants also pursued claims for breach of implied terms to comply with COB and breach of duty of care.

Judge Eady J rejected all of the claimants' breach allegations. The court came to this decision following the approach in *Spreadex v Sekhon.*[473] The test is whether reasonable care had been taken to determine that the clients had sufficient experience and understanding to be classified as intermediate customers under COB rule 4.1.9R.

The defendants discharged their responsibilities with respect to classification by way of a two-stage process. First, they undertook a preliminary classification in order to tailor documentation to be sent to the clients in order to obtain further information. Secondly, any information sent by the client would have been assessed before a final classification was made.

The defendants confirmed that they followed that process by making a preliminary classification of "intermediate customer" based on the information they obtained from Wilson over a telephone call. Wilson was subsequently sent documentation which he signed and returned, confirming:

[472] *Financial Services and Markets Act 2000, Section 150* (up to date with all changes known to be in force on or before 16 October 2020)
[473] *Spreadex Ltd v Sekhon [2008]* EWHC 1136 (Ch),

- He had more than two years' experience of trading in shares, bonds and funds, with an average daily trade of £20,000;
- He had less than six months' experience of trading in futures and options;
- He had between six months' and two years' experience of trading in CFDs; and
- His gross annual income is in excess of £300,000.

Amongst the claimants' submissions is that the alleged information provided was insufficient for the defendants to undertake a classification of his risk level and was also inaccurate. The court rejected this submission. The defendants were entitled to take Wilson's claims as to past trading and experience at face value.

Any inaccuracies in that information were his own fault. Further, the defendants' classification system was carefully designed to convey warnings and elicit information that would enable them to comply with their classification obligations. The claimants had no legitimate complaint about the classification process. It followed that the protections in COB for private customers could not have been triggered.

The court rejected the advisory claim.

With respect to the advisory claim and that the defendants gave the wrong advice to the claimant, the defendants accepted that regardless of the contractual documentation if personal recommendations had been made it would have been necessary to comply with COB rule 5.3.5R. The question for the court was, therefore, whether the relationship had been conducted on an advisory basis and whether any personal recommendations had been made.

The Judge emphasised the status of Wilson and Donwin as "intermediate customers" and the fact that Wilson's account included an on-line trading platform was designed to enable him to implement his own investment strategy and personal day-to-day trading using his own risk judgement. Against this background, there was no duty on the part of the defendants to provide advice and there was no obligation to ensure that recommendations were suitable. It would be clearly understood by any reasonable client in Wilson's position that he was not being given advice on the merits of particular transactions and any information or opinions offered were to be regarded as purely incidental to the dealing relationship.

The conversations between the claimant and the defendant were characterised as exchanging information or "bouncing ideas off each other". The Judge said that:

> "It would be unfair and unrealistic to pick upon certain passages in [the broker's] observations, with six or seven years of hindsight, and to conclude that he had suddenly changed into "advice mode" and was undertaking an obligation, on his own initiative, to give advice on behalf of his employers to an "intermediate customer". If such conversations were to be subjected regularly to analysis of that kind with a view to changing the express terms of the parties' relationship, brokers would not be able to operate and communications would soon be drastically curtailed."

In addition, the telephone transcripts and tapes offered as evidence clearly indicated that Wilson was an experienced and confident investor. The Judge also rejected the claimants' common law claims.

The court held that there was no basis to imply an obligation to comply with the applicable COB rules since that obligation was imposed by statute in any event. In doing so, the Eady J referred to *Redmayne Stockbrokers v Isaacs*[474].

In this case, Hamblen J declined to imply a suitability term requiring compliance with *COB rule 9R.* The decision was based on the difficulty in concluding that an implied term was necessary or that the contract was unworkable without the term where the obligation was covered by regulatory requirements in respect of which there is a cause of action for breach of statutory duty. As to a breach of duty of care, the defendants in *Redmayne* and *Duthie Wilson* were entitled to rely on the applicable exemption clauses in the account documentation. In addition, the court noted that the fact the broker expressed his views from time to time about the market or about particular opportunities did not amount to an assumption of responsibility on the part of the defendants. Hence, it does not bring on the full range of obligations of an investment adviser.[475]

Quantification of Loss: The court considered the claimants' case on quantification of loss and if they were properly advised, they would have implemented a long term trading strategy. The Judge rejected this submission on the basis that it was difficult to see why such advice should have been given, as Wilson never at any stage asked for advice on his trades. In any event, the court confirmed the defendant's statement that the defendants would not have advised him to approach certain products in which he traded on his own.

8.8. *CAMERATA PROPERTY INC. V CREDIT SUISSE*

In *Camerata Property v Credit Suisse*[476], the claimant requested that in the "course of the dealings they conducted with Credit Suisse, the relevant bank account manager increasingly became interested and excited by more adventurous investments that he solicited to the claimant

The judgment in *Camarata* was that the loss of an investment in a five-year note ("the Note") issued by a Lehman Brothers entity, had not been caused by negligence or gross negligence on the part of Credit Suisse under the terms of the investment advisory service agreement ("the Agreement"). Although the claim failed, the court considered the difference between negligence and gross negligence under English law.

Camarata, a company owned by a trust whose sole beneficiary was an individual, bought the Note through Credit Suisse for US$12 million. When Lehman Brothers became bankrupt, Camarata lost a significant part of its investment. Prior to the collapse of Lehman Brothers, Camarata sought advice from its relationship manager at Credit Suisse regarding its

[474] *Redmayne Bentley Stockbrokers v Isaacs* [2010] EWHC 1504 at [94]

[475] *JP Morgan Chase Bank & ors v Springwell Navigation Corp* [2008] EWHC 1186)

[476] Camerata Property Inc v Credit Suisse Securities (Europe) Ltd [2011] EWHC 479 (Comm) (at para 125).

investments, including the Note. Camarata claimed that the advice it received was negligent and in breach of the Agreement. Camarata also had claimed that, but for this advice, Camarata would have sold the Note before Lehman Brothers failed. Credit Suisse argued that it was not in breach of its duties and that, in any case, Camarata would not have sold the Note even if Credit Suisse had given different advice.

Decision

The Court held that the advice sought by Camarata was generic and did not specifically ask whether the Note was safe from neither risk of counterparty default nor whether the banks with which Camarata held investments were safe. In view of the general nature of the advice sought, Credit Suisse was not at fault in failing to check the identity of the Note's issuer before responding. Whilst it was accepted that Camarata would have sold the note had Credit Suisse advised that there was a serious risk of counterparty default, there was no way that Credit Suisse could have predicted the collapse of Lehman Brothers. Thus, even if Camarata had established that Credit Suisse had been guilty of negligence or gross negligence that would not have caused Camarata's loss.

The court held that the concept of gross negligence had to be considered in view of the Agreement as a whole as opposed to being a defined concept under English law. As the Agreement referred to both negligence and gross negligence, a difference between the two terms had been intended and mere negligence on Credit Suisse's part would be insufficient in the circumstances. The court suggested that the difference between the two was one of degree as opposed to kind and would need to be considered in the context of a contract on a case by case basis.

8.9. OBSERVATIONS ON MIS-SELLING CASES

These disputes have common themes. They involve complicated financial products such as derivatives and structured obligations. They involve sometimes implied sophistication by the client or investor in search of yield. The products sold or traded result sometimes in substantial losses often as a result of margin calls that were not met. The client will then tend to bring claims on a broad basis, alleging the existence of mis-advice rather than an execution-only relationship. In *Standard Chartered v Ceylon Petroleum,*[477] a claim for damages arising out of alleged breach of advisory duty partly on the basis of the asymmetry of sophistication between the parties, the court held that the bank did not in the circumstances hold itself out as an adviser; rather, the bank acted in a sales capacity.

Other claims involve breach of fiduciary duty, negligent or even fraudulent misstatement.[478] Others may go as far as deceit, misrepresentation and breach of implied terms. In *Raiffeisen Zentralbank Osterreich v Royal Bank of Scotland*[479] the Austrian bank claimed that RBS was liable in deceit for knowingly making false misrepresentations.

[477] *Standard Chartered Bank v Ceylon Petroleum Corporation* [2011] EWHC 1785 (Comm)
[478] *Cassa di Risparmio della Repubblica di San Marino S.p.A. v Barclays Bank Ltd* [2011] EWHC 484 (Comm)
[479] *Raiffeisen Zentralbank Osterreich AG v Royal Bank of Scotland plc* [2010] EWHC 1392 (Comm)

In *Risparmio. v Barclays*[480], the court found no evidence that any such false representations had been made by Barclays PLC with requisite knowledge. In *Cassa di*, the San Marino bank claimed that Barclays Bank was liable for deceit in relation to certain structured credit notes.

The claims varied from lack of sophistication, misunderstanding about the nature of the investment, contractual terms signed but neither read nor understood, the unsuitability to the investor of the products sold or trades made, and breach of regulatory or statutory duty, as well as illegality, lack of capacity and lack of authority.[481]

9. GOVERNANCE THROUGH AWARD SETTLEMENT

Arbitration laws in most jurisdictions are quite detailed. They cover matters such as the consent of the parties to an arbitral or conciliation proceeding, the appointment of arbitrators, provisions regarding witnesses, evidence, costs, registration, modification, and correction of the award. A notable shortcoming, however, is the absence of important detail regarding the procedures to be followed when it comes to award enforcement.

Other provisions in most jurisdictions are apparent in allowing their national courts wide discretion in interfering with the procedure of enforcement of awards itself. Here, the scope of analysis should move from the realm of procedural norms to the substance of the applicable laws that govern payment of awards.

Those are the provisions of the substantive applicable laws with common consent of the parties to arbitration. Those provisions are what a clearing process needs to refer to and upon which the enforcement and payment of the arbitral award is to be based.

Based on these considerations, it is clear that there is no unified, single legal framework that is accepted by all parties as being a process for the payment of awards resulting from disputes between financial institutions and their clients. Financial regulatory authorities rely on statutory laws that are still, after years of numerous crises strongly entrenched in reactive legislations and regulations.

These laws apply in principle in individualistic jurisdictional systems over entire countries, but in practice their use is confined to domestic banks and locally disputed transactions. However, further confirmation of the difficulty of resolving international financial disputes is based upon the fact that conflicts have exacerbated in the 2008 crisis.

This increase was mostly influenced by the intensifying of financial regulations and legislation upon tribal like banks and corporate intermediaries. They failed to register excessively large high risk items on their balance sheets and financial reports either out of

[480] *Cassa di Risparmio della Repubblica di San Marino S.p.A. v Barclays Bank Ltd* [2011] EWHC 484 (Comm)

[481] *Raiffeisen Zentralbank Osterreich AG v Royal Bank of Scotland plc* [2010] EWHC 1392 (Comm) (claim that the bank made certain implied representations that had induced the client to participate in the syndication of a loan to an Enron entity; it was held that no such representation had been made; even if it had, it was not false and had not induced the client to invest); and *Standard Chartered Bank v Ceylon Petroleum Corporation* [2011] EWHC 1785 (Comm) (the alleged implied representations that the investment was a proper one were held to be vague, imprecise and inherently implausible).

being overwhelmed by the intensity and volume of regulations or out of ignorance of the law and how to abide by it.[482]

This chapter has submitted justifications on the thesis that arbitration can be a tool in the regulatory processes and the governance of the financial sector against acts of moral hazard as well as restrain panic runs. It must be noted that this does not present arbitration as a replacement of regulations or regulatory authority and the supervisory power they can provide. However, regulators are restricted from interfering in financial disputes due to the contractual nature of such disputes which can only be resolved through litigation or some form of ADR.[483]

The network model of investors and clients can be able to assess the size of potential direct contagion channels due to cross-holding of securities between investors. The network can also simulate how an outcome of an arbitration involving one bank can lead to a flow of information and modification of links within the banking sector. Banks and financial institutions can distance themselves from one risky institution if news come out that they were compelled by arbitration to compensate their clients. [484]

Moreover, it may also give guidance to regulators on practices taking place within the banking interconnected network. The network model can therefore help to identify situations where outcomes of one or more disputes do involve financial stability risks. It will alert authorities to ex-ante crises, so they can take mitigating measures to reduce such contagion risk.

This thesis proposes, in conjunction with the clearing of awards, another process where awards can be discounted for financing the losing party and to instantly pay the claimant. This mechanism will help inform policy makers and regulators about the adequacy of capital levels in the banking sector and the ability of banks to meet further resolutions such as bail-in.

This can support regional regulatory authorities where there is the need for possible restrictions on bail-in or state interference bailouts. The minimum requirement for an eligible liabilities level can then be set for each bank on a case-by-case basis.

As mentioned earlier, between 2007 and 2009, there were high numbers of national and transnational bank failures such as Fortis Bank in Belgium, Lehman Brothers in US, Anglo Irish Bank in Ireland, Dexia Bank in Belgium, plus the entire Icelandic banking system offshore and local. Those failures revealed essential inadequacies in the existing financial regulatory tools available to regulators.

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[482] *Crédit Agricole v European Central Bank* (T-758/ 16) 24 April 2018, EU General Court 5.35– 5.36

[483] A. Kashyap, R. Rajan and J. Stein (2008), *"Rethinking Capital Regulation"*, in Federal Reserve Bank of Kansas City, 2008 Economic Symposium, "Maintaining Stability in a Changing Financial System", pp. 431-471.

[484] *European Commission v Kingdom of Spain*, 21 March 2012 [2012] ECR I-55 12.09 **(**Opinion of Mr. Mengozzi the Advocate General, Court of Justice of the European Union)

The main shortfall is that banks are global operators while regulatory rules are based on national policies. This entails a serious lack in coordination of financial regulatory reforms and the resolution of investors' claims. Transnational coordination requires to be brought up to date with the rapid development in financial markets, to be effective in mitigating undesirable practices of moral hazard in the financial sector.[485] Disputes of mis-selling, misrepresentation and asymmetric information have multiplied in view of such impairment and the absence of suitable platforms for resolving financial disputes.[486]

Nevertheless, regarding consumer disputes and household depositors, governments, such as those in the US, India, EU and many Asian States, provide for consumer alternative dispute resolution schemes, such as ombudsmen, mediators or complaint boards that are put in place to resolve disputes between consumers and their financial service providers out-of-court. Usually, these ADR schemes offer a much quicker and cheaper way to settle disputes than in courts.

In the EU, the currently dispute resolution (ADR) schemes in different member states either cover financial services sectors (e.g. the Italian Banking Ombudsman scheme, the German Insurance Ombudsman, the French Ombudsman of the Authority of Financial Markets) or cover all financial services sectors (e.g. the UK Financial Ombudsman Service, the Consumer Complaints Manager of the Malta Financial Services Authority, and the Dutch Financial Services Complaints Institute).

On the other hand, there are schemes that handle consumer complaints in general, for example the Swedish National Board for Consumer Complaints and the Lithuanian State Consumer Protection Authority.

Most of the ADR schemes are central but some, such as the Lisbon Arbitration Centre for Consumer Conflicts, are regional. There are schemes that were established by public authorities (e.g. the Complaints Service of the Bank of Spain, and the Irish Financial Services Ombudsman's Bureau) and others were established by private actors such as the associations of financial services providers (e.g. the Ombudsman of the German Cooperative Banks).

In other cases, those schemes are established by associations of financial services providers in cooperation with consumer organisations such as the Danish Complaint Boards.[487] This has led this thesis to particularly examine corporate and banking disputes that are mainly between investors, banks and financial institutions.

This thesis presents an arbitration proposal as a solution for general defects in the judicial systems around the world which have to deal with increasingly complicated financial disputes and the excessive duration of civil cases in front of courts.

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[485] M. Dewatripont and X. Freixas (2012), "Bank Resolution: Lessons from the crisis" in M. Dewatripont and X. Freixas (eds.), The Crisis Aftermath: New Regulatory Paradigms, eReport, Centre for Economic Policy Research.
[486] Antonucci, A., The Mandatory ADR in The Financial Services, 2011, Riv. Trim. Dir. Econ.
[487] *ALTERNATIVE DISPUTE RESOLUTION IN THE AREA OF FINANCIAL SERVICES, EUROPEAN COMMISSION, FINANCIAL INSTITUTIONS*, Retail Issues, Consumer Policy and Payment Systems, Brussels, 11.12.2008

The right for speed and immediate justice is a main principle established in the EU Lisbon Treaty, to "ascertain social justice". It expressly affirms the principles adopted by the European Parliament ensuring the development of alternative methods of dispute resolution as a right for swiftly satisfying the need for justice (Article 81 of the Treaty on the Functioning of the EU*)*.

The establishment of a swiftly satisfying financial dispute resolution process and overcoming the difficulties in enforcing the outcomes of such disputes' resolution to all parties in the dispute are the basis for this thesis. The proposed process operates in a unique sector where disputants are banks and financial institutions that hold assets for one another. The award paying mechanism proposed here will use the existing interbank clearing and settlement systems such as SWIFT[488] and CHAPS.[489]

The clearing systems can be used for immediate enforcement and payment of international arbitration awards within a network of a banks' forum for the resolution of financial and banking disputes. The forum will include, therefore, the positioning of doctrines derived from within the rules and regulations of the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards (1958).

As a result, current financial market disputes which accentuate uniform means of settlement now will in the future be able to lead other industry sectors towards the containment of disrupted economies in times of crisis by swiftly resolving creditors' disputes. In the specific sector of banking and financial services most of the transactions are of international nature.

The said mechanism will give an added value by circumventing slow paced national judicial systems of given countries and apply a level of efficiency through fully comprehending the disputed transaction in hand. However, recourse to such mechanism will not only be for avoiding litigation. To an extent, the main objective is to decelerate multiplying breakdown in the relation of trust between financial institutions and their creditors.

Arbitration as a form of dispute resolution enjoys certain privileges of privacy and secrecy. The benefit of avoiding the damaging effect of "excessive" publicity on the substandard conduct of certain financial institutions can be positively perceived. Confidentiality will soften the negative publicity of the financial sector and reduce the risks of panic runs by the public.

As explained earlier, this thesis does not identify dispute resolution as the only effective approach for the mitigation of moral hazard and containment of crises. Results of financial disputes are indicative evidence of noticeable disagreements. If those disputes are in the

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[488] SWIFT payments are a type of international transfer sent via the SWIFT international payment network. The SWIFT international payment network is one of the largest financial messaging systems in the world.
[489] Clearing House Automated Payment System (CHAPS) is an electronic bank-to-bank technology that enables same-day payments to be made within the UK.

banking sector it may constitute a beginning of an undesired trend requiring strict regulatory intervention.[490]

Europe and the US experienced institutional failures in their financial sectors during the crisis due to existing traditional banking regulatory models that were developed but never changed. The global financial crisis that ensued has brought about profound changes to the world of banking. Within those changes, there was greater awareness of the rights and duties of those operating in the financial sector.

The search has continued for suitable measures to protect the interests of investors, customers and financial intermediaries as an essential safeguard for the stability of financial systems around the world.[491] A swift payment process for arbitral awards in the financial sector can be the answer for this search.

10. CONCLUSION

Corporate governance influences the efficiency of firms' production at the corporate level so that the effectiveness of a nation's corporate governance system shapes economic performance at a country level. Standard agency theory defines the corporate governance problem in terms of how institutions may be held liable for the actions of their executives, and the extent to which shareholders as well as depositors of a financial institution can induce managers to act for the benefit of both, the institution represented by the shareholders and the public represented by depositors and investors.

In particular banks and financial institutions, in certain cases may allocate with the blessing of their shareholders, high stake incentives to induce fund managers to behave in ways that favour the interests of the institution but may hurt the interests of the public and the nation's overall financial system. In that, shareholders will be satisfied if the profitability of their institutions mounts and shares gain value regardless of how the directors they elected attained such profits.

Regulatory governance of banks, financial intermediaries and non-bank financial intermediaries is different from standard corporate governance. Financial intermediaries and banks in particular have special attributes that intensify standard corporate governance problems and pervasive government involvement which raises impediments to effective corporate control.

In essence, standard theories of financial corporate governance highlight the special problems facing the corporate governance of banks and financial intermediaries. By combining this theoretical perspective with international observations it is possible to conclude that the proposed arbitration method to resolve enforcement of investors disputes in the banking and financial sector will be effective.

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[490] Benoît Cœuré, "Financing the recovery after the crisis- the roles of bank profitability, stability and regulation", speech on behalf of ECB at Bocconi University, Milan, 30 September 2013

[491] M. Pellegreni, *Le Controversie in Materia Bancaria e Finanziaria* (Cedam : Padova), 2007, Chs. 5&6

The global financial crisis of 2008 was a crisis largely of human making. It was also a financial institutions' governance crisis. Internal imbalances proved just as significant as the other triggers to the financial turmoil, and the events sparked a fresh round of deliberation about the most likely deficiencies in the governance of financial intermediaries.

The roots of the crisis predominantly lay in unsupervised, inadequate bank capital, highly leveraged hedge funds, subprime mortgage securities and reckless loans. For years there were low interest rates, weak government enforcement efforts, minimal government interference and deregulations.

The collapse of Northern Rock in the UK, Lehman Brothers in the US and other banks occurred because the financial risk generated by the US subprime mortgage lending was being directed and reused across the world through shadow banking structures. With hindsight, the credit-rating agencies failed terribly in the performance of their duties.

Financial derivative products were so complex and non-transparent that even those who created them were unable to understand what they meant and too much legal manipulation was employed to blame investors' apparent sophistication. There were profound failures of the regulatory policy inadequate transparency. These ingredients came together to trigger a financial crisis of global proportions.

Certainly, the question of how far poor regulatory governance of financial institutions led to a crisis is still a controversial topic to date. An immeasurable number of 'wrongdoers' have been identified to have contributed to the global financial crisis and there are more reasons now to isolate the key elements which contributed to it.

Those reasons lay mostly in weak regulatory governance, absence of rapid restitution methods against offenders, profit driven executives, greedy and inattentive bank shareholders and unsuitable remuneration structures.

Financial intermediaries lacked understanding of the technical strategies of the financial products they were selling and showed low ethical standards when they pushed those products onto their clients.

Shareholders appeared unable to scrutinise and monitor their company boards. They accepted all transactions they believed to be leading to higher profits for their holdings. They gave low priority to governance issues, thereby encouraging the risk-taking that eventually proved fatal for many institutions including their very own.

In addition, there were clear and unquestionable failures of the system of regulatory governance. There were no regulatory rules on the quality and quantity of executive pay. There was no interest in the accountability and personal qualifications of those who managed financial firms when they were hired, for assessment of possible legal liabilities.

Mostly, there was no emphasis on recourse methods particularly on the potential monitoring and supervisory role institutional investors can play or resort too apart from litigation.

The issue this thesis addresses is regarded as the pivotal point in regulatory governance of the banking and financial intermediary sector: investors confronting the aforementioned issues through an arbitration process that should not take longer than a few days can help redress the balance in governance of financial institutions.

At the very least, it can identify deficiencies that can play a significant role in leading to a crisis, even if that role was in an indirect form.

Investors equipped with such indirect governance over their bankers can provide a thorough critique of at least three fundamental elements of moral hazard:

- Executives' personal and professional accountability
- Executive remuneration and its role as an incentive for high risk and immoral transactions
- Regulatory authorities' alerting, engagement and activism

The last point is especially important as it evaluates coordinated regulatory developments in a comparative perspective and will draw out some of the implications for the broader global trends in the area of financial institutions' governance.

However, with a focus on the position in the UK and US, the issues underlying governance of moral hazard activities are in particular the rationalisations and conceptions through individualistic disputing actions. It will contribute productively and effectively to the ongoing worldwide efforts on financial institutions' governance.

A key dilemma in any corporate governance system is how to make corporate executives accountable while still allowing those same executives the autonomy, the motivation and the power they need to create tough and solid institutions. The attention here is on the restoration of personal accountability primarily through law. The focus is on the failure of banks, and therefore the discussion predominantly talks about bankers' accountability.

Significantly, the approach taken is designed to address recklessness rather than fraud; this is because this latest crisis period is one characterised by reckless business decisions and lack of understanding of consequences, characteristics that have proven disastrous for the UK and global economy. The general consensus is that precisely this type of behaviour pushed many institutions, particularly banks, to the brink of collapse.

Even though the damage done cannot be overturned, the sharpening of bankers' accountability can make less likely the occurrence of episodes that can cause serious externalities. Personal liability is imperative, primarily due to the conflicting enticements promoted through limited liability and the phenomenon of moral hazard. Yet, despite the crisis and the subsequent regulatory response, some of this behaviour remains.

Although there are robust new liquidity standards and personal liability measures, more can be done to tackle mismanagement, incompetence and reckless risk-taking. Inconsistencies in law and regulation need to be eradicated. For instance, while it is possible to disqualify the directors for unfitness, or make them personally liable to contribute financially to their institutions' liabilities, the director of a company brought to the brink of insolvency but rescued by nationalisation or another form of government protection is not held accountable for the debts of the failing institutions.

This is so irrespective of the level of wrongful or reckless trading they have engaged in. Certainly this is a serious deficiency of the current system of accountability, made worse by the fact that directors are generally confident that the system will not allow large institutions to fail.

Directors frequently appear unable to comprehend the density of their institutions' activities. Due to the complexities of financial models, directors frequently lack the knowledge to make good decisions and manage risk. The recent crisis is indicative of this: many of those who were involved with the production of complex products such as highly leveraged hedge funds and subprime mortgage securities had not really grasped the meaning of those products.

But institutions can and do suffer when those who manage them are unable to appreciate fully the multifaceted operations their institutions are participating in; the crisis that started in the summer of 2007 showed a collective wisdom of individual ignorance, and ultimately many appeared out of their comfort zone. The weakness of executives to properly calculate and stick to a degree of risk suitable to their particular circumstances led them to place excessive reliance on internal advice, as shown by the events of Lehman Brothers and Northern Rock.

Crucially, this reinforces the need to have appropriate behavioural incentives in place that can potentially diminish their cognitive limitations, at least to a degree. Therefore, as the current law has not proven to be an effective constraint against reckless behaviour, it is necessary to consider a variety of legal and regulatory strategies that can help eradicate the aforementioned weaknesses.

Reinstating and reinforcing personal and professional responsibility in the financial sector will require a blend of different strategies; for instance, the promotion of ethics through the medium of education can be a cost-effective way to push for more responsibility in decision-making. But a key focus falls upon the examination of two types of personal liability: monetary and non-monetary, including disqualification, wrongful trading and strict liability. These are considered as means to better the current accountability regime. The monetary liability of executives, promoted through the wrongful trading provisions of the Insolvency Act 1986, has been considered in depth, as well as the role the Banking Act 2009 can play in the sharpening of bankers' accountability. Refining this area will enable the loophole that currently exists in law, whereby directors of nearly failed banks can escape liability, to be filled, at least to a degree.

In relation to non-monetary liability, the effectiveness of disqualification, promoted through the Company Directors Disqualification Act 1986, is deliberated at length, as well as the new criminal sanctions proposed by the government to tackle the kind of managerial misconduct witnessed during the past few years.

Yet, despite its powerful reappearance following the latest crisis, the levels of litigation and dispute resolution methods of enforcement do not seem to have been effective to a notable degree (if at all); in fact, directors have continued to reward themselves rather excessively.

In the economic literature, the agency theory, which supports the client to bank primacy model, has long been the dominant theoretical framework used to validate executive actions. This theory reinforces all that executives enjoy, such as pay, remuneration and incentives. Theorists view "Pay for Performance" as an efficient mechanism for proper behaviour by company executives. However, a by-product of the incentives idea is another mechanism for motivating management to boost performance regardless of the risk associated with it. This can be generally regarded as an alignment problem.

The question addressed is whether the current incentive mechanisms remain appropriate for rationalising executive actions. From this is generated the theoretical foundation of executive penalisation through a rapidly deployed dispute resolution mechanism that is final and immutable to appeal such as arbitration.

The agency theory forms the basis of the corporate governance debate, but the catastrophic events of recent years create doubts as to whether it is still sensible to use it to rationalise the current levels of executive remuneration. The key principle of the agency theory is its efficiency in improving the corporate practices of executives through penalising the firm for the actions of their agencies. Rewards are supposed to motivate executives of a bank to act with a long-term focus on the welfare of the firm and its clients.

However, this is the part where speedy enforceable arbitration awards can act as an incentive method and it is right to assume that they can motivate executives to do the right thing. The key is that performance targets can narrow an executive’s focus, motivating them to take reckless risks instead unless they are to face retaliating damage payments and compensations.

Realistically, regulations alone will never be sufficient if we fail to consider the problematic nature of banking and financial executives’ perspective of financial incentive psychology. Bankers get paid instantly for the profits they make for their institutions. Since key financial incentives are arguably effective to get bankers to break all rules of morality, countering that by imposing instantaneous damages and compensations will certainly explore the psychology angle of the most dominant part of a banker’s method of conducting business.

This research takes a micro-perspective of individual investors and their capabilities to raise issues with the banks when needed. It introduces the interconnectedness of financial institutions as well the tendency for problems to be hidden during boom and exposed during crisis.

The dispute resolution mechanism proposed will help identify financial institutions with large capacity to create high risk operations of financial market instruments and the risk of such instruments to breakdown the entire financial system. The mechanism will utilise a payment process of awards resulting of such disputes. It will be a clearing mechanism that grants instant international payment to arbitral awards in banking disputes. The mechanism will pay claimants their awarded compensation instantly. At the same time, such compensation will represent instant retribution upon risk-taking bankers.

Such compensatory payments will serve as an alert to financial regulatory authorities as to the activities of bankers and the nature of their high-risk activities. Such data will be available daily to the regulators due to the Standard Accounting Reporting requirements in most jurisdictions which require banks to present a closing financial report statement on a daily basis to their central banks.

The proposed mechanism will use existing standard bank clearing networks for the enforcement and clearing of arbitral awards. The technique proposed identifies the possibility of clearing, trading and discounting of arbitral awards for the sake of guaranteeing speed and maintenance of liquidity in the market.

CHAPTER FIVE
INTERBANK AWARD CLEARING FRAMEWORK

There are two essential components in the process of clearing of an international arbitration award for the final payment:

1- Authentication;
2- Enforcement.

This Chapter introduces the possibility of implementing an award payment framework designed specifically for financial institution disputes. The framework can be implemented so that it can clear and pay out awards through existing international banking clearing systems such as SWIFT, European Standard Bank (ESB), TARGET, etc. The clearing process in this case should not take more than a few hours for an award to be presented for enforcement and be fully paid to the award creditor.

On the other hand, there are several options that may involve blockchain and distributed ledger technology (DLT). Certain models that were developed involve central banks as the clearing hub which can also be introduced for the clearing of awards. However, the possibility of involving central banks may remove the confidentiality element of arbitral disputes and may influence the financial sector from resorting to this process in resolving their disputes.

Another model to be proposed here will involve a third party formed of a forum of banks. The forum will have a more passive role than central banks trespassing into a confidential dispute process. Currently, there are currency and securities clearance models that can be evaluated on monetary supply implications and the positive impact on liquidity management for commercial banks, securities settlement risk, credit risk, and complexity of transactions.[492]

1. INTERBANK AWARDS CLEARING

The proposed framework in this thesis builds upon the existence of existing interbank clearing networks and identifies the possibility of clearing, trading and discounting of arbitral awards. By using such models, the process is guaranteed immediate functioning, the same speed of clearing awards as with financial instruments and the maintenance of liquidity in the market. As mentioned in earlier chapters, this theory follows empirical research showing that enforceable and swift dispute resolution mechanism for financial disputes can establish certainty and assist in deterring imbedded acts of moral hazard within the financial sector. In addition, by maintaining liquidity in the markets, it can impede financial crises and alleviate the burden on state bailouts using taxpayers' money. [493]

The essential characteristics of an award are summarised in four main functions:

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[492] Zhao, Xiaohang, H. Y. Zhang, Kevin., Rutter, Clark Thompson, Clemens and Wan. "R 3 Reports Cross-Border Settlement Systems: Blockchain Models Involving Central Bank Money." (2017).
[493] Gerard J. Meijer & Camilla M.L. Perera – de Wit, "*P.R.I.M.E. Finance: A New Dispute Resolution Facility for Conflicts Relating to Complex Financial Products*", 14 BUS. L. INT'L 153, 153 (2013)

1- Conclusion of dispute - A final award terminates the tribunal's jurisdiction

2- Determination of parties' rights and obligations - An award concludes the dispute as to the specific issue determined by the disputants so that it has "*res-judicata*" effect between the parties;

3- Disposition of disputants' claims - so as to dispose of parties' respective claims;

4- Recognition and enforceability - An international arbitration award should receive recognition by national judicial courts for the purpose of enforcement.

These four main functions provide for the legal context and appreciation of arbitral awards.

1.1. LEGAL DEFINITION OF ARBITRAL AWARDS

There are very few definitions offered of arbitral awards. It is worth pointing out, for definition purposes, that there is no legal distinction to be made between international commercial awards and financial awards. Both instruments have the same function as they bring an end to a dispute with a decision rendered by an independent and impartial tribunal and are capable of being enforced.

However, it is essential to ascertain the essential characteristics and legal nature of arbitral awards in order to appreciate their legal or economic value. Such consideration is essential for the enforcement process which follows the issuing of the award.

A meaningful definition and delimitation of the legal nature of arbitral awards may be well aligned with discussions about the juridical nature and philosophical foundations of arbitration. A legal definition of an arbitral award is that it is a decision made by an arbitration tribunal in an arbitration proceeding.[494] It is a form of a declaration upon a decided matter determined in the arbitration proceedings, an injunctive relief, specific performance, contract rectification, setting aside or cancellation of a deed or other document. What is relevant in this definition is that an award is considered to be similar and corresponding to a court judgment.[495]

Therefore an award is vested with the same functionality and powers as that of a court order. This definition aims to establish that arbitration has a powerful outcome and is not a poor alternative to court litigation. This is undisputedly a true statement, courtesy of The NY Convention on the Recognition and Enforcement of Foreign Arbitral Awards which was designed to give coinage and international legal tender to arbitral awards.[496]

The concern now is that the New York Convention has its weaknesses since the mechanics for enforcement are left to domestic courts and national judicial procedures. Efficiency of the

[494] 'Arbitral Award Law & Legal Definition' in US Legal Definitions accessed 10 December 2018.
[495] Herbert Kronke and others, Recognition and Enforcement of Foreign Arbitral Awards: A Global Commentary on the New York Convention (Kluwer Law International 2010)
[496] W Laurence Craig, *'Some Trends and Developments in the Laws and Practice of International Commercial Arbitration'* (1995) 30 Texas Intl LJ 1, 11.

enforcement mechanism is often intertwined with judicial efficiency, as well as nationalistic judicial attitudes towards the arbitral process.

1.2. INTERNATIONAL ACCEPTABILITY OF AWARDS CLEARING

An essential part of the worldwide financial system payment, clearing and settlement systems, also known as financial market utilities (FMUs), is to secure liquidity to financial institutions through speedy settlement of payments and securities clearance. Membership in FMUs allows financial institutions to maintain liquidity levels while serving customers and clients around the globe.

The possibility of starting the clearing of financial awards in one of the currently existing clearing systems such as TARGET or FMU is to start the award clearing process working without regulatory or start-up delays of forums. On the other hand it will ensure that financial disputes processes and financial markets daily transactions function smoothly and effectively. Essentially, trust in banks is a fundamental ingredient in the effectiveness of the economy. Hence, the trust in a system that guarantees investors' indemnity and restitution of rights is fundamental to the smooth operating of interbank relations. Such principle will motivate the free flow of capital across borders and support the implementation of general investment objectives without fear of misrepresentation or delays in award enforcement which is representative of legal remedies.

Upon this principle, financial markets and financial institutions can bank on a dispute resolution system guaranteeing swift results between themselves and within the global financial sector. However, it is necessary to point out that dispute resolution processes currently in place, especially international arbitration, do not suffer shortages or defects in processing disputes.

Parties choose arbitration as a dispute resolution process with the expectation that, with a settlement, an award will be rendered at the end of the arbitral process. The end-product of the arbitral process, the award, is clearly of utmost importance to the parties, and the successful party expects the award to be performed without undue delay. Unless parties can be relatively certain that they will be able to enforce the award at the end of the arbitral proceedings (if not complied with voluntarily), "an award in their favour will be only a peripheral victory" and would render the arbitral process largely meaningless.[497]

A sound legal framework is indispensable in ensuring the recognition and enforcement of awards. The relative extensiveness and ease of enforceability of the arbitral award is an advantage of arbitration process. It arises because of networks of international and regional treaties providing for the recognition and enforcement of international awards.

Similarly, a widespread and better developed network of corresponding financial institutions can be well coordinated for the payment of enforceable awards. Treaties and conventions form part of the legal framework for recognition and enforcement of arbitral awards. This

[497] Lew, Mistelis and Kroll, Comparative International Commenial Arbitratio11 (The Hague: Kluwer Law International, 2003) at 688.

network will ensure an effective and reliable enforcement tool for the banks to commence on the clearing of arbitral awards. Meaningful arbitral awards are conditional upon effective and reliable enforcement mechanisms. [498]

Legal frameworks of enforcement such as national courts should not include only domestic interpretation and the black-letter law encapsulated in treaties and various national laws. They should also, encompass the underlying spirit of the scheme and principles of arbitration treaties, particularly the New York Convention.

Judicial understanding of such principles and judicial attitude towards the enforcement of arbitral awards and arbitration in general, is crucial for the world economy and the continuation of such a process of dispute resolution. Statistics evidence the effectiveness of the legal frameworks in place for the enforcement of arbitral awards.

However, while there is an international policy favouring the enforcement of international arbitral awards, and it is increasingly rare to find 'horror stories' of non-enforcement in published cases, exceptions unfortunately persist. In Asia for example, where the practice of international arbitration is more recent, there have been cases of non-enforcement which are contrary to international standards and practices in relation to the enforcement of arbitral awards.[499]

Financial markets are naturally fragile and over regulated more so after the 2008 crisis as regulatory authorities and states stay non-trustingly vigilant over market innovations by banks of complicated financial transactions. One way to ensure that the global financial industry stays healthy as a whole, even if individual impact investments struggle, is to develop innovative and value-aligned approaches to dispute resolution that mirror the innovations and value alignment found in financial investment deal structures as happened in subprime notes and mortgage backed bonds.

Therefore it is necessary to examine trends in disputes in financial transaction structures and the documentation (contracts) that distinguishes financial disputes from other banking and commercial disputes such as commercial and syndicated loans. It is also necessary to identify unique challenges that may arise in disputes concerning weak or failing investments. [500]

2. INTERNATIONAL COINAGE FOR ARBITRAL AWARDS

This thesis argues for international coinage and legal tender status for arbitral awards that essentially stems from the NY Convention principles. Universal acceptance requires recognition of international awards and instant enforceability.[501] For an award to be

[498] Marc Blessing - The Major Problems Areas in the New York Convention, p.9 - 2006

[499] Nicola Christine Port, Dirk Otto, Patricia Nacimiento and Herbert Kronke, *Recognition and Enforcement of Foreign Arbitral Awards: A Global Commentary on the New York Convention* (Kluwer Law International, 2010), p 145.

[500] *"International Bank Insolvencies, A Central Bank Perspective"*, (Eds) Mario Giovanoli & Gregor Heinrich, Kluwer Law International, 1999.

[501] S Bollee, "*Les Methodes Du Droit International Prive a Lepreuve Des Sentences Arbitrales" Economica 2004.*

universally acceptable on face value, it implies examining the following characteristics of an international arbitration award and the processes that may be required by national courts:

- Any document having the form of an award be easily recognized and enforced as a promise to pay, in a form similar to a bill of exchange or other negotiable instrument;[502]
- The role of recognition and enforcement by national courts is to view the award as if it were a judgment of another national court of the same jurisdiction;
- National courts may satisfy themselves as to the procedures followed by the tribunal in reaching the award through authentication;[503]
- The Blockchain and smart contract technology may further speed the required authentication process and validation of the award.

By legally qualifying a foreign arbitration award and the various theories relating to the nature of arbitral awards, this Chapter is to examine the missing elements needed to provide a comprehensive all-around internationally recognisable award payment framework.[504]

2.1. DEFINITION AND LEGAL NATURE OF ARBITRAL AWARDS

The discussion of the legal nature of arbitral awards is connected to the debate about the legal or juridical nature of arbitration. Although at first glance it appears to be a theoretical debate, it does have practical consequences.

There is consensus as to the main theories about the juridical nature of arbitration with associated conclusions as to the legal nature of arbitral awards:

(i) The contractual theory focuses on the origin of arbitration in the agreement of the parties to refer their dispute to arbitration and the consensual nature of arbitration. Since the arbitration agreement is enforceable, the outcome of the arbitration, the award, must also be enforceable. The arbitral award is the outcome of the agreement to arbitrate.

For many, this is the result of agent theory: the award is a contract made by the arbitrators acting as an agent for the parties. This is an important concept as it ascertains the possibility that the holder of the award will maintain the right to sell, dispose clear or endorse the award to a third party, should it be agreed upon in the arbitration agreement.[505]

(ii) The jurisdictional theory focuses on the endorsement of arbitration by national legal systems and the status of the arbitrator, which is equated to the judicial function of the judge.

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[502] Adam Samuel, "*Jurisdictional Problems in International Commercial Arbitration: A Study of Belgian, Dutch, English, French, Swedish, Swiss, US and West German Law*" (Schulthess 1989)

[503] Julian DM Lew, Loukas Mistelis and Stefan Kroll, "*Comparative International Commercial Arbitration*" (Kluwer Law International 2003) para 24-1.

[504] J Alan Alexandroff & Ian Laird, 'Compliance and Enforcement' in Peter Muchlinski, Federico Ortino and Christoph Schreuer (eds), Oxford Handbook of International Investment Law (Oxford University Press 2008) 1170; Julian DM Lew, *Applicable Law in International Commercial Arbitration* (Oceana 1978) 51–66.

[505] Donaldson J in Bremer Schiffbau v South India Shipping Corp Ltd [1981] AC 909, 921

The caveat, of course, is that judges and arbitrators are in the same business: the judge on the public side, and the arbitrator on the private side.

It is the premise of this theory that arbitration and the national courts and national law interact, and that the law of the seat of arbitration is critical in determining the level of interaction.[506] The arbitrators perform a judicial function and the result of this work, the arbitral award, is treated and is given the effect of a judgment of a national court at the place of enforcement.[507]

(iii) However, the autonomous theory sees arbitration as a self-sufficient system founded on party autonomy and at least tolerated or endorsed by national laws. In the pure form of this theory, 'the award is not a judgment and the arbitral agreement is not a contract like any other'.[508]

The autonomy of arbitration combined with enforceability of its awards is indeed the ideal concept, even though this is possibly unattainable during the current world situation. Nevertheless, the concept could be feasible via the application of certain coordinated processes of award enforcement mechanisms in certain economic sectors such as the financial and banking sector as proposed by this thesis.

On the other hand, a long term plan can still be put through for increasing harmonization of arbitration laws and practices through the New York Convention. This can be brought gradually to realisation at varying rates as different states require longer than others to impose alterations or amendments to their judicial processes and established laws.

The focus now would be on the convention for more justification and legitimacy of arbitration as a dispute settlement system. The essential duty is of the instantaneous enforceability and monetizing of arbitral awards within the community of nations operating under the same principles of the NY Convention. However, these theories can have a major impact on how we legally define enforcement of arbitral awards. [509]

2.2. THE CONTRACTUAL LEGALITY OF AWARD ENFORCEMENT

If an award were solely the outcome of a jurisdictional theory, then it would be fully controlled by the courts in whose territory the award was made. However, if an award is the outcome of a purely contractual approach, its enforcement will be entirely in the hands of the parties.[510]

In the case of *Saipem v Republic of Bangladesh*, The International Centre for Settlement of Investment Disputes (ICSID) confirmed that when determining the validity of an award, they need to look at the entire operation. That included the initial transaction contract, the

[506] Francis A Mann, *'Lex Facit Arbitrum'* (1983) 2 Arb Intl 245.
[507] Ashjan Faisal Shukri Daoud, *The Legal Nature of Arbitration Award, Its Effects and Appeal Mechanisms—A Comparative Study* (2008) accessed 27 December 2018
[508] Pieter Sanders, *'Trends in the Field of International Commercial Arbitration'* (1975) 145
[509] Emmanuel Gaillard, 'Representations of International Arbitration' (2010) 1 J Intl Disp Settlement 271.
[510] *Chromalloy Gas Turbine Corp v Arab Republic of Egypt*, 939 F Supp 907 (D DC 1996)

transaction itself, the warranties, any retention money paid or received and the related ICC Arbitration Award.[511]

The ICSID Tribunal explained that an award cannot be viewed in isolation. In other words, an award is part of the entire contractual agreement including all consensual provisions leading to the enforcement of the award. Should the parties consent that the award is to be exchanged or assigned, the rights are attached to the award.

The Tribunal in its decision indicated that in taking the ordinary meaning of an arbitral award's wording, rights under awards include the ordering of a party to pay an amount of money. This reflects the tradable nature of arbitral awards and the possibility of any document having the form of an award to be easily recognized and paid. It can be endorsed or cleared as a promissory note, a bill of exchange or other negotiable instrument. [512]

The French *Cour de Cassation* in the much discussed *Putrabali*[513] case stated that an international award is not connected to any legal system. It is an international judicial decision in its nature, whose legality is examined with regard to the applicable laws in the country where its recognition and enforcement are sought.

However, international and transnational law, such as the New York Convention, also have an influence on the recognition and enforcement process. An award is *de facto and de jure* a judgment with transnational effect. This is supported by the New York Convention (Articles III-VI) and the ICSID Convention (Articles 53-55).

The articles clearly impose a public international obligation on their respective contracting states to recognize and treat an award as if it were a decision of a local court. Irrespective of where the debate regarding the legal nature of the arbitration as a system is, it is undisputed that the functionality of an award is judicial but has a wider enforceability than the judgment of a state court. [514]

3. THE VALUE OF MONETIZING ARBITRAL AWARDS

Much like an investor willing to fund the legal fees and expenses to progress a claim, other investors also exist who have an investment appetite to purchase arbitration awards. The motivations for a claimant to want to monetize or partially monetize their award can vary enormously according to the discounted value of the award.

For some it could simply be down to business survival and a pressing need for capital. The arbitration award might be the company's most valuable asset, yet it is not one likely to be

[511] *Saipem SpA v People's Republic of Bangladesh*, ICSID Case No ARB/05/7

[512] Charles Claypoole, 'Recent Developments in the Jurisprudence of Investment Arbitration Tribunals' (2012) Eur Middle Eastern Arb Rev. www.globalarbitrationreview.com/reviews/40/sections/140/chapters/1433/recent-developments-jurisprudence investment-arbitration-tribunals

[513] *Société PT Putrabali Adyamulia v Société Rena Holding, 29 June 2007, Cour de Cassation*

[514] Loukas Mistelis, 'The Settlement-Enforcement Dynamic in International Arbitration' (2008) 19 Am Rev Intl Arb 377, 379ff

recognized by traditional financial institutions. For others it might simply be spending fatigue (arising, for example, from a wish see an exit to what may have been a half decade or more of paying legal fees). [515]

For larger enterprises, an award can represent "non-asset backed" corporate finance so that the underpinning collateral is solely limited to the arbitration award rather than secured against other more tangible assets. Other reasons to monetize arbitration assets can be for bolstering the balance sheet in turbulent times. A government may use arbitral awards as collateral for supporting rather their local banks rather than the usual Bailout method.

3.1. AWARD DISCOUNT CONCEPT

The list of possible motivations could go on and on, but it is important to stress these arrangements have potential application regardless of the financial status of the claimant. There are no specific formulas as to how these arrangements are structured. Each case so far, had its own unique features such as:

- The level of award and whether the award could be susceptible to future challenges in its enforceability;

- The respondent's financial status being in question;

- The level of advance the claimant or respondent are seeking;

- The pricing of the discount.

Another important aspect when considering monetizing an award is that it doesn't necessarily have to be at the post-award stage. For example, some professional investors will consider a partial monetization before an award is rendered, if required. Clearly this is a higher risk to the investor since they not only have to worry about whether the claim will prevail on liability, but also lack certainty as to the quantum of the award if a favourable decision is received.

Sometimes these pre-award monetization arrangements will form part of a wider litigation funding agreement, with the investor also funding some or all the legal budget on the claimant's behalf. Whereas in other cases it might be a standalone arrangement, perhaps with the claimant self-funding fees or where the lawyers are on some form of contingency fee arrangement.

Some (non-exhaustive) examples of how monetization arrangements might be structured are:

i) The claimant is self-funding fees and expenses, but nonetheless has a need to raise capital from their arbitration asset. A partial monetization payment is made by an investor pre-award in exchange for a share of the proceeds ultimately recovered. The claimant is free to use the capital for whatever purpose they require.

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[515] JE Vinuales & D Bentolila, *'The Use of Alternative (Non-judicial) Means to Enforce Investment Awards'* in L Boisson de Chazournes, M Kohen and JE Vinuales (eds), *Diplomatic and Judicial Means of Dispute Settlement: Assessing their Interactions.*

ii) As above, but the monetization payment is only made at the point an award is received. In this scenario the parties might have already agreed the financial structure in advance of the award (perhaps with each expecting a favourable award being received). If the case is successful, the pre-agreed terms are immediately executed within weeks of the award being received.

That payment might be an outright purchase or more likely a partial monetization. The investor and claimant would then have an agreed earn-out split based on the proceeds ultimately recovered.

iii) A combination of the above two proposals. For example, the investor advances payments in two tranches. Typically, it would be a smaller payment for the pre-award payment given the heightened risk to the investor, followed by a subsequent (and often larger) payment if and when a favourable award is received.

iv) Any of the three points above but combined with a traditional litigation funding agreement. For example, the investor finances the legal fees and expenses (or portion thereof) from the outset, but also integrates some monetization structure into the deal.

3.2. BUYING AND SELLING AWARDS

The market for trading awards did not seem to exist except only in one case. In 2011, only one example of assigned awards appear to have come openly to light which concerned investment arbitration awards with DR Congo being the award debtor. This example provides some interesting illustration of potential markets that might arise if a proper framework comes to exist.

In *FG Hemisphere v DRC*[516], two International Chamber of Commerce (ICC) awards had been assigned from EnergoInvest, a Bosnian state company, to FG Hemisphere, a US fund. FG then sought to enforce the awards in a number of jurisdictions, including the US, Jersey and Hong Kong. It is interesting to note that in the Hong Kong proceedings the judge was initially "concerned that the assignment of the awards might constitute maintenance or champerty"[517]. However, the court subsequently accepted that, "on case authorities, assignment of awards do not constitute maintenance and champerty".

In *Euler Hermes v PJSC Odessa Fat and Oil Plant*[518], EH (the assignee) sought to enforce a Federation of Oils, Seeds and Fats Associations (FOSFA) award in Ukraine. The application was refused on the basis that only the original party to the arbitration had the standing to seek

[516] *FG HEMISPHERE v. Democratic Republic of Congo, 637 F.3d 373 (D.C. Cir. 2011)*

[517] An agreement between the party suing in a lawsuit (plaintiff) and another person, usually an attorney, who agrees to finance and carry the lawsuit in return for a percentage of the recovery (money won and paid.) In Common Law this was illegal on the theory that it encouraged lawsuits. Today it is legal and often part of a "contingent fee" agreement between lawyer and client. It is not the same as barratry which is active encouragement of lawsuits.

[518] *Euler Hermes Services Schweiz AG v OJSC Odessa Fat and Oil Plant*, April 8 2015 High Specialised Court, Ukraine

enforcement of the award. Whilst the Ukrainian Cassation Court set aside the lower courts' decisions, the case illustrates a potential hurdle in enforcing an award in certain jurisdictions.

Interestingly, a similar point was raised, unsuccessfully, by Argentina before the US court in *Blue Ridge Investments v Argentina.*[519] That case concerned enforcement in the US of an International Centre for the Settlement of Investment Disputes (ICSID) award in the *CMS Gas v Argentina* case. [520]

The award was assigned to Blue Ridge Investments LLC. Similarly, in a recent decision of the Thai Supreme Court, Judgment No 9691/2554, it was confirmed that awards are a stand-alone right of payment with legal tender that are transferable. It may therefore be enforced for the benefit of the transferee and ultimate recipient of the transferred award.[521]

The benefit of the award had been assigned to Blue Ridge, the petitioner in the case. Argentina argued, amongst other things, that "as an assignee, Petitioner lacks authority to seek recognition and enforcement of the Award", and "only a party to the underlying arbitration can seek recognition or enforcement of the award under *ICSID Convention Article 54(2)*[522], while a transferee or assignee cannot."

Nevertheless, the judge carried out a detailed textual analysis of the use of the term "party" in the ICSID Convention and concluded that it "[did] not always refer to a 'party to the arbitration". The New York court found that "[nothing] in the ICSID Convention, in Congress's legislation implementing ICSID, or in New York law prevents an assignee from seeking recognition and enforcement of an ICSID award." [523]

The *CMS Gas/Blue Ridge* award was eventually settled by Argentina in 2013, along with four other awards: *Vivendi, Azurix, National Grid* [524] and *Continental Casualty* [525]. The latter two awards had also been assigned, reportedly to the US fund Gramercy. It seems that the assignment of those awards was part of the settlement structure, and it was not intended that the assignee companies would seek recognition and enforcement through courts.

More recently, in October 2018, further ICSID awards against Greece, Venezuela and Argentina were assigned to third parties. The cases were *Poštová Banka* [526], *Venoklim Holding B.V* [527] and *El Paso*. All three awards were assigned to what appears to be special

[519] *Blue Ridge Investments, L.L.C. v. The Republic of Argentina*, No. 1:2010cv00153 - Document 29 (S.D.N.Y. 2012)
[520] CMS Gas Transmission Co. v. Republic of Argentina, ICSID Case No. ARB/01/8.
[521] *CMS Gas Transmission Company v Argentine Republic*, ICSID Case No ARB/01/8, Award (12 May 2005).
[522] The International Centre for Settlement of Investment Disputes (ICSID) is part of the World Bank's Group and was established by the Convention on the Settlement of Investment Disputes between States and Nationals of Other States. The Convention itself was formulated by the World Bank on March 18, 1965
[523] Originally published in 2011 in International Investment Law and Sustainable Development: Key cases from 2000–2010 https://www.italaw.com/cases/288
[524] Compañía de Aguas del Aconquija S.A. and Vivendi Universal S.A. v. Republic of Argentina, ICSID Case No. ARB/97/3
[525] *Continental Casualty Co. v. Republic of Argentina*, ICSID Case No. ARB/03/9
[526] Poštová Banka, a.s. and Istrokapital SE v. The Hellenic Republic, ICSID Case No. ARB/13/8
[527] Venoklim Holding B.V. v. Bolivarian Republic of Venezuela, ICSID Case No. ARB/12/22

purpose vehicle corporations. As with the *National Grid* and *Continental Casualty* awards, the assignees pursued enforcement through negotiations with the award debtors.

It is worth noting, however, that the Argentine settlements in 2013 and 2016 were reported to have had over a 25% discount of the nominal value of the awards. This gives an indication as to the likely level of discounts that the assignors agreed with the assignees due to the bad credit rating Argentina was suffering from at the time.

This brief overview suggests a few conclusions:

1. The secondary market for arbitral awards seems to be gathering strength although limited to cases where the award may have enforcement issues. The other observation is that most of the publicly available information relates to investment arbitration awards that were traded publicly.
2. Enforcement of assigned awards may give rise to certain legal issues such as the legal standing of the assignee. Whilst the likelihood of such matters arising as legal issues might be limited, particularly in arbitration-friendly jurisdictions, the examples above suggest that assignment of arbitral awards is striving and active.
3. It seems that awards are "sold" at a deep discount when arbitration debtors may be facing financial difficulties. As noted above, the Argentine awards settled at over 25% below the nominal value, implying an even deeper discount on assignment. In *FG Hemisphere*, the underlying award for US $11.7 million was reportedly sold for US $2.6 million.

However, in other reported cases a leading litigation funder *Burford Capita,l*[528] has sold a successful arbitration award for a premium of £77 million. The case, once again arose out of an Argentinian government's expropriation of two Argentine airlines.

In July 2017, an arbitration tribunal ruled that Argentina should pay £233m in damages plus pre- and post-award interest. Burford's got involved as third party finance and their entitlement from the award was in the range of £101m with an ongoing and compounding interest entitlement.

3.3. MONETIZING AWARDS THROUGH CLEARING

The above brief overview suggests that the market for selling arbitral awards seems to be workable. However, whilst the idea of selling an award might sound appealing in principle, it seems that in practice the opportunities to do so are limited mainly to fairly large awards in investment arbitration cases against sovereign states.[529] However, if a process of clearing awards rather than discounting them is available, awards may not need to be sold at a discount as they did in the case of *Argentina*[530].

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[528] *Teinver S.A. (for Groupo Marsans), Transportes de Cercanías S.A. and Autobuses Urbanos del Sur S.A. v. The Argentine Republic*, ICSID Case No. ARB/09/1

[529] *Democratic Republic of the Congo and Others v FG Hemisphere Associates LLC* (Final appeal nos 5, 6 and 7 OF 2010 (Civil) (8 June 2011)

[530] IBID - n 347

Recently, the mobility and enforceability of arbitral awards has arrived to unprecedented levels. However, subject to specific limited exceptions, courts, even in such states which contract to the NY Convention, can render an international award non-enforceable in their jurisdiction.[531] In industries such as the financial sector, it is of great importance that arbitral awards be acknowledged as an instrument capable of recognition and enforcement. For the arbitrating parties and the tribunal, the award is nothing but an 'instrument recording the tribunal's decision provisionally or finally determining claims of the parties'.

It may deal with 'legal or factual differences between the parties, may involve interpretation of contract terms or determining the respective rights and obligations of the parties under the contract'. Ultimately, it is the enforceability and indeed the enforcement of the award that gives credence to the entire arbitration process and justifies the cost and time that the parties to a dispute have invested in the resolution process.[532]

It is against this background that this thesis is proposing the instant monetizing mechanism of arbitral awards resulting from banking disputes. The purpose for the choice of the financial sector as a pilot for such a proposal is the ready availability of funds within the interbank clearing networks. Such networks can play an important role in re-injecting funds back into the market through the ease of monetizing the awards and instantly transferring funds to claimant investors.

Applying this concept particularly in the financial sector will clear backlogs of investors' funds, which will unfailingly find their way back into the financial markets through the banks. Recycling the funds back into the markets will instantly speed markets' recovering cycle and avert deep crises.

4. EXECUTION, CLEARING AND SETTLEMENT

For the purpose of efficacy and speed, the interbank clearing of dispute awards should follow the same process as in the clearing of securities or promissory notes. Any clearing of financial instruments in the primary or secondary markets involves three processes:

1. **Presentation** is the transaction whereby the award creditor agrees to present the financial instrument to the clearing bank for exchange of funds to be collected from the award debtor. Thereafter, all the processes that lead up to settlement are referred to as clearing, such as recording the transaction, authentication and processing of the award for payment.

2. Clearing is the process of updating the accounts of the trading parties and arranging for accepting payment on behalf of the award creditor and the transfer of money and award between parties.

There would be two types of clearing:

[531] *Mondev International Ltd v United States of America*, ICSID Case No ARB(AF)/99/2, Award, paras 126–7ff (11 October 2002). The *Mondev Tribunal* presented an extended discussion on denial of justice as related to domestic judicial attitudes and presented a denial of justice test in paras 126ff.
[532]*Chevron Corporation (USA) and Texaco Petroleum Company (USA) v Republic of Ecuador*, UNCITRAL, PCA Case No 34877, Interim Award, para 185 (1 December 2008).

I. Bilateral Clearing is where the award creditor will present the award to the debtor financial institution which will voluntarily agree to undergo the steps legally necessary to settle the payment of the award as applied to any other financial papers. However, until 2008, many derivatives and repurchases (REPO) trades were settled bilaterally between banks. After the financial crash in 2008, the G20 governments decided that all derivatives trades are to be cleared through central counter party platforms (CCP's). Those are namely clearing houses such as the London Clearing House and the NY Clearing House Association.[533]

II. Award clearing will similarly be performed through one of those central counterparty clearing platforms (CCPs). It is worth noting that clearing houses are used by banks and financial institution who are members of those houses and who would also own a stake in it.[534]

In the case of award clearing, the member banks would have financial responsibility to the clearinghouse for the transactions that are cleared. It is the responsibility of the member firms to ensure that the financial instruments are authenticated and are physically or electronically available for transfer between parties. If the award is presented to a member bank for clearing, it is the duty of the bank to verify the authenticity of the award.

At the same time it is their responsibility to ensure the award debtor has provided payment, either directly or through setting up a credit margin to meet their obligation under the terms of the award. Otherwise, the member bank will have to make up for any shortfalls.

If a member firm becomes financially insolvent, only then will the clearinghouse members have to collectively make up for any shortcomings in the transaction. In other transferable securities, clearinghouses aggregate the trades from each of their members and net out the transactions for the trading day. At the end of the trading day, only net payments and securities are exchanged between the members of the clearinghouse.

Awards will be treated initially just like options and futures derivatives where the clearinghouse acts as a counterparty to both the buyer and the seller. That way the transactions can be guaranteed while virtually eliminating counterparty risk. Additionally, clearinghouses record all transactions by their members, providing useful statistics, as well as allowing regulatory oversight of the transactions.

3. Settlement is the final step where actual exchange of money and securities between the parties. Most settlement of securities is done electronically and no actual physical exchange of documents is required. The award settlement, as in trades of Futures contracts will refer to

[533] The New York Clearing House Association, known since 2004 as the Clearing House Payments Company. Modelled after the London Clearing House, founded nearly one century earlier in 1773, the New York Clearing House Association was the first of its kind in the United States and helped to stabilize the nation's monetary system by acting as an impartial referee. Since then it helped to stave off fraud and panic-induced crashes, bringing much-needed stability to financial markets.

[534] The New York Clearing House Association for example is owned by some of the world's largest commercial banks such as Allianz, Bank of America, BlackRock, Citi, Goldman Sachs, Société Générale, JPMorgan, State Street, T Rowe Price and Vanguard, which combined hold more than half of all U.S. deposits.

the amount of money credited to the account of the award creditor accounts by the end of the day. Modern day settlement and clearing has evolved since the 1960s and 1970s, when payments were still made with paper cheques. Brokers and dealers at the time had to use messengers or the postal service to send paper documents and securities or cheques to settle the trades.

The proposal here is that awards will change hands and be recorded electronically in a book-entry format. In New York for example, the system is run through the Depository Trust and Clearing Corporation (DTCC). While in Europe, Euroclear and Clearstream are the major central clearing houses for securities who can handle award clearing processes.

4.1. SMART CONTRACTS

The introduction of the blockchain has given rise to the actualisation of smart contracts. A smart contract is an immutable automated software program that is built on a blockchain protocol and made possible by general-purpose computation that takes place on the blockchain. Smart contracts can be used for allocating digital transactions between two parties, when the requirements established in the contract are fulfilled. In short, smart contracts are programmable contractual tools that are embedded in a software code. Thus, a smart contract can include the contractual arrangement itself, governance of the preconditions necessary for the contractual obligations to take place and the actual execution of the contract or document. Smart contracts result from a pre-defined relationship between the legal concept of contract and the element of *"smart"*. That is the fact that the contract could be embedded within and defined by software with the possibility of self-enforcement.

Self-enforceability means that the software executes the pre-agreed conditions in the document while adopting the role of conflict prevention. This is achieved as electronic execution limits the scope of potential disputes arising from the enforcement of a non-modified and fully authenticated document. In the document, the conditions of the document have the assets digitally allocated by the parties on the document. Receiving a payment is then no longer dependent on the willingness of the debtor to make the payment nor affected by bankruptcy proceedings that take place after entering the contract. The contract executes its content autonomously according to the embedded contract terms such as the digital assets placed within the contract that are allocated by parties at the outset of the issuing of the document.

To further elaborate how smart contracts function and what the possibility of having and arbitral award to be self-enforcement may entail, I depict here an example of a smart award: The scenario is intentionally a simple one: two parties receive an award about a commercial dispute. In the arbitration agreement it is agreed that the award may be in the form of a smart contract. The award itself decided how the assets of the award debtor will be allocated based on verified facts. The smart contract will then allocate the funds to the winner after the facts on the award are verified as to the pre-set conditions.

It is noteworthy that the normal vocabulary of voluntary compliance, escrows, etc. does not actualise in this example. The objective of this example is to demonstrate, how legally relevant information is embedded within the lines of the smart contract code. From a legal perspective the situation is simple: parties enter into a binding contractual relationship that obliges the losing party to pay the winner a certain amount of money after the facts have been established by a third party. [535]

On the other hand, the Depository Trust & Clearing Corporation (DTCC) in the US, announced in February 2020 the successful completion of a proof concept to manage the netting process for U.S. Treasury and repurchase agreements (REPO) transactions using the blockchain distributed ledger technology (DLT). Working with digital assets demonstrates the possibility of netting transactions such as arbitral awards within the interbank end-of-day netting of securities-like obligations in the clearing environment.[536]

Nowadays, governments around the world are promoting, or even requiring, central clearing, so that they can assess the systemic risk being imposed upon economies by their financial institutions. Financial disputes, especially in the trading of derivatives, can be clear indicators for regulatory authorities, as was witnessed in the recent credit crisis of 2007-2009. [537]

4.2. AWARD INTERBANK CLEARING PROCESS

Any clearing process starts with a paper that can exchange hands upon a traded value similar to a cheque or a promissory note. Arbitral awards have proven to be of such qualities where in certain cases actual arbitration awards were traded, discounted or exchanged for agreed monetary values. The assignees were not necessarily a party to the dispute, but they were granted the same enforcement rights as those of the prevailing party in the dispute. On the other hand financial dispute arbitration agreements may authorise for the award to be cleared through the CCP network.[538] Obviously, the clearing house contractual duty to pay is not absolute. Rather, it is subject to the availability of funds in the accounts of the award debtor bank similar to any security clearing process.[539]

Determining the point of time in which payment is made in the course of award clearing is not a matter of interpretation of clearing rules. Rather it is by reference to banking commercial usage and practices and it need not be strictly governed by one country and one specific clearing house rules.[540] At the initial stages there will be instances where absence of definite applicable clearing rules will incur. This can be either because the process is not yet comprehensive or is in the process of being drafted. A pre-emptive consideration however, for the parties to agree at the outset for the tribunal to determine the rights and assumed responsibility of the award holders and debtors as the right to place the award for clearing is essential for the process. The certainty of award payment is a fundamental objective which

[535] Li, J., Greenwood, D., & Kassem, M. (2018). *Blockchain in the Built Environment: Analysing Current Applications and Developing an Emergent Framework*. Diamond Congress Ltd.

[536] De Filippi, Primavera, and Samer Hassan. 2016. Blockchain Technology as a Regulatory Technology: From Code is Law to Law is Code. First Monday 21 (12).

[537] Delphine Rooz & Antonio Musella, *'International arbitration and alternative dispute resolution'* (2014) International Business Law Journal, p 157.

[538] B. Geva, "Presentment and Payment in Cheque Electronic Clearing: *Advance Bank v. TD Bank*" (2005)

[539] Barclays Bank v. W.J. Simms 1 Lloyd's Rep. 225 at 238, [1980] QB 677 (Goff J.).

[540] H.H. Dimond v Australia and New Zealand Banking Group Ltd, [1979]2 NZLR 739

can be easily deduced from a clearing rule point of view by reference to cheque and promissory note statutory rules.[541]

Yet, in the absence of such a legality, as far as the award clearing process is concerned, a result can be reached as a matter of statutory interpretation in conjunction with general principles of law at the place of enforcement. In other words, the award creditor, should they wish and with leave from the tribunal may resort to authorities under the NY Convention for the enforcement of the award within the clearing mechanism. [542]

4.3. AUTHENTICATION OF AWARDS FOR CLEARING

The NY Convention (NYC) provides for the recognition of arbitral awards by excluding any review of the merits of foreign awards. On the other hand, it stipulates a number of provisos to be considered during enforcement, such as the duty of the party seeking enforcement to supply the court at the time of application with an authenticated original or duly certified copy of the award and arbitration agreement.

This might raise some enforcement issues, as discussed in detail below. One of the most effective and efficient solutions to authenticate the electronic award in online arbitration is the electronic signature, which might be useful in enforcing the arbitral award.

However, its application depends on whether the courts in the enforcement country validate and recognise such a process. Consequently, in explaining the authentication and certification of arbitral award in accordance with the NYC rules we need to explore the differences between authentication and certification, and identify some of the issues that might arise, such as the governing law, the competent authority and the required documents.

Under article IV (1), the party seeking the enforcement and recognition of the arbitral award must provide the court of enforcement with authenticated copies of the arbitral award in addition to the original arbitral agreement. Because most national laws did not provide for a specific certificate of 'finality' other than getting an award declared enforceable in that country, this was 'practically the only way to prove finality.[543]

The NYC does not define the term 'authenticated', but the International Council for Commercial Arbitration defines it as 'the process by which the signatures on the award are confirmed as genuine by a competent authority.[544] According to Julian Lew, authentication means that the tribunal signed the award and it is genuine.[545]

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[541] Relevant provisions in the *English Bills of Exchange Act, 1882 (c. 61)*; in Canada the *Bills of Exchange Act* ss. 85(l) (b), 84(3), 86(1),87(b), 84 and 91; in the US Discharge and payment are governed by UCC §3-601 to 3-604.

[542] Dezalay, Yves, and Bryant G. Garth. 1998. Dealing in Virtue: International Commercial Arbitration and the Construction of a Transnational Legal Order. University of Chicago Press.

[543] Nicola Christine Port, Dirk Otto, Patricia Nacimiento and Herbert Kronke, Recognition and Enforcement of Foreign Arbitral Awards: A Global Commentary on the New York Convention (Kluwer Law International, 2010),

[544] ICCA's Guide to the Interpretation of the 1958 New York Convention: A Handbook for Judges (International Council for Commercial Arbitration, 2011), II.2.1.

[545] Julian D. M. Lew, Loukas A. Mistelis and Stefan Michael Kröll, Comparative International Commercial Arbitration (Kluwer Law International, 2003), p 705.

Consequently, the main aim of authenticating the award is to assure the enforcing court where the party is seeking enforcement that the signature on the award is genuine and has been signed by the arbitrators. Something the Blockchain technology may have sorted.

With the same approach to authentication, the NYC does not define the term 'certification'. Its role was explained by the ICCA in Article (II. 2.2) as being 'to confirm that the copy of the award is identical to the original'. In addition, Julian Lew and colleagues defined certification as 'an assurance that submitted documents are a true copy of the original'.[546]

Furthermore, the issue might arise whether the certified copy should be a copy of the authenticated original award, or just a copy of the original award. Some decisions[547] and researchers suggest that the certification of the copy should be a copy of an authenticated original award. Otherwise, the certified copy does not guarantee that the original award is genuine. It is necessary for the copy to conform to the original.[548]

On the other hand, other courts have not required a certified copy of an authenticated award and have considered it sufficient to produce the certified copy of the original award[549]. Arguably, this is the most appropriate approach, because it facilitates the general implementation of arbitration.

The requirement of an authenticated original award was a later insertion.[550] According to the NYC, the court has the choice to determine the applicable law to examine the validity of authentication or certification and the required documents.[551] However, leaving the choice to the court to determine the applicable law may raise other issues with regard to the competent authority authorized to authenticate the award to consider that an authentication is valid.[552]

4.4. THE GOVERNING LAW AND COMPETENT AUTHORITY

Since there is no specific law stated by the NY Convention to govern the authentication or certification validity of the award, different views have emerged among national courts about how to determine the applicable law. Some courts have applied the law where the award was rendered to examine the authentication validity. In these cases, the party seeking enforcement

[546] Comparative International Commercial Arbitration, p 705

[547] Bezirksgericht, Zurich, 14 February 2003 and Obergericht, Zurich, 17 July 2003 (Italian party v. Swiss company) Yearbook XXIX (2004) pp. 819-833 (Switzerland no. 37).

[548] Frank-Bernd Weigand, ed, Practitioner's Handbook on International Commercial Arbitration (2nd edn, Oxford University Press, 2009)

[549] Germany: BGH, NJW 2001, 1730 = XXIX Y.B. Com. Arb. 724, 726–727 (2004); OLG Rostock, BB 2000, Beil. 37, pp. 20, 22–23 = RPS 2000, 20 = XXV Y.B. Com. Arb. 717, 718 (2000).

[550] Albert van den Berg, 'The New York Convention: Summary of Court Decisions' in Marc Blessing (ed.), The New York Convention of 1958 (ASA Special Series No. 9, Juris Net 1996), p 257.

[551] Travaux préparatoires, United Nations Conference on International Commercial Arbitration, Report of the Committee on the Enforcement of International Arbitral Awards, E/2704, E/AC.42/4/Rev.1, Annex, at 14; Albert van den Berg, 'The New York Convention: Summary of Court Decisions', p 246.

[552] Emmanuel Gaillard and John Savage (eds.), Fouchard, Gaillard, Goldman on *International Commercial Arbitration* (Kluwer Law International, The Hague/London/Boston, 1999)

was required to fulfil the requirements of authentication under the law where the award was issued.[553]

Other courts have required that in order to consider the authentication to be valid, the governing law is where enforcement and recognition is sought.[554] Determining the applicable law to authenticate the award effectively determines the competent authority, which might vary from one country to another. [555]

For example, in some countries, the foreign ministry is the competent authority for authentication, while in other countries the public authority or a diplomatic or consular officer is authorised to authenticate.[556] In some cases, the members of arbitral institutions (e.g., the secretary general) may authenticate awards. In the United States of America, attorneys or notary public officers have the authority to authenticate documents.

4.5. ELECTRONIC AUTHENTICATION

Relying on a protected electronic signature fulfils the requirements of article IV of the NYC, which is to confirm that the signature on the award is genuine and added by a competent authority. In this case, the competent authority is the Certificate Authority, which examines the identity of the digital signature holder, and confirms whether the digital signature belongs to the person who used it.

It guarantees that it was controlled by the right person at the creation or usage at time of signing. It also examines whether the electronic record that is linked to the digital signature was not changed or amended. Relying on the protected electronic signature to authenticate an electronic arbitral can be valid and effective. Enforcing an electronic arbitral award that is signed electronically is not in opposition with the NYC provisions; on the contrary, it supports the NYC approach of speed and enforceability.

4.6. AWARD AUTHENTICATION

Under Article IV of the NYC, the party seeking enforcement of an award must provide the duly authenticated original arbitral award or a duly certified copy. Additionally, if the award is not in the official language of the country in which enforcement is sought, Article IV requires that an official or sworn translation be provided. It is clear that the creditor bears the burden of proving the existence of an award under Article IV.

Many arbitration laws around the world contain provisions regarding proof of an arbitral award closely paralleling those of the NYC. Article 35(2) of the UNCITRAL Model Law requires parties seeking to enforce an international arbitral award to provide the original

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[553] Italy: *CA Milano, VII Y.B.* Com. Arb. 338, 339 (1982); India: *Renusagar Power Co. Ltd. v. General Electric Co.*, XVI Y.B. Com. Arb. 553, 570 (1991); Bulgaria: *Sup. Ct. of Appeal, XXV Y.B.* Com. Arb. 678, 680 (2000).

[554] Italy: *Cass., XXI Y.B.* Com. Arb. 607, 608 (1996); France: *TGI Strasbourg*, *II Y.B.* Com. Arb. 244 (1977); Spain: *TS, VIII Y.B.* Com. Arb. 408 (1983); Mexico: Tribunal Superior de Justicia, *IV Y.B. Com*. Arb. 301 (1979).

[555] Japan: Tokyo High Court, XX Y.B. Com. Arb. 742, 744 (1995).

[556] Australia: Transpac Capital Pte Ltd. v Buntoro, [2008] NSWSC 671 = XXXIII Y.B.Com. Arb. 349 (2008); Switzerland: Bezirksgericht Zürich, XXIX Y.B. Com. Arb. 819, 824 (2004); US: Guang Dong Light Headgear Factory Co., Ltd. v ACI Int'l Inc., 2005 U.S. Dist. LEXIS 8810 (D. Kan. 2005) = XXXI Y.B. Com. Arb. 1105, 1109–1110 (2006).

award and arbitration agreement, or "duly certified" copies thereof. Arbitration legislation in a few jurisdictions imposes less rigorous proof requirements than Article IV of the NYC.

For example, the French Code of Civil Procedure omits any requirement for a certified translation or original copy of the award, instead embracing a simpler approach that an award can be proven in the same manner as contracts. Another preliminary issue concerns the procedures that apply in national courts for actions to recognize arbitral awards.

The NYC leaves this issue largely to national law, subject to a general principle of non-discrimination awards. The NYC thus does not require either speedy or efficient procedural mechanisms for enforcing awards. It merely requires contracting states to use procedures that are no more burdensome than their domestic enforcement procedures. [557]

It is clear that the NYC imposes a mandatory rule, requiring contracting states to recognize and enforce foreign awards, except where one of Article V's exceptions applies. Article III provides that "each Contracting State shall recognize arbitral awards as binding" and enforce awards in accordance with the NYC and its national procedural rules.

One of the central objectives of the NYC was to eliminate the "double exequatur", meaning that the award needed the confirmation in the place of the arbitration before it could be recognized internationally. If either court denied exequatur, the award could not be recognized and enforced. This process made the recognition and enforcement of arbitral awards difficult, unreliable and slow. The NYC eliminated the double exequatur requirement, with the objective of making foreign awards efficiently enforceable and subject to fewer opportunities for judicial challenges.

Blockchain - If the goal is to have foreign arbitral awards efficiently enforceable, blockchain technology can provide another perspective to this issue. As mentioned earlier, Blockchain can best be described as a digital platform or a distributed and immutable ledger that stores records, known as "blocks". A key property of blockchain technology which distinguishes it from traditional database technology, is that it is publicly verifiable and supported by the integrity of the system. In other words, it would be practically impossible to change an entry in the database or in the wording of an award, because it would require changing all of the data that comes before it on the entire network.

With this mechanism, it is possible to store a duly rendered award in an arbitration process by having this information in distributed ledger technology (DLT) format. The enforcing authority is then able to verify the existence of the award, authenticate the judicial proceedings, and the authenticity of the award itself. This means that once the award is created and placed in the smart contract format, it cannot be changed, altered or modified. If a financial smart contract codes are deployed, it means the contract is compiled and "stood up". This means that the contract can run on the blockchain carrier system such as IBM World Wire or JP Morgan Payments Network. The smart contract will be located at its coded

[557] Report on the survey relating to the legislative implementation of the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York, 1958) Note by the Secretariat (United Nations Commission on International Trade Law, Forty-first session, New York, 16 June-3 July 2008) A /CN.9/656.

address and will remain perpetually unchanged. The burden of proof to show the existence of the award and that it is duly certified is fulfilled.

5. BLOCKCHAIN AND ARBITRAL AWARD ENFORCEMENT

A stateless-award-enforcement model in interbank disputes can constitute a significant advantage. It will allow the award clearing forum to enforce the value of the award upon the award debtor bank autonomously and without incurring any delays which unavoidably affect parties involved in arbitral disputes generally.

In financial disputes, where the disputants are financial institutions, banks and financial service providers, the blockchain DLT will support a decentralized mechanism for payment of wards within the interbank sector without the need for state interference. This is possible due to the possibility of the full-proof authentication facility provided by the nature of DLT environment. The Blockchain will serve as a conceptual space technology that fundamentally manages assets, and smart contracts to enable them to be zipped across the globe in a matter of seconds.[558]

Below is a demonstration of how an international award generated via a tribunal can rely on a decentralized DLT Blockchain system to be cleared and paid through the interbank framework. Using a current platform such as the Interbank Information Network (IIN), it can function as a launching pad for the award clearing process proposed in this thesis.[559]

Example - Starting by the final step of a financial dispute, the presiding tribunal will produce a legally enforceable award that can be managed and digitally signed via a blockchain DLT process.

Due to the nature of bank clearing networks, only an interbank dispute awards may be presented for clearing through a network such as IIN. Once the award is signed and launched on the blockchain, the award creditor would trigger an online award proceeding transaction. Through this approach, the IIN protocol is able to increase the speed with which the transaction is documented and executed, while simultaneously providing contracting parties with an agreement containing a payment provision of the enforceability of the arbitrator’s decision in the real world.

The IIN system normally implements and works through a programmatic interface with the member banks to easily incorporate a payment procedure, which in this case will be an award payment process. Once configured, IIN will send the smart contract notice of a confirmed award to the award debtor. The smart award will then transfer any identified digital assets to a virtual escrow account, thus locking these assets for payment through the “Award Clearing Forum”.

[558] Milne, A. (2012). *OTC Central Counterparty Clearing: Myths and Reality*. Journal of Risk Management in Financial Institutions, 5(3), 335-346.
[559] Delemarle, A. (2017). *Standardization and Market Framing: The Case of Nanotechnology*. Handbook of Innovation and Standards. Edward Elgar Publishing.

The award payment procedure can be accessed via parties of the Clearing Forum through a basic user interface. Using this interface, the Clearing Forum can notify each party that the funds are available for payment and agree on the blockchain address of whom the parties select as a receiving account. At that time, any of the parties can access the interface, review the statement of facts, render a decision, and have the arbitration award automatically transferred from the assets maintained in escrow.

5.1. RISKS OF CROSS BORDER SETTLEMENT

This is a demonstration of a comprehensive step towards a vision debuting an end-to-end transaction that incorporates a smart arbitration award system. Financial Disputes can be very complex and resolving them in a legally enforceable way requires flexibility to adapt to different jurisdictional requirements. However, once a decision is taken the real resolution of the disputes only occurs when the award is finally realised and paid.

Making use of Blockchain data processing along with expanding operating models that work within an eco-system of third party partners will undoubtedly represent a challenge for traditional banks with inherited structures. Nevertheless, it is absolutely necessary for the stability of the financial markets. The future of banking will be determined by those banks that start early and those willing to disrupt traditional business models to push the boundaries of their interbank dispute resolution experience.

If implemented, the end result would be game-changing as a globally accessible award payment forum where disputants in a financial arbitration process are able to produce immediate funds upon the issuance of an award. To build such a forum, the blockchain ecosystem needs several baseline tools. Those are mainly inter-forum/interbank agreements that will seamlessly interact with smart contract codes to ensure the enforceability of any arbitral awards. Those are similar to online interbank SIPA system.[560]

Vulnerability in any financial system depends on a number of factors. The size and duration of participants' credit and liquidity exposures in the interbank settlement process are basic factors affecting the potential for systemic risk. As these exposures last for longer and become larger, the likelihood that some participants may be unable to meet their obligations increases, and any participant's failure to settle its obligations is more likely to affect the financial condition of others in a more serious manner.[561]

Interbank funds transfer systems in which large intraday exposures tend to accumulate between participants therefore have a higher potential for systemic risk. [562] The settlement of

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[560] International Organisation of Securities Commission, *Recommendations for Securities Settlement Systems*, Report of the CPSS-IOSCO Joint Task Force on Securities Settlement Systems, International World Bank, Bank for International Settlements. https://www.bis.org/cpmi/publ/d42.pdf

[561] Ernkvist, M. (2015). *The Double Knot of Technology and Business-model Innovation in the Era of Ferment of Digital Exchanges: The Case of OM, a Pioneer in Electronic Options Exchanges*. Technological Forecasting and Social Change, 99, 285-299.

[562] The definition of systemic risk is consistent with the one used by the Bank for International Settlements (BIS) (1994: 177): Systemic risk is the risk that the failure of a participant bank to meet its contractual obligations may in turn cause other participants to default, with the chain reaction leading to broader financial difficulties. Robert Parry (1996: 2), President of the Federal Reserve Bank of San Francisco defines Systemic

financial market transactions from a real-time gross settlement (RTGS) perspective means the transfer of balances in the books of a central bank (i.e. central bank money) or commercial banks (i.e. commercial bank money).

In practice, settlement in the vast majority of large value funds transfer systems takes place in central bank funds. Although the rules and operating procedures of a system and the legal environment generally may allow for differing concepts of finality, it is typically understood that, where settlement is made by the transfer of central bank money, final settlement occurs when the final (i.e. irrevocable and unconditional) transfer of value has been recorded on the books of the central bank.

5.2. FINAL SETTLEMENT OF INTERBANK FUNDS

Interbank funds transfer systems can be classified in several ways. Differences in the way settlement takes place provide a useful framework to distinguish the settlement systems. A common distinction in this respect is to divide systems into net settlement systems and gross settlement systems. In a net settlement system, the settlement of funds transfers occurs on a net basis according to the rules and procedures of the system.

A participating bank's net position is calculated, on either a bilateral or a multilateral basis, as the sum of the value of all the transfers it has received up to a particular point in time minus the sum of the value of all the transfers it has sent.

The net position at the settlement time, which can be a net credit or debit position, is called the net settlement position. Net settlement systems for large-value funds transfers are primarily multilateral (rather than bilateral) net settlement systems in which each (settling) participant settles its multilateral net settlement position. In a gross settlement system, on the other hand, the settlement of funds occurs on a transaction-by-transaction basis, that is, without netting debits against credits.

Interbank funds transfer systems can also be classified according to the timing (and frequency) of settlement. Systems can in principle be grouped into two types, designated-time (or deferred) settlement systems and real-time (or continuous) settlement systems, depending on whether they settle at pre-specified points in time or on a continuous basis.

These two types are more narrowly defined in terms of the timing of final settlement. One type of system is thus a designated-time (or deferred) settlement system, in which final settlement occurs at one or more discrete, pre-specified settlement times during the processing day. Designated-time settlement systems, in which final settlement takes place only once, at the end of the processing day, are called end-of-day settlement systems.

Currently, net settlement systems for large-value transfers are typically end-of-day net settlement systems that settle the net settlement positions by means of transfers of central bank money from net debtors to net creditors. In some countries, there are systems in which the final settlement of transfers occurs at the end of the processing day without netting the

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Risk as the risk that one bank's default may cause a chain reaction of...failures and even threaten the solvency of institutions.

credit and debit positions, on a transaction-by-transaction basis or on the basis of the aggregate credit and aggregate debit position of each bank.

Such systems are often called end-of-day gross settlement systems. On the other hand, a real-time (or continuous) settlement system is defined as a system that can effect final settlement on a continuous basis during the processing day. It is worth stressing here that the distinction between different systems such as RTGS and designated-time net settlement (DNS) systems concerns the form of settlement, not the form of transmission and processing.

Like RTGS systems, many net settlement systems transmit and process payment messages in real time on a transaction-by-transaction basis, but they settle, by definition, on a net basis at discrete intervals. An important concept that is often used in connection with the timing of finality is intraday finality or an intraday final transfer capability.

This finality mostly depends on the legal framework in which the system is operating. If the intraday finality is recognized in the legal framework where the system is operating, then the system can be defined as a true RTGS system.

In some countries though, the IT systems offer the RTGS technically but the legal framework does not recognize the intraday finality, without which all the risk that can be eliminated because of RTGS system remains there.

6. CENTRAL BANKS AND PRIVATE SECTOR CLEARING SYSTEMS

Interbank funds transfer systems are sometimes classified according to whether they are central bank systems or private sector systems. The distinction typically depends on who owns and operates the systems (rather than on the identity of the settlement agent).

At present, it is possible to identify two "typical" types of large value funds transfer system:

(a) Central bank systems owned and operated by the central bank (or its affiliated entities) in which the central bank also provides settlement

(b) Private sector systems owned and operated by a private sector group (e.g. a banking association or clearing house), where the main operational role of the central bank is to act as the settlement agent.

In the G-10 countries, for example, RTGS systems often belong to the former category and many DNS systems belong to the latter. Nonetheless, a number of DNS systems are owned and operated by the central bank. In some cases RTGS systems are owned and operated by private sector groups.

Moreover, there are several DNS and RTGS systems in which ownership and operation are shared between the private sector and the central bank.

6.1. MAIN FEATURES OF RTGS SYSTEMS

An RTGS system is defined as a gross settlement system in which both processing and final settlement of funds transfer instructions can take place continuously (i.e. in real time). As it is a gross settlement system, transfers are settled individually; that is without netting debits against credits. As it is a real-time settlement system, the system effects final settlement continuously rather than periodically at pre-specified times provided that a sending bank has sufficient covering balances or credit. Moreover, this settlement process is based on the real-time transfer of central bank money. An RTGS system can thus be characterized as a funds transfer system that is able to provide continuous intraday finality for individual transfers.

6.2. PAYMENT PROCESSING IN RTGS SYSTEMS

Within this broad definition, the operational design of RTGS systems can differ widely. In particular, important differences may arise in the approaches to payment processing when the sending bank does not have sufficient covering funds in its central bank account. One possible way of treating transfer orders in such circumstances is for the system to reject the orders and return them to the sending bank.

The rejected transfer orders will be input into the system again at a later time when the sending bank has covering funds. Until that time, sending banks may keep and control the pending transfers within their internal systems (internal queues). Alternatively, the RTGS system may temporarily keep the transfer orders in its central processor (system or centrally located queues) instead of rejecting them.

In this case, the pending transfers will be released for settlement when covering funds become available on the basis of predefined rules agreed between the system and the participating banks. In many cases the transfer orders are processed and settled with the extension of central bank credit, normally provided for a period of less than one business day (intraday credit); in other words, the central bank provides banks with the necessary covering funds at the time of processing by extending such credit.

The central bank could take a range of approaches to the provision of intraday credit in terms of:

a) the amount of credit (including a zero amount)
b) the method by which credit is extended (e.g. overdraft or repo)
c) the terms on the credit (e.g. free or priced)
d) the collateral requirements (if any)

These possibilities of payment processing (i.e. rejected, centrally queued, and settled with central bank credit) are not necessarily mutually exclusive. For example, when the provision of central bank credit is constrained in some way, the transfer orders for which the sending bank could or would not obtain central bank credit will be rejected or centrally queued.

In recent years, new or planned RTGS systems have tended to apply a combination of these possibilities rather than being based on only one form of payment processing.

6.3. LIMITING SYSTEMIC RISK

RTGS systems can contribute substantially to limiting payment system risks. With their continuous intraday final transfer capability, RTGS systems are able to minimize or even eliminate the basic interbank risks in the settlement process. More specifically, RTGS can substantially reduce the duration of credit and liquidity exposures.

To the extent that sufficient covering funds are available at the time of processing, settlement lags will approach zero and so the primary source of risks in interbank funds transfers can be eliminated. Once settlement is effected, the receiving bank can credit the funds to its customers, use them for its own settlement purposes in other settlement systems or use them in exchange for assets immediately without facing the risk of the funds being revoked.

This capability also implies that, if an RTGS system were linked to other settlement systems, the real-time transfer of irrevocable and unconditional funds from the RTGS system to the other systems would be possible. The use of RTGS could therefore contribute to linking the settlement processes in different funds transfer systems without the risk of payments being revoked.

6.4. INTRADAY LIQUIDITY REQUIREMENT

Provided that there are no legal problems with regard to settlement finality, the only structural impediment to continuous intraday finality is any liquidity constraint a sending bank may face during the day. A liquidity constraint in an RTGS environment has two basic characteristics, namely that it is a continuous constraint for settling funds transfers and that intraday liquidity requirements must be funded by central bank money; banks must therefore have sufficient balances in their central bank accounts throughout the processing day.

Intraday liquidity requirements raise important issues for both the central bank and the private sector. Central banks, for their part, face a choice as to whether or not to provide banks with intraday liquidity and, if so, what form that provision will take (e.g. by what mechanisms and on what terms the credit will be provided, and how any resulting exposures will be managed).

The intraday liquidity requirements under a particular RTGS system depend critically on (a) the structure of financial markets and systems (e.g. the adequacy of private sector sources of liquidity, the amount of collateral or securities available, reserve requirement regimes) and (b) the central bank's policy regarding the provision of intraday credit.

The means by which intraday liquidity is provided can significantly affect the extent to which immediate, or at least very timely, final settlement occurs, and, ultimately, it can influence the balance between the potential benefits and costs of RTGS systems.

6.5. APPLICABLE LAWS

In the case of security settlement, the issue of applicable law is particularly crucial and complex. This is especially true when securities are held on account with a financial institution in one country and then held through a chain of intermediaries, with a custodian in another country which itself then holds such securities with the central securities depositary system where the underlying securities have been directly issued and are primarily held. This is the daily management of securities held with international central securities depositaries systems such as Euroclear or Clearstream.

Global custodians and certain custodians are also acting through the same holding pattern. One may also think of the case of links between national central securities depositaries.[563] In that context, the type of entitlement that is granted on the basis of the intermediary's books to reflect such indirect holding of securities though sub-custodians and central securities depository (CSD) should be taken into account.

A CSD is a specialist financial organization holding securities such as shares either in certificated or uncertificated (dematerialized) form so that ownership can be easily transferred through a book entry rather than the transfer of physical certificates. This allows brokers and financial companies to hold their securities at one location where they can be available for clearing and settlement. This is usually done electronically, making it much faster and easier than was traditionally the case where physical certificates had to be exchanged after a trade had been completed.

Usually, in cross-border holdings, the securities accounts of the investor with its intermediary, recording a deposit of foreign securities, will represent not the underlying securities themselves but a securities entitlement. This will not be the case with arbitral awards. Entitlements under arbitral awards are the financial rights in the underlying award that may be protected by law as giving to the investor ownership rights in a book-entry pool of the award debtor assets. Such underlying awards may consist of physical award forms kept safe in the vaults of a custodian and circulating by way of book-entry transfers when traded or changing hands to be finally delivered to the award debtor.

On the other hand the award can be kept, as mentioned earlier in the form of a DLT electronically registered form which is noted in the award creditor books and circulating in the books of the local central counter party platforms (CCP) or through the intermediation of correspondent banks. The test of applicable law here for the enforcement of proprietary rights in instruments or other rights in such instruments which are recorded in a register or a centralised deposit system. Rights of enforcement of arbitral awards in this case, shall be governed by the law of the state where the register or centralised deposit system is held or located unless agreed otherwise by the parties in the arbitration agreement.[564]

In the case of clearing of securities, the law in England, Wales and N. Ireland provides for transfer of securities based on transfer of legal title on registration. The regulations covering each regime provide for electronic book entry transfer of title effected pursuant to settlement of a properly authenticated instructions attributable to one or more members in accordance with the rules of the securities settlement system.

7. CONCLUSION

In order to resort to this award clearing process it has been essential in this Chapter to establish:

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[563] R. Guynn and N. Marchand, *"Transfer of pledge of securities held through depositories"* in *"The law of cross-border securities transactions",* Sweet & Maxwell (1999), p. 47 Richard Potok, "Legal certainty for securities held as collateral" in International Financial Law Review, Dec. 1999

[564] *The Hague Securities Convention* of 5 July 2006, http://www.hcch.net/e/conventions/menu36e.html

(i) Whether an arbitral award is equated to a local court judgment, irrespective of where it was made

(ii) Whether the award can be deemed as a stand-alone right of payment instrument, capable of being cleared or traded in accordance with banking regulations

In this regard the case law is reviewed above and shows that the practice of trading awards is consistent with an emerging trend as what occurred with Argentina.

In financial disputes, clearing an award starts by introducing it to the clearing network via the holder's financial institution. It can then be processed for payment by charging the award debtor's assets held with another financial institution. In that, the Blockchain technology lends a hand in providing self-enforcing smart awards. The introduction of the blockchain has given rise to the actualisation of smart awards that can resemble a smart contract. In essence, it will be an automated software program built on a blockchain protocol and its automated self-enforcement is made possible by general-purpose computation that takes place on the blockchain.

Thus, a smart award can include the contractual arrangement itself, governance of the preconditions necessary for such obligations to take place and the actual execution of the award. Smart awards would result from a pre-defined relationship between the legal concept of arbitral awards and the element of "smart". The ground-breaking novelty of blockchain smart awards lies in the benefits of decentralisation. Decentralised smart awards will remove the authentication burden on local courts as the focal concept of enforcement. In addition, external influence is excluded from the blockchain and all transactions take place in public ledgers leading to speed and settlement of the actual dispute.

CHAPTER SIX

CONTEXTUAL CONCLUSION

The continuing importance and resonance of arbitration relies heavily, if not exclusively, on the enforceability of arbitral awards. A 'speedy victory' in arbitration will be a useless win if the outcome award cannot be enforced as efficiently and as speedy. However, not all cases suffer non-compliance. To a large extent voluntary compliance in banking and financial disputes is the norm. An interbank self clearing framework will then be of more use.

Such a norm is what justifies arbitration as a self-standing jurisdiction, or even as an alternative juridical system. However, in those instances where awards are not voluntarily complied with, the assistance of national courts will be sought and judicial enforcement is the second best alternative, thanks to the provisions of the New York Convention.

However, on occasion, the system may be tedious, long and subject to national or local law and court peculiarities, leaving a frustrated award creditor. *Chapter One* provided the basis for the need of a specialized award paying framework for international banking disputes. Such a process is well positioned to address many issues that arise in financial disputes and to fill the international void of delayed settlement of enormous inter-bank disputes.

Chapter Two continued with the conclusion that New York Convention does not harmonize national court procedures and hence enforceability of international financial awards can occasionally be affected or even become hostage to domestic court practices, nationalistic public policies and the relevance of local procedural laws.

Chapter Three continues to conclude the importance of promptness and authoritarian enforcement of arbitral award for the control of moral hazards. Disregard to social commitment and excessive risk-taking was certainly a recurring theme within the banking sector in the last financial crisis. No other industry than the financial sector has a compatible talent for privatising gains and socialising losses. However, when social gains are ascertained through efficient dispute enforcement, such talent may become more compliant.

When international arbitration interacts with national courts there is potentially an increased legal risk that things may not develop exactly the way in which the prevailing party may have expected. Consequently, certain alternatives can be developed to ascertain the instant payment of arbitral awards resulting in financial and banking disputes.

Post-arbitration settlement is usually a common practice between banks with tight correspondent and financial relations. Other choices such as transfer, selling or assignment of the arbitral award are known to have been transacted in the market, albeit with discount.

On the other hand, arbitral awards offer tangible economic and monetary value as they embody real value. They function as an asset in the context of business negotiations and between the parties and funders in cases of third party finance.

As prescribed in *Chapter Four*, a legally potent enforcement process through banking clearing networks can be a viable solution. The clearance process is most importantly to avoid long legal delays that consume a vast amount of time and expenses while large sums of investment money lie idle waiting for a resolution.

Chapter Five finally concludes by prescribing "smart awards" (as opposed to smart contracts) as a process that applies swift justice on rogue bankers and discharges panic runs as investors gain confidence in the enforceability of a compensatory judicial process. Operating the mechanism within a framework of the banking sector will also serve as an alternative to enforcement via national courts which may not be arbitration friendly. Difficulties and public policy inspired objections are particularly tested when action is brought by foreign parties against local banks. What is a clear and undisputed conclusion to draw is that the enforcement of commercial arbitration awards is not the sole objective for such framework.

Investor protection from high risk and embedded moral hazard is the main concern. Fast and speedy implementation of compensatory awards that is ratifying to bank clients can impede actions of moral hazard in the financial industry. A function that instant remedy brought by an efficient interbank award payment framework, can fulfil.

On the other hand, there may be certain banks that may initially decline joining the award clearing forum to avoid instant adherence to arbitral awards they do not agree to. In this case, and as proposed above, awards held against those banks and are traded in the market will start declining in value and trade at deep discounts as happened with Argentina. That in turn will have a negative impact on the ratings of such banks and their interbank borrowing rates. Eventually, the pressure of expensive interbank funding will lead such institutions to comply with the enforcement.

It is to conclude that fast and efficient clearing of financial disputes arbitral awards is a high threshold and if implemented with success in the financial sector, it will have a positive and far reaching effect onto the entire global financial system as well as other sectors of the world economy.

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