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1. Typical disputes in investment services

***** I will use "investment services" as in the ISD Directive: all services in relation to securities performed by investment firms and banks.

***** Investment services are based on two

Contracts
- agency
- sales and purchase

***** Disputes typically evolve from default of the basic obligations assumed by parties in these contracts:

- non compliance by the agent of the instructions received;
- failure of the agent to defend his client's interest;
- conflicts of interest, specially if the investment firm is a universal bank;
- bad advise;
- no allocation or non delivery of securities;
- excessive price or unfair charges.

***** Special feature of disputes in investment firms are that they often have a collective aspect:

- securities are admitted to trade in stock exchanges;
- sales may take the form of
  - public offer to sell (IPO)
  - public offer to buy (OPA)

- issuers in IPO's or buyers in OPA's have to issue prospectuses;
- investments are bundled in UCITS (funds and investment companies).

The dispute affects not one, but a multitude of investors. Presents numerous problems.

* Second special feature is that investment services generally imply a general appeal for savings; there is a public interest in the protection of investors; this implies a regulated sector, in which the state, through a regulator, submits investment firms to a special discipline.

  Disputes can arise as a consequence of the breach by investment firms of their statutory obligations.

2. Consequence: the trilateral structure of investment services disputes

* One side in a dispute is always an investment firm (which may or not be a bank).

  It is always a professional

  - Licensed
  - supervised

  By a regulator, which is a public entity body, which in the Last 30 years has been taking over functions traditionally performed by SRO's

* The other side my be

  1. Private investor: is the equivalent of the consumer; a physical person without specific knowledge, which must be protected by the law.

  2. Professional investor: he is assumed to have sufficient knowledge and does not need the same type of protection.

     Caveat: often the distinction is blurred and professional investors are included within a general "investor concept".

  3. A collective group of investors (as in an IPO, OPA or UCIT), or

  4. an investment firm/bank, in general a licensed, supervised entity.

* Third element: institutional

  - stock exchange or other regulated market;
  - association of banks or investment firms, often acting as self regulatory organization;
  - public law regulator.

* This institutional element is unique to financial services and it provides a structure, which can sponsor or even impose schemes of alternative dispute resolutions:

  - a stock exchange can create an arbitration structure for its members;
  - an SRO may create an arbitration scheme in order to appeal against its sanctions;
  - a regulator may create a mediation system to which investors can have recourse;
  - a private dispute can also imply a regulatory dispute with the regulator.

3. Methods of solving the dispute

* Methods: the two, which we know from ADR, in general are:

  - mediation: a neutral is called in, hears both parties, and issues a non binding opinion;
  - arbitration: an independent arbitrator hears both parties and renders a binding award.

* The surprising situation of investment services is that

  - mediation is very popular; there probably is no other sector in which mediation is more prevalent;
  - arbitration is, at least in Europe, very unusual; probably there are few sectors which use arbitration more rarely than that of financial services.

* How is this to be explained?

* Mediation is very frequent because of the ombudsman schemes. Art. 14 of Directive on Distance selling of investment services 2002/65 orders States to develop ADR forums to solve consumer disputes, and that such forums cooperate with each other at European level. Like so often

in European law, the Directive stays at very high level, and different States have legislated creating very different structures:

- who can claim;
- if claims have or not a ceiling;
- if the decision is or not binding.

- Ombudsmen are independent institutions created by law or by a SRO, with the aim of hearing complain from private investors. Investors have the right but not the obligation to present their case to the ombudsman before having recourse to the courts. The ombudsman hears both parties, and then issues an opinion. Depending on the jurisdictions, the ombudsman's opinion may be legally binding on the investment firm, or just a recommendation. In any case it carries a lot of weight, and is usually complied with by the investment firm. The opinion, however is never binding upon the investor, who, if not satisfied, keeps full recourse to the courts.

***** Arbitration on the other side is less frequently used than in most other business areas (except possibly banking). Three reasons:

1. The traditional mistrust between banks and financial entities and arbitration. I will not try to analyse the reasons for this mistrust, or to venture an opinion if who is wrong and who is right. But it is a fact that in international financial transactions the use of international arbitration is the exception, not the rule. (The submission to international arbitration is substituted by submission to the Courts of London and New York).

2. Problems of arbitrability, both objective and subjective:

   Objective: issue which can be submitted to arbitration.
   Subjective: persons who can submit to arbitration.

   A) Objective arbitrability:

   - The problem regarding arbitrability of securities disputes arose in the U.S. There the Securities Act 1933 and the Securities Exchange Act of 1934 called for disputes to be resolved in the Courts and prohibited waiver of any of the act's provisions. In 1953 the Supreme Court held that in the light of the imbalance in bargaining power, arbitration lacked the necessary level of protection. The result was that parties could enter into

arbitration by mutual consent, but courts would not compel arbitration.

The rule was overturned in 1989 in Rodríguez de Quixas and […….]/American Express which ended the old judicial hostility to arbitration, and provides for the enforcement of arbitration contracts in the securities area. This has led to a very extensive use of arbitration in American Securities disputes. Every stockbroker and every brokerage firm is a member of NASD and is bound by the rules of NASD to arbitrate the disputes, in one of various arbitration forms. The one organized by NASD itself handles more than 6.000 arbitrations every year, and is one of the biggest arbitrations in the world.

Two ¿? special characteristics:

- disputes are primarily disputes between clients and brokers;
- arbitration is organized by NASD (business organization!);
- supervision of SEC to guarantee non existence of bias.

- In Europe, the problem of arbitrability only exists, in a similar fashion, in Germany, where § 37 h Wertpapierhandelsgesetz only permits that securities disputes between full merchants be arbitrated. Consumers must consent to arbitration ex post, once the dispute has arisen.

- In other countries, there is no § 37 h, but public policy constitutes a limitation to arbitration. Public order can be affected by

  - Protection of savings.
  - Correct functioning of the markets.
  - Equality between investors.

  This implies: arbitrators cannot determine

  - Disputes which confront one person and an indefinite number of investors
    - e.g.: responsibility for prospectuses

- compliance with an OPA
- compliance with an IPO

- Penalties for violations of mandatory rules issued to regulate the market.

B) Subjective arbitrability

Disputes between investment firms and regulator cannot be solved through arbitration - there is a clear lack of subjective arbitrability.

The situation is different as regards disputes with regulated markets. Historically, stock exchanges in many countries were public law entities; difficulties for arbitration; now they are Private Corporation, which provide services and are listed, → should be treated as any other professional.

3. Problems related to consumer protection

Investors typically sign standard form agreements.

Directive 93/13: a contractual term which has not been individually negotiated cannot create a significant imbalance in the parties' rights and obligations, to the detriment of the consumer. The Annex contains an indicative list of clauses, which are unfair. This includes clauses, which exclude the consumer's right to take legal action or exercise any other legal remedy.

Green paper of the commission 4.02: raises the question whether this clause prohibits any type of arbitration for consumers.

Is it unfair for investors to have to submit in their agreements with the investment firm to arbitration? Is the clause null and void?

First answer: clearly not if:

- the clause has been individually negotiated with the consumer and
- the consumer has the option to submit to arbitration, once the dispute has arisen (but not the obligation).

Other cases: standard contract, which provides that all future disputes between consumer and investment firm must necessarily be arbitrated.

My tendency is to think that this is an unfair term, except if the Arbitration tribunal grants the consumer a level of protection equivalent to that of a State Courts. And that can only be achieved if the Arbitration Tribunal is regulated and supervised by the public administration, in order to guarantee its independence and quality.

* Summing up: in securities disputes

  - mediation through publicly created or sponsored ombudsman schemes very frequent and reasonably successful;

  - arbitration: unusual; not possible in disputes with indefinite members of investors (IPO, OPA, prospectus), nor with the public regulator, because of lack of arbitrability; consumers in general may have the option, but not the obligation to arbitrate.

* There have however been two recent developments in order to facilitate arbitration between professionals.

- Euronext:
  - totally new approach;
  - arbitration institution sponsored by Euronext (French, Belgium, Dutch, Portuguese markets);
  - only disputes among market professionals, <u>not</u> with clients
  - arbitration clause to be inserted in agreements (not in the by laws) and the Market Rules provide that disputes between the market and members, and between the members must be solved by arbitration;
  - only financial disputes;
  - speciality:
    - <u>designation of arbitrators</u> not in the hands of the parties;
    - sole arbitrator out of a list chosen by Permanent Committee;
    - specialized knowledge;
    - <u>duration maximum 6 months</u>
    - no possibility of extension, except in exceptional circumstances.

  Euro Arbitration

- Conseil des Marches Financiers

4. <u>Future</u>

***** Traditionally the world of arbitration and the world of securities and investment services have been worlds apart.

European Investment firms, generally speaking, have not been convinced by the advantages that arbitration offers - the contrary of what has happened in the U.S.

***** My final point:

Investment firms and banks are not *per se*, due to some predisposed bias averse to any type of arbitration. There is the example of arbitration in the U.S. There is also the example of Diriban, an inter bank dispute settlement mechanism created by the Spanish banking association, which has solved more than 900 inter bank disputes. There are the new systems created by Euro Arbitration and by the [……] MF.

Financial entities like arbitration … what they are way of is "international commercial arbitration as it currently stands". And these are not my words, but those of French Baber, Georges Affaki, vice chair of the ICC Banking Commission, stated a couple of days ago.

I end with a note of hope: large areas of investment services can be won over to arbitration - if we are able to create a type of arbitration which is appropriate to efficiently and equitably solve these kinds of disputes, which gives to all involved the certainty that their dispute will be heard by independent and knowledgeable professional arbitrators, and that the decision will be rendered in the time frame which is required in financial markets.