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Fintech Disputes on Trial

By Tim Hardy

Will the Fintech revolution lead to a greater appreciation of the benefits of arbitration, and therefore its greater use, in the financial sector?

Traditionally, the financial services sector has preferred to resolve its disputes through litigation in trusted jurisdictions such as New York, London and Frankfurt. However, a recent report[1] by the International Chamber of Commerce (ICC) concluded that attitudes are changing and financial institutions are becoming more open to arbitration, particularly in international disputes.

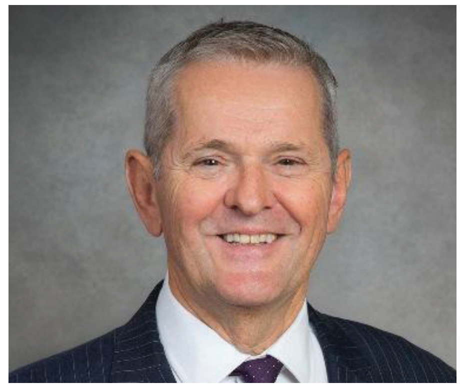
The apparent shift in mindset comes at a time when financial institutions, brokers, investors, industry bodies and regulators are faced with a set of novel challenges posed by automated trading, cryptocurrency, cybersecurity and blockchain technology. Add to that mix the decision to end the use of Libor, described by the Federal Reserve Bank of New York's general counsel as a "DEFCON 1 litigation event," and it is no wonder that the sector is facing a massive amount of litigation.

How best to protect investors, and the sector more generally, in the face of a coming storm must be balanced against industry's need for transparency in decisions of consequence. Transparency is the principal reason why most financial contracts provide for the resolution of disputes in courts. But while transparency is good, there are obvious downsides to fighting disputes under the glare of public scrutiny, and doing so in courts away from home.

With some of these considerations in mind, the International Swaps and Derivatives Association published reports in 2014 and 2018 on the suitability of arbitration in financial services disputes. They particularly focused on instances where parties are based in emerging jurisdictions in which it may be difficult, or even impossible, to enforce a foreign judgment. Agreeing to arbitrate, rather than litigate, can avoid bringing or defending proceedings in a jurisdiction where the probity of the courts is doubtful, and arbitration also includes an enforcement mechanism recognized globally under the New York Convention.[2]

The rise of cryptocurrency disputes

In June, Facebook announced that it was establishing Calibra, a financial services platform for Libra, its own cryptocurrency. The company's announcement caused a resurgence of interest in cryptocurrencies, and bitcoin rose to an 18-month high. However, a number of high-profile backers have recently pulled out of Calibra, and CEO Mark Zuckerberg must defend the project before the U.S. House Committee on Financial Services. Cryptocurrencies



currently have a capitalized value of over $500 billion, but despite inherent riskiness, there is no unified inter-governmental approach to regulation, and some countries have even banned them.

What could possibly go wrong?

The following examples illustrate not just how vulnerable the sector is to disputes, but also the damaging consequences of litigation-related information entering the public domain, further destabilizing an already volatile market.

- In 2011, a startup in Missouri leapt to prominence due to rumors that its technology allowed its users to mine bitcoin up to 1,000 times faster and therefore generate massive profits. It was swamped with orders, and by September 2013, the Federal Trade Commission reported that more than 20,000 people had placed orders but received nothing. Regulatory proceedings followed, resulting in an agreed settlement. The firm is still trading despite suffering serious reputational damage.

- Ripple entered into a technology provider agreement (TPA) in 2016 with R3 to promote its XRP cryptocurrency to financial institutions, and R3 received an option exercisable until September 2019 to buy 5 billion XRPs at $0.0085. By June 2017, XRP was trading at 28 cents, valuing the option at $1.35 billion, and Ripple announced it was terminating the TPA for breach. R3 sued to enforce the option. In January 2018, the currency had risen to $3.67, valuing the option at $18.3 billion, but in September 2019, it was back down to 26 cents. This case is full of claims and counterclaims about alleged failings, all of which would have been dismissed in court but for the fact that the case settled before the testimony of the confidential dealings was aired.
- In a 2011 hack, bitcoin exchange Mt. Gox, then the largest bitcoin exchange in the world, lost 850,000 bitcoins, valued at the time at about $460 million. It was put into protective insolvency in the United States and Japan with 24,000 creditors. About 200,000 bitcoins have been identified, and litigation is being proposed to recover and sell them to pay creditors. In the meantime, distribution has been threatened by litigation from an early-round investor in the exchange.
- Earlier this year, QuadrigaCX, once Canada's largest cryptocurrency exchange, collapsed as a consequence of "inadvertently" losing 103 bitcoins that were transferred into wallets whose passwords were only known by the CEO, who had suddenly died. The company is now being wound up, still owing customers about $190 million.

Tracking market values also shows how rumors and speculation about disputes adversely affect the performance of, and confidence in, all cryptocurrencies. Litigation of financial services disputes inevitably attracts publicity, which can spook the entire market and create uncertainty that can last for years while the disputes wander their way through the courts. The confidential nature of arbitration can eliminate many of these problems, a consideration the industry may find merits closer scrutiny.

The benefits of arbitration

In this context, there are three main reasons why arbitration may be a better option. The first is confidentiality. The process is private, and third parties have no right of access to proceedings. If necessary, awards can also be kept confidential through agreed-upon provisions in the arbitration clause and the choice of arbitral rules. Second, the process is far more flexible, is governed by fewer rules and provides considerable discretion to the tribunal. Procedures can be tailored to the specific circumstances of the dispute, such as the location of the hearing, the number of arbitrators, the extent of document production, how evidence is presented and if appeals are allowed. Third, and most important, it is customary to specify the specific expertise that the arbitrators must have, which is usually related to the subject matter of the dispute.

Another very important distinction is that the arbitration process culminates in an arbitral award that binds the parties and is readily enforceable through the courts of 160 countries worldwide. Overall, arbitration offers confidentiality as well as greater certainty and finality.

Conclusion

The 2018 ICC report identified a lack of appreciation of the benefits of arbitration and misconceptions about how the process works as the main reasons for its limited use in financial services. With the pace of technological change across the sector accelerating, and with it the capacity for multijurisdictional and cross-border deals, the case for arbitration in 2019 seems compelling. Its broader adoption offers not just the most pragmatic response to the challenges ahead, but a more certain safeguard for investors and the future of the industry.

Tim Hardy, FCIArb, *is an arbitrator and mediator at JAMS, experienced in handling international financial, corporate and commercial disputes. Previously, he was head of the commercial disputes team at a leading global law firm in London.*

[1]Report of the ICC Commission on Arbitration and ADR Task Force on Financial Institutions and International Arbitration, March 2018.

[2]Convention on the Recognition and Enforcement of Foreign Arbitral Awards, 1958.

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