Dispute Resolution in Transnational Securities Transactions

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Introduction: Transnational Securities Disputes and Legal Pluralism

[C]ross-border problems call for cross-border solutions.[1]

This book explores the dispute resolution systems for securities transactions in a transnational environment. The argument is that a transnational legal infrastructure for transnational securities transactions, especially regarding dispute resolution, is still lacking, undermining the emergence of stronger transnational financial markets. It attempts to identify the problems of transnational securities disputes and to propose a solution to improve the legal infrastructure that addresses them.

Globalisation results in a higher number of cross-border financial transactions, many of which involve securities transactions, which are regulated predominantly at the local level. While the flows of capital are becoming more and more global, the markets, from a legal perspective, are highly local, as are the regulatory systems and dispute resolution mechanisms available to investors. Since financial markets are legal constructs,[2] the rule of law is essential to their proper functioning and therefore this situation may pose serious problems, especially to small and medium-sized investors, who may not be able to seek legal relief due to transaction cost constraints in pursuing a lawsuit against an entity in which they have made an investment.

The problem becomes even more acute in an environment in which, notwithstanding the existence of multiple jurisdictions, there are political and legal processes in development which aim to facilitate a common internal market, such as the European Union. Solving it would create the scope for a higher number of transnational financial transactions as a wider pool of capital would be available for investment, enhancing the benefits of the free flow of capital[3] and guaranteeing that investors' rights would be protected.

[1] T Bingham, *The Rule of Law* (Allen Lane 2010) 115.

[2] K Pistor, 'A Legal Theory of Finance' (2013) Columbia Public Law Research Paper No 13–348.

[3] For the benefits and risks of an increased flow of capital, see International Monetary Fund, 'The Liberalization and Management of Capital Flows: an Institutional View' (2012) 10–14.

I. Setting the Scene

The world is a different place than it was 100 years ago. Technology has changed it completely, generating greater interconnectivity than ever before; financial transactions are not an exception. Two recent financial transactions with dire consequences for their investors can illustrate this point:

1. Paulson & Co, a New York-based hedge fund, requested that Goldman Sachs structure a synthetic financial product based on Residential Mortgage Backed Securities[4] to be sold to qualified institutional buyers under Securities and Exchange Commission (SEC) Rule 144A[5] and to foreigners outside the United States under SEC Regulation S.[6] Thereafter two different legal entities, one based in the Cayman Islands[7] and another based in the State of Delaware in the United States were set up as Special Purpose Vehicles (SPVs) to issue such securities. To increase their marketability, ACA Management LLC, a portfolio selection agent, was chosen to select the underlying mortgages. During the selection process Paulson & Co helped ACA Management but the hedge fund had—since the beginning—been betting against the residential mortgage market without disclosing such information. The deal was closed on 26 April 2007, the securities were sold, including to foreign investors,[8] and by 29 January 2008 those investors had already lost more than US$1 billion on the product, while the hedge fund that helped to choose the underlying mortgages was profiting by a figure of around the same amount, i.e. US$1 billion.[9]
2. In another case, National Australia Bank, an Australian bank with shares not traded on an American exchange, but traded on various foreign exchanges and also having American Depositary Receipts traded on a US exchange, purchased HomeSide Lending, a company headquartered in Florida that was in the business of servicing mortgages. The purchase was made in 1998 and until 2001 National's annual reports touted the success of HomeSide.[10] On 5 July 2001 National Australia Bank wrote down HomeSide Lending assets by US$450 million and did the same again on 3 September, this time by US$1.75 billion, heavily impacting a multitude of Australian and other non-US investors.

The transnationality of these transactions is evident. Capital flows across borders and parties engage in commercial relationships that are anchored in many different legal systems. Globalisation brings many advantages but it also poses

[4] This product is the ABACUS 2007-AC1 created by Goldman Sachs.
[5] 17 CFR § 200.144a (1992).
[6] 17 CFR § 200.901–§ 200.905 (1998).
[7] Abacus 2007-AC1 Indicative terms.
[8] eg, IKB Deutsche Industriebank AG.
[9] See Complaint, *SEC v Goldman Sachs and Fabrice Tourre*, WL 2305988 (SDNY 2011).
[10] *Morrison v National Australia Bank*, 561 US 247, 251 (2010).

serious risks, especially when it comes to finance.[11] As the pace of globalisation increases, the number of financial transactions with a transnational character also tends to increase, posing serious legal problems to the existing state-based legal framework.[12]

The problem is one of a plurality of legal systems governing the same transactional scheme without any consistent mechanism of coordination. The rule of law and different legal concepts of national legal systems, which are essential to the successful functioning of markets, become increasingly difficult to manage when they are tied to different sources of legal authority that apply either to the specific parts of the transaction or to the transaction as a whole, often failing or being insufficient to address market failures that are essential to the development of healthy markets.

Law, when applied to commercial and financial transactions, provides a background in which transactions can be made and disputes can be peacefully resolved in cases of disagreement between the parties. It provides a level of certainty that allows parties to engage in transactions and to avoid the necessity of the private deployment of force. Trust solely in the counterparty is substituted, at least in part, for trust in the legal system. An investor living in a country with a robust legal system can invest in a company without having to worry if the information provided to him is true; if he has been misled he can summon his lawyer and recover the money that has been lost in the transaction.

Now imagine this investor is in the United States, a country considered to have a robust legal system and strong securities regulation. Make him invest in China. If the businessman invests in a Chinese company and that company's shares lose value because of fraudulent information, the investor may be left penniless, even though the whole strength of the US Securities Regulation system may be on his side, simply because the Chinese company has its assets in China.[13]

There are additional questions in relation to transactions that are transnational as opposed to merely national: Where can the dispute be entertained? Which law is applicable? Where and how is the decision enforceable? These questions bring new factors that have to be weighed in deciding whether to invest abroad; the decision will depend on how developed the legal infrastructures are of the place in which the transaction is anchored. When it comes to finance, another wrinkle

[11] HS Scott, *International Finance: Transactions, Policy, and Regulation* (Foundation Press 2010) 20–22.

[12] Randall Kroszner claims that 'many international financial transactions occur in a realm that is close to anarchy'; see RS Kroszner, 'The Role of Private Regulation in Maintaining Global Financial Stability' (1999) 18 *Cato Journal* 355, 355.

[13] Cultural, language and legal barriers raise the costs of pursuing litigation in a case like this, since either the case is pursued in the US and the judgment has to be enforced in China or the whole case has to be litigated in China. The small settlement amounts that have been reached in securities cases with Chinese companies listed in the US are indicative of these possible hurdles. See K LaCroix, 'The Modest Early Settlements of Securities Suits Involving US-Listed Chinese Companies' (*The D&O Diary*, 22 June 22) www.dandodiary.com/2012/06/articles/securities-litigation/the-modest-early-settlements-of-securities-suits-involving-u-s-listed-chinese-companies/.

emerges in conceptualising the problem: many of the transactions involve the use of securities, which are heavily regulated by national states. National mandatory law defines what securities are, the duties of the issuer and the range of action that brokers and market players are afforded when transacting these instruments, even though these transactions, considering the bigger picture, are often in fact transnational.

The transnational character, embedded in the legal pluralism that is inherent in transactions occurring across borders, increases the complexity of legal problems that need to be managed. Due to the size of many transnational securities transactions and the amount of trading that is done, there is a lot at stake.[14] The health of financial markets is tied to the legal and technological infrastructures underpinning them, and a decision of a national court can completely change expectations, sometimes risking billions of dollars that are based on transactions similar to the one on the basis of which the decision was made.[15]

At a more individual level, the question arises to what extent investors are able to rely on the legal infrastructure in place. The free flow of capital is good for economic efficiency but the aperture of the system can also bring fraudsters to the market, who may harm investors in places far away from where they actually operate. A robust transnational legal system for dispute resolution could ease these concerns, as it would allow investors to obtain redress.

[14] There has been an increase in the number of securities transactions in recent years. The US and Brazil can be seen as good examples of the increase of foreign positions on securities. In the US there has been a significant increase in foreign private securities assets in the last 40 years, from US$44,157 million in 1976 to US$6,222,864 million in 2010. Brazil also experienced an increase; on December 2001 Brazil's international position regarding foreign securities assets was US$6,402 million and 11 years later the amount increased to US$25,759 million. In Spain the increase in foreign positions in private securities investments was not so impressive; it went from €78,053 million in 2004 to €89,494 million in 2012. Before the crisis, Spain reached €132,954 million in foreign securities assets, but evidenced a strong decrease following it. Nonetheless, the foreign position in securities remains substantial and it has been recovering. See Banco Central do Brasil, 'Série Histórica da Posição Internacional de Investimento', www.bcb.gov.br/?SERIEPIIH; Bureau of Economic Analysis, 'International Investment Position of the United States at Yearend, 1976–2010', www.bea.gov/international/xls/intinv10_t2.xls; Banco de España, 'Boletín Estadístico 12/2012' (2013).

[15] Interesting examples are two cases involving the same transaction in the Lehman Brothers bankruptcy: *Lehman Brothers v BNY Corporate Trustee*, 422 BR 407 (SDNY 2010) and *Belmont Park Investments v BNY Corporate Trustee* [2011] UKSC 38. The transaction in these two cases was composed of a series of credit swap transactions through the use of various SPVs incorporated in jurisdictions chosen for tax purposes. In the specific transaction under consideration involving the SPV Saphir Finance plc, which was incorporated in Ireland, English law was chosen. The SPV had a credit default swap (CDS) with Lehman Brothers Special Financing. The transaction was collateralised, and the trustee for the collateral was BNY Corporate Trustee Services Ltd. There was a provision in the transaction documents that the priority of the collateral would shift in case there was an event of default by Lehman Brothers Special Financing, which occurred when Lehman Brothers Special Financing went bankrupt. Even though there was an expectation of the parties ex ante that this was a possible transaction, the US decision in 2010 signalled otherwise, creating an uncertain environment for all similar transactions where the CDS counterparty is American. Later, the UK Supreme Court confirmed that the transaction was valid under English law. The American case settled in 2010, without a decision of a higher court, and new litigation on the same subject has started again. See T Alloway, 'The Lehman flip-clause flap gets settled – sort of' (*FT Alphaville*, 27 July 2011) ftalphaville.ft.com/2011/07/27/634976/the-lehman-flip-clause-flap-gets-settled-sort-of/.

The existence of multiple legal orders to which a single economic transaction can be attached is a legal risk that can become problematic to the development of global securities markets. Legal instability due to the competing sources of norm creation, decision making and enforcement mechanisms affects the predictability of results, which in turn affect the costs of doing business. The development of complementary mechanisms of dispute resolution and coordination among different legal systems can be a valuable instrument to improve the costs of transacting in a globalised world.

II. The Objective of This Book

The instability of legal relations arising from the tension of the transnational being regulated nationally is the starting point of this book. While capital mobility is deemed to be easier today than it was 100 years ago, be it due to the increasing interlinkage between the different corners of the world or the technological developments that have been made in recent decades, moving capital and goods across borders is not yet as easy as moving them within a country. Notwithstanding claims as to the loss of power of the nation state, its power is still substantial in regulating economic activity under its area of influence.[16] There is no vacuum; the nation state is still present with its entire institutional framework, remaining relevant to every aspect of everyday business life, either by exercising power through direct regulation or by setting the background environment for business.[17]

The role of the legal system in the operation of a market is threefold: first, it provides the background framework so economic transactions can be entered into; secondly, it regulates behaviour that should not be allowed due to the negative effects that it may have; and finally, it provides avenues for redress for those who have been harmed by a party that does not comply with what has been promised or that does not behave according to the rules of the market.

In contract law, an example of the first role of the legal system is the possibility to recover damages from a broken contract in a court of law.[18] In the securities area, the example of the second role and third role of the legal system is the

[16] For a discussion of the nation state in a globalised era, see V Cable, 'The Diminished Nation-State: a Study in the Loss of Economic Power' (1995) 124 *Daedalus* 23.

[17] It is true that illegal activities fall outside the direct control of the state, but this is not the focus of this work. In every other activity the state is deeply present. Think about a business that operates according to the legal rules, obtaining the necessary permits and paying all the required taxes. The entrepreneur may decide to avoid such rules and taxes and move to another nation state, but he will have to abide by the rules and pay the taxes imposed by the second state. Contracting around one nation state is possible, but this means not doing business in it and invariably being subject to another state.

[18] Specific performance is not the usual method for compensation in the US. See J Calamari and J Perillo, *The Law of Contracts* (4th edn, West Group 1998) 611–13.

following: if A is obliged to disclose information and fails to do so, A will be liable to B for the loss of value in stock when the information is subsequently discovered.

The framework of a given legal system affects the way in which people behave. This is true not only in respect of the identification of the substantive rules and the expected outcome given the occurrence of a legal fact, but also with regard to the costs of engaging the state in the dispute, by solving it and enforcing the outcome. In each legal system the architecture is defined by policy choices that have been made throughout history, creating different substantive rules and enforcement mechanisms depending on the jurisdiction that is analysed. These are aspects that have to be taken into consideration. It is clear that given a breach of a legal rule in a country where the legal system is effective, it is less likely that the party harmed will need other guarantees for the transaction since the legal system will be available to solve the problem. Where the legal infrastructure is weak, for example with high costs of litigation and trials that are too long, the parties would use other means of protection, such as demanding collateral in an escrow account or the guarantee of a trustworthy person, before engaging in a transaction. This is important for the development of a local financial market as high legal costs and uncertainty as to the rules operating at a given time, or the enforcement of those rules, may discourage investment.

The transnational aspect brings new considerations that have to be taken into account. In this environment, there is no longer only one legal system that has to be considered, but rather, as many as the different jurisdictions that may be involved in the transaction. The *BNY* case cited above involved Australian investors purchasing securities from an Australian SPV that purchased securities from an Irish SPV, which in turn had a swap transaction governed by English law with an American company, with England being the chosen forum for any disputes. There were at least four different jurisdictions involved in this single case.

The legal uncertainty arising from this scenario undermines the safety that law can provide for securities transactions. The problem of legal uncertainty is even stronger in this field as finance is a legal construction.[19] Legal uncertainties create risk, but the fewer legal risks that are present, the better it is for the parties to engage in transactions.[20]

The answer to any question arising out of these considerations has to include both the national and the international legal framework, substantively and procedurally. Depending on the legal question being decided, the answers can differ widely across different jurisdictions, even if the substantive rules of behaviour are similar. In addition, even if the rules are the same, the enforcement of a decision from one jurisdiction is not always enforceable in a second one, where the assets of the person liable for the harm caused to the investor may be located. This is due to the public policy aspect of securities regulation, and more generally financial

[19] See Pistor (n 2).

[20] For an overview on legal risk, see R McCormick, *Legal Risk in the Financial Markets* (2nd edn, Oxford University Press 2010) 13.

regulation, especially in the so-called public markets, where the general population can purchase securities. Business and investment decisions are, consciously or not, embedded in this social reality.

The stability of the legal infrastructure upon which a transnational transaction is anchored matters because it allows for the enforceability of the parties' rights when duties are breached, being related to the costs of doing business. As the legal structures in place to address these concerns are far from being perfect, the objective of this book is to propose mechanisms to improve the legal infrastructure for transnational securities transactions disputes.

To achieve this objective it is first necessary to assess the current problems present in the transnational framework for dispute resolution in securities disputes and then to provide options to strengthen the procedural efficiency of the legal framework used to resolve transnational securities disputes, improving investor protection and creating a background for the development of a more robust global financial market.

Notwithstanding that all countries do indeed have securities regulation and are interested in investor protection, the level of protection is a matter of public policy, which can be a barrier to the effective transnationalisation of securities transactions, or at least to the enforcement of decisions related to them. Therefore, in reaching the objective of this book, it is also necessary to consider the extent to which public policy considerations of securities transactions influence private (national and international) law.

The book proceeds in the following way: in Chapter 2, I analyse how the state and the legal system relate to markets; in Chapter 3, I establish the purpose of and importance of securities regulation and enforcement and the policy choices behind it; in Chapter 4, I analyse the private liability regimes arising out of securities regulation in order to define the scope of disputes that are relevant in this field; in Chapter 5, I propose two systems for dispute resolution of transnational securities transactions; in Chapters 6 and 8, I provide a framework to analyse the important aspects of a dispute resolution system, generally and regarding aggregate dispute resolution; in Chapters 7 and 9, I survey certain frameworks that can be used in securities disputes, justifying the choices made for the two proposed systems in Chapter 5; finally, in Chapter 10, I analyse the private international law regime and the legal problems arising therefrom, related to securities disputes.

III. Outline of the Argument

The book is premised on the following thesis: 'Considering that private enforcement is a crucial mechanism for the application of securities laws, investor protection and the construction of efficient capital markets, a more stable system of

dispute resolution for transnational securities transactions is necessary for a better functioning of the transnational securities market.'

The main claims that I make throughout the next chapters can be briefly summarised as follows:

1. As financial markets are legal constructs, the rule of law is necessary for their development (Chapters 2 and 3).
2. The role of law for financial markets is twofold: to provide protection for property and to enforce promises and to regulate market failures in order to protect investors and avoid the 'lemons problem' (Chapters 2 and 3).
3. These two goals run together: the regulatory aspect creates expectations; breaches of these expectations are better addressed through private rights of action as a starting point, both from an economic as well as a social point of view (Chapter 3).
4. Therefore, the enforcement of these expectations becomes a problem of access to justice, where the investor needs to be able to enforce both the rights arising out of the security itself as well as the rights related to the regulatory background within which the transaction was embedded (Chapters 6, 7, 8 and 9).
5. The adequacy of a dispute resolution method for securities transactions depends on the type of dispute at stake, since their specific characteristics may warrant different types of schemes (Chapter 4).
6. Collective redress is adequate for disputes involving a multitude of claimants based on the same underlying facts, but not for transactions made with financial intermediaries (Chapters 6, 7, 8 and 9).
7. At the transnational level, the transnational infrastructure of private law enforcement does not yet provide a proper solution for the problem as the rules of private international law remain too uncertain to be relied upon due to the underdevelopment of its rules concerning securities transactions and due to public policy considerations (Chapter 10).

Based on these claims and the analysis undertaken throughout the rest of this work, which shows that there is no one-size-fits-all solution, I propose in Chapter 5 two dispute resolution system designs to increase legal certainty and to provide better access/protection to investors in transnational securities transactions.

IV. Scope and Limitations

The volume of literature on transnational litigation and securities regulation is quite dense, but the discussion of transnational securities litigation is still in its infancy. While a few studies have already been undertaken, a systematic understanding of the problems involved in these kinds of disputes is still lacking.

The importance of this book is based on the use of securities as a method of financing the most varied types of economic activities. The process allows corporations to raise equity or to issue debt in order to pursue their business as well as to structure different investment vehicles through the securitisation process,[21] which is backed by the legal system in creating duties and liabilities for the parties involved. The breach of a duty is corrected through litigation or another form of dispute resolution, either public or private.[22] Both types of enforcement form part of the regulatory architecture but the private one plays a crucial role in stabilising the expectations of the parties in a securities transaction and providing confidence for engaging therein, contributing to the integrity of a securities market.

As the legal systems involved in securities regulation and the disputes in this area of law are grounded in state structures, the research is comparative in nature, which imposes a limitation on the current work. Its main focus is on the United States, the European Union and Brazil; however, some consideration will be given to important developments occurring in other jurisdictions. The choices have been made on the basis of determinations pertaining to relevance and practicality.

The United States is the crib of securities regulation and securities disputes; discussing transnational securities dispute resolution without discussing the American literature would lead to a failure to grasp some important questions in this area. The European Union was chosen due to its internal transnational aspect and its federalist structure, which is interesting both from a securities regulation perspective and in light of the legal infrastructure for transnational dispute resolution. Finally, with its growing importance in the international arena and being a developing country, Brazil was the third jurisdiction chosen for this study. Moreover, the different aspects of the dispute resolution structure and the practice involving securities litigation in these countries were deemed relevant to this decision. The United States has a predominantly dual structure, with the possibility of class actions against issuers and a highly institutionalised arbitration system against broker-dealers; The European Union has seen some litigation against financial intermediaries, particularly following the demise of Lehman Brothers, generating a good source of material to analyse dispute resolution in practice, while at the same time bringing to the fore relevant legislation as well as interesting mechanisms underpinning the creation of alternative methods of dispute resolution in this area. Finally, Brazil presents an obscure arbitration system that is mandatory for corporations listed within the two higher corporate governance levels in the Brazilian stock exchange; at the same time, there is almost no court litigation on securities matters, despite specific legislation for aggregate litigation in this area.

[21] For an overview of the securitisation process, see DR Muñoz, *The Law of Transnational Securitization* (Oxford University Press 2010).

[22] Public litigation in this work is understood as litigation initiated by governmental bodies, such as securities and exchange commissions or public attorneys' offices, while private litigation is understood as that initiated by a party due to its capacity as an investor, or as an investor's representative, be the litigant a private party or a state.

The peculiarities of these systems provide ample material for the analysis of the problems in dispute resolution systems for securities transactions, giving foundation to a deeper reflection on how to improve the transnational infrastructure for dispute resolution in securities transactions.