

DISPUTE RESOLUTION AND MEDIATION ON CAPITAL MARKET

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Abstract

Capital Market is usually depicted as a place for experts, for people with high trading skills. This is a half truth. There are entities established and functioning under strict scrutiny of Romanian National Securities Commission (RNSC), in compliance with Capital Market Law and regulations. There are also the investors, in many cases individuals involved in shares/financial instruments trade. In both cases disputes can rise. Disputes are inevitable a part of human interaction, hence the need for dispute resolution. First option is the judicial court system. Alternative dispute resolution comprises arbitration and mediation. Arbitration is an alternative choice to provide simpler, speedier and more accessible justice than ordinary courts as well as expertise in matters that are technical in nature and require special knowledge to adjudicate upon. Capital Market environment provides an institutional arbitration court for all participants, including investors. In many cases the agreement executed between participants under RNSC scrutiny. The other option for settling disputes outside the court is mediation. Mediation can provide a much cheaper and quick extrajudicial resolution of disputes in commercial matters without time consuming procedures and rigid rules. Agreements resulting from mediation are more likely to be complied with voluntarily and are more likely to foster the commercial relationship between the parties. The interaction between investors and brokerage houses is based on investment services agreement concluded by parties. This is the usual framework for disputes between parties and the usual “landscape” for mediation on capital market.

Keywords: *alternative dispute resolution, regulated market, mediation, capital market, investment services agreement.*

Introduction

1. European laws and regulations lay down detailed rules regarding financial instruments trade, regulated market and investment firms. Directive 2004/39/EC, on markets in financial instruments (MiFID), was sought to establish the conditions under which authorised investment firms and banks could provide specified services in Member States. Following this European framework the Romanian law on capital market (Law no 297/2004) enacts certain rules regarding the interaction between investment firms and clients.

The document concluded by and between the firm and the client set out the rights and obligations of both parties and other conditions under which the investment firm will provide services to the client. The rights and duties of the parties to the contract may be incorporated by reference to legal texts. Our paper is intended to observe disputes that can arise from this business relationship - investment services agreement concluded by investment firms with their clients – and mediation alternative dispute resolution.

The subject is important because disputes are expenses and time consuming and clients need effective redress for their losses in order to remain interested on capital market trading. Mediation can satisfy investment firms as well as clients, preserving even their business relationship and “appetite” for trading on regulated market.

The contract between the investment firms and clients contains certain obligations prescribed by law. Investment firms shall establish and implement effective arrangements regarding an order execution policy to allow them to obtain, for their clients, the best possible result. Further, in order to enable clients to assess at any time the terms of a transaction in shares that they are considering and

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to verify afterwards the conditions in which it was carried out, rules should be established for the publication of details of completed transactions in shares and for the disclosure of details of current opportunities to trade in shares. In this framework we intend to reveal circumstances in which disputes can arise and mediation can intervene.

Despite the extensive regulation of the financial services and the rules laid down for investment services agreement consisting in rights and obligations of the investment firms and the client for pursuing transactions in shares, the nature of this contract is still disputed by scholars. Some scholars consider the brokerage house is acting as a proxy for its client¹. Others embrace the different legal status: the agent (investment firm) acts in his name, but on client's account². Thus this investment services contact need scrutiny as well as mediation in such specific framework.

Investment services agreement – ground for disputes in Capital Market domain.

2. The investment firms defined by Capital Market Law has the exclusive right to operate on regulated markets, to provide one or more investment services to third parties and to perform one or more investment activities on a professional basis (investment services and activities means any of the services and activities listed in Directive 2004/39/EC, on markets in financial instruments (MiFID), Section A of Annex I relating to any of the instruments listed in Section C of Annex I).

Investment services contract entered into by investment firms and investors is the only framework in which investors could have their market orders executed on regulated market or MTS (multilateral trading system). This investment services agreement is a compulsory premise, the preliminary step for participants to enter trading ring in order to sell or purchase financial instruments.

Investment services agreement is a *sine qua non* condition in order to access the regulated market. On the other hand this contract is the ground for the most common disputes on the capital market, the disputes between clients and investment firms. The alternative dispute resolution for such situation can rest in mediators' hands.

The Bucharest Stock Exchange offers a regulated framework for dispute resolution: Arbitration Chamber of Stock Exchange³. Its regulations set the procedure for settling cases borne by operations concluded on regulated market or on alternative trading system (ATS) operated by BSE between participants (authorized firms) on trading system of BSE, between participants and issuers which securities are admitted to regulated market operated by BSE and between clients and participants (investment firms)⁴. The last situation is borne by investment services business relationship. Besides the arbitration, mediation is an alternative approach for such dispute resolution.

The content of the investment services agreement.

3. Investment firms can be authorized to execute orders on own account or on behalf of their clients. In such cases firms should implement procedures which provide for the prompt, fair and expeditious execution of client orders and they should undertake a bundle of obligation laid down in a predefined contract. The regulation on investment services and activities⁵ aims clients' protection and market integrity. According to relevant provisions an investment firm shall provide investment

¹ A. Tutuianu, *Capital Market, Legal regime of participants*, Bucharest: Hamangiu, 2007.

² Cristian Gheorghe, *Capital Market Legal Science*, and Bucharest: CH Beck, 2009; C. Dutescu, *Capital Market Law annotated and commented*, Bucharest: CH Beck, 2010.

³ Regulation for Procedures, Bucharest Stock Exchange Arbitration Chamber, adopted by Stock Exchange Council based of Art. 134 para. 6 from Law no 297/2004, Art. 10 para. e), 22 para. e), 64 para. 1 letter. i) from RNSC (Romanian National Securities Commission) Regulation no 14/2004, approved by RNSC Decision no 372/31.01.2006.

⁴ Participants are the investments firms authorized to operate on a specific market.

⁵ RNSC Regulation no 32/2006.

services according to a contract “in written form, on paper support or other durable support” which shall comprise rights and obligations of the firm and client⁶.

The minimum content of the contract laid down by the law encompasses the framework within which the firm-client business relationship shall evolve.

*Investment services and activities provided and financial instruments traded*⁷. Investment services agreement shall have a defined object agreed upon by parties concerning the investment services and activities and the securities such services applied on (this should include appropriate guidance on and warnings of the risks associated with investments in those instruments or in respect of particular investment strategies)⁸. The contract shall include the types of securities (shares, bonds, and derivatives) without specifying an individual financial instrument. This last one will be pointed by orders given to broker on the basis of the contract, orders that represent part of a transaction concluded on a regulated market.

Rights, obligations, term and other conditions under which the investment firm shall provide client with investment services. Specific rights and obligations can be added to legal framework of the investment services contract the clauses will reproduce the appropriate legal provisions. Regulation states already the behaviour and the minimal content regarding the parties’ rights in the investment services contract. If special communication channels are intended (i. e. phone orders or orders via e-mail) parties should expressly agree such alternatives (including electronic signature if applicable) including recording and preserving these orders for proofing purposes.

Investment firm have to ask the client to provide information regarding his knowledge and experience in the investment field so as to enable the investment firm to assess whether the investment service or product envisaged is appropriate for the client or not. In case the investment firm considers, on the basis of such information, that the product or service the client asks for is not appropriate to him, the investment firm shall warn the client or potential client about this risk⁹.

Interests, currency exchange, estimated charges. Investment services contract shall comprise in a comprehensible manner all the ancillary obligations as well as the interests accrued to sums deposited by clients, currency exchange rates, etc.

Investment services agreement shall include clauses regarding investment services agreed upon by parties including the broker’s fee and other estimated costs and associated charges incurred by orders execution.

General conditions for alteration and termination of the contract shall be included too.

Without prejudice to the right of client to bring their action before the court, the regulations encourage private bodies established with a view to settling disputes out-of-court¹⁰. Parties can agree upon arbitration clause, denying court jurisdiction and ensuring out of court dispute resolution. Such clauses exclude legal “ability” of a court to exert jurisdiction over parties and reveal the parties’ appetite for alternative solution, including mediation procedures.

The consequences of client-firm business relationship based on investment services agreement. The agent’s duties and disputes that arbitration or mediation can deal with.

4. The record of the client-firm business relationship comprises the extent of the outcome of the contract, rights enjoyed by parties. Such extent of rights and obligations governs the future

⁶ Directive 2004/39/EC („MiFID”), Art. 19, para. 7. The investment firm shall establish a record that includes the document or documents agreed between the firm and the client that set out the rights and obligations of the parties, and the other terms on which the firm will provide services to the client.

⁷ RNSC Regulation no 32/2006, Art. 110, 119.

⁸ Ibidem, Art. 19 para. 3.

⁹ Ibidem, Art. 19 para. 5.

¹⁰ See Commission Recommendation 98/257/EC of 30 march 1998, on the principles applicable to the bodies responsible for out-of-court settlement of consumer disputes.

behaviour of the parties and arbitrates the disputes that orders execution can arise. The clients could claim that the agent breach the contract and could find out remedy for their inflicted damage.

Damages inflicted by breach of contract usually applied to agent's behaviour contrary to client's best interest in orders execution on market or in financial instruments portfolio management.

The investors can fill with the court or access out-of-court procedure like arbitration or mediation. Investment services and activities record covers the obligations of both parties. Investors shall cover all costs and associated charges revealed by agent and shall comply with all requirements to support the agent in providing his services. Most of the disputes in this domain are borne by failure of the agent to comply with legal standard laid down for executing clients' orders. Mediation procedure can support the process of indemnifying investors for their losses as a result of misleading behaviour of the agent or his brokers.

5. The obligation of investment firm to act honestly, fairly and professionally in executing the client's orders. The most important obligation of the investment firm consists in receiving and executing orders communicated by clients and fulfilling the procedure requested for securities transactions on behalf of client. The investment firm receives specific orders that conclude a sell-purchase agreement in the form accepted by a regulated market. The brokers receive orders in a form established by regulated market rules (limit orders, stop losses orders, market orders, etc.) and are supposed to execute them in accordance with the best interests of clients.

Following the principal agent theory, the broker acts in his name (or in the client's name) but on the client's account. The property of securities as well as the price to be paid stands finally for the client. He remains the beneficiary of the bundle of rights incurred by fulfilled transactions.

6. A possible conflict can arise in case of "self-contracting" situation, when the investment firm acts both on behalf of its client and on own account, in the same transaction. That means, for example, that investment firm is buying what client selling or firm selling what client is buying, client being represented in transaction by the same firm.

In case of "self-contracting" situation the investment firm aims for maximum consideration in exchange for its offer. Generally speaking such expectation can conflict with the interest of the counter-part whose interest should be defended by "opponent".

In such situation dispute resolution and particularly mediation should start from observing the market quotes made public by market operator on a reasonable commercial basis.

In this case, concerning a regulated market that makes public quotes based on independent transactions, good commercial practice accepts this kind of contract¹¹. In this situation the investment firm can deal directly with its client. The balance of consideration given by parties is verified by full disclosure in the benefit of the client who have to be inform about the particular transaction and be able to evaluate personally the protection of his interest in that transaction¹². These are the reasons why "self-contracting" situation is allowed in this domain, the client's interest being observed with no effort by the client itself.

Any discrepancy between the quotes revealed by the market operator and the reported price entitles the client to indemnification, dispute that can be solved in a mediation framework.

¹¹ Commercial Code, Art. 411. Romanian provisions regarding commission (agency like) agreement: When the agent is ordered to buy or sell bill of exchanges, T-bonds or other bonds, existing on the market and goods, with quotation prices on an stock exchange or market, he can provide such titles or goods on his name as a seller or to receive on himself as a buyer such goods he was ordered to sell on principal account paying current price notwithstanding his payment, if principal doesn't forbid such operations.

¹² Law no 297/2004, Art. 27, para. 1: „... to reveal to clients all the material information regarding agreements in which the agent is contracting on his own account”.

7. Conduct of business obligations when providing investment services to clients. Obligation to execute orders on terms most favourable to the client. The agent should carry out his obligations “in good faith and at professionally standard” - requirements stated by scholars as a distinctive agent’s obligation¹³.

On the capital market this obligation is transposed in the principle of “best favourable execution” of orders the investment firms are receiving from their clients. Investment firms should take all reasonable steps to obtain, when executing orders, the best possible result for their clients, taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration relevant to the execution of the order¹⁴. Investment firms are obliged to establish and implement effective procedures and order execution policy to allow them to obtain, for their client orders, the best possible result¹⁵.

The order execution policy implemented by investments firms will allow them to act honestly, fairly and professionally in accordance with the best interests of clients as well as ensuring an equal treatment of them¹⁶.

Any failure in implementing such principles can create disputes between investment firm and clients. The client can employ the services of a mediator in order to settle such conflicts.

Other examples of inappropriate agent behaviour are: client financial instruments or pecuniary resources theft, unauthorized borrowing, surety or any kind of encumbrances on client financial instruments undertaken by investments firm, disposing without written consent of the client, direct or indirect, of his assets, executing market orders with sole intention of misleading on proprietor real identity.

Some revealed agents’ or brokers’ behaviour is prosecuted as criminal offence.

8. There are fraudulent practices of the investment firm that harm the clients’ interest. So called marketing techniques or even (dishonest) advertising which are widespread in commercial practices are strictly forbidden on capital market.

Other illicit agents’ practices can encompasses providing information from undisclosed sources as confidential information in order to deceive clients and make them give market orders, providing misleading, incomplete or exaggerated information about a financial instrument in order to determine client to pursue transactions regarding such instrument, false promising or guaranteeing the client future profit from transaction executed on market, etc. Securities industry doesn’t support common commercial ad and prohibits misleading investors and client enticement. Investment firms are obliged to provide investors public, correct and documented information.

Against good practices in domain are such practices too: the priority given to own agent’s order against previous clients’ orders, excessive trading on clients account with sole end of generating trading cost for the firm, using clients assets for fulfilling agent’s obligation, any payment (reward, bonus, etc.) in the benefit of the broker aside the framework of the parties contract, etc¹⁷.

9. Conflicts of interest. Investment firms shall take measure to identify conflicts of interest between themselves, their managers, employees and tied agents, or any person directly or indirectly linked to them by control and their clients or between one client and another that arise in the course

¹³ St. D. Cărpenu, *Romanian Commercial Law*, (Bucharest: All Beck, 2004), 479. Capital Market Law asks for agent to act „honestly, impartially and with professional care in order to protect investors interest and uphold the market integrity” (Law no 297/2004, Art. 27 al. 1).

¹⁴ MiFID (Directive 2004/39/EC), Art. 21. Nevertheless, whenever there is a specific instruction from the client the investment firm shall execute the order following the specific instruction.

¹⁵ RNSC Regulation no 32/2006, Art. 137.

¹⁶ *Ibidem*, Art. 102.

¹⁷ *Ibidem*, Art. 163.

of providing any investment and ancillary services, or combinations thereof¹⁸. We have two kinds of potential conflicts of interest: between investment firm and clients and between different clients working with the same agent.¹⁹

In order to avoid such conflicts of interest the law enforces simple rules: clients order have higher priority than own agent's orders and the investment firm shall execute received orders from clients on chronological basis: first received order shall be first initiated and executed in regulated market²⁰.

Even so, whether the internal regulations made by the investment firm in order to avoid or manage conflicts of interest "are not sufficient to ensure, with reasonable confidence, that risks of damage to client interests will be prevented, the investment firm shall clearly disclose the general nature and sources of conflicts of interest to the client before undertaking business on its behalf"²¹.

10. The agent's obligation to report operation executed on client's behalf. The client must receive adequate and detailed reports on the services provided by the investment firm on his account²². Such obligation is ordinary in agency theory law. Agent shall inform principal on all operations pursued in his account²³.

Reports concluded by investment firm shall include all relevant data and, where applicable, the costs associated with the transactions and services undertaken on behalf of the client.

Reports shall be made available for investors on contractual basis. Competent authority will be provided with detailed reports too, in order to ensure transparency and to uphold the market protection. Investment firms shall keep at the disposal of the competent authority, for at least five years, the relevant data relating to all transactions in financial instruments which they have carried out, whether on own account or on behalf of a client. "In the case of transactions carried out on behalf of clients, the records shall contain all the information and details of the identity of the client. The reports shall, in particular, include details of the names and numbers of the instruments bought or sold, the quantity, the dates and times of execution and the transaction prices and means of identifying the investment firms concerned"²⁴.

From contractual perspective client is entitled to receive from his agent adequate reports describing operations executed on his behalf. Although, the investment firms keeps his position of services provider who doesn't guarantee the executing of orders irrespective of regulated market evolution. In fact the fulfilling of orders stand for other participants: central counterparty, clearing house, etc.

Conclusions

11. The business relationship between investors and their brokers is governed by the investment services contract, an agent-principal relationship type. The best favourable execution, the obligation to execute orders on terms most favourable to the client can rise disputes between client and broker. Mediation can be a solution for any situation when broker fails to comply with professional and contractual standards.

Clients are put in the position to defend their rights as they receive full report concerning order execution and they are in the position to observe and compare their concluded transactions with market quotes displayed by market operator. This comparison should represent a tough ground for

¹⁸ MiFID (Directive 2004/39/EC), Art. 18, para. 1.

¹⁹ RNSC Regulation no 32/2006, Art. 96.

²⁰ Ibidem, Art. 141.

²¹ MiFID (Directive 2004/39/EC), art. 18 para. 2

²² Ibidem, art. 19, para. 8.

²³ Stanciu D. Cârpenaru, *Romanian Commercial Law*, (Bucharest: All Beck, 2004), 478.

²⁴ MiFID, art. 25.

clients' rights defence. Mediation renders an appropriate framework for dispute settlement and confidentiality the parties are seeking for.

Investment firms are keen to mitigate the echo of their disputes with clients and on the other hand these clients appreciate a rapid and fair redress for their losses. Nevertheless the capital market is a specialized domain that needs expertise of an arbiter or mediator rather than a common commercial court expertise.

However present law asks for conciliation prior to filing with the court in commercial disputes, conciliation that can be realized through mediation procedure.

Investment services agreement and obligations borne by it can be the framework for pursuing a success mediation process and rendering a solution equitable for both parties involved: investment firm and clients.

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