

## PROTECTION OF FOREIGN INVESTORS IN OTC DERIVATIVE TRANSACTIONS: WAY TO GO?

**Malik Ramazanzade**

(malik.ramazanzade@gmail.com)

Ph.D Candidate

(Baku State University)

### **Abstract**

*In light of the recent amendments in legislation it may be concluded that the legislator is seeking to establish robust regulatory framework for capital markets. Despite remaining lack of regulation, the derivative transactions are being concluded in Azerbaijani market. Such agreements are concluded with Azerbaijani counterparties or with foreign counterparties. This tendency raises certain questions pertaining not only to legislation directly governing such transactions but also leads to a thought what kind of protection apart from contractual protection is offered to foreign counterparties of derivative transactions. The Article seeks to identify whether over-the-counter ("OTC") derivative transactions in particular, may fall under category of foreign investment, what are the threats for foreign investors entering into OTC transactions and what kind of protection are they offered should there be lack of protection envisaged by a given Bilateral Investment Treaty.*

*For addressing the issues raised above, the Article offers two perspectives: protection offered by international agreements (namely Bilateral Investment Treaties) and arbitration or protection offered by national legislation of the Republic of Azerbaijan. Speaking of first perspective, the Article analyzes tendencies in drafting of Bilateral Investment Treaties, in particular definition of investment provided in Bilateral Investment Treaties. In addition, applicable court practices, namely rulings of International Centre for Settlement of Investment Disputes are also being analyzed.*

*Speaking of second perspective, the Article refers to applicable legislation of the Republic of Azerbaijan in order to identify whether the rights of a foreign counterparty to OTC derivative transaction may qualify as foreign investment and enjoy respective level of protection.*

**Keywords:** *foreign investment, portfolio investment, derivatives, OTC, bilateral investment treaties, international investment law, ICSID, capital markets, national legislation, the law on protection of foreign investment, definition of investment, international law*

Past few years marked adoption of provisions governing derivative transactions into the Civil Code together with adoption of the new Law "On securities market". Establishment of regulatory framework for derivative transactions was considered as a measure for enhancement of such transactions in domestic market. A derivative itself may be defined as a "an asset whose value is derived from that of some other asset known, as the underlying" [1, 1]. Azerbaijani legislator in Article 403-1 of the Civil Code upholds this approach by defining derivative as an agreement aimed to acquire, sell or change any underlying asset. It is also worthwhile to mention that securities, currency, credit risk, and others qualify as underlying asset pursuant to the Civil Code.

While Azerbaijani capital market is emerging, the companies in Azerbaijan are looking to secure their risks by concluding over-the-counter ("OTC") transactions with foreign counterparties. At this point it should be clarified that OTC transactions are derivative transactions concluded directly between counterparties i.e. without

involvement of exchange or other intermediaries. However, it should be noted that relevant articles of Azerbaijani legislation do not deal with OTC derivatives rather governing those concluded in exchanges.

Nonetheless, given the risky character of derivative transactions by their nature, parties of OTC transactions bear even more risks in comparison to those associated with trading in exchange. That eventually leads to analysis of existing mechanisms aimed to protect parties of such transactions.

For the sake of clarity, it should be noted that in this paper protection of parties of OTC transactions from perspective of international investment law will be observed. That is, contractual arrangements such as, for instance, title transfer shall not be observed in this paper as they solely relate to measures undertaken directly by the parties to a particular agreement. Precisely speaking, this paper seeks to identify whether a foreign counterparty to an OTC transaction may be regarded as foreign investor and which protection mechanisms are offered to such foreign investor should such transaction fall under the definition of investment. For this purpose, the applicable laws of the Republic of Azerbaijan as well as literature in this regard should be observed.

At this point it is worthwhile to note that international investment law is mostly comprised of bilateral investment treaties (the "BIT"). Furthermore, considering that no global investment treaty has been adopted till date, most relations between the state pertaining to investment are governed by respective BITs. In addition, some states also opt for protection of foreign investors by adopting specific laws or even Investment Codes. In the absence of BIT with a particular state, national laws may be also referred to. Azerbaijan is not an exclusion from this tendency and also aims to protect foreign investors either by means of BITs (or, as the case might be, other international agreements) or the laws. With that being said, for addressing of issues raised in the current paper BITs and applicable laws should be observed. In the meantime, the nature of risks that foreign investors may face should be also observed. Analysis of risks is crucial since it gives allows to understand whether OTC derivative transactions should be protected at all. In other words, if the host state cannot somehow violate rights of a foreign counterparty to OTC derivative transaction – is there any need to protect them?

The risks for foreign investors are mainly associated with either changes in regime or changes in existing political and economic policies of the host state. [4, p. 69] It is beyond any doubt that each state is entitled to exercise its sovereignty to which the above matters explicitly pertain. In my view, changes in economic policy may result in hostility to foreign investors, nationalization and certain changes in industry. While the first two do not directly affect parties of OTC transactions, the third factor is noteworthy. Namely, changes in industry influenced by the host state may require parties to re-negotiate existing agreements which will eventually lead to loss of anticipated gains or even termination of existing agreements. Speaking of anticipated gains, it should be noted that according to arbitral awards investors are entitled to have their legitimate expectations as to the operation and return on their investment respected by the host state [5, 39].

At this point it should be noted that literature on the matter distinguishes foreign direct investment and portfolio investment. As such, while foreign direct investment contemplates physical transfer of tangible or intangible assets from one country to ano-

ther for the purposes of wealth generation, portfolio investment involves movement of funds for acquisition of shares or financial instruments. Given these categories it should be outlined that a foreign party to OTC derivative transaction would rather fall under definition of portfolio investor, rather than foreign direct investor.

Such contrast between the categories leads to a question whether both types of investment should enjoy the same level of protection or whether portfolio investors should be protected at all. Obviously, investors assume certain risk by investing into foreign state. However, when it comes to portfolio investment, suffering loss is an ordinary commercial risk taken by investor. Consequently, should a portfolio investor sue stock exchange for such loss there will be few chances to succeed. Despite all arguments for difference in treatment the recent tendency shows that portfolio investments are included into the scope of foreign investment in bilateral investment treaties. If portfolio investments after all ensure capital flow to the state concerned why wouldn't it be regarded as foreign investment?

Furthermore, as noted in literature, when developing states realized effect of foreign investment they started competing each other for foreign investment which eventually ended-up in defining investment as broadly as possible and including portfolio investments in definition of investment [6, 100].

Taking the above into account, it is suggested to analyze legal standing of OTC transactions from the following perspectives:

#### **I. OTC derivative transactions in BITs and court practice**

Study of bilateral investment treaties conducted by the United Nations shows that bilateral investment treaties have developed to more complex documents and their application is extended so that more issues now fall under their scope [7, 11].

While it is obvious that most of the BITs have similar structure and deal with more or less same issues it still cannot be said that they are identical. That's to say, conclusion that every BIT provides protection of specific type of investment cannot be regarded as completely true. On the contrary, the details of each BIT represent broad variety of approaches with regard to individual provisions [7, 13]. That is, each particular BIT applies only in relation to those investments qualifying as investment as defined by that BIT provided that the mentioned investment is made by persons enjoying protection under the BIT. However, despite ever-growing numbers of BITs it still possible to highlight certain tendencies in drafting of BITs. As such, most of BITs provide broad and open ended definition of investment with non-exhaustive list of assets illustrating which forms and investment may take (usually such lists embody both direct and portfolio investment) [8, 49-51]. Considering constantly changing forms of investment such approach seems even more reasonable as it mitigates the risk of certain new form of investment not falling under the scope of BIT. It is notable that most BITs define investment from the following perspectives:

- 1) Form of investment;
- 2) Area of investment's economic activity;
- 3) Time when investment is made;
- 4) The investor's connection with the other contracting state [9, 37]

Following this approach broad definition of investment in most instances includes claims to money and claims under a contract having financial value. It is evident from such wording that treaty-makers intend to protect not only property but also contrac-

tual rights. Should such wording be present in given BIT, then OTC derivative transactions may without any doubt fall under such definition of investment. As it is evident from court practice, it is not the only wording allowing OTC derivative transactions to qualify as an investment.

Court practice may as well serve as an additional argument in favor of recognition of OTC derivative transactions as foreign investment under BITs. In this regard the ruling of International Centre for Settlement of Investment Disputes (“ICSID”) on *Deutsche Bank AG v Democratic Socialist Republic of Sri Lanka* is particularly notable. In the mentioned case, the Tribunal considered the hedging agreement concluded by Deutsche Bank with counterparty from Sri Lanka to be an investment as defined by BIT. As such, in the opinion of the Tribunal, hedging agreement fell under category established by the BIT, namely, it represented “a claim to money which has been used to create an economic value” [10, 57].

Another issue raised in the mentioned dispute was territorial nexus of Sri Lanka. Speaking of territorial criteria of investment, the Tribunal has referred to *Abaclat* case wherein it was stressed that criteria for determination of place of investments of financial nature is where the funds were made available to the host state and did they support economic development of that host state [9, 145]. Taking into account global character of financial instruments it is not essential where exactly the paperwork was done. It is rather crucial to understand where the engagement took place and where it had its impact. With reference to the perspectives from which investment is being defined in BITs listed above, it may be concluded that the ruling of ICSID covers perspectives that are the most crucial for this study.

In the meantime, it should be also noted that back in times when ICSID Convention was drafted, the parties were not able to reach consensus on definition of “investment dispute”. Furthermore, it was considered that limitation of the ICSID’s jurisdiction may lead to unintended consequences and for this reason ICSID Convention does not define investment, leaving it for the parties of particular treaty to decide [12, 70]. However, this does not mean that any definition may be regarded sufficient for instituting proceedings in ICSID. Namely, a line between an ordinary commercial transaction and investment should be drawn. It should be also noted that absence of definition in ICSID Convention leads to certain difficulties in application. Precisely, it is not clear whether the tribunals should apply “a double-barreled” test (*i.e.* meeting criteria of both ICSID Convention and given BIT) or does the consent of contracting states in BIT prevail? [2, 2] In this regard, reference to ICSID Convention may be challenged as it does not clearly define investment. To address this issue, in *Salini Costruttori SpA and Italstrade SpA v Kingdom of Morocco* the Tribunal defined that investment contemplates (i) contributions (ii) certain duration of performance (of the contract), (iii) participation in the risks of transaction and (iv) contribution to the economic development of the host State of investment [3, para 52]. Despite being challenged in further court practice, these criteria nonetheless shed some light on definition of investment. That is, when speaking of protection offered to foreign participants of OTC derivative transactions from standpoint of court practice these criteria should be also regarded.

Coming back to BIT coverage of OTC derivative transactions it should be added that ever increasing BIT practice resulted in drafting of Model BITs concluded by

certain states. As an example, 2012 US Model BIT expressly defining futures, options and other derivatives as investment may be mentioned [13, 3].

On the other hand, different types of investments have different economic implications. With that in mind contracting parties may opt to promoting specific types of investment by means of BIT. That is, certain types of investment may be protected by BIT while the rest shall fall out of its scope. To achieve this goal parties to a BIT opt for close-ended definition of investment and list exhaustive types of assets regarded as investment [6, 10]. In this case protection of OTC derivative transactions depends on provisions of particular BIT.

## **II. OTC derivative transactions in legislation of the Republic of Azerbaijan**

Based on the above, it may be outlined that OTC derivative transactions are or may be protected by BITs. However, despite growing number of BITs there are still countries which have not signed a BIT with the Republic of Azerbaijan. Relations with such investors should be governed by general rules established by the Law No. 57 "On protection of foreign investment" dated 15 January 1992 (the "Law"). Article 3 of the Law lists forms of investment which also includes conclusion of agreements with nationals and legal entities of Azerbaijan envisaging other forms of foreign investment (*i.e.* other than those listed in Article 3 of the Law). This subparagraph refers to definition of foreign investment provided by the Law. As such, the Law defines foreign investment as any kind of property and proprietary rights, including for results of intellectual activity and other immaterial rights being contributed by foreign investors to the objects of business activity and other kinds of activity with the objective of obtaining the profit [14]. Given this definition and general wording it may be concluded that the Law provides certain level of protection to foreign investors concluding OTC derivative transactions with Azerbaijani counterparties. However, lack of regulation and practice on the matter would suggest that every particular transaction should be reviewed on case-by-case basis.

In the meantime, as noted above, BITs may provide certain protection for foreign investors concluding OTC derivative transactions. With that said, it should be noted that BITs concluded by the Republic of Azerbaijan do not fall under certain model and therefore it may not be said that every BIT provides same or almost the same level of protection. It should be also noted that BITs are subject to negotiations between the states and therefore they may not be all regarded under the same approach. However, most of the BITs include claims to money in definition of investment and therefore suffice for protection of foreign counterparties to OTC derivative transactions.

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