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New Information and Disclosure Requirements for Banks in Relation to Spread Ladder Swaps

Germany's highest court in civil matters, the *Bundesgerichtshof* ("BGH") decided on information and disclosure requirements for banks when selling a specific type of structured products, spread ladder swaps, to their customers.

Over the last years, German courts had to decide in a number of cases on disclosure and information requirements for a bank entering into structured swap transactions with German municipalities as well as corporate and private customers. In particular, disclosure requirements on potential conflicts of interest and risk awareness have been a focus in these decisions. On 22 March 2011, the XIth Senate of the BGH decided on further information and disclosure requirements for banks when selling a specific type of structured products to their customers (the "**Decision**"). A German corporate had brought an action seeking compensation for damages it allegedly suffered as a result of the insufficient information and disclosure by its bank / counterparty.

The BGH held that a bank selling such structured products to its customers is obliged to clearly disclose whether the risks associated with a so-called CMS spread ladder swap (such as in the case at hand) are unlimited and could in fact (and not only "theoretically") result in significant losses. The bank has to ensure a level playing field of information which enables the customer to form a reasonable decision about the transaction. Furthermore, under specific circumstances, a bank must disclose its own interests when structuring and selling such spread ladder swap products. Whilst it were apparent (and, thus, does not need to be specifically disclosed) that a bank acts with the aim to make profits, the BGH ruled that specific features of the product structure which are particularly disadvantageous for customers (in particular if the relevant spread ladder swap has an initial negative market value on the trade date) or which create an unequal distribution of risks between the bank and the customer must be clearly disclosed. Furthermore, the bank is obliged to explore the customer's risk tolerance.

The Decision will provide an important indication for other pending or future lawsuits regarding similar structured products offered to municipalities as well as corporate and private customers. As no municipality was involved in the case leading to the Decision, it does not focus on the limitations under public law applying to municipalities and other entities established under public law.

This Newsletter is based on a press release only, the BGH is expected to publish its full reasoning shortly.

Contents:

Facts

Decision by the BGH

What to think of the Decision

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1. Facts

The bank (defendant) proposed to a German mid-size customer (plaintiff) to enter into a CMS spread ladder swap agreement (the "**Swap**") which was finally entered into on 16 February 2005. According to the Swap, the bank was obliged to pay to the customer a fixed interest rate of 3% p.a. in relation to a reference amount of EUR 2,000,000 for a five-year period whereas the customer was obliged to pay for the first year an interest rate of 1.5% p.a. in relation to the same amount and thereafter a floating rate equal to at least 0.0% dependent on the development of the spread between the 10- and 2-year swap rate on EURIBOR-basis (CMS10 - CMS 2) (the "**Spread**") calculated by using the following formula: "interest rate of the previous period + 3 x [Strike - (CMS10 - CMS 2)]". The strike was initially at 1.0% and was reduced over the contract term from 0.85%, 0.70% to 0.55%.

The Swap was entered into under a standard German Master Agreement for Financial Derivatives Transactions (*Rahmenvertrag für Finanztermin-geschäfte*).

During the negotiations, the bank provided the customer with presentation materials which included a statement that the customer may be obliged to pay higher interest amounts than it receives if the spread decreases strongly. Furthermore, the materials contained a statement that the risk of the customer may be "theoretically unlimited". At the trade date of the Swap, the underlying swap had an initial negative market value of about 4% of the reference amount (EUR 80,000) which helped the bank to immediately hedge itself in the market. This was not disclosed by the bank.

From autumn 2005, the Spread continuously decreased resulting in losses for the customer. On 26 January 2007, the parties terminated the Swap against payment of the current negative market value of EUR 566,850 by the customer. The customer sued the bank, but its claims were rejected by the lower courts.

2. Decision by the BGH

The BGH deviated from the decisions of the first and second instance and decided that the bank had violated its information and disclosure obligations and granted the request for repayment. In its decision, the BGH stipulated that in connection with highly complex and highly risky products the bank had to satisfy corresponding high disclosure standards in order to discharge its duty of care under the investment advisory agreement. Accordingly, the BGH defined new requirements for information obligations which a bank owes to its customers when recommending spread ladder swaps.

The Decision is based on the German law principles of investor-oriented and object-oriented advice (*anleger- und anlagegerechte Beratung*) which was previously established by the BGH with respect to advisory agreements in the so-called Bond decision on 6 July 1993. Under German case law, an advisory contract is entered into tacitly where a customer is approached by or approaches a bank, the bank provides (or makes statements which are interpreted as or deemed to be) recommendations which are of relevance to the customer or where the bank has an economic interest in the relevant transactions.

Investor-oriented advice requires that a bank considers – before offering any financial instruments to a customer – the customer's investment profile, the customer's willingness to take risks, its personal knowledge and experience and its financial situation ("know your customer"-principle). Object-oriented advice means that the bank must inform the customer about the specific characteristics and risks of the recommended financial instrument which are required to be in a positions to take an informed investment decision.

2.1. Investor-oriented advice

The BGH stressed the point that a bank is obliged to ask for a customer's willingness to take risks before making a recommendation in relation to a certain financial instrument, unless the bank is already aware of the customer's risk-tolerance due to a long-standing business relationship or recent investment decisions of the relevant customer.

Contrary to the opinion of the relevant Court of Appeal (*Oberlandesgericht*), the BGH confirmed that the obligation to collect such information about its customer does not cease to exist if the customer's representative has certain professional qualifications such as a degree in economics. The professional qualifications of a representative does not necessarily suggest that the customer has sufficient knowledge to understand the specific risks of complex structured products such as CMS spread ladder swaps. Furthermore, existing knowledge or experience does not allow a conclusion in relation to the customer's willingness to take risks.

2.2. Object-oriented advice

Furthermore, the BGH specified further requirements in relation to the principle of object-oriented advice.

Due to the complexity and the risk structure of the Swap, the bank had to comply with strict requirements in relation to its information and disclosure obligations. The customer must be informed in a clear manner that it is exposed to an unlimited risk which is not only of a "theoretical" nature, but rather depends on the development of the Spread which may become "real and ruinous", whereas the bank's risk is reduced by limiting the Spread at 0.0% with the consequence that the bank's interest payment obligations cannot be increased by a negative Spread. The BGH took the position that whenever such complex structured products are involved, the bank is obliged to ensure that the customer's knowledge and information in

relation to the risk profile of such product is at the same level as the bank's own knowledge and information.

Furthermore, the BGH stated that the bank was obliged to inform its customer about the initial negative market value of the Swap at the trade date amounting to about 4% of the reference amount (EUR 80,000) because the deliberately structured negative market value would imply a serious conflict of interest. In such "bet on interest rates" the profit of one side qualifies as the mirror-image loss of the other side. In other words: The Swap is only beneficial for the bank if the customer suffers a loss. But, under the advisory agreement between the bank and the customer, the bank is obliged to protect the customer's interest. In order to manage such conflict of interest, a bank must inform its customer about the initial negative market value.

According to the BGH, a bank recommending its own investment products does not have to inform its customers about its intention to make profit. In principle, such pure profit-making interest is obvious. But, the afore-mentioned conflict of interest has to be disclosed to the customer due to the fact that the bank (in the court's view) deliberately structured the risk profile of the Swap to the disadvantage of the customer.

3. What to think of the Decision

3.1. Negative Value

Investor-oriented and object-oriented advice requirements have long been established by German courts. However, the obligation to disclose the initial negative market value of a financial instrument is now of particular interest to financial market participants. At first glance, it is disappointing in this context that the BGH did not discuss why exactly the initial negative market value of a financial instrument, in the BGH's view structured into the transaction in order to ease an immediate hedging (and to secure profitability), is for the customer so important to know. After all, if the bank did not hedge itself at all, its interest (and expectation of the future interest development) would have been the exact opposite of that of its counterparty / customer in any event, and the customer must be aware of this (as the court itself has pointed out). That the bank hedges itself (or maybe not) is important for the bank but should not lead to any other assessment of the deal by the customer.

Moreover, it is market standard that a counterparty to a swap agreement does not pay any additional fee, such fee is rather included in the swap calculations with the result that any swap agreement has a negative market value at the beginning of the transaction. However, the BGH's reasoning has not been published yet and it might contain more insights into the court's view on these issues.

3.2. Scope

The Decision expressly only relates to CMS spread ladder swaps and does not contain any explicit statement in relation to other financial instruments. Nevertheless, the plaintiff's lawyers and investor protection lawyers all over the country will of course try to argue that the BGH's conclusion should not be limited to this case but to all spread ladder swaps, to all complex structured products and even to all financial instruments. However, this case's facts are quite special and the BGH's arguments and findings are very much based on these factual circumstances. There are many spread ladder swaps in the market which are differently structured (i.e. with different types of algorithms, or with loss limits for customers) and/or were sold to customers under entirely different circumstances, not to speak of entirely different structured or other products. Only after careful analysis of the details of the BGH's reasoning, it will be possible to better assess whether and to what degree one or the other of the BGH's arguments and information and disclosure requirements will have to be applied in other cases and with respect to other complex products.

3.3. Outlook

The BGH will have to decide further cases relating to spread ladder swaps and at the lower courts there are currently further cases pending, a number of which relate to public sector counterparties (mainly municipalities). But after this decision it is not unlikely that a large number of further cases will be brought to the courts.