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UPDATE: 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 certain information and disclosure requirements for banks.

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 regarding potential conflicts of interest, risk awareness and wrongful advice 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 ("**Plaintiff**") had brought an action seeking compensation for damages it allegedly suffered as a result of the insufficient information and disclosure by its bank / counterparty ("**Defendant**") in the context of entering into a so-called spread ladder swap.

This was the first time that the BGH had the opportunity to define some disclosure standards for the offering of structured derivatives products by banks to their customers. Hence, the decision of the BGH may provide some clarification and guidance in the sprawling but not always consistent body of case law on disclosure duties of banks in relation to structured products.

The BGH held that a bank selling a "CMS Spread Ladder Swap" to a customer is obliged to clearly disclose the risks associated with this product and it has to ensure a level playing field of information which enables the customer to form a reasonable decision of his own about the transaction. In particular the BGH requires the following:

- When providing investment advice, a bank is obliged – before making a recommendation – to ascertain the investor's risk tolerance, unless that is already known to the bank as a consequence of a long-term business relationship or of the investor's prior investment behaviour. The fact that one of the investor's employees is professionally qualified with a degree in economics does not automatically warrant the conclusion that such employee is familiar with the specific risks inherent in a CMS Spread Ladder Swap.

- With an investment product as complex as a CMS Spread Ladder Swap, the advising bank must ensure that the investor possesses the same level of knowledge and information about the risks inherent in the transaction as that of the bank advising him, since only in this way is it possible for him to make an informed decision whether to accept the deal offered to him.

- In connection with highly complex investment products such as a CMS Spread Ladder Swap, the bank must disclose any initial negative market value that it built into the swap formula because that would constitute a conflict of interest which gives rise to the danger that the investment recommendation is being made not solely in the customer's interest.

Key Issues

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- Generally, a bank which recommends its own investment products is not obliged to disclose that (and to what degree) it generates profits with such products. Such conflict of interest is so apparent that there is no need for disclosure, unless special circumstances arise. These might occur in case of a CMS Spread Ladder Swap since, according to the BGH, its risk structure was intentionally designed by the bank to be to the detriment of the investor in order to enable the bank to sell the risk that the customer assumed as a result of its advisory services.

The Decision will provide an important guideline 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, the latter does not focus on the limitations under public law applying to municipalities and other entities established under public law. In any event, the Decision is another example of the BGH's "paternalistic" approach towards the avoidance of conflicts of interest between banks and customers, regardless of the customers' level of actual know how and financial sophistication.

1. Facts

The bank proposed to a German mid-size corporate customer to enter into a CMS Spread Ladder Swap agreement ("**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 notional 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 - CMS2) (the "**Spread**") calculated by using the following formula:

"interest rate of the previous period +
3 x [Strike - (CMS10 - CMS2)]"

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 Finanztermingeschäfte*) in which the parties agreed that the mutual payments would be netted, meaning that the party owing the higher amount on the respective due dates was to pay the difference between the two amounts owed.

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". Additionally, the presentation materials included model calculations demonstrating both positive and negative developments of the Spread. For the customer the negotiations were conducted not only by its managing director but also by an experienced employee with bank training and a university degree in economics. During the court hearing, the managing director testified that he approved the contract despite not understanding the underlying model.

At the trade date, the Swap had an initial negative market value of about 4% of the notional amount (EUR 80,000) which enabled the bank to immediately hedge itself in the market. The initial negative market value was not disclosed by the bank to the customer.

Contrary to the bank's initial outlook, the Spread continuously decreased from autumn 2005, 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 of the BGH[1]

The BGH reversed 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 damages. In its decision, the BGH set forth 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 arising under an investment advisory agreement with the customer. Accordingly, the BGH defined new requirements for information obligations which a bank

[1] Whereas the Higher Regional Court had raised the question whether a CMS Spread Ladder Swap contract was ineffective by virtue of a violation of public policy pursuant to section 138 of the German Civil Code (*Bürgerliches Gesetzbuch* – the "**BGB**") or violated the transparency requirements for standard business terms (section 307 para. 1 sentence 2 of the BGB), the BGH deliberately bypassed these issues in order to be able to address the conflict of interest issue. The Higher Regional Court argued that such contract did not violate section 138 of the BGB as everyone's individual autonomy permitted risky transactions to be entered into. Furthermore, the court decided that the swap formula was sufficiently transparent pursuant to section 307 of the BGB. It was not apparent in this case that the complex model could have been described in any simpler terms, particularly since an experienced commercial company did not require as much protection as a consumer.

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 were initially established by the BGH with respect to advisory agreements in the so-called Bond decision of 6 July 1993[2]. According to German case law, an advisory contract is entered into tacitly where a customer is approached by, or by itself approaches, a bank as a consequence of which 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 (for example "suitability") requires that a bank explores – 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" or "KYC" principle). Object-oriented advice means that the bank must inform the customer about the specific characteristics and risks of the recommended financial instrument which is required in order to put him in a position to make an informed investment decision. While the disclosure to the customer of facts material to the investment decision must be accurate and complete, the market assumptions, evaluations and recommendation of an investment product, taking into consideration the afore-mentioned special features, need merely be reasonable when looked at from an *ex ante* perspective. As a consequence, the risk that an investment decision made on the basis of an advice that was investor-specific and investment-specific subsequently turns out to be disadvantageous has to be borne by the investor.

2.1 Investor-oriented advice (suitability)

The BGH stressed the point that the advising bank is obliged, prior to making its recommendation in relation to a certain financial instrument, to ascertain the customer's knowledge, experience, and investment objectives, which includes the customer's investment objectives and risk tolerance. This duty is also defined in supervisory law rules relating to investment services companies like the Defendant (section 31 para. 2 sentence 1 no. 1 (old version) and section 31 para. 4 (new version) of the German Securities Trading Act (*Wertpapierhandelsgesetz* – "**WpHG**")). The advising bank is under no duty to inquire only when it is already aware of these circumstances, for instance, as a consequence of a long-term business relationship with the customer or the investor's prior investment dealings.

In case of a highly complex financial product, a bank may also not assume that the customer entering into the transaction is entirely prepared to accept high risks. It is incumbent upon the investment advisor to recommend only such products that in fact conform to the customer's investment goals and risk tolerance. If it does not inquire the customer's risk tolerance prior to making its investment recommendation – as required by case law and supervisory law rules – then it can meet its duty to make an investor-specific recommendation only by attaining certainty prior to the customer making its investment decision that he has understood all aspects of the risks inherent in the financial product as described by the investment advisor. Otherwise, the investment advisor cannot assume that its recommendation conforms to the customer's risk tolerance[3].

Contrary to the opinion of the relevant Higher Regional Court (*Oberlandesgericht*), the BGH confirmed that the obligation to establish 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. In the BGH's view, the professional qualifications of a representative do 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 risk tolerance.

2.2 Object-oriented advice

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

(a) Scope of the disclosure and information obligation

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. According to the relevant Higher Regional Court, the recommended CMS Spread Ladder Swap contract involved a risky transaction, a "type of speculative bet". The BGH followed this interpretation and stated that –

[2] NJW 1993, p. 2433.

[3] According to the BGH, the fact that the managing director of the customer testified that he approved the swap despite allegedly not understanding the underlying financial model did not alter the court's decision: the claim for damages is not mitigated due to contributory negligence of the managing director pursuant to section 254 of the BGB. The BGH argues that section 254 para. 1 of the BGB generally does not entitle the party under a duty of disclosure to claim that the party suffering damage should not have relied on the information and should therefore be found contributorily negligent in causing the damage. If this were the case, it would conflict with the fundamental principles of the advisory duties pursuant to which the investor is normally entitled to rely on the accuracy and completeness of the advice given to him. The customer decision to make the investment without having understood the investment concept is very much an expression of this special fiduciary relationship which causes the investor to focus primarily on the recommendation of "his" advisor and discourages him from asking further questions or undertaking further research.

even though the steps needed to calculate the obligation to pay variable interest can be comprehended (especially by an employee with a graduate degree in economics) – it is still not even remotely possible to understand the risks inherent in the said deal.

The BGH took the position that whenever such complex structured products are involved, the advising bank has to ensure a level playing field of information, since only in this way it is possible for the customer to make an informed decision whether to accept the deal offered to it. The bank must direct the customer's attention to the fact that an unlimited risk of loss is not merely "theoretical" but instead can be real and ruinous, depending on the spread trends, and it must do so in a way that is understandable and does not downplay this risk. This requires the disclosure of the following:

- extensive explanation of all elements in the swap formula
  - the multiplying factors,
  - the strike,
  - tying the interest rate to the prior period,
  - the customer's minimum interest rate of 0%;
  - the specific effects on such formula in all conceivable interest scenarios
  - leveraging,
  - "memory effects";
- an unambiguous disclosure that the risk/opportunity profile is not balanced
  - the customer's risk is unlimited, and
  - the bank's risk is limited – irrespective of its hedge transactions (with third parties) – by capping the Spread at 0.0% with the consequence that the bank's interest payment obligations cannot be increased by a negative Spread.

Unless it describes all of these factors, the advising bank (in the BGH's view) cannot assume that the customer has understood all the risks inherent in the transaction.

(b) Disclosure obligation in relation to the negative initial market value

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 notional amount (EUR 80,000) because the deliberately structured negative market value would imply a serious conflict of interest. By entering into an advisory contract, the bank assumes the obligation of making a recommendation tailored solely to the customer's interests. Therefore, it must avoid or at least disclose conflicts of interest that could endanger the advisory objective and the customer's interests. This principle is also stipulated in section 31 para. 1 no. 2 of the WpHG.

The BGH argued that in such a "bet on interest rates" the profit of one side qualifies as the mirror-image loss of the other side. In other words: A swap is only beneficial for the bank if the customer suffers a loss. From this follows an acute conflict of interest for the advising bank. For the bank, the swap is favourable only when its forecast for base interest rate trends – the widening of the spread – is wrong and the customer suffers a resulting loss. But as advisor, the bank is also obliged to safeguard the customer's interests. According to its contractual obligations arising from the advisory contract, it should be primarily interested in achieving the highest possible return for the customer, which would mean that itself would experience a corresponding loss.

In case the advising bank takes advantage of the fact that the market assesses the risk assumed by the customer in accepting the bank's recommended product as negative, there is a real danger that the bank is making its investment recommendation with more than just the customer's interests in mind. As a consequence, the BGH assumes that the customer would assess the investment recommendation differently if it knew that the exceedingly complex interest calculation formula was designed in such a way that the market viewed the customer's risks more negatively than the countervailing risks of its contractual counterparty from whom it was also receiving advice.

According to the BGH, a bank recommending its own investment products, however, does not have to inform its customers about its intention to make profit. In principle, the inherent conflict of interest is so apparent that there is no need to make express reference to it, unless special circumstances arise. However, a duty of disclosure arises due to the special features of the product if such product is intentionally designed with a risk structure to the detriment of the customer only in order to "sell" the risk that the customer assumed on the basis of its advisory services. In contrast to the bank's general intention to generate profits, the objective of selling its risk as hedging counterparty is not readily recognisable to the customer.

3. What to think of the Decision?

3.1 Initial negative market 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, which in its view had been structured into the transaction in order to allow an immediate hedging (and to secure the bank's profit), 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. And each and every customer should be aware that its counterparties are likely to hedge themselves, too.

Moreover, it is market standard that a counterparty to a swap agreement does not pay any additional transaction fee. Accordingly, it is obvious, at least for a customer of average sophistication, that the bank's profit must be generated out of the financial engineering of the swap formula with the result that any swap agreement has a negative market value at the beginning of the relevant transaction.

Furthermore, the requirement stipulated by the BGH that the bank and the customer must have the same level of knowledge when entering into structured derivative products like CMS Spread Ladder Swaps raises doubt or at least the question whether the bank really had an advance in knowledge.

In the end the parties entered into a transaction the price of which was based on the unpredictable future development of the spread between two interest curves. It is true that the bank as initiator of such deal bases its predictions on complex calculation models. It is worth to mention in this context that the actual formula used in the Swap was by no means overly complex; it could, despite the truth behind the "*iudex non calculat*" saying, be understood by any lawyer of average intelligence, not to speak of economists. However, it was created by qualified financial mathematicians, but even such mathematicians can – as shown by the developments in the recent past – neither foresee all events. Nor is it the purpose of such a financial model to perfectly reflect all possible future events. In contrast, it is just an algorithm deriving from previous experiences.

Basically, the only basis for the calculation of the market value of a swap transaction are the historical curve movements which are also publicly available for the bank's customers. In this case, the historical developments had apparently been disclosed to the customer in the offering material and several sample calculations were apparently shown to outline that the future developments of the interest curves might go either way. In the end, a precise forecast is never possible, the bank has simply taken the view that the curves are most likely to move into one of two possible directions whereas the customer has taken the opposite decision. And this is nothing more than the usual situation in all trading situations.

Furthermore, the BGH overshot the mark by not considering any contributory negligence of the customer. The managing director of the customer had expressly testified that he approved the swap despite allegedly not understanding the underlying model.

Despite such testimony, the BGH did not mitigate the claim for damages due to the contributory negligence of the managing director. Hence, the managing director violated one of the major principles of professional ethics – "*only buy something that you understand*" – without being held responsible. Even if one wanted to ignore (which one actually should not ignore) that this managing director was assisted by an economist, it is encouraging irresponsible behaviour not to accept a good deal of contributory negligence by the Plaintiff, particularly in a case where such Plaintiff was not a private customer but a merchant.

Finally, it is especially the partly apodictic tone of the BGH's Decision that will lead to an over-generalisation and oversimplification of what should be a more balanced and complex legal analysis, and will lead to an unjustified condemning of all spread ladder swaps, although many of the many thousands of them concluded in recent years do not come with an unlimited risk for any of its parties and although the parties hedging themselves via such products have themselves properly analysed the risk structure of the hedging price to be paid by them.

3.2 Scope

Whilst the Decision relates to CMS Spread Ladder Swaps and does not contain any express statement in relation to other financial instruments, the requirements stipulated by the BGH may also apply to other financial instruments. Also, the customers' lawyers and investor protection lawyers will of course try to argue that the BGH's conclusion should not be limited to this case but to all spread ladder swaps as well as 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 different circumstances, not to speak of entirely different structured or other products.

3.3 Some practical consequences

The Decision does not include an express prohibition to sell complex, or even highly complex, structured derivatives products, or CMS Spread Ladder Swaps as such. The BGH "only" increases the standards for a sufficient and competent advice. Following this, the BGH defined some obligations which an investment advisor is obliged to comply with when recommending structured derivatives products to its customers in order to mitigate any potential liability:

- The bank has to ascertain with certainty that the customer has understood all aspects of the risks inherent in the recommended financial product.
- The bank should not rely on the customer's professional qualifications, which is usually insufficient for assuming appropriate

knowledge and experience in connection with specific structured products, unless there is specific evidence that the relevant customer has in fact acquired such knowledge / experience in the course of its professional activities.

- Upon analysis of the facts of the case it appears that the structure of the CMS Spread Ladder Swap was neither extremely complicated nor did it require an economics degree to understand it. In the case at hand, the customer was not as unsophisticated as the BGH's reasoning may suggest. Nevertheless, the BGH's reasoning implies that a bank may not discharge its duty of care by only providing a clear and comprehensive documentation. Rather it seems that the BGH believes that a bank owes further duties to explain the implications of the otherwise clear documentation. Such rationale seems to borrow from recent case law of the BGH where it held that a (private) investor's ignorance of proper risk disclosures contained in a prospectus he had not read did not exclude the bank's liability for recommending such product.

- The bank should provide an extensive explanation of all elements in the calculation formula regarding its counterparty's contractual financial duties (hedging price), and their specific effects.

- Furthermore, the advising bank should also provide the customer with sample calculations considering all relevant market scenarios. Any risks must be clearly identified and should be substantial. A mere statement that the risk of loss is "in theory" unlimited is not sufficient.

- Additionally, the advisor should disclose the initial negative market value of the recommended product, if any, as it may express a severe conflict of interest.

- Finally, it is highly recommended that the actual fulfillment of all of the afore-mentioned obligations should be expressly documented and signed by the customer in order avoid any evidence difficulties.

- Of course, the potential conflicts of interests in the BGH's view identified and deriving from an initially negative market value of a recommended product could be significantly lowered, if not avoided, by using separate legal entities for advising a customer and for acting as "counterparty" in a hedging transaction. However, to demand such a separation would be to crack a nut with a sledgehammer.

3.4 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.

It is perhaps the most disappointing effect of the Decision that it might encourage even commercial and professional as well as public sector counterparties to follow a behavioural pattern well known from private investors: Do a complex transaction and, if it works out, take the profit; but if it doesn't work out, sue the bank for wrongful advice and make cash in the courts.