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BGH: Third pillar of advisor liability

Swap case law at the German Federal Court of Justice (Bundesgerichtshof, BGH) is on the move again and is establishing a system of liability for banks providing investment advice that now rests on three pillars. The familiar obligations to provide investor-oriented and investment-specific advice have been joined by a third obligation to disclose concealed conflicts of interest on the part of the advisor ("**integrity-oriented advice**"). An obligation of this nature had already been postulated in the "kickback case law" (case references XI ZR 56/05, XI ZR 204/12, XI ZR 147/12); the BGH is now generalising it in its third swap judgment (XI ZR 278/13) and fourth swap judgment (XI ZR 425/14).

However, the BGH is squandering the legal certainty that was probably its objective in making this generalisation due to a lack of a practicable definition of concealed conflict of interest. It is therefore obvious to assume that the BGH is pursuing a legislative policy by, as it were, banning some derivatives transactions through excessive protection of bank customers from speculation. At any rate the BGH's third swap judgment excludes "connective" swaps that provide protection against an existing risk to the customer from the disclosure obligation regarding the initially negative market value of the swap contract. The fourth swap judgment finally specifies what the BGH understands by such "connective" swaps.

Advisor liability 1.0

The BGH's case law on the liability of investment advisors was previously based on the two pillars of the Bond judgment (case reference XI ZR 12/93): investor-oriented and investment-specific advice.

Recommendations for investment products must be tailored to the customer's investment goals and personal circumstances (**"investor-oriented advice"**). The customer must also be informed of the features and risks of the investment object that may be of vital importance for the customer's investment decision (**"investment-specific advice"**).

The substance and extent of advice obligations depend on the circumstances of the individual case. Relevant features are firstly the customer's level of knowledge, readiness to assume risks and investment goal, and secondly general risks such as the economic climate and capital market trends as well as specific risks of the investment product.

While the customer must be correctly and completely informed about the circumstances of relevance to an investment decision, the assessment and recommendation of an investment object need only be acceptable taking into account the aforementioned conditions considered *ex ante*.

The investor bears the risk that an investment decision taken on the basis of investor-oriented and investment-specific advice proves to be mistaken.

Investor-oriented advice / Suitability

Even if the bank providing advice specifically makes reference to the risks of the product and to a "theoretically unlimited" risk of loss with the aid of calculation examples, in the case of a highly complexly structured financial product it may not assume that the customer is prepared to tolerate high risks.

If the investment advisor does not, before making its investment recommendation, enquire about the customer's specific risk tolerance regarding the transaction that is to be concluded, it can only comply with its obligation to make an investor-oriented recommendation by making certain before its customer makes its investment decision that the customer has understood the risks outlined by the advisor in every respect.

(Case reference XI ZR 33/10, paragraph 24.)

Key messages

- The BGH is refining integrity-oriented advice as the third pillar of advisor liability
- Investment advisors are obliged to disclose concealed conflicts of interest
- Conflicts of interest are
  - concealed commission for the bank providing advice and
  - a concealed initially negative market value of a swap contract from the customer's point of view

Investment-specific advice

The requirements for investment-specific advice in connection with "complexly structured and risky" swap contracts are stringent.

The bank providing advice must clearly demonstrate to the customer, in a comprehensible manner that does not downplay matters, that the risk of loss, which has no upper limit for the customer, is not merely "theoretical" but can in fact be "real and ruinous".

The requirement not only includes detailed explanations of all elements of the formula for calculating the variable interest rate in the event of all conceivable developments but also clear disclosure to the customer that the opportunity/risk profile is disproportionately shared between the participants in the interest rate bet.

(Case reference XI ZR 33/10, paragraph 29.)

Initially negative market value

On the other hand, the initially negative market value of a swap contract from the customer's point of view is not a circumstance that the bank providing advice must disclose within the scope of investment-specific advice.

The reason for this is that according to the BGH an initially negative market value does not reflect anticipated failure of the transaction.

In fact, latest market value is determined on the basis of financial calculation models by means of the anticipated future fixed and variable interest payments of the parties being compared and discounted at the valuation date. The market value is said to become negative as a result of the bank building into this established "model value" its net profit and its costs by means of appropriate fixing of the structural elements of the swap.

No "overwhelming" probability of loss

For the customer this means that it would first have to earn this built-in margin in order to start making a profit in turn.

However, the initially negative market value does not indicate an overwhelming probability of loss provided that no excessive change in the opportunity/risk profile were to take place as a result of increased costs and earnings portions.

Ultimately, the success of the swap depends solely on the trend of interest rates or exchange rates during the contractual period (which frequently runs for years).

Therefore, the recommendation for a swap contract could be investment-specific despite the initially negative market value provided that the opportunities for profit and thus the "intrinsic value" of the swap are not impaired in the long term by excessive cost and profit components for the bank to the detriment of the customer.

(Case reference XI ZR 378/13 paragraph 31.)

Forward option case law

The case law of the German Federal Court of Justice on disclosure and advice when selling forward options also does not give rise to the assumption of a disclosure obligation regarding the initially negative market value provided that only the pricing in of a customary profit margin is claimed, since according to this case law disclosure is not required regarding commissions in general but only in the event that the commissions could consume the profit to a substantial extent and considerably adversely affect the opportunity to make a profit.

(Case references II ZR 84/80; II ZR 355/87, XI ZR 214/92, XI ZR 244/95, XI ZR 453/02.)

Advisor liability 2.0

The Bond judgment was amplified by the BGH in the kickback case law that first charged advisors with disclosing concealed refunds. Subsequently the BGH extended the obligation to all commission income.

In a three-person relationship in which the commission is paid by a third party (e.g. issuers, initiators) to the bank providing advice, from the point of view of a concealed conflict of interest the bank is obliged to disclose to the investor the reason for and level of the commissions received.

The BGH approved this in the past in two groups of cases: in concealed inflows of reimbursements

(case references XI ZR 56/05, XI ZR 262/10)

and if in the case of sales commission being paid a concealed sales commission is provided by the seller.

(Case reference XI ZR 204/12.)

The BGH aggregated the two groups of cases with effect from 1 August 2014 and expanded them to include all contributions that the bank providing advice receives from a third party regardless of whether they are openly identified or concealed in the investment amount.

(Case reference XI ZR 147/12.)

Advisor liability 3.0

Since 2015, the BGH's swap case law has generalised the obligation to inform customers of concealed conflicts of interest on the part of the bank, with this case law now being extended to pure two-person combinations.

In a two-person relationship the principle applies that the bank is not obliged to inform its customers that it obtains profits from recommended products, since it will be obvious to the customers that the bank will pursue profit interests and so in principle separate reference need not be made to this.

(Case references XI ZR 378/13, 316/13 and 33/10.)

A circumstance that is obvious to the customer results in its protection-worthy status lapsing.

(Case references XI ZR 182/10, XI ZR 247/12.)

Margin on swaps surprising

In contrast, the customer, which, as presumed by the BGH, assumes that the bank gains only the amount of the interest rate differential if the interest rate bet favours it, could not recognise that a margin had been built into the risk structure of a swap contract.

Key messages

- The BGH lacks a practicable definition of a concealed conflict of interest
- Swap case law can be better explained by rejecting speculation
- Third swap judgment exempts risk-mitigating contracts from the obligation to disclose the initially negative market value

(Case reference XI ZR 378/13 paragraph 38.)

According to the most recent BGH case law, the obligation to disclose the initially negative market value includes the obligation to provide information about the level thereof. Only if the customer is also aware of the level of the initially negative market value can it correctly estimate the bank's own interest in recommending the product in question.

(Case reference XI ZR 378/13 paragraph 39, 40, cf. XI ZR 56/05 and XI ZR 341/12.)

The bank is likewise not obliged to explain that it achieves the gross margin due to the circumstance that the market negatively assesses the customer's risk at the time of conclusion of the contract. If the initially negative market value is not an indicator of an overwhelming risk of loss but in fact only reflects the bank's margin, the disclosure obligation is limited to providing notification of this.

(Case reference XI ZR 378/13 paragraph 40.)

Furthermore, the bank is not obliged to provide clarification about the initially negative market value if a "connective" swap is involved. This is the case in swap contracts that in economic terms at least partially either change a variable-rate loan into a synthetic fixed-rate loan or change a fixed-rate loan into a synthetic variable-rate loan. However, this should only apply if the bank as the customer's swap contract partner is at the same time its lender, the reference amount of the swap corresponds to (or at least does not exceed) the loan proceeds that are outstanding for repayment and the term of the swap for variable-rate loans corresponds to the term of the loan agreement and in the case of fixed-rate loans corresponds to (or at least does not exceed) the term of the fixed interest rate. The bank's payment obligations must coincide with the variable or fixed interest taken on by the customer in the associated loan agreement at least in terms of partial hedging against opposing interest rate risks. In each case, as of the same reference date, the bank must either take on the customer's variable interest rate with regard to the same base value, for example a reference interest rate, on the basis of the loan agreement in exchange for a fixed interest rate or must pay the customer the fixed interest that the latter owes on the basis of the loan agreement against a variable interest rate.

(Case reference XI 425/14).

Comments

The premise is that the bank's margin is "unexpected" and therefore there is a conflict of interest that must be disclosed.

The swap case law does not substantiate why the bank customer may assume that it is concluding swap contracts with the bank without a margin.

Nor are any convincing reasons for this apparent.

The circumstance that the customer frequently will not be alone in the situation of deducing the existence of the margin from the swap formula of the contract is not an adequate justification. However, this also applies to the usual case of a bilateral banking transaction for which the BGH specifically emphasises that notification is not to be provided of the margin because the bank's own profit interests are "obvious".

The situation cannot be different with respect to the sale of swap contracts, especially if the bank, as is customary in these cases, does not calculate any separate fees. There is nothing to justify the assumption that a bank could offer its customers swap contracts without a margin, i.e. by subsidising its own costs. Justification is required as to why such an "objective normative" expectation should nevertheless be worthy of protection.

Acceptable grounds would not be provided by the supposed fairness concept according to which the customer could rightly expect the exchange of equal opportunities and risks. There could be no question of fairness because without a margin the bank would not receive compensation for its costs and thus an adequate return for assuming the risk. The bank customer would be as it were gifted the opportunity to conclude a swap contract.

The fiction: No overwhelming probability of loss

The starting point for the BGH's swap case law was originally the premise that the bank "knowingly designed the risk structure to the detriment of the customer".

In recommending a swap contract in which profit for one party means a contrasting loss for the other party, the bank providing advice faces a serious conflict of interest. In making its recommendation it must be concerned with the highest possible profit for the customer, but this would mean a corresponding loss for the bank itself.

At the time the contract was concluded, the simulated "market" assessed the risk that the customer was assuming as being negative. For the bank, this would mean that its prospects are assessed positively.

(Case reference XI ZR 33/10, paragraphs 31, 38.)

The BGH's premise is not a good fit with its other statement that the initially negative market value does not indicate an overwhelming probability of loss for the bank's customer. Against the background of the BGH's other remarks, this statement could only be true if, due to a lack of reliable forecasts, it was completely impossible to design the "risk structure knowingly to the detriment of the customer".

The BGH therefore also immediately exposes its second statement as fiction: No overwhelming probability of loss would exist for the customer only "if no excessive change in the opportunity/risk profile took place as a result of increased costs and earnings portions". Additionally, the customer would first have to earn the margin that had been built in, and no complaint could be made about this.

The BGH thus apparently follows its case law on excessive internal commissions that trigger a disclosure obligation, albeit on the basis of investment-specific advice.

(Case reference III ZR 404/12.)

If the BGH wished consistently to take the view that the assessment of a swap contract depended only on future developments and not on its risk structure, the criticism of a conflict of interest for the bank could not be maintained.

However, it chooses a fiction that releases the investment advisor from liability in three-party combinations. There may have been a desire here to make only the party offering the swap liable.

Moreover, the objectivity that the BGH ascribes to the market value that is based on mathematical calculation models and on premises that are sometimes debatable is questionable.

An example of such a premise is the hypothesis of efficient capital markets. However, in practice only swap products which take advantage of market inefficiencies in a targeted manner and thus are able to offer the customer overwhelming profit opportunities despite a negative initial market value are known.

The initial market value is in fact only a more or less standardised forecast that need not be either correct or incorrect. The BGH also recognises this in its case law on forecasts in investment brochures.

There is no reason always to accord higher validity to the forecast described as "market value" than to competing forecast methods. It is therefore to be hoped that the BGH will abandon its mistaken concentration on the initially negative market value and will shift to better criteria for correct advice in the case of high-risk transactions on the basis of forecasts.

Conflict of interest: meaningfulness?

However, selective liability on the part of the swap contract partner fits well into the picture painted in the third swap judgment of the reasons for the swap case law of the BGH:

The BGH makes an exception from the disclosure obligation for initially negative market values in the case of "connective" swap contracts that mitigate risk for the customer. However, in so far as the market value gives rise to a conflict of interest it does not depend on the contractual role undertaken by the bank. In other words, the alleged conflict of interest for the party offering the swap exists even if the swap customer concludes the contract in order to limit risks arising from other contracts, for example variable-rate loans.

This demonstrates that the BGH does not in fact accord the conflict of interest resulting from the initially negative market value a constitutive effect on a disclosure obligation. Instead, the one-sided focus on the swap provider and the "speculative end" of the swap contract indicate that the speculative possibilities of derivatives are a thorn in the side of the BGH. The extremely restrictive "connexity" requirements that the BGH established in its most recent swap decision (XI ZR 425/14) reinforce this impression.

Practical hints and outlook

Banks that sell swap contracts and at the same time become the opposing party (two-party combination) can exclude liability risks as well as they possibly can by means of comprehensive clarification regarding the initially negative market value (including calculation method and amount on the reference date) and its detailed documentation.

Three-party combinations in which banks sell third-party products without becoming an opposing party involve a much lower level of liability, but even here a precautionary market value clarification can reduce liability risks. If an imbalanced opportunity/risk ratio is possible, clarification should be provided.

Unanswered questions

The BGH made it plain that the disclosure obligation regarding the initially negative market value includes not only its mere existence but also its level.

However, it is also unclear whether this means that precise clarification should be provided regarding the market value or whether information about the approximate level suffices. There are more compelling reasons for the latter view: A precise clarification would require the existence of a single calculation method for value determination. However, no such single method exists. Moreover, for customers an awareness of the approximate level of the market value is sufficient to classify the magnitude of the conflict of interest. However, the case law on kickbacks makes it appear advisable to provide clarification that is as precise as possible about the level of the market value.

The circumstance that a multiplicity of calculation methods or variants exist to determine the market value leads to further questions:

Must the bank disclose the method it used to calculate the market value and the date for which the value was calculated?

Must the assessment be updated to reflect the date at which the transaction is concluded?

The disclosure of the calculation method is a very technical question that in many cases is probably of no value to the customer. However, it ought to be easy for the bank to update the calculation for the date on which the transaction is concluded and this update should be of greater significance to the customer. In order to reduce liability risks it is therefore recommended that the customer be informed of the current market value on conclusion of the transaction or more precisely shortly before the contract is signed.

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