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Newsletter

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News on Prospectus Liability

Higher Regional Court Munich, decision of principle of December 30, 2011, Case Kap 1/07

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In a recent decision on prospectus liability, the Munich Higher Regional Court has set in a decision of principle that both the bank and the initiator are held liable for the incorrect prospectus of VIP 4 media fund.

Facts

In March 2004, VIP Vermögensberatung München GmbH had published a prospectus for investment in Film & Entertainment VIP Medienfonds 4 GmbH & Co. KG, which was supposed to clarify details of such an investment for potential investors of this fund and which was also used for attracting further investors. The Higher Regional Court of Munich has now ruled in a decision of principle that the prospectus was incorrect, incomplete and misleading insofar as the recognition of risk according to tax law, the risk of loss and the forecasting were incorrectly displayed. The Higher Regional Court also decided that the defendants (the fund initiator and the bank) are responsible for this as they have acted in culpable manner whereas the plaintiffs (the investors) may be entitled to claim compensation for damages. However, meanwhile meanwhile an appeal has been lodged against the decision.

Reasons

The defendants were held responsible that the transfers of money from the investment company to the participating companies occurred in a manner that deviated from the provisions of the prospectus. The court considered the entire practice as an „evasive transaction" within the meaning of Section 42(1) of the General Tax Code. That means that the underlying transactions are effective, but they are not accepted by tax authorities since the legal form had been misused. This is because mere 20% of the money from the fund was allocated to the movie production, whereas the rest of the capital was supposed to be deposited at a bank account. The investment company was supposed to receive a fixed amount in 2014, regardless of the economic success of the movies. However, such a deposit transaction would not be recognized as an entrepreneurial investment that could be used by the investors for tax deduction. This is why the contracts were designed in such a manner that the money could be managed via various firms, which were involved in the movie production.

The actually existing risk of loss was downplayed to the investors. The fund was described as a „guarantee fund," even though there was no guarantee to the investors. Repeatedly, the wording „coverage of 115% of the limited liability capital" was used, even though such coverage did in fact not exist.

Furthermore, the forecasting, which outlines the expected profit of investors, was calculated incorrectly and included a profit forecast, which was afflicted with large risks. The first investment was supposed to be made with the money collected from the investors. Instead of being paid out as distributions the profits were supposed to be reinvested. The earnings outlook was based on a multiplicity of these investments. If the initial movie productions flop though, there is no more money available for subsequent reinvestments and the entire earnings outlook fails.

Conclusion: Regardless of whether the Federal High Court of Justice as appellate instance upholds the ruling, banks and initiators of prospectuses should describe as clearly as possible tax risks, risk of loss and forecast. Particularly, catchwords such as "Guaranty Fund" should be avoided if there is in fact no guaranty.

Assignment of Loan Receivables

Federal High Court of Justice creates greater legal certainty with regard to the assignment of loan receivables

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In a decision on the assignment of loan receivables, the Federal High Court of Justice (Case XI ZR 256/10; BKR 2011, 327) ruled that the assignment to a non-bank does not breach Section 134 of the German Civil Code due to an alleged infringement of Section 32(1) sentence 1 of the German Banking Act, and is therefore not void. The Court hereby confirms its adjudication on the generally free assignment of loan receivables thereby enhancing legal certainty as assignments to non-banks are also effective.

In the case at issue, mortgage-backed receivables from a final maturity loan were together with its collateral assigned to a non-bank by the bank granting the loan. By bringing an action the borrower claimed repayment of interest paid to the defendant non-bank arguing that the assignment had been ineffective so that the non-bank had not been entitled to the interest.

The Decision

The Federal High Court of Justice dismissed the claim because the transfers of receivables and mortgages to the non-bank were effective. In this context, the question could be left open as to whether the sale and assignment of loan receivables actually constitutes a lending business that requires permission within pursuant to Section 1(1) sentence 2 no. 2 of the German Banking Act. According to the German Banking Act, the permission requirement is merely a commercial police regulation since the corresponding provisions are not intended to apply to both contractual parties. For this reason, even a loan agreement concluded without the necessary permission would be effective under civil law. Therefore, any infringement of the police law by the lender does not have an impact on the effectiveness of the transaction under civil law.

Furthermore, the Federal High Court of Justice made it clear that the assignment of a mortgage securing the loan is to take place according to the forms of transfer as set out in Sections 1154, 1192(1) of the German Civil Code. Beyond that it is not necessary for the effectiveness of the mortgage assignment that the assignee enters into the security contract between the assignor and the borrower.

Development of Jurisdiction

Based on a judgment of the Frankfurt Higher Regional Court in 2004 (Case 8 U 84/04; BKR 2004, 330), for years it has not been clear as to whether banks can assign their loan receivables to third parties. The Frankfurt Higher Regional Court had decided at that time that the assignment of loan repayment receivables is ineffective due to a violation of bank secrecy.

The Federal High Court of Justice ruled differently in a decision in 2007 (Case XI ZR 195/05, BKR 2007, 194) in which it set that neither the principle of bank secrecy nor the data protection law are opposed to the effective assignment of loan receivables.

In 2010, the Federal High Court of Justice (Case XI ZR 8009/09; NJW 2010, 2041) then strengthened the rights of lenders in that it decided that the assignee of a security mortgage could only act under a notarial declaration of submission when he enters into the security contract.

Conclusion: The Federal High Court of Justice has clarified that neither any infringements of bank secrecy nor the Federal Data Protection Act nor the German Banking Act in the course of the assignment of loan receivables do have any impact on the effectiveness of the assignment under civil law. Nevertheless, one should bear in mind that these infringements are sometimes subject to fines or criminal penalties and under certain circumstances they can lead to liability for damages. These may be avoided, however, through careful planning and contract design in the course of the spin-off or assignment of loan receivables.

BaFin sees Need for Improvement of Product Information Sheets

BaFin publishes results of a test of product information sheets

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Securities services companies are meanwhile required to provide their customers with short information sheets about their financial instruments. The German Federal Financial Supervisory Authority (BaFin) has now inspected the information sheets already produced by financial institutions thus far and sees substantial need for improvement.

The already existing duty of securities services companies to inform their customers sufficiently about the financial instruments and securities services offered by them has been expanded since July 1, 2011 by Section 31(3a) of the Securities Trading Act. Hereafter, the companies have to provide their customers in due time prior to the conclusion of the transaction with a short and easily understandable information sheet about the financial instrument to which the buy recommendation is related.

Requirements

The content-related and formal design is regulated in greater detail in the Ordinance specifying the Rules of Conduct and Organizational Requirements for Investment Service (Wertpapierdienstleistungs-, Verhaltens- und Organisations-Verordnung – WpDVerOV). The latter prescribes a maximum length of two to three letter-size pages, depending on the complexity of the respective financial instrument. With regards to content, the information must enable the customer in a clear and easily understandable manner to assess the nature of the recommended financial instrument, its mode of operation and the risks associated with it, the prospects for return of capital and earnings under different market conditions and the costs associated with the product as well as to compare it with other investment products, where necessary.

Findings of the Investigation

The BaFin has now conducted a random test of the product information sheets used by different institutions and has noted in many cases considerable deficiencies. The following problems were identified by the BaFin:

- Lack of Individualization
  Frequently, the actual costs of a product were not itemized, but only an abstract reference was made to the list of prices and services of the institution. In many cases, no product-specific description and no selection of the risks relevant to the product concerned were provided.

BaFin sees Need for Improvement of Product Information Sheets

- Lack of Comprehensibility
  Frequently, the wordings selected were abstract, superficial or hard to understand. At the same time, the BaFin criticizes particularly the use of abbreviations and undefined technical terms.
- Deficiencies with respect to Required Information
  In some cases, information was lacking on the term, market value, rate of return and currency.
- Impermissible Information
  According to the BaFin, exclusions of liability for the accuracy of the information in the information sheet are impermissible. Also, information on ratings should be avoided.

Conclusion: Therefore, the authors of such information sheets must particularly ensure that their product information sheets conform to the individual financial products and that they do not leave it at general descriptions; this applies particularly to the costs incurred and the resulting risks. Also, references to the list of prices and services as well as the inclusion of liability exclusions should be avoided.

New Requirements for the Qualification of Investment Advisors

Announcement of the Securities Trading Act Staff Notification Ordinance

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In the course of the financial market crisis, strengthening the protection of investors has become the central focus of legislators not least in order to reestablish the lost trust of investors. It is the new provision of Section 34d of the Securities Trading Act, that will enter into force on November 1, 2012, which shall serve to prevent alleged undesirable developments in the area of investment counseling in the future. Moreover, on December 30, 2011 the Securities Trading Act Staff Notification Ordinance was promulgated, which specifies the requirements that securities services companies will have to adhere to in the future while performing their duties as prescribed by Section 34d of the Securities Trading Act, and which is also to enter into force on November 1, 2012.

According to the assessment of the legislature, the recent past has shown that the investment counseling practice in retail banking is frequently featured by sales specifications, commission interests and a lack of expertise while the interests of the investor often tend to be ignored. By means of introducing qualification standards and strengthened supervision, such deficiencies are to be a thing of the past.

Set of Requirements

According to Section 34d of the Securities Trading Act, securities services companies will be required to notify their investment advisors, sales representatives and compliance officers to the Federal Financial Supervisory Authority (BaFin) and to report complaints about these individuals. The BaFin will make an electronic notification procedure available for this purpose. In addition, the notifiable employees shall meet certain qualifications and be able to prove their trustwothiness in order to be authorized to carry out their activities.

It is the Securities Trading Act Staff Notification Ordinance (WpHGMaAnzVO) that establishes in detail the requirements concerning the obligation of the company to notify and that provides for the necessary qualifications of the respective employees. For example, Section 1 of the Securities Trading Act Staff Notification Ordinance specifies that in the future employees in investment counseling will be required to have the necessary professional knowledge, including legal and financial expertise.

They shall also be able to apply their knowledge in practice. This is to be proved by means of appropriate professional qualifications. Furthermore, any complaints about certain employees from this field of activity shall be notified in a manner prescribed by the Ordinance.

Authority of the BaFin

The respective securities services company bears responsibility for the fulfillment of these duties and guaranties that the information is correct and up-to-date. The BaFin will be authorized to issue warnings, to impose fines or to prohibit the employment of certain employees.

Independent Investment Agents

In the course of its efforts to impose stricter regulation and supervision on the capital markets the legislator also alters the legal framework for the activities of independent investment agents. Indeed, at first sight the mere tightening of the obligation to obtain a permit according to Section 34f of the Trade, Commerce and Industry Regulation Act appears far less strict than the aforementioned Securities Trading Act Staff Notification Ordinance. Nevertheless, in the future they are also required to prove their expert knowledge, have an appropriate professional liability insurance and be registered with the Chamber of Industry and Commerce.

Conclusion: From November 2012 on, securities services companies are responsible for their employees having sufficient qualification in the areas of investment advice, sales and compliance. The obligation to notify and the qualification requirements to be adhered to from this point on are specified in the Securities Trading Act Staff Notification Ordinance.

Newsletter on OTC Derivatives

The Draft Regulation for the Regulation of the OTC Derivatives Market

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In the course of the financial crisis, unregulated markets for financial instruments have been increasingly regarded as a danger for the entire economy. Now the European Commission has drawn up a regulation for trading with OTC derivatives (Over-The-Counter), that shall extend supervision to this formerly unregulated market.

Background

After the G20 Member States had adopted a declaration on the regulation of the OTC derivatives market in September 2009 in Pittsburgh, the European Commission presented the draft of a regulation for the regulation of OTC derivatives, central counterparties, and trade repositories (European Market Infrastructure Regulation – EMIR). After months of negotiations, the EU Parliament and national governments agreed on February 10, 2012 on a final version, which however, still requires the formal approval by the Council and Parliament. On January 1, 2013, the law is to finally enter into force.

Overview of the Planned Changes

According to Article 1 (1) of the Draft Regulation, the focus of the regulation is on OTC derivatives contracts. Pursuant to the draft submitted, trading with such derivative financial instruments is to be subject to graduated regulation. The degree of regulation thereby depends on the type of financial instrument and the respective counterparty.

Basically, the introduction of authorized central counterparties (CCPs) is provided for, by means of which clearing of the OTC derivatives contracts is going to take place in the future. Instead of a bilateral contract between the parties of a derivatives contract, two separate contracts are then to be concluded with the CCP acting as a mediator, which on its part will demand guarantees from the contracting parties. In this way, the default of counterparties is supposed to be prevented.

However, according to the draft regulation, an obligation to clear shall be introduced only for standardized derivatives contracts as they can be evaluated rapidly and efficiently by the CCPs. In contrast, individualized contracts shall be exempted from the clearing-requirement. The European Securities and Markets Authority (ESMA) is going to decide what kind of derivatives contracts are to be regarded as standardized contracts, and will publish its decisions in a register. However, non-standardized

contracts are also supposed to be subject to tighter regulation specified in Article 8 of the Draft Regulation by means of which the default risk of a counterparty shall be reduced.

Furthermore, the counterparties are required to report the conclusion, the amendment and the termination of derivatives contracts to the central trade repository. According to the parliamentary draft, in addition to the responsible supervisory authorities, other public authorities may refer to the collected data of this register too if they require the data for the fulfillment of their duties and responsibilities.

Differentiation

According to the draft regulation, the highest degree of regulation is going to be applied to "financial counterparties". Basically, the latter must have all qualified derivatives contracts handled by a CCP, in case of non-qualified contracts they must comply with the requirements set out in Article 8 of the Draft Regulation and must report all transactions to a register. Among others, securities firms, credit institutions, insurance companies and investment firms fall under the term "financial counterparty".

In contrast, "non-financial counterparties" are only required to clear when derivatives positions held by them exceed specified volume limits still to be drawn up by the ESMA. As far as the reporting requirements to be complied with by the non-financial counterparties are concerned, the draft submitted by the Commission and the one submitted by the Parliament differ. While the Commission wants to make a reporting requirement dependent on exceeding the volume limits, the draft of the Parliament provides for a reporting requirement for all derivatives.

Conclusion: Regardless of the precise wording of the final version of the regulation, it is has become already clear that at the end of 2012 unregulated trading of over-the-counter derivatives will be a thing of the past. In particular, financial institutions must then prepare to be subject to extensive reporting requirements and they have to endeavor to participate in a CCP. Expenditures and costs for transactions are thereby likely to increase.

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This Newsletter does not contain legal advice. The information included has been carefully researched. However, they only reflect excerpts of case-law and legal development and cannot replace individual legal advice taking into account the particularities of the individual case.

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