ФИНАНСИЈСКА ТРЖИШТА

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LEHMAN, THE FINANCIAL CRISIS AND THE LAW: LITIGATING AND REGULATING STRUCTURED PRODUCTS

Summary

The Lehman financial conglomerate had engaged in extensive securitisation programmes, selling structured products to financial institutions and mass retail investors. When its holding company collapsed, governments rushed to save banks of systemic importance. Private purchasers of Lehman-backed structured products were disappointed to realise that help was less readily available to them. The end of the Lehman group challenges the belief that private ordering in the finance industry, reputation mechanisms and ex-post private law enforcement through courts are good substitutes for regulatory action. This paper takes a typological approach, assessing the fate of Lehman investors in four European jurisdictions (France, the United Kingdom, Switzerland and Germany) which have varying policy preferences for administrative action, alternative dispute resolution under reputational constraints, and litigation.

Key words: *securitisation, investor protection, capital market regulation.*

I Introduction

1. The Ingredients of a Crisis

Lehman Brothers was a financial conglomerate of 2,985 entities globally, offering structured products and cross-border services in many jurisdictions, some regulated and other unregulated[1]. On 15 September 2008, Lehman Brothers Holding Inc. (LBHI) filed for protection under chapter 11 of the US Bankruptcy Code, triggering the largest bankruptcy in US history[2]. A global banking crisis unfolded, prompting Governments to save banks of systemic importance[3]. On 12 October 2008, the Heads of State and Government of the Euro Area Countries issued a Declaration on a Concerted European Action Plan: The European Union (EU), Euro area governments, central banks and supervisors pledged to pursue a coordinated approach to address funding problems of liquidity-constrained solvent banks and to provide financial institutions with additional capital resources to maintain proper financing of the economy[4]. Since the October 2008 summit, the Member States of the European Union have implemented a massive array of national rescue measures[5].

According to the 2009 report of the Committee of the European Securities Regulators (CESR), market concerns about capital adequacy accelerated LBHI's demise[6]. Recently, an examiner appointed by the US Bankruptcy Court for the Southern District of New York determined that LBHI had pursued an accounting strategy to shield its liquidity problems from public scrutiny[7]. The collapse of the group has given rise to substantial litigation,

1 Cf. Committee of European Securities Regulators (CESR), The Lehman Brothers default: an assessment of the market impact, Paris, 23 March 2009 (Ref.: CESR/09-255).

2 For an insider's account on the sequence of events leading to the chapter 11 petition: *Tibman*, The Murder of Lehman Brothers – An Insider's Look at the Global Meltdown (2009), 177 et seq.

3 CESR, The Lehman Brothers default, supra N. 1, p. 2.

4 For an English version of the summit declaration see the website of the Portuguese government at *http://www.portugal.gov.pt/en/Documentos/Decla_Zona_Euro_12_10_08.pfd*, or the press release of the full text, published at: *http://www.reuters.com/article/usDollarRpt/idUSLC6791120081012*.

5 For a survey see: *Petrovic/Tutsch*, National Rescue Measures in Response to the Current Financial Crisis, European Central Bank Legal Working Paper Series No. 8/July 2009. Germany's crisis management has focused on state-owned banks and on solvency problems of private banks with systemic importance: cf. *Annoff*, Verstaatlichung systemrelevanter Banken gut begründet, Börsen-Zeitung, 29 April 2009.

6 CESR, The Lehman Brothers default, supra N. 1, p. 2.

7 In re Lehman Brothers Holdings, Inc. et. al., Report of the Examiner, Vol. I. p. 17 et seq., 150 et seq. (Bkrtcy. S.D.N.Y., 11 March 2010).

complicated by complex private international problems[8] and a debate on the liability of financial intermediaries. The end of Lehman Brothers challenges the belief that private ordering in the financial industry[9], reputation mechanisms and *ex post* private law enforcement through courts are good substitutes for regulatory action[10].

Lehman Brothers had significant mortgage businesses in the US and the United Kingdom (UK)[11]. In order to maintain an adequate level of liquidity, Lehman's business strategies were dictated by the economics of securitisation. It was a firm with short and long-term intangible assets, such as accounts receivable or instalment loans (with Lehman as the lender), and had an interest in converting their collateral value into immediate liquidity[12]. By turning the receivables and the instalments into cash Lehman could enjoy the economic use of its assets prior to their maturity. To ensure access to the public credit markets special purpose vehicles were established which purchased the receivables or other illiquid assets from the original lender (the 'originator', i.e. Lehman)[13]. Although created by the originator the special purpose vehicle is a separate legal entity[14]. This special purpose vehicle issues its own securities

8 This may also include potentially conflicting proceedings in various jurisdictions. See the discussion in: In re Lehman Brothers Holdings Inc., et al. v. BNY Corporate Trustee Services Limited, 422 B.R. 407 (410 et seq.) (Bkrtcy. S.D.N.Y., 2010), and in: *Fleming*, After the storm, Europ. Lawyer 91 (2009), 10 et seq.

9 Cf. *Quinn*, The Failure of Private Ordering and the Financial Crisis of 2008, N.Y.U.J.L. & Bus. 41 (2009) 549 et seq.

10 Cf. Council of the European Union, Council conclusions on Packaged Retail Investment Products, 2948th Economic and Financial Affairs Council, Luxembourg, 9 June 2009:
"The Council
-notes that legal requirements on product transparency, sales and advice for retail investment products differ according to the legal form of the product and the distribution channel, as well as across Member States, which may hamper the functioning and development of the Internal Market; ...
-welcomes the publication of the Commission's study of credit intermediaries (...); and invites in that respect the Commission to further analyse whether the distribution of other substitute retail financial products as well as credit instruments offered to consumers, such as consumer credits and mortgages, should be covered by further appropriate regulatory measures to ensure consumer protection, address possible market failures and mitigate financial stability risks."

11 CESR, The Lehman Brothers default, supra N. 1, p. 2.

12 Cf. *Bratton*, Corporate Finance (6th ed. 2008), 287 et seq.

13 Cf. Gariety v. Grant Thornton, LLP, 368 F. 3d 356 (359) (4th Cir., 2004); Aurora Loan Services; LCC, v. Dream House Mortgage Corporation, 2010 WL 678131 (D.R.I., 2010); Lehman Brothers Holdings v. First Financial Lender, 2010 WL 1037950 (N.D. Cal., 2010); In re Lehman Brothers Securities and ERISA Litigation, 2010 WL 337997 (S.D.N.Y., 2010).

14 The special purpose vehicle may take the form of common law trust where the trustee distributes the cash flow generated by the pool of assets: In re Lehman Brothers and

which are 'asset-backed' since they build on the cash flows generated by the originator's former receivables[15]. A special purpose vehicle may re-package the originator's former assets, by issuing securities representing a mix of risky and less risky assets[16]. Conversely, the risk characteristics of the asset-backed securities may differ substantially from the underlying receivables[17].

Lehman's special purpose vehicles issued certificates and warrants for which the underlying risks had been repackaged[18]. As such, they were linked to an index or an asset class for a fixed period of time, using derivatives to provide a return based on the performance of the asset (structured products). Under some schemes LBHI would guarantee the return of the capital at maturity[19]. Sometimes LBHI would only have to honour its repayment guarantee if the index had exceeded a pre-determined threshold. As a corollary to its securitisation programme, Lehman insured its payment risks by entering into credit default swap transactions with financial institutions[20], including European banks and hedge funds. As LBHI broke down, the entire structure of its special purpose vehicles unravelled[21]. The value of the warrants and certificates evaporated, leaving many investors with a remote chance of recovering their initial capital.

ERISA Litigation, 2010 WL 337997 (S.D.N.Y., 2010); *Coughlin/Peabody*, Caught in the Cross-Fire: Securitization Trustees and Litigation During the Subprime Crisis, 917 PLI/Comm 515 (518 et seq.) (2009); *Walters*, Lehman Brothers and the British Eagle Principle, Comp. L. 31 (3) (2010), 65.

15 *Bratton*, supra N. 12, 288.

16 Cf. Trust for the Certificate Holders of the Merrill Lynch Mortg. Investors, Inc. Mortg. Pass-Through Certificates, Series 1999-C1, ex rel. Orix Capital Markets, LLC v. Love Funding Corp., 556 F. 3d 100 (104) (2nd Cir., 2009); Plumbers & Steamfitters Local 773 Pension Fund v. Canadian Imperial Bank of Commerce et al., 2010 WL 961596 (S.D.N.Y., 2010).

17 *Bratton*, supra N. 12, 288. For a comprehensive account on securitization practices, see: *Wilmarth*, The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis, Conn. L. Rev. 41 (2009), 963 (985 et seq.).

18 In re Lehman Brothers Securities and ERISA Litigation, 2010 WL 337997 (S.D.N.Y., 2010).

19 See the joint information provided by the United Kingdom Financial Services Authority, the Financial Ombudsman Service and the Office of Fair Trading, Case Studies WI-A13, Lehman-backed structured products, available at *http://www.widerimplications.info/case_studies/wi_13.html*.

20 See infra, sub II. On the economics underlying swap transactions: *Bratton*, supra, N 12, at p. 159 et seq.

21 Cf. the liquidation of Lehman Brothers (Luxembourg) S.A. subsequent to the bankruptcy of LBHI: Judgement of the Tribunal d'arrondissement de et à Luxembourg, 2e chambre, siégeant en matière commerciale, of 1 April 2009, in: OJ C 125/18 of 5 June 2009 (Extract from the Decision concerning Lehman Brothers (Luxembourg) S.A. pursuant to the Directive 2001/24/EC of the European Parliament and of the Council on the reorganisation and winding-up of credit institutions (2009/C 125/07) and the facts in In Re Lehman Brothers International (Europe) (In Administration) (No.2), [2009] EWCA Civ. 1161 (C.A. Civ., 2009).

2. The Economics of Lehman's Securitisation Programme

Lehman used several distribution channels to market financial products. Some of its derivative securities, other securities and guarantees were not registered under the relevant US securities legislation or under the US rules on trading in commodity futures, respectively[22]. Instead, they were targeted at non-US investors. Dutch, Luxembourg and Netherlands Antilles subsidiaries operated as issuers of financial products guaranteed by LBHI New York. Lehman Brothers Treasury Co. B.V. (Amsterdam) offered unsecured notes guaranteed by LBHI New York[23]. Lehman Brothers Securities N.V. (Netherlands Antilles) and Lehman Brothers (Luxembourg) Equity Finance S.A.[24] acted as special purpose vehicles for LBHI (New York), offering a Warrant and Certificate Programme which was targeted at retail investors[25]. Although each special purpose vehicle was legally independent and registered in a different jurisdiction, it was the strategy of the Lehman group to integrate its subsidiaries into the conglomerate financing structure[26]. Lehman had established a policy that each special purpose vehicle should hedge its obligations by offsetting derivatives with other Lehman Brothers companies, principally Lehman Brothers Finance S.A[27]. The upshot of this hedging mechanism is that the issuer's obligation to perform (a duty owed to the purchasers of structured products) would be affected by disturbances occurring elsewhere in the Lehman group[28].

Securitisation is intended to address problems of uncertainty and bounded rationality. Contrary to the theory of the firm (as promulgated by Coase)[29],

22 See Basic Prospectus relating to Derivative Securities of 30 August 2006 filed with the German BaFin by Lehman Brothers Securities N.V. and Lehman Brothers (Luxembourg) Equity Finance S.A. (Warrant and Certificate Programme Unconditionally and Irrevocably By Lehman Brothers Holdings Inc.), and Basic Prospectus relating to Principal Protected Notes and Derivative Notes of 30 August 2006 filed with the German BaFin by Lehman Brothers Treasury B.V. Amsterdam (Note Issuance Programme Unconditionally and Irrevocably Guaranteed by Lehman Brothers Holdings Inc.).

23 Basic Prospectus of 30 August 2006 filed by Lehman Brothers Treasury Co. B.V.supra N. 22.

24 Registration Document of 30 August 2006 filed with the German BaFin by Lehman Brothers (Luxembourg) Equity Finance S.A.

25 Basic Prospectus of 30 August 2006 filed by Lehman Brothers Securities N.V. and Lehman Brothers (Luxembourg) Equity Finance S.A., supra N. 22.

26 Cf. *Walters*, supra N. 14, Comp. L. 31 (3) (2010), 65 et seq.

27 Registration Document of 30 August 2006 filed with the German BaFin by Lehman Brothers Securities N.V. See also, *Walters*, supra, N. 14, Comp. L. 31 (3) (2010), 65.

28 The market risks associated with indexed financial instruments are magnified if the guarantor holding company is faced with a combination of inadequate capital and liquidity problems: cf. Senior Supervisors Group, Risk Management Lessons from the Global Banking Crisis of 2008 (21 October 2009), at: *http://www.ny.frb.org/newsevents/news/banking/2009/SSG_report.pdf*.

29 *Coase*, The Nature of the Firm, Economica New Series IV (16) (1937, 386 (at 390 et seq.); *id*., The Nature of the Firm: Influence, J. L. Econ. & Org. 4 (1988), 33 (at p. 38 et seq.).

securitisation reduces credit risk by externalising and spreading it on the market[30]. However, firms which had integrated exposure across businesses for both market and counterparty risk management fared much better during the financial crisis[31]. Although Lehman subsidiaries and special purpose vehicles were integrated into the hedging structure of the conglomerate, this was not an internalisation of market processes. Instead, the group attempted to reap the benefits of its securitisation schemes without increasing investor protection. Theoretically, it is for the market to rate the risk associated with various asset-backed securities and structured financial products. But securitisation and structured finance techniques create specific adverse selection problems when the originator of an asset-backed security has more information *ex ante* than the retailer or the ultimate investor[32]. Neither Lehman nor its special purpose vehicles had an incentive to internalise information asymmetries[33]. Moreover, there are 'long-distance' repercussions of these informational problems. Although fully informed in accordance with current disclosure rules (EU and national), retail investors may not be aware of risk associated with structured financial products as crucial internal information was not passed on to them. On a macro-level, this begs the question whether the financial systems is well prepared to absorb shocks like the one triggered by the collapse of the Lehman group[34].

3. A Case for Regulatory Action?

Structured products such as those offered under the Lehman warrant and certificate programmes are governed by the EU's prospectus[35] and the market in financial instruments (MiFID)[36]directives[37].[37]The Council direc-

30 Cf. *Richter*, Entrepreneurs as Surrogate Forward Traders of Goods and Services – Seen from the Viewpoint of New Institutional Economics, Eur. Bus. Org. L. Rev. (EBOR) 11(2) (2010), forthcoming.

31 Senior Supervisors Group, Observations on Risk Management Practices during the Recent Market Turbulence (6 March 2008), at *http://www.ny.frb.org/newsevents/news/banking/2008/SSG_Risk_Mgt_doc_final.pdf*.

32 *Quinn*, supra N. 9, N.Y.U.J.L. & Bus. 41 (2009) 549 et seq. Cf. Autorité des Marchés Financiers (France), AMF's answer to the European Commission in relation to the European Commission's call for evidence on substitute investment products, Paris, 28 January 2008.

33 Cf. *Kiff/Michaud/Mitchell*, Une revue analytique des instruments de transfert du risque du crédit, Banque de France, RSF June 2003, 110 (128 et seq.).

34 Cf. *Kiff/Michaud/Mitchell*, supra, N. 33, Banque de France, RSF June 2003, 110 (128 et seq.).

35 Directive 2003/71/EC of the European Parliament and of the Council of 4 November 2003 on the prospectus to be published when the securities are offered to the public or admitted to trading and amending Directive 2001/34/EC, OJ L 345/64 of 31 December 2003.

36 Directive 2004/39/EC of the European Parliament and the Council of 21 April 2004 on markets in financial instruments, OJ L 145/1 of 30 April 2004.

37 Cf. Commission of the European Communities, Communication from the Commission to the European Parliament and Council – Packaged Retail Investment Products, Brussels 30 April 2009 (COM(2009) 204 final.

tive on investment services is applicable to financial intermediaries and banks selling financial products to retail investors[38]. Lehman's European business activities took place under the auspices of national securities regulators. LBHI and its subsidiaries had complied with Member State Law implementing the EU Prospectus Directive and submitted prospectuses for clearance.

Historically, banks, financial institutions such as funds, and wealthy investors were the main purchasers of structured financial products[39]. But asset securitisation and repackaging of financial products has ushered in the advent of retail investors. In the aftermath of the Lehman collapse the European Commission criticised the 'regulatory patchwork' which covers packaged retail investment products under Community law[40]. However, a comprehensive EU regulatory approach is complicated by the segmentation of retail financial services along national lines[41]. In the Member States different marketing patterns and policy responses towards structured financial products persist. French authorities have undertaken some administrative measures. Apart from Germany, there is very little private litigation against banks which sold or distributed Lehman-backed products. In the UK and Switzerland, private mass retail investors filed complaints with an ombudsman.

This paper takes a typological approach, assessing four European jurisdictions with varying preferences for administrative action, alternative dispute resolution under reputational constraints, and litigation[42]. Ultimately, the question is whether the predicament of Lehman-backed structured products and their purchasers has established a case for specific EU legislation on selling and distributing packaged retail investment products. This would also

38 Council Directive 92/33/EEC of 10 May 1993 on investment services in the securities field, OJ L 141/27 of 11 June 1993.

39 Cf. *Blundell-Wignall*, An Overview of Hedge Funds and Structured Products: Issues in Leverage and Risk, Financial Market 92 (1) (2007), 37 (44): "Passive buyers of puts, including investment banks buying for capital guarantee purposes in structured products, benefit from spread narrowing in pricing their products for retail, private banking and institutional clients..."

40 Commission of the European Communities, Packaged Retail Investment Products, supra N. 37. For a Swiss perspective see the case study on Lehman products and related regulatory policy challenges by the Swiss Financial Market Supervisory Authority FINMA, Madoff-Betrug und Vertrieb von Lehman-Produkten: Auswirkungen auf das Anlageberatungs– und Vermögensverwaltungsgeschäft, Bern 2 March 2009, p. 15 et seq. (available at *http://www.finma.ch*).

41 *Moloney*, EC Securities Regulation (2nd ed. 2008), 551.

42 For a survey of regulatory approaches towards retail products from a global perspective: *Bates*, Regulatory Review September 2009: Global Themes and Challenges in Financial Regulation, 1783 PLI/Corp 93 (100 et seq.) (2010), 1783 PLI/Corp 93 (100 et seq.) (2010). Hong Kong regulators, e.g., persuaded banks which had sold Lehman's mini-bonds to buy back outstanding mini-bonds from willing investors for between 65% and 70% of their nominal value with possible additional payments received by the banks through the insolvency proceedings, *ibid.*

imply that regulation through litigation[43] or alternative dispute settlement resolution from an *ex post* perspective do not outweigh the benefits of an *ex ante* regime of mandatory rules[44].

II Lehman's Structured Products in European Jurisdictions

As Lehman fell, diverse groups of victims voiced concerns. Financial institutions such as hedge funds had placed deposits with Lehman Brothers as part of their business relationship. These deposits were frozen as soon as bankruptcy proceedings commenced. Banks faced similar problems as counterparties to credit swap agreements which Lehman had concluded to insure its obligations under the structured products deals. A settlement with the Lehman administrator was reached, releasing some of the funds previously deposited with the investment bank[45]. Private mass retail investors have been more fortunate in Switzerland where Crédit Suisse and other banks implemented compensation schemes[46]. In the UK, investors have been urged to seek redress through alternative dispute settlement. German banks, which had sold Lehman-backed structured products to consumer-investors, were less conciliatory. In order to recoup some of their investments, German buyers of Lehman certificates have been very active in suing financial intermediaries. There are a substantial number of lower court judgements which attempt to address moral hazard problems from an *ex post* perspective.

1. France

a) Market Structure and Regulatory Policies

In 2007, French per-capita sales of structured products were less than 10 % of the Swiss trading volume in structured products, and slightly more

43 See the title of the book by *Viscusi* (ed.), Regulation through Litigation, AEI-Brookings Joint Center for Regulatory Studies, Washington, D.C. (2002).

44 Cf. on risks of investor detriment: European Commission, Impact Assessment, Commission Staff Working Document Accompanying the Communication from the Commission to the European Parliament and the Council, Packaged Retail Investment Products, Brussels, 30 April 2009 (SEC(2009) 556), p. 12 et seq.

45 Reuters, Business & Financial News, Breaking US & International News, 15 July 2009, Lehman's Europe administrators set repayment plan – WSJ (*http://www.reuters.com/assets/print?aid=USBNG43783820090715)*; NZZ Online, 29 December 2009, Lehman-Geschädigte bekommen 11 Milliarden Dollar, available at *http://www.nzz.ch/nachrichten/schweiz/lehman-geschaedigte_bekommen_11_milliarden_dollar_1.4394757html*; see also the facts of In re Lehman Brothers Holding Inc. v. BNY Corporate Trustee Services Limited, 422 B.R. 407 (413 et seq.) (Bkrtcy. S.D.N.Y., 2010).

46 See infra, sub II.3.a.

than one third of comparable German transactions[47]. Although French banks have attempted to make major inroads into private retail investing, the traditional patterns for retail investment persist: Financial institution and wealthy investors are the main purchasers of structured products. Industry representatives describe the French market in retail structured products as very mature[48]. Unlike some other European countries, France has opted for sector-wise approach of oversight, leaving the French Autorité de Marchés Financiers (AMF) with no overall supervision of banking products and services and life insurance contracts[49]. Prior to the collapse of Lehman, it was standard French regulatory practice to rely on internal controls by institutional investors and wealthy individuals who were thought to be knowledgeable enough to negotiate for adequate protection when investing in innovative financial products. As the financial crisis accelerated[50], the AMF stepped up its regulatory controls, imposing fines on banking agencies for distributing securities without sufficient information[51] and on a fund management company with unconvincing governance structures[52]. The AMF exercised its statutory powers to strengthen the financial structure of some investment funds[53].

47 Financial Times, 26 May 2008, *Johnson*, UK takes shine to structured products.

48 *Benson*, Market View: Igniting growth in a mature market, 1 July 2006, at: *http://www.risk.net/structured-products/feature/1528305/market-view-igniting-growth-mature-market*; cf. the Governor of the Banque de France and Chairman of the Commission Bancaire *Noyer*, Presentation of the Annual Report 2008 of the Commission Bancaire, Paris, Banque de France, 26 June 2009.

49 Inspection générale de Finances, Rapport de la Mission de Réflexion et de Propositions sur l'Organisation de le Fonctionnement de la Supervision des Activités Financières en France (Établi par Bruno Deletré – (Rapport Deletré I) (Paris, January 2009), at p. 13 et seq.; AMF on substitute investment products, supra N. 32, p. 1.

50 Cf. on the French impact of the Lehman collapse: *Prüm*, Faillite de Lehman Brothers, les dépositaires d'OPCVM sous pression, Revue de Droit Bancaire et Financier, Mai-Juin 2009, 2 et seq.; *Casal Flottes*, Asset management – Les Dommages collatéraux de Lehman Brothers, Finance Option – 22/28 Septembre 2008, at p. 3 et seq.; *Henry,* France: The Impact of Lehman, IFLR 1 June 2009, at *http://www.iflr.com/Article/2213376/France-The-impact-of-Lehman.html*.

51 AMF, Rapport Annuel 2008, Chapitre 6, Les décisions de la Commission des sanctions publiéés en 2008, at p. 213 et seq. (Paris 2009), at http://www.amf-france.org/documents/general/8989_1.pdf. See also report by *Herbert Smith/Gleiss Lutz/Stibbe*, A changing landscape – Regulatory developments in the distribution of retail investment products – UK, France, Germany, Spain, Netherlands, UAE and Hong Kong (2010), at p. 9 et seq.

52 AMF, Décision de la Commission des sanctions à l'égard de la Société Oddo Asset Management du 18 juin 2009, at *http://www.amf-france.org/documents/general/9046_1.pdf*.

53 See AMF, Cartographie 2009 des Risques et des Tendances sur les Marchés et pour l'Épargne – Risques et tendances n° 8 (Paris, June 2009), p. 78 et seq.; for a general assessment of the situation of the French banking and financial system after the Lehman bankruptcy: Annual Report of the Commission Bancaire 2008 (Paris 2009), p. 13 et seq.

Although France implemented the capital market and financial services directives, its current regulatory regime of *ex ante*-controls and oversight has been found to be deficient. A report commissioned by the Ministry of Finance proposes more stringent controls of banks and financial intermediaries with respect to their discharge of professional duties towards investors[54]. In its policy recommendations on structured investment, the AMF acknowledges the competitive impact of retail investment products[55]. This should, however, not affect the transparency of the credit market. The AMF warns of a potential conflict of interests between the originator of the financial product and the intermediaries and between intermediaries and the ultimate investor-client[56]. Similar to transparency on secondary markets for listed products, post-trading efficiency would be greatly enhanced by regulatory clarification of the duty to be transparent[57]. In June 2009, the AMF published a strategic plan, redefining its oversight priorities. The AMF's policy statement explicitly acknowledges that retail investors pursue portfolio strategies typical of depositors with a savings account[58].

b) Private Law Aspects

The current structure of the French market has important consequences for a private law approach towards the repercussions of the collapse of Lehman. French private law recognises a duty to provide clients with adequate information at the right time (*obligation de conseil*)[59]. This would require a delicate assessment whether the standards of professional advice vary according to the investor's expertise and the amount of money invested. Banks recognise a duty to assess the background of a potential investor in a suitability test in order to ascertain the amount information owed to a client[60]. If an in-

54 Inspection générale de Finances, Rapport de la Mission de Conseil sur le Contrôle du Respect des Obligation Professionnelles à l'égard de la Clientèle dans le Secteur Financier, (Établi par Bruno Deletré – (Rapport Deletré II) (Paris, July 2009), at p. 23 et seq., at http://lesrapports.ladocumentationfrancaise.fr/BRP/094000591/0000.pdf.

55 AMF on substitute investment products, supra N. 32, 1.

56 AMF on substitute investment products, supra N. 32, at p. 9 et seq.

57 *Jouyet*, The future of financial regulation, Banque de France, Financial Stability Review 13 (September 2009), 89 (92 et seq.).

58 AMF, Plan stratégique de l'Autorité des marchés financiers (Paris 29 June 2009), p. 1 et seq., at *http://www.amf-france.org/documents/general/8983_1.pdf*.

59 See the practical implications of this approach for the day-to-day management of the bank-client relationship *Deloitte*, Ouverture sur les enjeux de las gestion privée en France – S'adapter dans un environnement en mutation, Étude Deloitte Conseil (Paris September 2009), 31 et seq.

60 *Piccarrougne/Doron/Duroyon*, Le contexte réglementaire et fiscal européen pour la banque privée, Horizons Bancaires – Numéro 333 – Septembre 2007, 35 (at 39 et seq.).

vestment fund lost money on structured financial products, this provokes the question to what extent the fund management or its representatives may be held liable by investors. Under current French investment law, the rules of the fund may provide for a limitation of liability towards investors. But it appears that French courts are beginning to question the scope of this exemption[61]. Ultimately, this will result in closer inspection to what extent due diligence procedures and internal control mechanisms were observed.

2. United Kingdom

a) The Financial Services Authority (FSA) and Lehman

At the time of the collapse of the Lehman group over 5,000 retail investors had invested a total of UK £ 107m in structured investment products backed by a Lehman guarantee[62]. The FSA initiated an investigation in order to assess the quality of advice afforded by financial intermediaries to retail investors[63]. The FSA analysed key documentation data of a sample of 11 firms, conducted interviews with relevant firm personnel and assessed the files of 157 customers who had bought Lehman-backed structured investment products between November 2007 and August 2008[64]. Advice given by the financial intermediary was unsuitable if the customer had been recommended a product ill-matched with their financial circumstances or the investment time scale[65]. Moreover, professional advice was classified as unsuitable if it disregarded customers' risk preferences, did not assure an appropriate level of diversification in the individual investment portfolios or disregarded specific tax needs[66]. The FSA investigation extended to the suitability of disclosure to adequately alert the customer to the risks of structured investment products (including the disclosure of counterparty risk).

61 Cf. *Prüm*, supra, N., Revue de Droit Bancaire et Financier, Mai-Juin 2009, at p. 2 et seq.; *Storck/Riassetto*, Cour d'appel de Paris de 26 mars 2009, Note (Gestion individuelle – Responsabilité civile du gestionnaire de portefeuille), Revue de Droit Bancaire et Financier 10 (5) (2009), 44 et seq.

62 FSA Press Release of 27 October 2009, FSA's investigation into the impact of Lehman's collapse on the UK structured investment product market – review of findings, available at *http://www.fsa.gov.uk* (FSA website).

63 As early as 2004, the FSA had issued a fact sheet warning mass retail investors about the dangers of purchasing capital-at-risk products: FSA Factsheet, Capital-at-risk products (London 2004), at: *http://www.moneymadeclear.fsa.gov.uk/pdfs/capital_risk.pdf*.

64 FSA, Quality of advice on structured investment products, London, October 2009, at p. 6.

65 FSA, Quality of advice, supra N. 64, at p. 7.

66 FSA, Quality of advice, supra N. 64, at p. 7.

The FSA also scrutinised the quality of internal governance mechanisms to supply advisors with adequate information on the respective financial product recommended to the customer[67]. This included the quality of compliance, monitoring and oversight arrangements and advisors' understanding of the intricacies of the structured investment products. The FSA's findings are sobering. Although most firms had performed an acceptable analysis of customers' needs and circumstances, customers were exposed to an inappropriate level of risk in a substantial number of cases (43% of all files reviewed)[68]. Disclosure by advisors was generally found to be deficient with respect to specificities of the product recommended and the counterparty risk[69]. The results on internal governance mechanisms and quality controls were mixed. Even after the collapse of Lehman Brothers most investment firms failed to substantially mitigate the risk of providing unprofessional advice[70]. The results of its review prompted the FSA to clarify the standards for a professional quality assessment of structured investment products[71]. A note to the FSA's regulatory guide on responsibilities of providers and distributors for the fair treatment of customers was published, urging the industry to improve due diligence procedures with respect to credit providers and distributions channels and to assume post-sale responsibility towards their customers[72]. The FSA has made it clear that it will insist on improving standards for structured investment products. In February 2010, the FSA imposed a fine of £ 700,000 on a financial intermediary who had failed to adequately advise on investment, credit and liquidity risks associated with Lehman-backed structured products[73]. The FSA was also highly critical of internal risk management systems which had failed to channel relevant financial information to the individual advisor[74].

b) Alternative Dispute Resolution

Litigation in the UK is costly, and retail investors appear to shy away from suing financial intermediaries as long as law on retail investor claims is

67 FSA, Quality of advice, supra N. 64, at p. 7.

68 FSA, Quality of advice, supra N. 64, at p. 10.

69 FSA, Quality of advice, supra N. 64, at p. 15.

70 FSA, Quality of advice, supra N. 64, at p. 19.

71 FSA, Using the FSA's structured investment advice suitability assessment template, London, October 2009.

72 FSA, Treating customers fairly – structured investment products, London, October 2009.

73 FSA, Final Notice to RSM Tenon Financial Services Limited of 24 February 2010 and FSA Press Release of 25 February 2010, FSA fines national financial advice firm £ 700,000 for failings relating to Lehman-backed structured product sales (FSA/035/2010), both documents available at the FSA website (*http://www.fsa.gov.uk*).

74 FSA, Final Notice to RSM Tenon Financial Services Limited, supra, N. 73.

unclear[75]. Instead, purchasers of Lehman's structured products have turned to the Financial Ombudsman Service to settle their claims against financial institutions[76]. The Financial Ombudsman Service is a statutory dispute resolution scheme established under the Financial Services and Markets Act 2000[77] and the Consumer Credit Act 2006[78]. There are no empirical data available on how and whether claims related to Lehman-backed structured products were settled. However, both the Financial Ombudsman Service and the FSA recognise the regulatory challenge emanating from Lehman's collapse for the UK structured investment product market[79].

The current UK regulatory approach towards Lehman-backed structured investment products creates two classes of investors. Retail investors who bought Lehman-backed securities from financial intermediaries which are still operative will have to rely on the Financial Ombudsman Service to negotiate a settlement of their claims through alternative dispute settlement mechanisms. However, if a financial intermediary has gone into administration under insolvency law, the investor is entitled to compensation under the Financial Compensation Scheme (FSCS)[80]. FSCS was established by the Financial Services and Markets Act 2000[81]. FSCS is funded by levies on author-

75 This may, however, change after investors have come to realise that they have been misled about Lehman's financial state by, *inter alia*, expert opinions on English law: *Hollander*, Linklaters 'could face litigation' over explosive Lehman report, The Lawyer, 15 March 2010, at: *http://www.thelawyer.com/linklaters-%E2%80%98could-face-litigation%E2%80%99-over-explosive-lehman-report/1003768.article*; and *Frean*, Linklaters and Ernst & Young face action over Lehman Brothers collapse, Times online, 13 March 2010, at: *http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article7060424.ece*. See generally on the UK enforcement of securities laws regulating public issues and admissions to trading: *Ferran*, Principles of Corporate Finance Law (2008), 444 et seq.

76 See Financial Ombudsman Service Limited, Summary Minutes of the meeting of directors on 13 March 2009 and on 20 May 2009, and *Herbst*, UK litigation over mis-selling is a different ballgame to the US, The Daily Telegraph on line, 3 October 2009, at *http://www.telegraph.co.uk/finance/comment/6258274/UK-litigation-over-financial-mis-selling-is-a-different-ballgame-to-the-US.html*.

77 S. 225 et seq. of the Financial Services and Markets Act (FSMA) (ch. 8).

78 S. 59 et seq. of the Consumer Credit Act 2006 (ch. 14)

79 Cf. FSA Press Communications of 7 May 2009 (Wider Implications referral: Lehman-backed structured products), 14 August 2009 (Wider Implications referral: Lehman-backed structured products – update) and 11 September 2009 (FSA update on Lehmans-backed structured products), available at *http://www.fsa.gov.uk* (FSA website).

80 See FSA Press Releases of 27 October 2009, FSA takes action to help investors with Lehman-backed structured products (FSA/PN/144/2009), and of 29 October 2009, Lehman-backed structured products – update, and available at the FSA website (*http://www.fsa.gov.uk*); cf. FSA, Consumer awareness of the Financial Services Compensation Scheme – Consumer Research 75 (January 2009).

81 S. 212 et seq. of the FSMA (ch. 8).

ised investment firms, and the maximum compensation for lost investments is £ 50,000 per person per firm[82].

3. Switzerland

a) Conciliatory Banks and the Banking Ombudsman

When the Lehman group collapsed it had 83 different financial products outstanding on the Swiss market[83]. 46 of these products were capital-protected. The remainder included participation (11), yield enhancement (23) and other products (3)[84]. Banks which had marketed Lehman's products were quick to deny any liability to their clients as they had acted as mere intermediaries[85]. In the end, reputation mechanisms proved to be too powerful: Swiss banks paid compensation to private investors, yielding to a combination of administrative suasion[86], public criticism and alternative dispute resolution[87]. There had been incidences where a Swiss bank would emphasise that Lehman's structured products were guaranteed, thereby insinuating that investors were well shielded against loss of principal[88]. Crédit Suisse compensated non-institutional investors who had bought Lehman's structured products[89].

82 FSCS Compensation Scheme, Compensation Limits (as per 1 January 2010), at: *http://www.fscs.org.uk/what-we-cover/eligibility-rules/compensation-limits/*; See also the policy analysis in the government report for the States of Jersey, Lodged au Greffe on 19 September 2008 on the desirability of introducing a Financial Compensation Scheme for Jersey, available at *http://www.statesassembly.je/documents/propositions/42478-40228-1992008.htm*.

83 For a survey of the sequence of the financial crisis, both from a Swiss and global perspective: FINMA, Finanzmarktkrise und Finanzmarktaufsicht (2009), 71.

84 Swiss Structured Products Association (SSPA), Zurich, Media Release of 17 September 2008, Questions frequently asked by market participants, including investors and the media, regarding Lehman Brothers' current situation. The SSPA thought, however, that the volume of Lehman's products outstanding on the Swiss market was well below 650m Swiss Francs (*ibid.*).

85 NZZ Online, 24 September 2008, Lehman-Kollaps trifft Schweizer Anleger hart, available at *http://www.nzz.ch/finanzen/nachrichten/der_lehman-kollaps_trifft_die_schweizer_anleger_stark_1.899583.html*.

86 See account in FINMA, Jahresbericht 2009 (Annual Report 2009), 49 et seq.

87 See account in FINMA, Madoff-Betrug, supra N. 40, p. 15 et seq.

88 NZZ Online, 24 September 2008, Lehman-Kollaps, supra, N. 85.

89 FINMA had initiated an official investigation probing Crédit Suisse's marketing practices at the time when there was already negative information on the Lehman group on the market. This investigation was settled once FINMA realised that there had been no specific wrongdoing on the part of Crédit Suisse. Instead Crédit Suisse's practices appeared to be standard industry practice which requires regulatory action: FINMA, Madoff-Betrug, supra, N. 40, at p. 17 et seq.

The compensation ratio varied between 30% and 70% of the funds invested and was conditioned on the financial situation of the customers and the size of their Lehman investment[90]. The Luzerner Kantonalbank reimbursed 100% of the funds invested by its customers provided that a customer's deposits with the Kantonalbank did not exceed 100,000 Swiss Francs[91]. The Berner Kantonalbank pledged to reimburse non-professional investor-customers to whom it had sold Lehman-backed structured products[92].

In reaction to the fallout from the financial crisis Swiss mass retail investors made a clear choice in favour of alternative dispute resolution. In 2008, the docket of the Swiss Banking Ombudsman reached an all-time-high of 4,144 new cases, 50% of which were generated by Lehman-backed securities, products of the Icelandic Kaupthing Bank and absolute return products[93].

The Swiss Banking Ombudsman publishes his findings in case reports. In contrast to the FSA study on the quality of advice, the Ombudsman's reports do not allow for a quantitative finding on the efficiency of Swiss financial intermediaries or the potential of improving professional standards. The language of the Ombudsman's reports is closer to a factual analysis of a dispute associated with the sale of Lehman-backed securities. The Ombudsman evaluates the aspects of the case which establish a cause either for the bank or its client. To that extent, he seeks to settle a dispute against the background of the law. Each report gives information how the case was settled[94]

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90 Handelszeitung Online, 21 April 2009, Crédit Suisse entschädigt weitere Lehman-Opfer mit 50 Mio CHF (Zus), at *http://www.handelszeitung.ch/artikel/artikel_awp_526913.html*; NZZ Online, 10 September 2009, Lösung für Lehman-Opfer gefunden, at *http://www.nzz.ch/nachrichten/wirtschaft/aktuell/loesung_fuer_lehman-opfer_gefunden_1.3536030.html*.

91 Press Release by the Luzerner Kantonalbank LUKB, 26 September 2008, Lehman Brothers: Luzerner Kantonalbank garantiert vollen Kapitalschutz für Kleinanleger, available at *http://www.presseportal.ch/de/meldung/100570421*.

92 See Written Answer by the Berne Government of 10 December 2008 (Schriftliche Antwort des Regierungsrats vom 10. Dezember 2008), in: Protocol of the Sessions of the Berne Parliament (Grosser Rat) of 26 January 2009 (Fünfte Sitzung) – Nachmittag (Finanz), p. 80 et seq., at *http://www.be.ch/gr/VosData/Gwd/Tagblatt%202009/01%20Januarsession/20090210_141959/05%2026-01-2009%20Nachmittag%20S.%2061-91%20FIN-GEF.pdf*.

93 Annual Press Conference of the Swiss Banking Ombudsman, Bankenombudsman: "Kaufe nur das, was du wirklich verstehst, Zurich, 7 July 2009 (available at the the website of the Swiss Banking Ombudsman *http://www.bankingombudsman.ch*.; cf. NZZ Online, 1 July 2008, Finanzkrise beschäftigt Bankenombudsman, available at *http://www.nzz.ch/nachrichten/wirtschaft/aktuell/finanzkrise_beschaeftigt_bankenombudsman__1.773657.html*.

94 This may include a statement from the Ombudsman that an unwilling bank should have complied with his assessment, cf. Case No. 63, at *http://www.bankingombudsman.ch/de/fallsammlung/fall&fid=63*.

or whether the parties were advised to commence proceedings before a law court[95]. Thus, each case report conveys an 'educative message' which should be observed by both, the financial institution and its customer.

In opining on Lehman-related disputes the Swiss Banking Ombudsman makes a clear distinction between experienced investors and risk-averse consumers. Investors familiar with the risk of asset-backed securities and derivatives do not require extensive professional advice by the bank even if the financial product contains highly speculative elements[96]. Conversely, less experienced investors are entitled to detailed documentation on the issuer and may expect to be warned if it occurs to the bank that the customer's risk assumptions are erroneous[97]. However, the bank may exonerate itself if its client disregarded the bank's investment recommendations for structured products, opting for riskier multi-barrier reverse convertibles instead[98]. Sometimes the Ombudsman is at pains to determine whether the complaining customer is an experienced investor or a consumer in greater need of protection. This aspect is irrelevant, though, if the bank ignores the need for a diversified investment portfolio, exposing the investor to unreasonable risk[99]. The Ombudsman imposes on banks an *ex post*-duty to warn if subsequent to the investment transaction negative information on the issuer of a structured product becomes available. In a dispute on Lehman-backed securities acquired in 2006, the bank had recommended Lehman's financial products as a safe investment. The Ombudsman found for a duty to update information as soon as negative market information on Lehman became available, considering that the investor was an experienced customer[100]. In further fleshing out a bank's duty to warn, the Ombudsman explained that no more recommendations for Lehman-backed securities should have been given after negative rumours on the market had been heard. Nonetheless, a bank may escape

95 The Ombudsman will also recommend legal proceedings if his factual assessment results in a *non liquet*-finding, cf. Case 48, at *http://www.bankingombudsman.ch/de/fallsammlung/fall&fid=48*.

96 Schweizer Bankenombudsman, Anlageberatung beim erfahrenen Anleger, Case No. 185, at *http://www.bankingombudsman.ch/de/fallsammlung/fall&fid=185*.

97 Schweizer Bankenombudsman, Unterlagen nur beim erfahrenen Anleger genügend, Case No. 178, at *http://www.bankingombudsman.ch/de/fallsammlung/fall&fid=178*.

98 Schweizer Bankenombudsman, Bank hat Kunde auf Risiko aufmerksam gemacht, Case No. 191, at *http://www.bankingombudsman.ch/de/fallsammlung/fall&fid=191*.

99 Schweizer Bankenombudsman, Klumpenrisiko, Limite um ein Vielfaches überschritten, Case No. 186, at *http://www.bankingombudsman.ch/de/fallsammlung/fall&fid=186*, and Haftung bei unvollständiger Aufklärung und unsachgemässem Rat, Case No. 189, at *http://www.bankingombudsman.ch/de/fallsammlung/fall&fid=189*.

100 Schweizer Bankenombudsman, Warnpflicht der Bank, Case No. 187, at *http://www.bankingombudsman.ch/de/fallsammlung/fall&fid=187*.

responsibility, if an investor expresses a preference for speculative and risky securities transaction[101].

b) (Mature) Investors under Swiss Law on Collective Investments

The 2007 Federal Act on Collective Investment Schemes (CISA/*Bundesgesetz über die kollektiven Kapitalanlagen*) conditions the marketing and distribution of non-domestic securities on the approval of FINMA[102]. But there is no statutory scheme on continuous oversight. Instead, the legislator accepted that financial intermediaries would subscribe to industry standards laid down by self-regulatory bodies[103]. It is not the express intention of this statute to advance consumer protection[104]. According to art. 1 CISA, Swiss capital market law pledges to protect investors and to establish a transparent and well-functioning capital market. In assessing the ombudsman's report in the light of mandatory law, FINMA notes that Swiss private law is guided by the notion of a mature investor capable of assessing capital market information at his disposal[105]. Nonetheless, a new type of investor emerges from the Ombudsman's findings: Mass retail investors with little experience have entered the business of structured products who quintessentially behave as depositors with a savings account[106]. As FINMA explains, this is a category of investors not envisaged by the drafters of the statute. Excessive reliance on a prospectus is misplaced and does not afford sufficient investor protection[107]. More attention should be devoted to improving internal governance mechanisms of financial intermediaries[108]. In reaction to FINMA's criticism, the Swiss finance industry introduced new risk classification standards to assure the transparency of Swiss-made structured financial products[109].

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101 Schweizer Bankenombudsman, Spekulation mit kapitalgeschütztem Produkt?, Case No. 188, at *http://www.bankingombudsman.ch/de/fallsammlung/fall&fid=188*.

102 Art. 19 (1) CISA and *Frick*, in: Watter/Vogt/Bösch/Rayroux/Winzeler (eds.), Basler Kommentar, Kollektivanlagengesetz (einschliesslich der steuerlichen Aspekte in– und ausländischer kollektiver Kapitalanlagen), (2009), Art. 19 ¶ 2.

103 Art. 20 (2) CISA.

104 *Winzeler*, in: Watter/Vogt/Bösch/Rayroux/Winzeler, supra N., Art. 1 ¶ 11.

105 FINMA, Madoff-Betrug, supra N. 40, at p. 18.

106 FINMA, Madoff-Betrug, supra N. 40, at p. 16.

107 FINMA, Jahresbericht 2009 (Annual Report 2009), at p. 49 et seq.

108 FINMA, Madoff-Betrug, supra, N. 40, 18 et seq.; 49 et seq., pointing to deficiencies of the current Swiss regulatory regime.

109 Swiss Structured Products Association (SSPA), Zurich, Media Release of 2 June 2009, SSPA launches risk classification for structured products that sets a new standard.

4. Germany

Contrary to English and Swiss regulatory policy responses to Lehman-backed structured products, non-litigious dispute settlement mechanisms are almost inoperative in Germany. Germany had a great potential for mass investment in retail financial products. Both, banks with extensive international business experience and local savings banks sold Lehman financial products to a clientele of investors with considerable business acumen and risk-averse investor-consumers. Anecdotal evidence suggests that reputation mechanisms work less efficiently as soon as financial institutions enter into the field of mass retail business. Currently, German banks appear to be engulfed in litigation as investors have to beat the capital law statute of limitations[110].

a) The Law

The German regime on Lehman-backed structured products is governed by both, public and private law rules. The Act on Trading in Securities (*Wertpapierhandelsgesetz*) implements the EU's Directive on investment services in the securities field[111] and MiFID. S. 31 of the Act on Trading in Securities imposes a duty of information on a financial institution advising clients on potential investment strategies[112]. In order to assure the proper functioning of the capital market and its allocative function, the financial institution is required to maintain a high level of quality information, thereby protecting a client's interests[113]. From the language of the statute it is unclear, whether it is modelled upon the rational investor who weighs the information available to him, or it whether also claims to advance the interests of less versed investors[114]. Under certain conditions, a financial institution may exonerate itself, casting doubt on whether the statute accommodates the concerns of private mass retail investors with little experience in securities markets[115]. It should be noted, however, that in the context of retail investment transactions, the civil law on prospectus liability and contracts supplying investment advice

110 Claims have to be brought within three years after the incidence which gave rise to the claim occurred (see s. 37a of the Act on Trading in Securities (*Wertpapierhandelsgesetz*). For a practitioner's assessment of current litigation proceedings: *Witte/Mehrbrey*, Haftung für den Verkauf wertlos gewordener Zertifikate, Zeitschrift für Wirtschaftsrecht (ZIP) 30 (2009), 744 et seq.

111 Council Directive 93/122/EEC of 10 May 1993 on investment services in the securities fields, OJ L 141/27 of 11 June 1999.

112 *Koller*, in: Assmann/Schneider, Wertpapierhandelsgesetz – Kommentar (5th ed. 2009), § 31 ¶ 1.

113 *Koller*, ibid.

114 *Koller*, ibid.

115 *Koller*, ibid.

(*Anlageberatungsvertrag*) afford additional investor protection. Moreover, the German Banking Act (*Kreditwesengesetz*) requires a bank to inform non-institutional clients about its deposit insurance schemes or, if applicable, about the absence of depositor-protection mechanisms[116]. This creates a complex interface between the statutory duties under securities and banking laws and the stipulations of a private law contract on retail investment products[117].

b) Litigation

The German cases on retail investment transactions for credit swaps, derivatives and structured products are marked by a great factual similarity. They differ, however, considerably in the judicial assessment of the respective risk structures and the corresponding duty to warn the investor and to protect his financial interests. Investors had an ongoing contractual relationship with their (local) financial institution, including some transactions in retail investment products less risk-neutral than a mere savings account. Frequently, investors sought to improve the returns of their previous investment. Sometimes they approached their investment advisor at the bank. Sometimes the bank advisor called them, offering Lehman-backed structured products and other retail investment products. Under these circumstances, the German courts invariably imply a contract on investment advice to be supplied by the bank even if there is no evidence of an express conclusion[118]. The concept of duties owed under an implied contract of investment counselling is crucial to the current German concept of investor protection. The courts make an important distinction between the duty to recommend an investment product tailored to the client's financial situation and the duty to recommend a product corresponding to the client's risk preferences and the risk associated with the envisaged investment product[119]. The quality of this advice is to assure

116 Bundesgerichtshof (Federal German Supreme Court) (BGH), Judgment of 14 July 2009 (XI ZR 152/08); for details see: *Boos/Fischer/Schulte-Mattler*, Kreditwesengesetz – Kommentar (3rd ed. 2008), § 23a, ¶1 et seq. In this context, the EU Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes, OJ L 135/5 of 31 May 1994, and Directive 2009/14/EC of the European Parliament and the Council of 11 March 2009 amending Directive 94/19/EC on deposit-guarantee schemes as regards the coverage level and the payout day, OJ L 68/3 of 13 March 2009 apply.

117 For a detailed analysis against the background of the jurisprudence of the German Supreme Court (BGH): *Dörr*, Aktuelle Rechtsprechung des III. Zivilsenats zur Vermittlung geschlossener Fondsbeteiligungen, Wertpapiermitteilungen 64 (2010), 533 et seq.

118 BGH, Judgments of 6 July 1993, BGHZ 123, 126 et seq., and of 15 June 2000, Neue Juristische Wochenschrift 53 (2000), 3275 et seq.

119 See analysis of jurisprudence in Oberlandesgericht (Court of Appeal) (OLG) Düsseldorf, judgment of 30 November 2009 (I-9 U 30/09); Landgericht (District Court) (LG) Chemnitz, Judgment of 23 June 2009 (7 O 359/09).

that an investor will make an informed *ex ante* judgment about the implications of his decision to buy[120].

The cases tread a very fine between the client's inclination to engage in speculative transaction and a bank's duty to adequately warn about the risk assumed[121]. In fact, this risk assessment is a decisive threshold for deciding whether an investor has met the private law requirement for establishing advisor liability[122]. If the information supplied is adequate the investor will have to bear the risk associated with indexed financial products, including the risk of the issuer's insolvency. Courts have declined to impose a specific duty to warn prior to the Lehman collapse as long as the Lehman group was a financial institution awarded high rankings by the rating agencies[123]. In this respect, German cases differ factually from the business strategy of the Crédit Suisse which had continued offering Lehman-backed structured products[124] even though there had been negative information on the market place[125]. With respect to Lehman-backed structured products courts impose a duty on the bank to alert its client to the fact that these products are not covered by a depositor-insurance scheme[126].

Some cases are decided in favour of the client after the bank had failed to disclose that it had a financial interest in the transaction. The courts refer to the jurisprudence of the German Supreme Court (*Bundesgerichtshof*)[127] outlawing kick-backs awarded by the issuer of a security: In accordance with the statute[128], undisclosed remuneration earned under a contract for supplying

120 Cf. BGH, Judgment of 14 July 2009 (XI ZR 152/08); OLG Celle, Judgment of 30 September 2009 (3 U 45/09).

121 OLG Frankfurt, Judgment of 29 July 2009 (23 U 76/08) (Transactions on swaps and derivatives).

122 Cf. LG Landshut, judgment of 8 January 2010, Wertpapiermitteilungen 64 (2010), 513 (514).

123 See LG Frankfurt, Judgment of 28 November 2008 (2-19 O 62/08); LG Berlin, Judgement of 4 June 2009 (37 O 33/09); LG Mainz, Judgment of 22 June 2009 (5 O 384/08); cf. LG Chemnitz, Judgment of 23 June 2009 (7 O 359/09); LG Heidelberg, Judgment of 15 December 2009 (2 O 141/09); LG Landshut, judgment of 8 January 2010, Wertpapiermitteilungen 64 (2010), 513 (514).

124 See supra, sub II.3.

125 Nonetheless, under German law an investment advisor is required to scrutinise the market for information which may be relevant to clients' investment decisions. See BGH, judgment of 5 November 2009 (III ZR 302/08).

126 LG Mainz, Judgment of 22 June 2009 (5 O 384/08); LG Hamburg, Judgment of 23 June 2009 (310 O 4/09); LG Hamburg, Judgment of 10 July 2009 (329 O 44(09).

127 See judgments of the BGH of 19 December 2000 (XI ZR 349/99), Neue Juristische Wochenschrift 54 (2001), 962 et seq.; 19 December 2006 (XI ZR 56/05), of 19 December 2006, BGHZ 170, 226 et seq.; decision of 20 January 2009 (XI ZR 510/07), Neue Juristische Wochenschrift 62 (2009), 1416 et seq.; judgment of 12 May 2009 (XI ZR 586/07).

128 See § 31d of the Wertpapierhandelsgesetz (Act on Trading in Securities).

professional advice is illegal and constitutes a case for rescinding the contract and the investment transaction[129]. There are some court decisions, however, which question the wisdom of this analysis[130]. Although courts acknowledge the potential conflict of interest in this principal-agent relationship, they assert that customers will know that the investment advice is not offered *pro bono*[131]. For practical purposes, some courts have established a *de-minimis* rule exempting investment advisors from liability as long the commission earned does not exceed 15 % of the value of the transaction concluded with a customer[132]. It is unclear whether the Federal Supreme Court would apply the jurisprudence on kick-backs to commissions or soft commissions earned in the context of retail investment business with structured products[133]. There is some appellate evidence that a more nuanced approach is apposite[134].

From a regulatory policy perspective, Germany has decided in favour of regulation through litigation, letting private investors have their day in court. Swiss experience suggests that banks will accept alternative dispute settlement if strong reputation mechanisms exist[135]. German financial institutions appear to shun alternative dispute resolution. The underlying rationale for this Swiss-German divergence is, however, unclear. Reputation mechanisms have been diagnosed to lose importance as financial innovations are introduced[136]. Reputation mechanisms do not guarantee high quality advice if a new product is introduced[137]. Securitisation programmes externalise risk

129 LG Hamburg, Judgment of 23 June 2009 (310 O 4/09); LG Heidelberg, Judgment of 15 December 2009 (2 O 141/09).

130 See LG Chemnitz, Judgment of 23 June 2009 (7 O 359/09), and the analysis LG Mönchengladbach, judgment of 17 November 2009, Wertpapiermitteilungen 64 (2010), 515 (516). For an analysis of the EU law implications of the German private law approach: *Mülbert*, Auswirkungen der Art. 19ff. MiFID auf das Zivilrecht am Beispiel von Vertriebsvergütungen im Effektengeschäft der Kreditinstitute, Institut für deutsches und internationals Recht des Spar-, Giro– und Kreditwesens der Universität Mainz, Working Paper 2008.

131 OLG Frankfurt, Judgment of 29 July 2009 (23 U 76/08) (Transactions on swaps and derivatives), LG Chemnitz, judgment of 23 June 2009 (7 O 359/09), and LG Landshut, judgment of 8 January 2010, Wertpapiermitteilungen 64 (2010), 513 (514).

132 See analysis of the OLG Frankfurt, judgment of 29 July 2009 (23 U 76/08), of the Oberlandesgericht Celle, Judgment of 30 September 2009 (3 U 45/09), and of the OLG Düsseldorf, judgment of 30 November 2009 (I-9 U 30/09).

133 *Witte/Mehrbrey*, supra N. 110, Zeitschrift für Wirtschaftsrecht (ZIP) 30 (2009), 744 (at p. 748).

134 See OLG Hamburg, judgment of 15 May 2009 (1 U 85/08) (Credit Default Swaps).

135 See supra, sub II.3.a.

136 Cf. *Lin/Paravisini*, What's Bank Reputation Worth? The Effect of Fraud of Financial Contracts and Investment (July 2009), at http://ssrn.com/abstract= 1427330.

137 *Hunt*, Credit Rating Agencies and the "Worldwide Credit Crisis": The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement, Colum. Bus. L. Rev. 2009, 109 (163 et seq.).

and place the implications of uncertainty with a multitude of investors. Thus, reputation mechanisms lose their clout as the business for structured products moves from financial institutions and experienced wealthy investors to private mass retail trade fuelled by multiple financial intermediaries[138].

Closer inspection of German jurisprudence reveals that current statute law is ill-prepared to handle the specific challenges of mass retail investment products. Prior to Lehman, courts have held that surrendering of the investment prospectus to the client constitutes a valid discharge of the duty to advise and to warn[139]. Recent holdings take a more cautious approach towards the quality of advice offered by a bank or an investment advisor. The prospectus loses its predominant role as courts establish their own private law regime of transparency for the benefit of investors[140]. It is as yet too early to assert whether this ushers in judge-made law for mass retail investors who approach structured products with the attitude of a depositor in a savings account. Nonetheless, courts will not automatically protect retail investors from the negative consequences of what is essentially a transaction on a speculative product: A financial institution can escape liability as long as it affords the degree of transparency by the judges.

Germany – like Switzerland – upholds the principle of universal banks offering a range of services from savings accounts to sophisticated investment transactions[141]. The court cases send an important message to German financial institutions emphasising the need to improve internal information processes ensuring that the individual investment advisor understands the structured product recommended to a client[142].

III A European Regulatory Policy Perspective

Lehman's structured products had positive side-effects. They demonstrated the potential for innovation in world of global finance. They did also

138 Cf. *Mian/Sufi*, The Consequences of Mortgage Credit Expansion: Evidence from the U.S. Mortgage Default Crisis, Working Paper 13936, National Bureau of Economic Research (April 2008), analysing the rapid expansion of mortgage-backed securities where originators sold mortgages shortly after origination, and thus contributed to the divergence between buyers' and sellers' interests, due to diverse incentives.

139 OLG Stuttgart, Judgment of 15 December 2005 (13 U 10/05).

140 An investment advisor will, however, incur liability if he portrays the risks of a financial product more optimistically than the underlying prospectus, see BGH, judgment of 12 July 2007 (III ZR 83/06).

141 Cf. *Claussen*, Bank – und Börsenrecht (4th ed. 2008), at p. 12 et seq., on the structure of German banking institutions; for an overview of Swiss banking institutions see the website of the Swiss Banking Association at *http://www.swissbanking.org/en/home/fs-allgemein.htm*.

142 See the facts underlying the judgment of 26 November 2009 of the LG Münster (14 O 204/09).

establish a textbook case on how securitisation creates multiple informational asymmetries. Deficiencies have been found to exist in the governance structures of both, issuers and distributors of securities.

The advent of structured products reignites the debate on the thrust of capital market laws and securities regulation. Apparently, neither financial institutions and seasoned investors nor occasional consumer-investors shun the risk of purchasing financial products of a highly speculative nature. Nonetheless, Community and Member State legislators will have to enquire whether the traditional role model of the mature, informed investor is still valid after the collapse of the Lehman group. Alternative dispute resolution and litigation in European countries with extensive retail investment acutely highlight the need to reconsider the rationale for legislative intervention on the securities markets. This is not an issue of whether Member States may maintain private law standards which supplement established Community rules on transparency and investor protection[143]. Rather, a regulatory policy discussion is warranted on whether the diversity of market patterns requires a more nuanced regime on transparency and investor advice. Court holdings and alternative dispute resolution emphasise the need to warn potential, less-experienced investors before they acquire high-risk financial products. There is also a clear message from litigation and ombudsman proceedings that financial intermediaries cannot be held responsible for adverse selection of the issuer and his deficient governance structure.

The European Commission proposes to strengthen financial oversight and to tighten the rules on structured investment products[144]. Its communication on packaged retail products pledges to apply a horizontal approach to selling practices in order to thwart regulatory arbitrage[145]. It does not seem that the Commission aims at a complete overhaul of European securities regulation. Rather, it plans to introduce rules on pre-contractual disclosures, standardising, *inter alia*, information on risk, cost and performance metrics[146]. This would also include substantive legislation on the responsibilities for preparing the prospectus and on selling practices. The Commission seeks to refine the rules on conflicts of interest, inducements and the appropriateness and suitability of certain retail product in accordance with the needs of the potential investor[147].

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143 But see *Mülbert*, supra at N. 130.

144 European Commission, Packaged Retail Investment Products, supra N. 37; European Commission Press Release, Financial Services: Commission proposes better investor protection for packaged retail investment products, Brussels, 29 April 2009 (IP/09/666), and Update on Commission Work on Packaged Retail Investment Products of 16 December 2009.

145 European Commission, Packaged Retail Investment Products, supra N. 37, at p. 11 et seq.

146 European Commission, Impact Assessment, Commission Staff Working Document, supra N. 37, at p. 26 et seq.

147 Update on Commission Work, supra, N. 144.

Lehman has put an end to the belief that private ordering will generate adequate transparency on primary and secondary markets for structured financial products. Experiences with mass retail trade in some European jurisdictions suggest that a combination of *ex ante*– and *ex post*– enforcement mechanisms will assure more efficient investor protection. In this, private law still has an important role to play as investor behaviour becomes more diverse. The banking community and investors will have to find out whether reputation mechanisms are a viable alternative to enforcement by litigation or government agencies once packaged retail investment products have lost some of their innovative posture.

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ЛЕМАН, ФИНАНСИЈСКА КРИЗА И ПРАВО: УТУЖЕЊЕ И РЕГУЛИСАЊЕ СТУКТУРНИХ ПРОИЗВОДА

Резиме

Финансијски конгломерат Леман је био укључен у екстензивне програме секјуритизације, продајући структурне производе финансијским институцијама и маси малопродајних инвеститора. Када је пропала његова холдинг компанија, владе су пожуриле да спасу банке од системског значаја. Приватни купци структурних производа подржаних од стране Лемана су били разочарани када су схватили да им помоћ није била тако доступна. Крај Леман групе је ставио под питање веровање да су приватно уређење у финансијској индустрији, механизми репутације и ex-post принудно судско извршење добре замене за регулаторну акцију. Овај рад користи типолошки приступ, процењујући судбину инвеститора Лемана у четири европска правна система (Француској, Великој Британији, Швајцарској и Немачкој) који имају различите право-политичке разлоге за административну активност, алтернативно решавање спорова под притиском губитка угледа и вођења спорова.

Кључне речи: *секјуритизација, заштита инвеститора, регулација тржишта капитала.*