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Eddy WYMEERSCH

Regulation and Case law relating to Financial Derivatives

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Abstract

The widespread use of derivatives has created considerable new risks, especially of a systemic nature. To reduce risks regulators hare mandating the use of central counterparties, of trade repositories and of regulated trading facilities. The paper gives a short overview of pending European proposals. It also deals with the court decisions that have been rendered in relating to derivatives, or structured products in several European jurisdictions, especially opposing local authorities and private investors to banks.

Financial derivatives have been in the centre of public attention and discussion these last years. They are considered to be important vectors of systemic risk, what may be due to their intrinsic complexity, to their use in even more complex financial products- such as CDOs- , but also to their sheer volume. Trading in derivatives is not very transparent, most of it taking place in the OTC markets. Grown out of banking practice, a large part of the derivatives are custom made, and amounts outstanding are not easily visible from the trading volumes.

The nominal value of the outstanding derivatives of regular OTC statistics is mind boggling, but the market value is only 2,7% of the outstanding nominal value.

billion $	Nominal Value		Market Value[1]	
total	707569		19518	
Forex	64698	9,14	2336	11,97
IRS	553680	78,25	13244	67,86
equity	6841	0,97	708	3,63
commodities	3197	0,45	471	2,41
cds	32409	4,58	1345	6,89

BIS Statistics June 2011[2]

Of course these are nominal values and do not represent total risk as in case of default, only part of the claim will be due Usually contracts last for about 1 to 5 years, although many exceed that limit and some – esp. CDS- may stand for very long periods.

Derivatives are actively traded essentially by and among the largest banks and other financial participants such as hedge funds, investment funds, national treasuries, large companies. But other parties that do not belong to the financial sector use derivatives to mitigate their risks in specific parts of their commercial business: so e.g. do airlines cover their foreign exchange risk and their needs in fuel, or will large manufacturers cover their positions in commodities such as raw materials. More interesting is the use of derivatives by local communities and even by private investors, whether for managing their financial position, or as an investment. These market participants have often been very surprised – or rather disappointed - by the consequences of their investment, giving rise to interesting litigation.

The cases involving public entities frequently involve interest rate swaps, whereby the entity tries to reduce its interest rate risk on loans that have been concluded in the same context. Some entities go much further and create a swap that has only a nominal link with a liability in their books, whereby the reference to the liability is merely nominal: here the swaps are independent speculations, mere aiming a creating a return on the interest differential. In several cases there are up-front payments by the bank to the local entity: these are sometimes confused with loans, but are in fact prepayments of future returns, discounted to the day of payment, thereby considerably increasing the risk of the entity.

[1] **According to the BIS, gross market value provides a measure of market risk. It measures the cost replacing existing contract: BIS, OTC derivatives market activity in the first half of 2011, November 2011**
[2] BIS, Statistics Table 19, www.bis.org/statistics/otcder/dt1920a.pdf

Local authorities are very keen to receive these advance payments as this allows them to execute works e.g. in the run-up to an election. It would be interesting to further explore the accounting treatment of these swap transactions: in traditional public sector cash accounting, it is likely that the risks are largely unaccounted for. On the side of the bank, it is frequent that its position is hedged in the market, largely transferring its risk, but also its stake in the transaction

The subject of derivatives is a vast one, and only two aspects will be mentioned here as both carry specific legal aspects. The first one deals with the organisation of the market in derivatives, the second analyses some private law aspects.

Part 1. The organisation of the derivative markets.

As a consequence of the financial crisis, and more specifically of the Lehman failure, the public authorities started to claim a more adequate organisation of the trading in derivatives. Already in a previous crises, other aspects of the trade had to be streamlined: a first step was undertaken in 1992, when the need for having more standardised conditions led to a voluntary initiative undertaken by the London based ISDA International Swaps and Derivative dealers' Association[3], that drafted the first ISDA agreements that today after updating and expansion govern the major part of this market, although other standard contracts are known[4]. After a second crisis, the attention of the public authorities was drawn to the lack of precision in the registration of the thousand of contracts that were traded. Stories have been told that allege that piles of contracts has amassed in the brokers' office nobody knowing what the exact positions were. This major source of risk was dealt with by establishing a so-called trade repository, this is a place where the contracts are registered, and where changes in the contract parties or in their terms are registered. The existence of a trade repository may be constitutive of legal title – not so in the US – and is essential in obtaining a comprehensive view on the market and on the trading trends that develop there. On the basis of an international agreement concluded among the ISDA members, the trade depository for the Credit default Swaps and for Interrst rate Swaps is established in New York, organised by the DTCC[5],

In September 2009, the G 20 meeting in Pittsburgh formally called on the participant states to make work of the organisation of the derivative markets:

> *"All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements. We ask the FSB and its relevant members to assess regularly implementation and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk, and protect against market abuse".*

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[3] /www.isda.org/credit/

[4] see in Germany: Deutsches Rahmenvertrag fuer Finanzierungstermingeschaefte

[5] Originally Swedish Trioptima was designated as the Trade Repository for Interest Rate Swaps. However, it appeared that it could not meet the CFTC requirements and the function was transferred by ISDA to DTCC: http://www.risk.net/risk-magazine/news/2042257/cftc-proposals-render-trioptima-rates-repository-unfit-purpose: http://www.securitiestechnologymonitor.com/news/dtcc-trade-information-repository-isda-27889-1.html http://www.bankingtech.com/bankingtech/article.do?articleid=20000217601

The implementation of this recommendation is followed up by the Financial Stability Board[6]

In the US this recommendation has been worked out in the Dodd Frank Act, and is implemented by the CFTC and the SEC, working together on the new – massive and highly complex- regulations. In the European Union, the proposal to organise and regulate the derivatives markets is called EMIR, standing for a "regulation on the market infrastructure derivative transactions, central counterparties and trade repositories"[7] that is likely to be adopted in 2012. Moreover the Mifid 2 Regulation "Mifir" will deal with the market structure for trading derivatives. But also individual states in Europe are proposing specific initiatives[8]

1. The future European market organisation

While Emir[9] establishes the obligation to clear derivatives through central counterparties or CCPs, the more recent Mifir[10] proposes to organise trading in derivatives on exchanges or regulated electronic trading platforms, that could be exchanges, MTFs, or the new category "organised trading facilities" or OTFs. Differently from the first two types, where trading takes place according to pre-established algorithms, trading of OTFs is discretionary, essentially on the basis of a market making model. Trading against the own portfolio, or more precisely against the firm's own capital is not allowed. Transactions will have to be subject to transparency, adapted to the specific type of assets traded. Post-trade transparency will in any case be mandatory, although deferred disclosure may be allowed. **Pre=trade xx** The OTC market will continue to exist, and consist of all transactions of a firm on its own account with clients or other firms. But OTC trading will be limited by requiring clearing through a CCP, as explained below.

The second part of the new regulatory system relates to the clearing obligation: this is the main subject of EMIR. It identifies the parties that have to clear their derivatives – essentially if one is a financial counterparty - but more importantly contains the mechanism for designating the derivatives that will have to be cleared. .

The regulation contains the following procedure based on the well known top-down bottom-up approach

- the decision to qualify a derivative as clearable is one of the national regulator;
- upon the notification by the national regulator, ESMA will draft a binding technical standard declaring the class of derivative to be cleared through a CCP; this standard will become mandatory after endorsement by the Commission. Only derivatives that are standardised, have sufficient volume and liquidity and for which a price information system has been put in place will qualify for mandatory clearing.

But other classes of derivatives may also be put on the list: ESMA will identify the classes of derivatives that according to its analysis, should be subject to the clearing obligation but for which no CCP has yet been authorised; if a certain group is considered

[6] See Its report on: **OTC Derivatives Market Reforms Progress report on Implementation, 15 April 2011**
[7] This analysis is based on the compromise text between council and parliament of 11 July 2011. At the moment of writing, the agreement had not yet been reached, disagreement subsisting in the issue of the role of ESMA
[8] see eg in Germany: R Litten und M. Bell Regulierung von Kreditderivaten im Angesicht der globalen Finanzmarktkrise, BKR, 2011, 314; U Brandt and D. Quartner, The German Governement proposal on cash-settled equity disclosures, Euro Comp l, 2011, 8
[9] See EMIR Proposal 18 July 2011, 13012/1, for a regulation on [OTC] derivative transactions, central counterparties and trade repositories
[10] See MIFIR: Proposal 20 October 2011, Com (2011)652, on markets in financial instruments

fit for clearing, ESMA will invite CCPs to include this group; but in case of lack of interest ESMA will inform the Commission for further regulatory action.

To be mentioned is the initiative taken by some member states to prohibit certain derivatives: so eg has Germany forbidden credit derivatives relating to the obligations of EU Member States, thereby adopting a position that will be reflected in the later Short Selling Regulation[11]

The existence of a mandatory trading mechanism will therefore not mean that all derivatives will have to be cleared through a CCP: parties are still entitled to agree about individually negotiated derivatives if that suits their business interest. Moreover, a considerable part of the derivatives will be eliminated from the clearing process through so-called portfolio compression.[12] But the risk of evasion of the trading obligation is considerable and should be kept in check by the efficiency of the market organisation. But this freedom comes at a price: the parties engaged in that type of activity will have appropriate risk mitigation procedures or instruments in place, especially on timely confirmation and reconciliation procedures, and their derivatives will have to be valued to market, and if not workable to model. Stronger own fund requirements will also apply.

Certain parties will not be obliged to pass through this clearing mechanism as this would considerably upset their business model and constitute a heavy burden on their liquidity being obliged to put up collateral: these are the non-financial parties that engage into derivative trading but up to a level that is considered not relevant for systemic purposes. It is important to notice that the obligation is triggered only by derivatives " which are not objectively measurable as reducing risks directly related to the commercial activity or treasury financing" as this would reduce the obligation to transactions that constitute positions outside the normal area of that firm's business. But once the threshold is crossed, they will become subject to the clearing rule, it being unclear whether that would relate to all their derivatives or only those that exceed the threshold.

Reporting of transactions was considered one of the core objectives. Therefore all derivatives will have to be reported whether they qualify for mandatory clearing or not, including the derivatives that were entered into before the regulation came into force. Reporting will normally take place to a central trade repository (TR), an organism regulated in the same Regulation, and in the absence of a TR, to ESMA.

As this regulation was largely dominated by systemic concerns it will not astonish that much attention has been paid to risk mitigation, collateral, and appropriate capital for the remaining risk. Collateral will have to be distinguished in the reciprocal accounts[13] The core element in risk reduction is however the presence of a Central Counterparty, that will act as seller to all buyers, and buyer to all sellers. As it will concentrate risk after having

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[11] see R. Litten, Regulierung von Kreditderivaten im Angesicht de Globalen Finanzmarktcrise, BKR, 8/2011, 314; for the EU Regulation, see the proposals on Short Selling and certain aspects of Credit Default Swaps 2010/0251(COD) – version 15/11/2011

[12] For a description, see Trioptima, /www.trioptima.com/uploading_images/pdf/triReduce_brochure_for%20download.pdfISDA declares "The size of the CDS market has been reduced by more than 75 percent through a combination of clearing and compression; more than $15 trillion has been centrally cleared while portfolio compression has eliminated more than $70 trillion". Over 40 percent of the interest rate swaps market is now centrally cleared. Another $106 trillion of interest rate swaps has been eliminated due to portfolio compression" www2.isda.org/clearing-and-portfolio-compression/

[13] See about this segregation issue; art 6 §1b and 37, EMIR

offset the reciprocal positions, the CCP has to be strongly protected against especially the risk of failure of one of its members. Apart from capital – initially 5 m, but proportional to the business risks- the CCP should offer adequate protection against credit, counterparty, market, liquidity, operational, legal and business risks. The CCP will be authorised by the national supervisor of the place where it is located, allowing it to extend its activity to all European markets under a passport regime. That supervisor will liaise in a supervisory college with the other supervisors and other stakeholders – e.g. ESMA, central banks, the supervisors of the clearing members, and different other groups of stakeholders. But the last word remains with the first named supervisor.

The regulation also organises the legal regime applicable to the trade repositories, to be authorised and supervised by ESMA.

Part 2 Private law aspects

Derivatives are financial products that are entirely of a contractual nature[14]. Usually they are governed by the model contract clauses developed by ISDA, although other national bodies of rules exist[15]. Attached to the ISDA model agreement and related arrangements there is a body of legal interpretations both in published law cases, and in arbitration awards. With respect to CDS, ISDA has developed an elaborate regime that will apply in case of default of the debtor, providing for an auction of the underlying rights, eg the reference bonds[16]

In the present paper it is not the intention to analyse the ISDA regime, but to give a limited overview of the increasingly important case law dealing with different types of derivatives where the ISDA regime often comes into play. These law cases are closely related to the ongoing financial crisis as the great imbalances in several parts of the financial markets have fundamentally changed the risk perceptions of the contracting parties.

The litigation as available in published cases or reports typically relates to the hypothesis whereby a not very sophisticated investor has subscribed to a derivative contract – be it an interest rate swap, a credit default swap, a collateral debt obligation or any other usually customised contract – where it appears that after some time the losses have massively accumulated for the subscriber who then tries to have its commitments set aside, or reduced. Strikingly, many of the cases involve public authorities such as local communities, public interest companies but also private investors, who all can be qualified as less sophisticated investors. These contracts have been concluded with public entities in many European states, including – according to the cases - Norway, Germany, but obviously none in the UK, in the Netherlands and obviously also in Belgium[17]. The highest concentration is found in Germany, Italy and in France, jurisdictions in which the issue has been actively debated or reached the higher political levels[18]. Indeed according to some

[14] They are usually classified under "financial instruments", but lack the uniformity of the widely traded "securities.". There upon each trade the contractual relationship has to be novated: see
[15] See in Germany, nt 5.
[16] See the so-called Big bang protocol, or the 2009 Credit Derivatives Determination and Auction Settlement Committee protocol, that was included in the ISDA standard CDS documentation
[17] The explanation for the absence of these contract in the UK is the Hammersmith case, mentioned infra. In the Netherlands and in Belgium, there is strict monitoring of the local authorities finances by a provincial board.
[18] See for France: the so-called Bartolone Report: Assemblee nationale nr 4030, 6 December 2011, preceded by a request of a parliamentary investigation commission; Commission d' enquete parlementaire, www.assemblee-nationale.fr/13/rapports/r3464.asp, proposed by Cl Bartolone, 3464, 25 May 2011. See F Morard, Les emprunts

press reports, the amounts involved would be around 30 billion euro in Italy, and a similar amount is mentioned for France[19]. Strikingly, the known litigation essentially concerns contract parties in Italy, Norway or Germany, but almost none in France[20], where it seems that the issue is dealt with on an amiable basis with the support of the state authorities. But in France too, the public outcry has been considerable[21]. A last factual point concerns the offerors of these contracts: in many instances, these contracts have been offered by two banks, Dexia and its subsidiaries and the German Depfa bank, although in some cases other banks eg. Deutsche bank, of HSBC were involved as well.

The cases involving public entities frequently involve interest rate swaps, whereby the entity tries to reduce its interest rate risk on loans that have been concluded in the same context. Some entities go much further and create a swap that has only a nominal link with a liability in their books, whereby the reference to the liability is merely nominal: here the swaps are independent speculations, mere aiming a creating a return on the interest differential. In several cases there are up-front payments by the bank to the local entity: these are sometimes confused with loans, but are in fact prepayments of future returns, discounted to the day of payment, thereby considerably increasing the risk of the entity. Local authorities are very keen to receive these advance payments as this allows them to execute works e.g. in the run-up to an election. It would be interesting to further explore the accounting treatment of these swap transactions: in traditional public sector cash accounting, it is likely that the risks are largely unaccounted for. On the side of the bank, it is frequent that its position is hedged in the market, largely transferring its risk, but also its stake in the transaction.

Apart from the Lehman litigation, that will not be dealt with here, the published cases deal with three related of issues:

- a first series of cases relates to judicial competence: as most of these derivatives are construed under ISDA rules declaring the UK jurisdiction – sometimes also NY – competent, the questions arises to what extent local authorities from other jurisdictions are subject to the UK courts, or could find shelter under their national judicial system. UK courts generally concludes to UK competence, while in several cases the court of the debtor have found ways to affirm their own jurisdiction.

- A second series of cases relates to the conditions in which the contracts were entered into, especially in light of the debtors claim that they were not familiar with the intricacies of the derivative contracts, that there was not sufficient disclosure, that they have not been sufficiently informed nor warned about its pitfalls. The importance of the usually extensive disclaimers will play a first hand role.

"toxiques" souscrits par les collectivites locales, Banque et Droit, May-June, nr 137, 16, mentioning that Mifid is not applicable to structured products.
For Germany, See**:** Finanzausschuss - Zins-Swap-Geschäfte deutscher Banken mit Gemeinden und mittelständischen Unternehmen, Mittwoch, 6. April 2011
www.bundestag.de/bundestag/ausschuesse17/a07/anhoerungen/2011/048/index.html

[19] See the Bartolone report,p. 36 mentioning euro 32,125 billion structured products on total liabilities of of local authorities of 276,8 billion euro. Of these 6,561 billion represented different types of swap agreements.

[20] One case is mentioned in the Bartolone Report, nt. 17; one is referred to in Morard, nt 17

[21] see Hazell v Hammersmith & Fulham LBC (1991) [1992] 2 AC 1

[22] To mention a few titles : Prêts toxiques : Bartolone veut faire payer les banques, 21 September 2012; Des centaines de villes au bord de la faillite, 6 September 2011 Le 93 déclare la «guerre» aux banques, 9 February 2011; Emprunts risqués : l'État appelé à la rescousse,1 February 2011

- -A third series of cases goes deeper into the substance and analyses the extent to which banks can lawfully offer derivative contracts that are unbalanced as to the reciprocal risks and rewards, and where the level of understanding about these risks is fundamentally unbalanced.

In the present overview the different types of derivatives will not be differentiated as the issues dealt with a largely common to all types in litigation.

1. Issues of competence of the court and the Ultra vires doctrine

The usual ISDA contracts provide for the application of UK law including the competence of the UK courts. The debtors – usually the plaintiffs in the procedure - have several times tried to avoid this jurisdiction on the different grounds.

On the basis of Ultra Vires, the seminal House of Lords decision of Hammersmith & Fullham[22] stated that under the Local Government Act, a local authority, even if it could engage in regular borrowing, could not validly enter into swap contracts, even if these were mentioned as "debt management" as this would allow it to extract itself from government supervision.

Arguments relating to the powers of the local authority have been raised in many other cases and have been based whether on explicit local regulations, or on a general idea that these entities should not engage in "speculation" what may be forbidden in the applicable national law.

As far as cross border cases are concerned, the Council Regulation (EC) No 44/2001 of 22 December 2000 on the jurisdiction and the recognition and enforcement of judgments in civil and commercial matters[23] (OJ 2001 L 12, p. 1) plays a crucial rule. Art 22(2)[24] provides that:

> "the following courts shall have exclusive jurisdiction, regardless of domicile: …. 2. in proceedings which have as their object the validity of the constitution, the nullity or the dissolution of companies or other legal persons or associations of natural or legal persons, or of the validity of the decisions of their organs, the courts of the Member State in which the company, legal person or association has its seat. In order to determine that seat, the court shall apply its rules of private international law;

Also of importance in the present disputes is art 25 stating

> " Where a court of a Member State is seised of a claim which is *principally concerned* with a

[22] To mention a few titles : Prêts toxiques : Bartolone veut faire payer les banques, 21 September 2012; Des centaines de villes au bord de la faillite, 6 September 2011 Le 93 déclare la «guerre» aux banques, 9 February 2011; Emprunts risqués : l'État appelé à la rescousse,1 February 2011
All in : /www.lefigaro.fr/economie/
[23] OJ, L 12 , 16/01/2001p. 1
[24] Article 22: "The following courts shall have exclusive jurisdiction, regardless of domicile:

1. [….]

2. in proceedings which have as their object the validity of the constitution, the nullity or the dissolution of companies or other legal persons or associations of natural or legal persons, or of the validity of the decisions of their organs, the courts of the Member State in which the company, legal person or association has its seat. In order to determine that seat, the court shall apply its rules of private international law"

> matter over which the courts of another Member State have exclusive jurisdiction by virtue of Article 22, it shall declare of its own motion that it has no jurisdiction."

In the case of *Berliner Verkehrsbetriebe (BVG),v JPMorgan Chase Bank NA, Frankfurt Branch*[25] the ECJ decided that art 22(2) "must be interpreted as not applying to proceedings in which a company pleads that a contract cannot be relied upon against it because a decision of its organs which led to the conclusion of the contract is supposedly invalid on account of *infringement of its statutes'*.

The court refused to apply a broad application to this exception for several reasons, one of those being that it would deny the parties to a contract the autonomy to choose another forum, and that it would be contrary to the predictably of jurisdiction what is one of the objectives of the regulation. However it should be mentioned that the ruling only applies to purported violation of the statutes, but not to infringements of the restrictions imposed by the law itself, or by the nature of its activity.

In a case rendered before the ECJ decision, this issue was extensively discussed. *UBS v. Kommunale Wasserwerke Leipzig GmbH*[26] a public purpose entity organised in the private legal form of a GmbH, but owned by the city of Leipzig, the defendant in a cross border lease transaction that involved swap transactions under the ISDA 3 Agreement, argued that the transaction has been outside the statutory purpose of the GmbH and hence that the contract was null and void for lack of authorisation of the directors. This argument had been raised in a parallel procedure before a German court. The bank had however sued in an English court, where the defendant had argued that on the basis of art 22.2 of Regulation 44/2001, the decision to enter into the contract was subject to the law of the state where the company has its seat. On the basis of legal opinions from two reputed German law professors the UK court held that the defendant was not a public law body and therefore its powers of representation were not determined by a public law provisions, while – one of the exceptions to the binding character of the decision - there was no evidence of abuse of power by the company's managing director that was known to the third party. Therefore the court found that the case was not "principally concerned" (art 25) with the validity of the decisions of the defendant. On the basis of a list of factors, the Court held that the issues involved were "so predominant as to predicate the characterisation" as "principally concerned" with issues of German law. One can mention the fact that all "relevant documentation was in English, subject to English law, the transaction was a English swap transaction conducted in London on English ISDA terms, with the London branch of s Swiss bank, with English solicitors".

To a similar result came the OLG Frankfurt[27] in a case where the local entity, a Kommanditgesellschaft auf Aktien, the shares of which where owned by local public entities, pleaded that it could not engage in "speculation' – through CMS Ladder Swaps - as this was contrary to the law on the local communities. The court decided that this entity was not a public body, but a private company. Whether the transaction was speculative,

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[25] BVG v JP Morgan , ECJ, C-144/10, of 12 May 2011

[26] UBS AG, London Branch, UBS Global Asset Management (UK) Limited v. Kommunale Wasserwerke Leipzig GmbH, 2101 WL 4007066 (15 October 2010)

[27] OLG Frankfurt a. M., 4 August 2010, ZIP 2010, 1637

was not the affair of the bank, but of the local monitoring bodies. Moreover the bank had rightly informed the debtor, and pointed to the risks including the risk of unlimited and incalculable losses.

A similar argumentation was raised in *Haugesund Kommune, Narvik Kommune v Depfa bank*[28] were Norvegian local authorities had borrowed – under the form of an upfront payment - from the bank under swap contracts – standing for the NPV of future receipts from electricity plants - in order to invest in higher return assets. The issue raised concerned the legal prohibition for Norvegian communes to borrow otherwise than for restrictedly defined purposes, in accordance with the Norvegian Local Government Act 1992. The court paid ample attention to the notion of narrowly defined "capacity' under UK law, but concluded that lack of substantive power to conclude a contract would be equivalent to lack of 'capacity' under UK law. The consequence of that lack of capacity was to be determined by the applicable law of the contract. For the purposes of the English conflict of laws rules, the concept of "capacity" had to be given a broad "internationalist" meaning, referred to as a "comity" argument by the commentator. As the Kommunes did not have the capacity to enter into the Swaps, it followed that as a matter of English law that the Swaps were invalid and void. Although the local authorities were not held to the swap transactions, they will still be held to restitute the loans received, without the contractually provided instalment and at the nominal value, not necessarily what they had hoped for[29].

An important case illustrating the difficulty of multi-jurisdictional litigation concerns the suits involving Italian *Provincia di Pisa v Depfa Bank plc and Dexia Crediop Spa*, involving interest rate swaps that the banks had entered into with the Province. As the interest rates fell, the Provincia was obliged to make substantial payments. Proceedings were instituted by the Banks before the UK commercial court, while Provincia submitted the case to the Italian administrative jurisdictions.

The UK Commercial court [30] upheld its jurisdiction, arguing that the argument based on the defendant's lack of capacity - as illustrated in the Italian procedure - was not his only defence and hence that the proceedings were not "principally concerned ' with an art 22(2) of EU regulation 44/2001 issue i.e. a lack of capacity or power, but mainly on the basis that the contracts had an "implicit cost' that has not been disclosed to the Provincia and would have upset the economic balance of the transaction. The court concluded that in light of the many other issues raised such as misrepresentation, non-disclosure, mis-selling a.o., art.22(2) and 25 should not lead to exclusive jurisdiction for the Italian courts. The argument that later led to the decision of the Consiglio di Stato – as explained further below – was not considering to be "principally concerned" with the validity of the

[28] Haugesund Kommune , Narvik Kommune v. Depfa [7 july 2010]
ACS Bank, 2009 WL 2614092; for a summary: /www.lexology.com/library/detail.aspx?g=8191ca5f-4f05-4fb9-8d72-e02994c56d4e G. Mitchell and R. Brent, English law contracts, foreign counterparties and *Ultra Vires*, Butterworths J Int Banking and Financial Law, 2010, 463; Commercial court, 4 September 2009
[29] On the basis of Goss v Chilcott [1996[AC 788
[30] Depfa Bank plc v. Provincia di Pisa [2101] I.L.Pr 51. (11May 2010); G.Gauci and A Waters, see Italian derivatives litigation: just another case of history repeating, Butterworths J Int Banking and Financial Law, 2011, 166.

decisions of the Province, but only as a matter of "overall classification"[31]. A further argument related to the risk of contradictory judgments and which jurisdiction was best placed to decide: the court analysed the Italian approach of the "acted detachable" implying a 'two track' process, separating the administrative "act" from the civil agreement, whereby annulment of the first does not imply the second to lapse. Therefore the court concluded, there will in any case be two sets of procedures, although then under Italian law. As a consequence, exclusive Italian jurisdiction was dismissed.

The Italian side to this conflict lead to a different outcome. The Consiglio di Stato held, that the administrative decision of the Provincia was invalid[32]. The reasoning of the Council of state was based on a provision in Italian administrative law, that allow subordinate bodies to invoke a provision called "autotutela" according to which that body can annul the administrative act – mostly a unilateral expression of will – of a public body on the basis of the public interest for reasons referred to as "inconvenienza economica", what is imperfectly translated in "economic inconvenience". As the "autotutela" instrument has been put into action, the Province's consent to the transaction was invalidated. It had appeared from an analysis undertaken in 2009, that the swap contract, rather than resulting in a profit, of about 400.000 euro, would have led to a loss, because at the moment of concluding the Swap, it would have resulted in a negative value of about 1.850.000 euro, a negative value that was not taken into account at the moment of concluding the swap. This "implicit cost" that constituted the "inconvenienza economica", was not mentioned in the original documentation, had remained unknown to the Province and only discovered by an expert firm later on. It modified the balance underlying the contract and undermined its economic justification. The use of this administrative law instrument is subordinated to the adequate motivation of the nature and seriousness of the anomalies verified, the existence of a public interest in removing the anomaly and the period of time between the illicit act and its removal. As a consequence, the will of the Provincia was invalid, a preliminary decision that obviates the competence of the English jurisdiction. The correct exercise of the administrative competence is a matter of Italian public law and cannot be freely disposed off by the public entities, thereby rendering the ECJ interpretation in BVH v JP Morgan, supra inapplicable.

The decision of the Council of State to hold the agreement of the Province invalid only relates to the administrative act of the Province, while the private law aspects would have to be decided by the civil judge[33]. However , in the present case, the Council of State decided that the civil effects of the successive contracts should also be held null and void: "simul stabunt, simul cadent".

This case constitutes an example of lack of coordination between jurisdictions and the limits of the approach following in articles 22 and 25 of the Regulation: rather than each deciding in its own wisdom, a preliminary question on the legal entity's "competence" and the validity of its decision should have been decided first by the jurisdiction competent for this aspect of the litigation, rather than assuming that this preliminary issue was merely a element included in the overall dispute.

[31] See BVG v JP Morgan, supra nt 25
[32] Consiglio di Stato, 7 september 2011, sentenza n. 5032
[33] See eg. In that sense: Trib amministrativo Toscana, 27 January 2011 in re : Provincie di Pisa

A further point of controversy concerns the use of swaps for "speculative purposes'. This discussion is rooted in the provisions relating to the financial management of local entities, that explicitly allow the use of derivatives, but only for covering position. Hence if it appears that no underlying risk has to be covered the transaction would be held invalid for being "ultra vires" or at least not allowed.

An Italian regulation[34] conditions the use of swaps by public entities to a perspective of covering specifically mentioned risks and therefore imposes certain conditions aimed at securing their diligent and prudent use. If however swaps are used for other motives, they become speculative, and would be null and void as being contracted outside the boundaries of said regulations. Whether that is the case has – so was decided - to be determined by an expert, taking into account the swaps' characteristics, some of which are mentioned by the court[35]. Therefore contracts that due to their financial conditions could not have the purpose of covering risks would not be allowed[36]

A similar argumentation was tried in before the Tribunal in Bologna[37], where it was argued that the swaps had been signed by a representative of the Commune, but no decision of the Council of the Commune had taken place, as such would have been needed if it had been a loan ("mutuo"). The tribunal distinguished the swap from a loan, as the swap does not create a liability, but only serves to create two cash streams. The upfront cash payment does not change the nature of the transaction, as this payment represents the present value of the future cash flows. The capital as such is not due but merely serves as a parameter, related to the Commune's internal accounts .The liability that may result is a secondary effect, but is not the subject of the transaction. Therefore, the swap agreement not being a loan, does not have to be approved in Council.

2. Pre-contractual behaviour and conditions, Disclaimers and similar clauses.

Most of the lawsuits that are analysed here involve parties that can be considered less financially sophisticated: private investors, local authorities, small firm – but no investment funds nor pension funds. Once the transactions turned negative, they sued the bank invoking the lack of information, whether the right disclosures had been made, including whether the disclosure made may have been misleading for lack of stating essential elements of the transaction. More subjectively they also argue about their lack of understanding of the investment product, their lack of financial knowledge or expertise, their reliance of the indications given by the bank about the quality of the investment, their reliance on the external ratings, and other similar arguments.

The banks usually reply in great detail that the defendant has been able to analyse the information the prospectus, the term sheets at length, that extensive discussions have been held with the bank's representatives, or that he had ample experience from previous transactions, and that the defendant has been extensively and unmistakenly warned about the highly risky nature of the transaction, eventually leading to a loss

[34] Art 41, L. 28 December 2001, n. 448 and implementing decrees, such as Min Decree 1 december 2003, mentioned in Trib Pescara, 22 March 2010
[35] Trib Pescara, 22 March 2010
[36] Trib Bari, 15 July 2000
[37] Trib Bologna, Commune di Cattolica v BNL, 10 December 2009

beyond his investment; moreover the client had been warned about the relative meaning of ratings. They refused to admit the existence of an advisory relationship as this would have trigger regulation derived from Mifd. Finally they pointed to the duty of the investor to investigate and analyse himself.

As the number of cases is quite considerably we have regrouped them by jurisdiction. Many of these cases have not been reported, or could only be found on proprietary sites[38].

A - Belgian case law

Two recent Belgian cases involving individual investors have drawn the attention. A first case [39] concerned substantial investments by a well known industrialist in CDOs, issued by a well known Belgian bank, with whom the plaintiff has been banking for many years. The plaintiff alleged a whole series of deficiencies in the bank's behaviour: the bank, as an advisor, had giving misleading information by not disclosing the subordinate character of the investments, by not informing him about the intricate structure of the CDO, alleging even hidden defects – implying unwritten warranties- purportedly amounting to fraud, or at least to *culpa in contrahendo.* Once the downward trend of the CDO's value had started, the bank had not taken the necessary mitigating action. These arguments were refused by the tribunal: the information contained in the sales pitch documentation was provisional, and referred to the final prospectus, available on the website. However it appeared that the plaintiff had not retrieved the prospectus before the transaction, but only much later, once the investment had lost most of its value. The prospectus itself contained a clear statement about the structure of the CDO and of the subordination clauses and drew attention to its very low liquidity. The plaintiff moreover was an experienced businessman, with an economics degree, and holding several directorships, some even in financial firms. His assistant had worked at a Big Four accounting firm. Without summarizing the 50 odd pages of the judgment, it makes it clear that *caveat emptor* is fully applicable in these cases.

Another comparable case[40] reveal similar elements such as the role of disclaimers and warnings, the absence of a request for information, the absence of an advisory relationship, the fact that the prospectus has been retrieved only once the first defaults in the CDO appeared. In both cases it was held that the investor had behaved in a way that could be considered reckless or at least would not have warranted the transaction to be undone.

b- German case law

In Germany too, there is quite substantial body of case law dealing with the risks supported by local authorities and their attempts to have the derivative transactions set aside, or at least mitigated through a liability counterclaim.. The arguments are largely identical to those raised in other jurisdictions, although the effect of specific German legal provisions deserve to be mentioned.

[38] Special reference is to be made to the excellent site Ilcaso.it
[39] Comm.Brussel 28 January 2011, Bank Financiewezen, .Recht. 2011/VI, p. 363
[40] Comm Brussels, 12 January 2011, AR 2009/6547

The local authority sometimes alleges that the transaction violates the law, and hence would be void on the basis of § 134 of the BGB[41], that according to some decisions contains a prohibition of speculative transaction for the communes themselves, as these always have to be able to meet their obligations. But it is admitted that the rule would not be applicable to the subsidiary entities organised by most communes as "companies", mostly GmbH, even if their shares are entirely held by the communes, and they are part of communal action[42]. The prohibition of speculation is not a law in the sense of § 134 BGB, because not sufficiently specific [43] . The prohibition to engage in speculation, laid down in law on local communities or in local instructions is not the affair of the bank, but of the local bodies in charge of monitoring the local authorities [44]. Another restriction would flow from the BGH decision stating that the prohibition of speculation should be common to both parties to the transaction[45]. In some states, the state authorities have adopted rules or guidelines relating to derivatives, but these are matters that are of concern to the local entity, and are not to be taken into account by the bank. The bank has no duty to warn the local entity about these provisions : this is the area of action of the local entities and their overseers[46].

Another argumentation is based on § 31, WphG, the Securities Trading Act, according to which investment firms shall not only offer all pertinent information to their customers but also insure that they '"request from their customers particulars of their experience or knowledge of transactions …., of the aims they pursue with those transactions and of their financial situation" (know your customer). Here the knowledge and technical insight of the commune will come to bear. Several decisions deny damages on the basis that sufficient information has been given[47], as the risks were easy to evaluate, and the representative of the Commune had large and longstanding experience with the transactions as discussed. In other cases liability has been admitted as the debtor had not been adequately informed on all essential elements of the deal, and not all risks clearly spelled out, nor been warned about the burden the transaction may cause on the longer term[48]. There is no general obligation to warn[49]. Interesting in some cases where this reasoning is followed, it has not been extended to the subsidiary of the Commune that also had entered into derivatives transactions, sometimes along with the commune, as it acted in great haste, on order of the Commune, its exclusive shareholder, and did not possess adequate expertise itself[50].

In some liability cases, the local entity had to bear part of the losses, for having behaved imprudently e.g. for not having informed itself, or not having studied the matter in detail[51]
Finally in some cases, plaintiff attempts to argue on the basis of § 307 BGB, allowing the courts in general contract clauses (AGB) to exercise a certain oversight for reason of excessive damage due to a violation of good faith, or when the provision is not clear and

[41] "A legal transaction which violates a statutory prohibition is void, unless a contrary intention appears from the statute."
[42] LG Wurzburg,31 March 2008 See also OLG Bamberg, 11 may 2009, concerning a KGaA.
[43] Lg Ulm, 22 august 2008, re: Stadt Ravensburg
[44] OLG Frankfurt a.M., 4 August 2010
[45] BGH, 14December 1999 - X ZR 34/98 (Hamm), NJW2000,1186
[46] OLG Frankfurt a.M., 4 August 2010 , Lg Ulm, 22 august 2008, re Stadt Ravensburg LG Wuppertal 16 July 2008; See LG Wurzburg, about the Bavaria rules, based on a prohibition of speculation, to which the bank had to draw the Commune's attention, as the transaction implied a leverage of 3, and contained other speculative features.
[47] « anlegergerechte and objectgerechte Beratung »
[48] LG Wurzburg 31 March 2008
[49] Ulm, 22 August 2008 ; LG Wuppertal 16 July 2008;
[50] LG Wuppertal 16 July 2008, an interesting application of "reverse group law"
[51] OLG Bamberg 11 May 2009

adapted to the situation of the debtor. This requires a detailed individual assessment. But liability was denied

c- Italian case law

Case law about Italian cities or local entities also contain numerous illustrations of the same remedies.

A comparable set of arguments was submitted to the UK Commercial Court in *Cassa di Risparmio della Repubblica di San Marino v Barclays bank Ltd*[52] relating to the sale of complex financial products to the plaintiff, claim based on fraudulent misrepresentations. The products were CDOs square, that used CDS to replicated risks relating to underlying asset pools, each referring to other pools of CDS. According to the plaintiff, the notes had been sold as AAA, while it alleged that the bank had estimated the expected loss to be around 30% on the basis of its internal analysis.

It would be difficult to summarise this long and elaborate judgment, but suffice it to state that the court reviewed a long list of disclaimers, but further pursued it sanalysis on the basis of the allegation of fraud and misrepresentation. At the end, the case was dismissed, essentially because according to the court, the plaintiff could not have been misled and it should have made its own appraisal of the default risk.

The core argument related to the plaintiff's allegation that the notes had been sold as very low risk – hence AAA - while the defendant knew, as was appearing from its internal calculations, that the probability of default was around 30%. The discussion turned around the justification for the use of different calculation methods and their different objectives.

The Court considered that the reference to the ratings was merely a description of the characteristics which the notes are expected or required to have. It was not to be attributed to the defendant bank who considered that " a statement that a CDO square had been rated AAA does not imply anything more than, or other than it has been rated AAA by that agency". A reflection that many State could certainly subscribe these days.

The statements in the fact sheets – not a pre-contractual document, according to the court - were minutely analysed and no generalised statement about default risk - an estimation, says the Court, not a fact - or to a low risk of default appears to have been made by the bank. The disclaimers made it clear that the plaintiff should have made up his mind himself, and was responsible for its own independent appraisal especially of the default risk.

A large discussion developed about the implied probability of default derived from expected loss models and whether these provide a reliable measure of "real world probability of default". The court accepted the difference between a CRA rating, based on historical and statistical series, and the bank's pricing model, modelling the probability of default (PD) on the basis of CDS, leading to a much higher default rate. The latter implied PDs were considered by the court as not providing a "reliable measure of the real world PD", also because CDS spreads are based on elements other than PDs, but include market sentiment, liquidity aspects etc. The argument that the bank had selected assets with high

[52] CRSM v Barclays, 2011 WL: 674992, of 9 March 2011; see J.Roberts, Financial Derivatives: investments of bets? Butterworths J Int Banking and Financial Law, June 2011,315

CDS spreads, thereby maximizing its profit by selecting high spread names, was not considered to mean that there was a corresponding high real world PD. Hence there was no claim about adverse selection, nor fraudulent conduct of the bank's representative. The fact that the bank employee structuring the CDOs received a share of the profit was mentioned, but not considered relevant. Hence the plaintiff could not state to have been misled by the bank's method, as this had been based on different, for the plaintiff not relevant parameters.

Without further analysing here the numerous other arguments that were discussed in this case, the conclusion could be that investors buying this type of products should very carefully analyse the – final - documents, only rely on their own analysis, and not take into account third party opinions, such as CRA ratings. It leaves open the question what is the function of these ratings, and why they are mentioned at all.

Several others arguments have been used to challenge the validity of swap contracts. Some of these were based on the financial regulations that have implemented the Mifid in Italy, often in a way that is more comprehensive than the rules adopted in other jurisdictions.

On the basis of one of these provisions[53], financial services have to be offered on the basis of a financial service contract that has to be in writing. In the absence of a written document, a domestic currency swap was null and void for not having been laid down in writing, as mandated by art 6 (1) (c) of the Law 1/1991 according to which the societa di intermediazione mobiliare are obliged to lay down in writing the clauses relating to their relations with their clients.

Also based on a Consob Regulation[54] is the extensive obligation on financial intermediaries to inform the other party. The obligation to inform the client about the consequences of the transaction is also applicable to corporate clients[55]The content of this information is actively discussed.

The offer of a swap to an industrial company should not be limited to the characteristics at the moment of offer, but include the possible evolutions of the product in the context of that firm, including the returns, the degree of debt, the markets concerned, etc [56]

However, some of these obligations are not applicable to "qualified investors", whereby these investors knowledge and expertise has been the subject of extensive litigation[57] The manager of a small's company can not be supposed to be in possession of all the technical characteristics of the swap. But a representative of a large company who declared to be in possession of said knowledge, could not seek protection under his lack of knowledge[58]

It is not sufficient to have a mere attestation about the client's knowledge but it should contain indications from which it appears that the client was in possession of the declared experience but also that the intermediary was able to evaluate the level of understanding of the client[59]. The declaration of the client as a qualified operator[60] can normally be relied upon,

[53] See Cassazione civile it., 19 May 2005, nr 10598. The court analyses in some detail the status of these swaps under Italian law. See also Trib Bari 15 July 2010, nullity for absence of a document signed by both parties.

[54] Consob Reg. 11522/98

[55] Trib Catania, 18 February 2009

[56] Trib Mantova 9 June 2005; also 12 June 2004

[57] Consob 11522/1998 art 31 introduces simplified requirements for intermediaries that deal with professional clients, here called "qualified clients, "operatori qualificati", as defined in art 31.2

[58] Trib Mantova 9 June 2005; also 12 June 2004

[59] see also Cassazione civ 26 May 2009; the declaration of the client as a qualified operator - see Dlgs 58/1998 and Regulation Consob can be relied upon. These indications should refer to facts, not mere statements : Vicenza 29 January 2009 . But previous negotiations for similar contracts can prove sufficient expertise Trib Verona 1 april; 2008; Consob Regulation 11522/1998 art 31

but it should be based on facts, not mere opinions and illustrate his competence end experience[61]. But he should speak the truth[62]These indications should refer to facts, not mere statements[63] . But previous negotiations for similar contracts can prove sufficient expertise[64]

Although the lower court's decision present a wide range of attitudes, one sees that in Italian case law, local entities have to be careful in entering into derivative transactions, and that mistakes – especially credulity - made at the beginning will not be lightly pardoned. But banks should ensure that their interlocutors are sufficiently informed and warned, that all elements are on the table, and that they take into account the local entity's manifest interest, especially when dealing with inexperienced counterparties.

3. Fairness of the transaction

The German Supreme Court, the Bundesgericht[65] handed down an important decision opening a new perspective in the litigation relating to complex financial instruments.
The case concerned a medium size firm, Ille Papier Services GmbH, to whom Deutsche Bank had sold complex structured products, "CMS Spread Ladder Swaps", being essentially an interest rate swap. The transaction obviously aimed at covering risks from two other interest rate swaps, that had become negative for the plaintiff. Due to the fall of the interest rates in 2005, considerable losses for the plaintiff emerged, leading to the present law suit that was based on traditional arguments of violation of Gute Sitten, the transparency obligation, wilful deception, or fraud (arglistige Taeuschung), negligent advice, lack of disclosure about the risks of the transaction. The Court reversed the decision of the Frankfurt court of appeal.

The Court found that parties had entered into an advisory contract which – according to the Court's jurisprudence and the applicable law[66]– obliged the bank to take into account the objectives, knowledge and risk appetite of the client. It was not proved that the bank had ensured that the client was aware that its risk was unlimited, while the bank carried only a limited risk. The fact that the investor has been assisted by an economist was irrelevant as the latter did not appear to have specific or relevant knowledge nor experience. Nor could the bank have determined the client's risk appetite on the basis of previous transactions or of his professional activities.

But the court took exception from the fact that the bank had not explicitly warned the investor that his risk was unlimited and that the real evolution in the interest rate may have triggered these losses. It is not sufficient that the client has been informed, due to the complexity and the specific uncommon terminology used, the bank must ascertain that the

[60] Dlgs 58/1998 and Regulation Consob
[61] Trib Vicenza 29 January 2009
[62] Trib Vicenza 29 January 2009
[63] Trib Vicenza, 29 January 2009
[64] Trib Verona 1 April 2008: No need for the intermediary to investigate further if the company has presented itself as competent and experienced. This can be proved from previous transactions.
[65] BGH, Decision of 22 March 2011, XI ZR 33/10, appeal from OLG Frankfurt ZIP,201,921, comment by J. Koendgen, Grenzen des informationsbasierten Anlegerschutz, BKR, 7/2011, 283.
[66] WphG, § 31, implementing the Mifid.

client has really understood his unlimited risk exposure, and that his knowledge is at the same level as that of the bank[67].

But there was another argument that carried the day: it was the fact that the transaction carried from the beginning a negative market value of about 4% creating in the analysis of the Court a serious conflict of interest for the bank, creating the danger that it would only act in the interests of the client. The bank as advisor is bound to act in the interests of its client: in a swap transaction chances should be the same for each of the parties. This unbalanced situation – that cannot be covered by disclosure - puts in doubt the integrity of the advisory function of the banks. The violation was material in leading to the investment decision of the investor. The admission of the investor that he had not understood the model was considered immaterial as an investor should be able to rely on the exact and complete character of the explanation given by the bank. As the commentator remarks, not the advice, but the product itself was deficient[68]

This decision takes the protection of investors and other weaker operators in the derivative markets one – difficult - step further: the bank has to take a protective attitude, and it is not sufficient that it has respected its disclosure obligations. Especially the information about the negative start value, leading to a conflict of interest for the Supreme court and the complex calculations on which the pricing of these derivatives are based should be made clear to the investors, who must really "understand" what the position is. Whether clients will be able to really understand more than that they are incurring a serious risk, while counting on a considerable reward, deserves not much discussion: these product are of the family of sophisticated lottery ticket, and for these clients should not complain. But this message is obviously not clearly given to clients, although the sales material contain a reference that losses can be "unfathomable". Other recent cases in Germany have pointed to the unachievable level of requirements that this BGH decision imposes on the banks, thereby indicating the the information road is really not the right one[69].

Conclusion

The world of derivatives is one of the most challenging and most innovative, not only in financial or macro terms but also legally. One sees that courts, at least on the Continent attempts to find a balance between the interests at stake, and especially adopt a protective attitude towards the smaller operators, whose understanding of these techniques often a quite weak, notwithstanding their own perception. The supreme courts, and the politics demonstrate increasing nervousness and rejection about these practices, that often are too complicated to be understood by the normal user, or investor, but for which no protection is available. The question arises whether one should not regulate them in a sense that they would be less harmful; as is the case with CDS on sovereign debt, there is an argument that some derivatives should only be accessible to those who have a corresponding exposure; for other derivatives a cap on the respective risks might be considered.

[67] This point is criticized by Koendgen, nt 66
[68] Koendgen, nt 66, at 284, pointing at the idea that one should not bring a manifestly dangerous product into circulation; here information will not help.
[69] OLG Hamm, 10 November 2010, analysing a great number of the BGH arguments, and rejecting them.

Financial Law Institute

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