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Information Duties

Japanese and German Private Law

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Information Duties under German Capital Markets Law

Harald Baum[*]

I. Foundations of the German Capital Markets Law

The regulation of German capital markets has seen a rapid development with manifold changes during the last three decades. The term capital markets law (as it is called in Europe), or securities regulation (as it is labelled in the US), refers to the "rules which deal with the constitution of the capital markets".[1] These include the rules dealing with transactions in the primary market on the one hand – transactions between issuers, banks, and investors – and those in the secondary market on the other – transactions between investors and financial intermediaries of various kinds.[2] Germany's capital market law regime is in constant flux. Between 2008 and 2016

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1 K. J. Hopt, Capital Markets Law, in: Basedow/Hopt/Zimmermann/Stier (eds.), The Max Planck Encyclopedia of European Private Law (Oxford 2012) Vol. I, 141.

some 40 legislative measures were enacted.[3] Whereas reforms during the 1990s and 2000s were characterized by deregulation to a significant degree, developments in last ten years have shown a reverse tendency towards re-regulation in reaction to the global financial crisis of 2008.[4] One characteristic feature of most reforms, both deregulatory and re-regulatory, was that they dealt with the role *information* plays in capital market activities.

What are the economic reasons that caused the rapid development of capital markets law as a legal field in its own right in Germany and which regulatory assumptions brought information into to the regulatory focus? Both questions are answered below in 1. and 2. respectively. The ensuing parts of this chapter are then organized as follows. Part II provides a brief overview of the regulatory architecture governing capital markets in the EU and Germany. Part III discusses the different types of information duties and Part IV throws a light on the challenges to the "information model". Part V concludes with a look at some regulatory reactions to these.

1. Growing Importance of External Finance

In Germany as elsewhere, the importance of external finance via the capital markets has been constantly increasing over the last decades. Correspondingly, the traditional way of financing business activities via the banks – the so-called German "house bank system" – has lost its dominance.[5] Instead, the use of financial products via the capital markets has grown as a means for supplying financing. This development coincides with the need of aging populations, with their increased life expectancy, to provide for private pensions. The precondition for achieving this aim are sufficient opportunities to invest in lucrative, but at the same time safe, financial products.

These trends had regulatory consequences. Whereas banks in their role as supplier of finance are pretty much in a position to look after their own interest vis-à-vis their corporate customers based on their professional experience and their often long-term relationships with them, the opposite is true for average investors who engage in anonymous capital markets by purchasing financial products. Accordingly, capital markets law has become

2 *Ibid.*

3 *See* P. BUCK-HEEB, Entwicklung und Perspektiven des Anlegerschutzes, Juristen-Zeitung (JZ) 2017, 279.

4 *See* J.-H. BINDER, Vom offenen zum regulierten Markt: Finanzintermediation, EU-Wirtschaftsverfassung und der Individualschutz der Kapitalanbieter, Zeitschrift für europäisches Privatrecht (ZEuP) 2017, 569.

5 *See* W.-G. RINGE, Changing Law and Ownership Patterns in Germany: Corporate Governance and the Erosion of Deutschland AG, American Journal of Comparative Law 63 (2015) 493.

increasingly important for providing sufficient investor protection and thus for the functioning of the market. Investor protection must be distinguished from shareholder protection. Traditionally, shareholder protection was provided by company law and, additionally, by some rules on stock exchange trading, whereas investor protection is a fairly new concept based on capital markets law and encompassing all kinds of investments in publicly traded financial instruments.[6] In the age of globalized financial markets and international competition for funds, a country's regulatory regime for the capital markets has had to become globally competitive. This poses an additional challenge for a national legislator or a regional rule maker like the European Union to keep up with international benchmarks.

2. Regulatory Concept and Assumptions

The regulatory aim of capital markets law in Germany as elsewhere is the promotion of the efficiency of these markets in terms of allocation, operations, and institutions. This approach rests on the following assumptions.[7] Firstly, that capital markets are at least moderately efficient. Second, market participant trust is fundamental to the functioning of that market. Third, the participants' trust in turn depends on sufficient investor protection.[8] Fourth, for securing sufficient protection, it is crucial to solve the problems arising out of information asymmetries and conflicts of interests. Fifth, to achieve this aim, all relevant information should be made available in a timely manner, and without distortion. To this end, sixth, mandatory information (and disclosure) duties have been regarded, at least until very recently, as the most suitable means. In other words, modern investor protection so far has been based on the so-called "information model": If investors have received all relevant information in an appropriate form – and thus information asymmetries are deemed to be compensated for – they are bound to their investment contract and have to bear the economic consequences of their investment decision. Sensibly, differences exist regarding the scope of information with respect to what kind of financial services are offered to which type of investor.[9]

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6 *See* K. J. HOPT, Investor Protection, in: Basedow/Hopt/Zimmermann/Stier (eds.), The Max Planck Encyclopedia of European Private Law (Oxford 2012) Vol. II, 996 f.

7 For a comprehensive discussion *see* K. LANGENBUCHER, Anlegerschutz. Ein Bericht zu theoretischen Prämissen und legislativen Instrumenten, Zeitschrift für das gesamte Handelsrecht und Wirtschaftsrecht (ZHR) 177 (2013) 679.

8 K. J. HOPT, Die Haftung für Kapitalmarktinformationen, in: Kalss/Torggler (eds.), Kapitalmarkthaftung und Gesellschaftsrecht (Vienna 2013) 55 (58).

9 *See infra* at III.1.

II. Regulatory Architecture

The regulation of stock exchanges has a long history in Europe reaching back centuries, with the first modern (statutory) exchange laws dating from the 19th century.[10] Germany enacted its Stock Exchange Act in 1896.[11] Capital market law in the modern sense, on the other hand, is a more recent phenomenon that developed in the 20th century from the U.S. securities regulation of the 1930s, especially the Securities Act of 1933 and the Securities Exchange Act of 1934, that are administered by the Securities and Exchange Commission, an independent central agency.[12] This regulatory model spread to Europe and developments in the U.S. securities regulation are still often reflected to a certain degree in EU regulation. Germany's capital market regulation developed to a significant extent, though by no means exclusively, under the influence of EU law which it had to implement as did all Member States of the European Union.

1. EU

The EU's first core instrument of modern capital market regulation was the *Investment Services Directive* of 1993.[13] It was replaced by the *Markets in Financial Instruments Directive* (MiFID I) of 2004[14]. In 2017, the revised *Directive on Markets in Financial Instruments* of 2014 (MiFID II)[15] in turn replaced MiFID I.[16] This Directive is seen as "at least as broad and ambi-

10 A comparative historical overview can be found with H. Merkt, Zur Entwicklung des deutschen Börsenrechts von den Anfängen bis zum Zweiten Finanzmarktförderungsgesetz, in: Hopt/Rudolph/Baum (eds.), Börsenreform (Stuttgart 1997) 17; A. Fleckner, Exchanges, in: Basedow/Hopt/Zimmermann/Stier (eds.), The Max Planck Encyclopedia of European Private Law (Oxford 2012) Vol. I, 658.

11 The original version of the Act is reprinted at H. Pohl, Deutsche Börsengeschichte (Frankfurt a.M. 1992) 377 ff.

12 A classical analysis of the U.S. regulatory setting can be found with L. Loss, Fundamentals of Securities Regulation (Boston/Toronto 1988) 35 ff.

13 Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field, Official Journal L 141, 11.6.1993, p. 27.

14 Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, Official Journal L 145, 30.4.2004, p. 1.

15 Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU, Official Journal L 173, 12.6.2014, p. 349.

16 An informative overview can be found with D. Busch/G. Ferrarini (eds.), Regulation of the EU Financial Markets: MiFID II and MiFIR (Oxford 2017).

tious as the Dodd-Frank Act" – the US's regulatory response of 2010 to the global financial crisis.[17] The three consecutive Directives – together with their accompanying regulatory instruments – are regarded as the "basic law" of the EU financial markets and the central building block for the EU regulatory architecture that governs the provision of investment services in financial instruments by investment firms throughout the European Union. It primarily promotes market integration by granting market access and market integrity by regulating market supervision. As part of this, it also emphasizes investor protection as a regulatory goal in its own right. Thus, the Directives pursue the two-fold aim of protecting investors and ensuring the smooth operation of securities markets.[18] It should be noted that, from the beginning, the regulatory regime of capital markets law in the EU embraced the information model.

EU regulation in general comes in two forms: either in the form of a directive that needs to be implemented in the Member States' national laws to be applied or, increasingly, in the shape of a regulation that is directly applicable in the Member States without the need for prior implementation. A prominent example of the latter is the *Markets in Financial Instruments Regulation* (MiFIR) of 2014,[19] which supplements MiFID II and should therefore be read together with the Directive.[20] All directives are accompanied by delegated regulatory instruments.[21] In our context, the *Delegated Regulation* 2017/565 of 2016[22] is of special interest. As far as they apply, regulations directly replace the prior national Member States' law.

17 The Economist, 30 September 2017, 15.

18 *Cf.* Recital 44 of MiFID I, Recitals 3, 7 (et passim) of MiFID II; for a critical review of the specific aims and means of investor protection, *see* P. MÜLBERT, Anlegerschutz und Finanzmarktregulierung – Grundlagen, Zeitschrift für das gesamte Handelsrecht und Wirtschaftsrecht (ZHR) 177 (2013) 160–211.

19 Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012, Official Journal L 173, 12.6.2014, p. 84.

20 *Cf.* Recital 7 of MiFID II.

21 For an overview over the EU's regulatory architecture *see* M. LEHMANN/C. KUMPAN, Financial Services Law (Baden-Baden 2018, forthcoming); R. VEIL (ed.), European capital markets law (2nd ed., Oxford 2017); N. MOLONEY, EU securities and financial markets regulation (Oxford 2014).

22 Commission Delegated Regulation (EU) 2017/565 of 25 April 2016, supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive, Official Journal L 87, 31.3.2017, p. 1; to be applied from 3 January 2018.

2. Germany

The first major step to creating a modern capital market regulation was the enactment of the *Securities Trading Act* (STA, *Wertpapierhandelsgesetz – WpHG*) in 1994,[23] which implemented the EU's *Investment Services Directive* of 1993. Since then the STA has been amended numerous times to adopt the multitude of increasingly comprehensive reforms of pertinent EU regulation. The Act constitutes the legislative foundation of German capital market regulation and is characterized by a market-based approach.[24] Partly for historical reasons and partly because of the regulatory dynamics within the EU, various specific other laws dealing with different activities in the capital markets complement the STA.[25] Additionally, since 2016, the EU's *Market Abuse Regulation* [26] has replaced those previous sections of the STA that dealt with insider trading and market abuse. From 3 January 2018, MiFIR and the *Delegated Regulation* 2017/565 mentioned above will be directly applicable, partly substituting for sections of the STA, partly supplementing the Act. The STA itself was substantially revised in 2017 in order to implement MiFID II into German law. The major parts of the revised STA also enter into force on 3 January 2018 (hereafter "STA 2018" as opposed to the [old] STA). In short, capital market law in Germany resembles a kind of regulatory kaleidoscope but, all of the regulatory instruments stipulate, among others, varying types of information duties as a means of investor protection.

III. Information

1. Information Matrix

When we look at the manifold forms of information duties stipulated under the various regulatory instruments we see a complex matrix: The duties vary depending on, first, who of the different market players offers, second, what

23 Gesetz über den Wertpapierhandel *(Wertpapierhandelsgesetz – WpHG),* Act of 26. July 1994 (Federal Law Gazette I, 1749), as redrafted by Publication of 9 September 1998 (Federal Law Gazette I, 2708) and as amended by the Act of 17. August 2017 (Federal Law Gazette I, 3202).

24 *See* A. Fuchs, in: *id.* (ed.), WpHG (2nd ed., Munich 2016) Einl., marginal note 4 f.

25 The most important being the Securities Prospectus Act *(Wertpapierprospektgesetz),* the Capital Investment Act *(Kapitalanlagegesetzbuch),* the Stock Exchange Act *(Börsengesetz),* and the Takeover Act *(Wertpapiererwerbs- und Übernahmegesetz)* to name but a few.

26 Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (market abuse regulation) and repealing Directive 2003/6/EC of the European Parliament and of the Council and Commission Directives 2003/124/EC, 2003/125/EC and 2004/72/EC, Official Journal L 173, 12.6.2014, p. 1.

kind of financial services to, third, which type of investor or "client". The major players in the capital markets are marketplaces (e.g. exchanges), financial intermediaries (e.g. investment services firms like banks), issuers, and information intermediaries (e.g., rating agencies). With respect to clients, the STA distinguishes between three different classes of "clients": professional clients (institutional investors), retail clients (private investors), and eligible counterparties. In the context of this paper we will restrict our discussion to the information duties that are attached to the professional handling of financial products (or, in the legislative parlance, "financial instruments") in the secondary market in the form of the provision of "investment services" by "investment services firms" to "retail clients".[27]

Investment services within the meaning of the Act include, among others and broadly speaking, the promotion, recommendation, offering, purchase or sale of financial instruments.[28] *Financial instruments* are namely shares in companies, debt securities and derivatives.[29] *Investment services firms* are, in Germany, mostly banks that provide investment services.[30] *Retail clients* are clients who are not professional clients.[31] Professional clients are in turn investors whom an investment services firm can assume possess sufficient experience, knowledge and expertise to make their own investment decisions and properly assess the risks that they incur.[32] The protection provided by the STA depends on the type of client.[33] This concept of layered levels of protection is upheld under MiFID II and thus under the STA 2018. The Directive

27 Information duties in primary market come in form of issuer disclosure under prospectus regulation.

28 Sec. 2 (3) STA (in future Sec. 2 (8) STA 2018); for details see H. BAUM, in: Hirte/Möllers (eds.), Kölner Kommentar zum WpHG (2nd ed., Cologne 2014) § 2, marginal notes 141 ff.

29 Sec. 2 (2b) STA (in future Sec. 2 (4) STA 2018); for details see G. ROTH, in: Hirte/Möllers, *supra* note 28, at § 2, marginal notes 14 ff.

30 Sec. 2 (4) STA (in future Sec. 2 (10) STA 2018); for details see BAUM, *supra* note 28, at § 2, marginal notes 216 ff.

31 Sec. 31a (3) STA (in future Sec. 67 (3) STA 2018); for future details *see* P. BUCKHEEB/D. POELZIG, Die Verhaltenspflichten (§§ 63 ff. WpHG n.F.) nach dem 2. FiMaNoG – Inhalt und Durchsetzung, Zeitschrift für Bank- und Kapitalmarktrecht (BKR) 2017, 485.

32 Sec. 31a (2) STA (in future Sec. 67 (2) STA 2018); for details see T.M.J. MÖLLERS, in: Hirte/Möllers, *supra* note 28, at § 31(a), marginal notes 40 ff.

33 The German legislator (like the EU regulator) sharply distinguishes between consumer protection and investor protection. Capital markets regulation is addressed to investors whether these are consumers or not. If they also fall under the latter category, an additional layer of consumer protection may apply under certain circumstances like, e.g., in the context of door-to-door selling; for a discussion of this is-

stipulates that measures to protect investors should be adapted to the particularities of each category of investors although, irrespective of the categories of clients concerned, the principle of acting honestly, fairly and professionally and the obligation to provide fair, clear and not misleading information duties apply to the relationship with all clients.[34]

2. *Information Duties under the STA*

The above is reflected in the regulation of information duties under the STA. All information, including marketing communications, which investment services firms make available to their clients must be fair, clear and not misleading and marketing communications must be clearly identifiable as such.[35] Investment services firms are required to provide clients with information in a comprehensible form and in a timely manner. This information must be reasonably appropriate for these clients to understand the nature of, and risks involved with, the financial instruments or investment services being offered or demanded, and to take investment decisions on this basis. This information must relate to: the investment services enterprise and its services; the types of financial instruments and proposed investment strategies, including the risks associated therewith; the execution venues; and the costs and associated charges.[36] Regarding the risks of financial instruments, the investment services firms must not only inform about the risks specifically inherent to the given product, but also about the general risk that its issuer might become insolvent and a unable to repay, resulting in a loss of the capital invested.[37] All relevant aspects of the various types of information to be provided are laid out in great detail in an ordinance.[38]

One of the central regulations for the protection of retail investors is the so-called "appropriateness rule".[39] An investment services firm that provides either investment advice or financial portfolio management must obtain from its clients all *information* necessary to enable the recommendation of financial instruments or investment services that are appropriate for

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sue, *see* P. BUCK-HEEB, Vom Kapitalanleger- zum Verbraucherschutz, Zeitschrift für das gesamte Handelsrecht und Wirtschaftsrecht (ZHR) 176 (2012) 66.

34 Recital 86.

35 Sec. 31 (2) STA (in future Sec. 63 (6) STA 2018).

36 Sec. 31 (3) STA (in future Sec. 63 (7) STA 2018).

37 One could argue that the latter general risk is self-evident, *see* H. BAUM, Garantie-Zertifikate und 'Emittentenrisiko': Hinweispflicht in Werbefoldern?, Der Gesellschafter. Zeitschrift für Gesellschafts- und Unternehmensrecht (GesRZ) 2010, 311.

38 Sec. 4 ff. Wertpapierdienstleistungs-Verhaltens- und Organisationsverordnung, Ordinance of 20. July 2007 (BGBl. I, 1432) as amended; in future Art. 48 Delegated Regulation 2017/565.

39 Sec. 31 (4) STA (in future Art. 54 (2) Delegated Regulation 2017/565).

their clients, as will be explained hereafter. For an investment services firm that provides neither investment advice nor financial portfolio management but other financial services, the appropriateness rule also applies but is less strictly conceived.[40]

If an investment services firm plans to provide investment advice or financial portfolio management, it has to determine beforehand whether the product or investment service offered or demanded is appropriate for the given client. For this, the investment services firm must collect the relevant information from its client and undertake an assessment as to whether the pertinent investment service satisfies the following three criteria: (i) does it meet the investment objectives of the client in question, including the client's risk tolerance?; (ii) is the client financially able to bear any related investment risks consistent with his investment objectives?; (iii) does the client have the necessary experience and knowledge in order to understand the risks involved in the transaction or in the management of his portfolio? The aim is to create a basis of understanding, enabling the investment services firm to provide the client with appropriate *information* and competent investment advice, which in turn enables a retail investor to make a rational evaluation of the risks of his or her own investment decision.

An investment services firm is entitled to rely on the information provided by its clients unless it is aware or ought to be aware that the information is manifestly out of date, inaccurate or incomplete.[41] If the investment services firm does *not obtain* the information required, it may *not* recommend a financial instrument when it provides investment advice.[42] If the firm *does obtain* the information required it may recommend to its clients *only* those financial instruments and investment services that are appropriate based on the information obtained.[43] The overarching regulatory aim is thus *information,* but not paternalism. If the investor has received all relevant information in an appropriate form, he or she has to bear the economic consequences of the investment decision ("information model").

3. Information Duties Created by the Courts

Largely independent of the pertinent EU law and partly earlier to that, German courts developed an information-based approach when judging the civil liability of investment firms towards their clients. Insufficient regulation and supervision had led in the 1980's to wide-spread scandals defrauding investors. The scandals produced a flood of decisions by the German

40 Sec. 31 (5) STA (in future Sec. 63 (10) STA 2018).
41 (For the future) Art. 55 (3) Delegated Regulation 2017/565.
42 Sec. 31 (4) STA (in future Art. 54 (8) Delegated Regulation 2017/565).
43 Sec. 31 (4a) STA (in future Art. 54 (9) Delegated Regulation 2017/565).

Federal Court of Justice and appellate courts dealing with the duties of investment firms when providing investment services and especially when giving investment advice. The lack of specific statutory duties caused the German courts to develop standards based on general private law to be followed by the securities industry – the so-called "Bond"-jurisprudence.

The first major decision was the famous "Bond Judgment" by the Federal Court of Justice in 1993.[44] In its decision, the Court formulated the basic duty that investment advice has to be tailored, first, according to the need of the specific investor and, second, to the characteristics of the investment product in question. This rule is still held valid today. The basis of such information is either an explicit or, mostly, an implied advisory contract between the bank and its client. German courts regularly assume the implicit conclusion of such a contract from the moment the bank and its client start an advisory talk that concerns financial products. The result of this 25 years of development of case law is a highly refined structure of rights and obligations in the area of investment services based on private law rules, namely contract law and agency, as interpreted and developed by the courts. Statutory capital markets regulation played only a very marginal and indirect role in this context, if any.

Some 20 years later, the Federal Court of Justice issued the so-called "Spread Ladder Swap Judgment". In this controversial decision of 2011, the Federal Court of Justice extended the parameters of the Bond judgment for information duties of investment services firms when advising clients in complex and purely speculative swap transactions without underlying business transactions.[45] The Court interpreted the fact that the swap in question

44 Decision of 6 July 1993, Entscheidungen des Bundesgerichtshofes in Zivilsachen (BGHZ) 123, 126; confirmed by BGH, decision of 9 May 2000, Wertpapier-Mitteilungen (WM) 2000, 1441; BGH, decision of 25 June 2002, WM 2002, 1683; BGH, decision of 21 March 2006, WM 2006, 851; BGH, decision of 25 September 2007, Zeitschrift für Bank- und Kapitalmarktrecht (BKR) 2008, 199; BGH, decision of 19 February 2008, WM 2008, 825; BGH, decision of 12 May 2009, WM 2009, 1274; BGH, decision of 22. March 2011, BGHZ 189, 13; BGH, decision of 27 September 2011, BGHZ 191, 119; BGH, decision of 12 November 2013, WM 2014, 24; BGH, decision of 8 April 2014, WM 2014, 1036; for an analysis, see V. LANG/P. BALZER, Die Rechtsprechung des XI. Zivilsenats zum Wertpapierhandelsrecht seit der Bond-Entscheidung, in: Habersack et al. (eds.), Festschrift für Gerd Nobbe (Cologne 2009) 639; A. HELLGARDT, Praxis- und Grundsatzprobleme der BGH-Rechtsprechung zur Kapitalmarktinformationshaftung, Der Betrieb (DB) 2012, 673.

45 Decision of 22 March 2011, Entscheidungen des Bundesgerichtshofes in Zivilsachen (BGHZ) 189, 13; for a detailed analysis of that decision *see* H. C. GRIGOLEIT, Grenzen des Informationsmodells, in: Habersack et al. (eds.), Anlegerschutz im Wertpapiergeschäft. Bankrechtstag 2012 (Berlin 2013) 25 ff. The decision was con-

had an initial negative market value hidden in its complex structure as an indication for a severe conflict of interest for the bank selling the swap and held the bank without any restriction liable for damages because of its failure to inform the investor about this conflict beforehand. It did not make a difference that the pertinent investor was a medium sized company represented by its financial officer (a qualified economist) and not a retail investor. The Federal Court furthermore stated that the bank must make sure that its client (i) fully understands risk of the financial instrument involved in all its aspects and (ii) has achieved basically the same understanding and knowledge as the bank with respect to the product.

Regarding this second line of reasoning by the Federal Court, the decision has been criticized as overstretching the information duties of investment services firms and as an invitation for frivolous suits.[46] The decision indicates a paradigmatic shift in the interpretation of the information model.[47] Until this point, banks were obliged to deliver appropriate information on the financial instruments they promote and sell to their clients. Once that was done, clients could not hold them liable for any losses resulting from the purchase of that instrument. Now, that is no longer sufficient, banks must make also sure their clients had fully understood the information supplied. At least with regard to complex financial instruments this is virtually impossible and thus, in effect, the ruling leads to a *de facto* prohibition of such products (which may or may not be a good thing – probably a good one – but, it is scarcely a policy decision to be made by the courts instead of the legislator).[48] In other words, the baanks have to bear the consequences of the information overload caused by over ambitious regulatory demands. A more straightforward, but highly paternalistic, and also in itself questionable, approach would be a general prohibition of such products by the legislator.[49]

4. Tension Between Public and Civil Law Information Duties

The information duties established under the STA differ in scope and, partially, also in content from those created by the German courts. Capital market regulation is intended to guaranty a *general* and *preventive* protection that is granted *ex ante,* which is typical for public law. This contrasts

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firmed by further decisions of the Federal Court of Justice in 2015, for an overview *see* P. CLOUTH, Aufklärungs- und Beratungspflichten bei Swaps, in: Grüneberg et al. (eds.), Bankrechtstag 2015 (Berlin 2016) 163.

46 GRIGOLEIT, *supra* note 45, at 62 f.; for frivolous investor suits *see infra* at IV.2.

47 J. KOCH, Grenzen des informationsbasierten Anlegerschutzes, Zeitschrift für Bank- und Kapitalmarktrecht (BKR) 2012, 485, at 487 ff.

48 *Ibid.,* at 490 f.

49 *See infra,* at V.2.

with the *individual* protection courts provide *ex post* in a given case, which is characteristic for private law enforcement.

From the traditional German point of view, the regulatory regime of the STA qualifies as a regulation that falls into the domain of public law – as opposed to that of private law. German legal doctrine makes a clear distinction between (mandatory) public law and private law that is largely not mandatory but ruled by party autonomy. The EU, however, does not know such a clear distinction. The EU has refrained from unifying civil law because of the lack of authority. The *Treaty on the Functioning of the European Union* of 2012[50] does *not* provide a general authority for a unification of private law. There are some limited exceptions such as consumer protection or product liability but, in general, the EU has respected the substantial conceptual differences between the private law regimes in the Member States and has been hesitant to interfere in contractual relations between citizens out of fear of disrupting the consistency of national private law regimes. This lack of harmonization allows the German courts to deal with the liability of investment firms towards their clients under *national* civil law without being bound, at least not directly, by EU law.

By dealing with the way the firms have to do business in relation to their customers, the conduct of business rules in Sec. 31 ff. STA / Sec. 63 ff. STA 2018, despite being public law in principle, obviously have at least some connection with the contractual relations between an investment services firm and its customers and thus with private law. Accordingly, these rules are often qualified as "functional" civil law. The central question that arises here is whether the rules do actually create civil law effects, which interfere in the contractual relations and which the courts have to take into account.[51]

The answer has obvious practical consequences. If one sees the MiFID as a legal instrument that creates such effects, it would imply, among other conclusions, that investors are entitled to claim damages from the investment firms, which are in breach of the conduct of business rules under the STA. The Directive is – somewhat surprisingly – quiet on these matters. As before, Art. 51 of MiFID I, now Art. 70 of MiFID II, only postulates that the Member States must ensure in their national laws that their competent authorities may impose administrative sanctions and measures applicable to

50 Official Journal of the European Union, C 326, 26 October 2012.

51 *See* H. BAUM, Public vs. Civil Law: The German Controversy About the Interaction Between Capital Market Regulation and Contract Law, Hikakuhō Zasshi 48/3 (2014) 41; ID., Das Spannungsverhältnis zwischen dem funktionalen Zivilrecht der 'Wohlverhaltensregeln' des WpHG und dem allgemeinem Zivilrecht, Österreichisches Bank Archiv (ÖBA) 2013, 396; from the Austrian perspective M. OPPITZ, Kapitalmarktaufsicht (Vienna 2017) 391 ff.

all infringements of the Directive, MiFIR and national provisions adopted in the implementation of these. Member States must also ensure that these measures are effective, proportionate, and dissuasive. The *European Court of Justice (ECJ)* ruled in May 2013 that the Member States are free to decide whether or not they want to implement civil law sanctions against a violation of conduct of business rules.[52] If they do, however, the civil law effects have to be effective and proportionate.

A major question is therefore how the interaction of supervisory law and civil law can be managed and it has yet to be clarified how "functional" civil law can be consolidated with the traditional (general) civil law framework in the face of the pronounced dichotomy between public and private law that emerged in the early nineteenth century in German law.[53] This is an unsolved fundamental issue permeating all German capital market regulation.[54] While the duties of investment services firms based on private law as elaborated by the courts and their obligations under the conduct of business rules qualified as "functional" civil law do overlap part of the supervisory law to a certain extent, they are *not* identical. As a rule, the contractual duties developed by the German Federal Court of Justice for investment services firms are more *comprehensive* than the obligations resulting from supervisory law.[55] Thus the question is whether *only* behavior which fulfills *both* the private *and* the public law requirements is legitimate, or whether behavior that fulfills at least *one* of the two standards is also covered, and, if so, whether the *lighter* or the *stricter* standard should be the guideline. Three opposing views can be observed.

The Federal Court of Justice postulates a strict primacy of civil law in relation to the conduct of business rules of the STA.[56] According to the Federal Court, the conduct rules exclusively qualify as public law and es-

52 Decision of 30 May 2013 – Rs. C-604/11 (Juzgado de Primera Instancia n° 12 de Madrid, Spain), Zeitschrift für Wirtschaftsrecht (ZIP) 2013, 1417; *see* also ECJ, decision of 19 December 2013 – Rs. C-174/12 (Handelsgericht Wien, Austria), Die Aktiengesellschaft (AG) 2014, 445.

53 K. ROTHENHÖFER, Interaktion zwischen Aufsichts- und Zivilrecht, in: Baum et al. (eds.), Perspektiven des Wirtschaftsrechts. Beiträge für Klaus J. Hopt (Berlin 2008) 55; for an extended discussion, see J. FORSCHNER, Wechselwirkungen von Aufsichtsrecht und Zivilrecht (Tübingen 2013).

54 S. GRUNDMANN, Wohlverhaltenspflichten, interessenkonfliktfreie Aufklärung und MiFID II, Wertpapier-Mitteilungen (WM) 2012, 1745.

55 But sometimes it is also the other way round: the obligations under the "functional" civil law are stricter than the ones under general civil law.

56 *See* especially the Federal Court's reasoning in the decision of 17 September 2013, JuristenZeitung (JZ) 2014, 252, at nos. 15 – 24; for a comment see C. KROPF, Keine zivilrechtliche Haftung im beratungsfreien Anlagegeschäft, Wertpapier-Mitteilungen (WM) 2014, 640.

tablish only public law duties that have absolutely *no* civil law effects of their own.[57] In the view of the Federal Court, the conduct rules thus have neither a limiting nor an enlarging effect with respect to the civil law liability of investment firms.[58] A second opinion, diametrically opposed to the first one, emphasizes an unrestricted primacy of the "functional" civil law of the STA over the general civil law. Proponents of this view argue that the conduct of business rules have to be qualified as general civil law rules – though located outside the Civil Code – because of MiFID's expressed legislative aim of investor protection.[59]

A third view builds a compromise between these two contradictory views: it does not claim a primacy of public law in the form of "functional" civil law, but much more modestly assumes a "diffusion" *("Ausstrahlung")* of the pertinent public law rules into the general civil law and its application. This is probably the leading opinion in German academia today.[60] The "diffusion" is accordingly reduced to a *potential* but *not* mandatory interaction between both spheres of law. Supervisory law *might* influence contract law, but it does not necessarily do so.[61] The civil courts should have the freedom to deviate from the duties defined in the conduct of business rules as they deem appropriate.[62]

IV. Challenges to the "Information Model"

The concept of the "information model" as the basis for capital market regulation is challenged from two sides.

1. Bounded Rationality, Lack of Expertise, Information Overload

Recently, doubts have grown whether the fundamental assumption that a properly informed investor makes always a reasonable investment decision is

57 *Id.* at nos. 16–18.

58 Somewhat more ambiguous BGH, decision of 3 June 2014, Zeitschrift für Bankrecht und Bankwirtschaft (ZBB) 2014, 421; *cf.* R. Freitag, Überfällige Konvergenz von privatem und öffentlichem Recht der Anlageberatung, *Ibid.,* 357.

59 *See, e.g.,* Grundmann, *supra* note 54, 1752; D. Einsele, Verhaltenspflichten im Bank- und Kapitalmarktrecht – öffentliches Recht oder Privatrecht?, Zeitschrift für das gesamte Handelsrecht und Wirtschaftsrecht (ZHR) 180 (2016) 233.

60 For a detailed discussion, *see* Forschner, *supra* note 53, at 113 ff.; Rothenhöfer, *supra* note 53, at 70 ff.; Fuchs, *supra* note 24, vor §§ 31 bis 37a, marginal notes 76 et seq.; each with extensive further references.

61 R. Sethe, Anlegerschutz im Recht der Vermögensverwaltung (Cologne 2005) 749.

62 Grigoleit, *supra* note 45, at 39 f.

valid under all circumstances.[63] The fallout of the global financial crisis has amplified these doubts. Research in behavioral finance has shown that the average investor does not necessarily behave rationally. Among others, one can observe an asymmetrical approach to risk and chances, overconfidence as well as over optimism, an "irrational exuberance", and herd behavior influencing the investment decisions of retail investors.[64] Furthermore, these investors often have no expertise in financial matters in general, let alone any understanding of complex structured (derivative) financial products where the true relationship of risks and chances is hidden by their complexity. Also, and most critically, too much or overly complex information leads to a complete non-reception of information as cognitive limits prevent further processing ("information overload" or "information overkill").[65] In particular, prospectuses supplying extensive information as a precondition for initial public offerings of shares and other financial products are, as a rule, by far too long and complex for retail investors. These investors, furthermore, often do not the read periodical disclosures (annual reports etc.) of the companies in which they have invested. Thus, basic assumptions of the information model seem to come into question when speaking of retail investors.

2. General "Right of Repentance"?

A second challenge to the information model comes from what can be dubbed "right of repentance". German courts have been overwhelmed in the last two decades with tens of thousands of investor suits seeking damages from issuers and/or investment firms. An early climax came in 2001 when some 17,000 shareholders of *Deutsche Telekom* filed roughly 2,500 individual lawsuits as plaintiffs against the company at the Frankfurt trial court, involving more than 700 attorneys. Retail investors who had lost most of their investments due to a dramatic drop in the company's share price claimed the relevant prospectus had been false. The German legisla-

63 For an interdisciplinary state of the art discussion *see* K. U. SCHMOLKE, Information and Disclosure Duties from a Law-and-Economics Perspective – A Primer, in this volume, with manifold further references; *see* further the overviews by D. ZIMMER, Vom Informationsmodell zu Behavioral Finance: Brauchen wir „Ampeln" oder Produktverbote für Finanzanlagen?, JuristenZeitung (JZ) 2014, 714, L. KLÖHN, Der Beitrag der Verhaltensökonomik zum Kapitalmarktrecht, in: H. Fleischer/D. Zimmer (eds.), Beitrag der Verhaltensökonomie (behavioral economics) zum Handels- und Wirtschaftsrecht (Frankfurt am Main, 2011) 83.

64 *Ibid.*

65 *See* S. KALSS, Das Scheitern des Informationsmodells gegenüber privaten Anlegern, in: Gutachten für den 19. Österreichischen Juristentag, Bd. II/1 (2015) 3, 21; GRIGOLEIT, *supra* note 45, at 25 ff.; for a comprehensive discussion *see, e.g.,* C. STAHL, Information Overload am Kapitalmarkt (Baden-Baden 2013).

ture reacted by enacting a special law in 2005, the so-called "Capital Markets Model Case Act".[66] The aim of the Act is to provide a means for collective redress for investors, especially retail investors, who have suffered damages because of faulty capital markets information.[67]

One reason for the frequent redress to the courts is that the private law investor protection by the German courts is functioning well, sometimes even too well. Increasingly, courts have shown a tendency to overshoot, making peripheral or only perceived violations of the constantly expanding information duties a base for granting investors damages or even a right to rescind the contract.[68] This leads to the reverse problem of an open misuse of information duties and a perversion of investor protection providing an opportunity to step back *ex post* and be free of costs resulting from failed investment decisions.[69] The pertinent court decisions are in danger of creating *contra legem* a "right of repentance" *("Reuerecht")* and a general liberation of contractual duties violating the principle of *pacta sund servanda*. Investors take a chance of making profit with their investments, but in case of failure they refuse to bear the negative economic consequences and try to shift the loss to the investment services firms as their contract partners and/or advisors. In effect, this strategy amounts to nothing more than a socialization of their losses to the detriment of the public, i.e. other customers and owners (often shareholders) of the investment services firms. Courts in Germany as well as in Austria are swamped with such frivolous suits not only in the area of capital markets law but also in other consumer related fields of law. This poses an unexpected challenge to the information model.

In the light of the above findings, some simply state that the information model has failed with respect to private (retail) investors.[70]

66 Kapitalanleger-Musterverfahrensgesetz (KapMuG) of 19 October 2012 (Federal Law Gazette I, 2182), last amended by Art. 16 (1) of the Act of 30 June 2016 (Federal Law Gazette I, 1541).

67 For a brief overview in English *see* H. BAUM, The German Capital Markets Model Case Act – A Functional Alternative to the US-Style Class Action for Investor Claims?, available at *http://ssrn.com/abstract=2909545.*

68 KALSS, *supra* note 65, at 23.

69 For a detailed analysis *see* H. BAUM, Das prospektrechtliche Widerrufs- bzw. Rücktrittsrecht im Spannungsverhältnis zwischen Anlegerschutz und Reuerecht: gestörte Vertragsparität zu Lasten der Kreditinstitute, Österreichisches Bank Archiv (ÖBA) 2018 (forthcoming); ID., Reuerecht und Emittentenrisiko – Grenzen der Aufklärungspflicht aus prospektrechtlicher und beratungsvertraglicher Sicht, Der Gesellschafter. Zeitschrift für Gesellschafts- und Unternehmensrecht (GesRZ) 2015, 11.

V. Regulatory Reactions

The German legislator opened the regulatory floodgates in reaction to the fallout of the global financial crisis.[71] Among others, the following legislative reforms have a specific reference to information duties.

1. Key Information Document

In 2011, Germany introduced the obligation for investment services firms, when providing investment advice to retail clients, to supply a brief and easily understandable information sheet concerning the financial instruments being recommended for purchase. This has to be done well before a transaction in these instruments is concluded.[72] The information provided must not be false or misleading and must be in accordance with the information given in the prospectus. The obligation to supply such an information sheet arises only in relation to retail and not to professional clients and only with respect to certain types of financial instruments.[73] The length of the document depends on the complexity of the instrument in question: up to 2 pages as a rule and the maximum length is 3 pages in a pre-defined format. The restriction of length is mandatory.

The German initiative was a national one in reaction to the fallout of the global financial crisis and (at that time) not induced by European Community law. Due to the implementation of MiFID II, this obligation applies from 2018 onwards for *all* financial products, although still only within the context of investment advice provided to retail investors.[74] Additionally, at the end of 2016 the EU Regulation on Key Information Documents for Packaged Retail and Insurance-based Investment Products (PRIIPs) became effective, and is directly applicable in the Member States.[75]

The main purpose of the short information documents is to reduce the amount and the complexity of information – ironically induced by government regulation to enhance the information model – to avoid "information overload" especially for the average retail investor.[76]

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70 Kalss, *supra* note 65, at 23.

71 *See supra* at I.

72 Sec. 31 (3a) STA.

73 Details are regulated in Sec. 5a Wertpapierdienstleistungs-Verhaltens- und Organisationsverordnung.

74 Sec. 64 (2) STA 2018.

75 Regulation (EU) No 1286/2014 of the European Parliament and of the Council of 26 November 2014 on key information documents for packaged retail and insurance-based investment products, Official Journal L 352, 9.12.2014, p.1.

76 *See supra* at IV.1.

2. *Product Governance and Product Intervention*

In reaction to the global financial crisis and perceived shortcomings of the information model, the EU Commission introduced the regulatory means of "product governance" and "product intervention".[77] MiFID II introduced a system of "product governance". Art. 24 (2) MiFID II obliges investment services firms, which manufacture financial instruments for sale to clients, to make sure that the instruments have been initially designed to meet the needs of an identified target market of end clients. Also, the strategy for the distribution of these financial instruments must be compatible with the identified target market, and the firm has to take reasonable steps to ensure that the financial instruments are (only) distributed to that market.[78]

The Markets in Financial Instruments Regulation (MiFIR) of 2014[79] introduced a "product intervention" by the competent authorities as a regulatory measure which will be effective from 2018 and applies directly in the Member States. The powers of the authorities are complemented with an explicit mechanism for prohibiting or restricting the marketing, distribution and sale of any financial instrument that gives, among others, rise to serious concerns regarding investor protection or the orderly functioning and integrity of financial markets.[80] Appropriate coordination and contingency powers were vested with the European Securities and Markets Authority (ESMA).[81]

A competent authority may prohibit or restrict the marketing, distribution or sale of financial instruments or financial activities if it is satisfied on reasonable grounds that the pertinent financial instrument or activity gives rise to significant investor protection concerns or poses a threat to the orderly functioning and integrity of financial markets and, furthermore, that the existing regulatory requirements under Union law such as, e.g., information duties, applicable to the financial instrument or activity do not sufficiently address the risks.[82] The action has to be proportionate with respect to the nature of the risks identified, the level of sophistication of investors

77 For an overview of the new regime *see* D. BUSCH, Product Governance und Produktintervention unter MiFID II/MiFIR, Wertpapier-Mitteilungen (WM) 2017, 409. The regulation was preceded by the Final Report of the International Organization of Securities Commissions (IOSCO), Regulation of Retail Structured Products (2013), that discusses some similar measures; available at *https://rdmf.files.wordpress.com/2014/01/informe-iosco.pdf*

78 For an overview from the German perspective *see* P. BUCK-HEEB, Der Product-Governance-Prozess – MiFID II, Kleinanlegerschutzgesetz und die Auswirkungen, Zeitschrift für das gesamte Handelsrecht und Wirtschaftsrecht (ZHR) 2015, 782, 797.

79 *Supra* note 19.

80 *Cf.* Recital 29 MiFIR.

81 *Cf.* Art. 40 MiFIR.

82 Art. 42 (1),(2)(a),(b) MiFIR.

concerned and the likely effect of the action on investors who may hold, use or benefit from the financial instrument or activity.[83]

The German legislator had already introduced a regulation on "production intervention" in 2015 that was modeled along the lines of Art. 42 MiFIR. The aim was to create a supervisory instrument for direct intervention in the capital market. This legislative activity was motivated by the insolvencies of two issuers of financial products unsuitable for retail investors who had suffered massive losses caused by these defaults.[84] The German Federal Financial Supervisory Authority *(BaFin)* may now restrict or prohibit the marketing, distribution or sale of financial instruments etc. based upon the powers granted to it under the newly added Sec. 4b STA[85]. A first intervention in 2016 caused an intense discussion about the pros and cons of such a measure.[86]

Product governance and product intervention indicate a paradigmatic regulatory change and at least a partial departure from the information model. While the latter is based on an *ex post* control of financial instruments and services by the courts, the former relies on a paternalistic *ex ante* market control by the bureaucracy. The regulation under Sec. 4b STA / Sec. 15 STA 2018 is regarded as a general shift towards a collective consumer protection that is far more encompassing in its design than the traditional investor protection.[87] One obvious drawback is that even experienced retail investors with no need for protection are protected "by force".[88]

3. Fee Based Investment Advice

In 2014, the German legislator introduced a regulation for obtaining independent fee based investment advice as an alternative to the traditional commission based advisory business with its intrinsic conflicts of interest.[89] Again, the coming regulation under MiFID II was taken as a guideline. Any

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83 Art. 42 (2)(c) MiFIR.

84 *See* M. BOUCHON/N. MEHLKOPP, in: Fuchs, *supra* note 24, § 4a, marginal note 2.

85 In future Sec. 15 STA 2018.

86 *See, e.g.,* J.-H. EHLERS, Das Produktinterventionsrecht der BaFin nach § 4a WpHG, Wertpapier-Mitteilungen (WM) 2017, 420; P. BUCK-HEEB, Aufsichtsrechtliches Produktverbot und zivilrechtliche Rechtsfolgen – Der Anleger zwischen Mündigkeit und Schutzbedürftigkeit, Zeitschrift für Bank- und Kapitalmarktrecht (BKR) 2017, 89.

87 J.-P. BUßALB, Produktintervention und Vermögensanlagen, Wertpapier-Mitteilungen (WM) 2017, 553.

88 BUCK-HEEB, *supra* note 3.

89 Sec. 31 (4)(b)–(d) STA (in future Sec. 64 (1),(5),(6) STA 2018); for an overview *see* P. BALZER, Rechtliche Rahmenbedingungen der Honorarberatung, in: Habersack et al. (eds.), Bankrechtstag 2013 (Berlin 2014) 157.

investment services firm that intends to provide investment advice has to inform its clients beforehand whether or not it offers an independent fee based advice.[90] The legislator aimed at raising investor awareness of the difference between commission and fee based investment advice, with the intention of promoting the later.[91] The already existing duty to inform a client about the general nature and the source of unavoidable conflicts of interest prior to the execution of the transaction under Sec. 31 (1) STA was regarded as insufficient. An investment services firm that provides an independent fee based investment advice has to offer a sufficiently broad spectrum of financial instruments and may not accept monetary contributions from third parties.[92]

Whereas the UK prohibited commission based advisory business as early as 2013, the financial industry in Germany still mostly refuses to offer such advisory business on a large scale.

4. Evaluation

Simplifying mandatory information as well as holding investment services firms responsible for overly complex information are attempts to mitigate the problem of an information overload. The introduction of a strictly fee based investment advice may be a means to finally overcome the information and conflict of interest problems inherent to the traditional commission based advisory business model. Both measures fit into the concept of the information model. However, whether and, if so, how the (potentially) paradigmatic shift to paternalism in the form of product governance and product intervention by the supervisory authorities fits into the regulatory framework of the information model that is still officially upheld in general is an entirely open question to say the least.[93] As long as these regulatory instruments serve as a limited supplement to the information model and not as a principal alternative and substitute, we might learn to live with them. But a look to Japan may serve as a comparative caveat to a principal regulatory change towards paternalism: One should keep in mind that Japan had, till fairly recently, a long and not altogether happy history with general bureaucratic (paternalistic) *ex ante* regulation of its financial markets which was at least one of the causes of its lasting structural economic crisis.[94]

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90 Sec. 31 (4)(b) STA (in future Sec. 64 (5) STA 2018).

91 FUCHS, *supra* note 24, § 31, marginal note 202 f.

92 Sec. 31 (4)(c) STA (in future Sec. 64 (6) STA 2018).

93 Critical, e.g., P. BUCK-HEEB, *supra* note 3, 286 f.

94 *Cf.* H. BAUM, Der japanische „Big Bang" 2001 und das tradierte Regulierungsmodell: ein regulatorischer Paradigmenwechsel?, Rabels Zeitschrift für ausländisches und internationales Privatrecht (RabelsZ) 64 (2000) 633.