Legal non-enforcement as an instrument of financial market regulation

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Introduction

In many legal systems claims resulting from gaming or gambling are not enforceable. This is designed to protect the debtor from driving himself into financial ruin through gaming and betting debts. There is a German saying that “a gambling debt is a debt of honour”. Older case–law applied this legal principle to the financial market interactions that were speculative in nature. Many of today’s speculative financial instruments therefore lacked legal contractual protection and consequently were hard to sell. German civil code § 764 explicitly defined futures trading as gaming or betting but this paragraph was abolished in 2002. The case–law has since developed to make claims based on speculative financial instruments legally enforceable. This paper offers a short overview of the situation in Germany, Austria and Switzerland. Then it explains how the principle of legal non–enforcement, in other words the removal of legal protection from speculative financial interactions, can be applied as a regulatory method to stabilise financial markets.

The Situation in Germany

Until the late 1980s claims from speculative futures trading between two individuals were legally unenforceable. German civil code, § 762, states that no liability arises from betting and gaming transactions. § 764 stated (until 2002) that pure futures transactions (“differential transactions”) are a game in terms of § 762 and resulting liabilities are legally non–existent.

§ 762. (Incomplete liability) (1) No accrued liability exists resulting from betting and gaming transactions. Payment of accrued debt can therefore not be demanded because liability did not exist. (2) These regulations also apply to a deal where the losing party, to fulfil its gaming or betting debt, enters into a commitment to the winning party, especially an admission of liability.

§ 764. (Differential Transactions) If a deal is made relating for the delivery of stock or bonds, with the intention that the difference between the agreed price and the market price at the time of delivery is to be paid by the losing party to the winning party, then this deal should be seen as a bet. This is also the case when it is only the intention of one part to receive this differential payment but the other part is or must be aware of this intention.

With the introduction of the first Financial Markets Promotion law (Feb. 1990), the aim of which was the open up the market of speculative products to a wider public, in order to expand Germany’s financial market, the legal effectiveness of the civil law regulation on legal non–enforcement was limited through the introduction of the term “transaction capability through information” in the Stock Exchange Act (§§ 50 – 70 BörsG a.F.)
The circle of persons that were seen as “transaction-capable through information” was relatively broad. Alongside traders, people passed as transaction-capable, simply by having been provided by their bank with the standardised hand-outs about the risks of futures transactions. People with such transaction capability could no longer use the legal protection of §§ 762, 764 of the civil code against speculative transactions, because they, as per this definition, were aware of the risks and therefore did not need the protection of §§ 762, 764 any longer.

But this investor protection model through “information”, suffered from substantial gaps. To address these issues, on July 1st 2002, in the Fourth Financial Markets Promotion law, investor protection was moved from Stock Market Law into the new Bond Trading Legislation (WpHG). However, this new legislation was also based on the basic premise that an investor is best protected if made aware by his/her bank of the risks of speculative futures business transactions. On this point, the then Parliamentary Secretary of State Dr. Barbara Hendricks (SPD) stated in the German Bundestag on 22.03.2002: “in the bond trading legislation investor protection will be improved by increased transparency and market integrity.”

In this new legislation the duties of the banks to make investors risk-aware were more concretely identified, although it is doubtful whether investors sufficiently understood the risks due to the complexity of most investment models. The legislator however, did not harbour such doubts: the fourth Financial Market Promotion Law not only abolished § 764 of the civil code which had previously protected investors, but also explicitly set out in § 37e of the new Bond Trading Legislation that the legal non-enforcement protection of §762 is no longer applicable.

Bond trading legislation (WpHG)

§ 37e. (Exclusion of non-enforcement according to § 762 of the German Civil Code)

The legal enforcement exemption of § 762 of the civil code does not apply to demands from financial transactions where at least one partner to the contract is a business which conducts financial futures transactions or mediates their conclusion or conducts the acquisition, sale and mediation of financial futures transactions on a commercial scale or in amounts which require a commercial scale business operation. Financial transactions in terms of paragraphs 1 and §§ 37g and 37h are the derivatives in terms of § 2 paragraph 2 and subscription warrants.

Under these new rules, futures transactions only lack legal force if they are, in accordance with § 37g WpHG (below), prohibited by the Ministry of Finance by decree or do not qualify as financial futures transactions under § 2 IIa WpHG.
§ 37g (Prohibited financial futures transactions)

(1) The Federal Government Department can by decree prohibit or limit financial futures transaction deals as far as necessary to protect investors.

(2) A financial futures transaction, which contradicts a decree based on Paragraph 1 (prohibited financial futures transactions) is invalid. Paragraph 1 is applicable to
   1. the ordering of a security for a prohibited financial transaction deal,
   2. an agreement in which one party, to fulfil an obligation resulting from a prohibited financial futures transaction, enters into a commitment with the other party, especially an admission of liability.
   3. placing or accepting orders to complete a prohibited financial transaction deal.
   4. poolings (combinations) aimed to complete a prohibited financial futures transaction.

The financial crisis showed that the belief that investors are prevented from entering untransparent and risky investments through awareness-raising and information and that such unsuitable investments will be pushed out of the market due to lack of demand was wrong.

The Situation in Austria

Analogous to the German legal non-enforcement legislation in §§ 762, 764 of the German Civil Code, Austria has the §§ 1267 ff. (gambling) and § 1271(differential transactions) in the Austrian Civil Code (ABGB).

Similar to the development in Germany, the old legislation took a critical stand against differential transactions and attempted to curb these by suitable decrees. This has, however, recently changed decisively. The catalyst for this change came with the new regulations which abolished the legal non-enforcement provisions for certain differential transactions.

Thus in 1989 the § 28 Abs. 2 (Stock Market Law) extended exemptions from the legal non-enforcement provision to cover options and futures with published prices on domestic and foreign exchanges. Since 1.8.1998 legal non-enforcement provisions do not apply to standardised business transactions, if a registered bank is participating (§ 1. 5, § 100. 2 Banking Practice Legislation, BWG). This regulation in particular has great practical significance.
These new regulations were justified by stating that the legal non-enforcement exemption did not meet the needs of modern stock exchanges where futures and differential transactions are normal banking practice. If one retained the legal non-enforcement regulation, Austria would be decoupled from international financial markets. Therefore the legal insecurity caused by the non-enforcement exemption had to be abolished. (see Grassl - Palten, 169 ff.).

Similar to the argument used in Germany, investors were said to be protected by the legal requirement of making them aware of the risks and opportunities of transactions (§ 1 para. 7 BWG).

The Situation in Switzerland

The development in Switzerland is similar to that in Austria and Germany. Obligation Law (OR) (Art. 531) states that claims resulting from betting or gambling are not enforceable.

Art. 513 Obligation Law (OR)

A. The unenforceability of the claim

1 No claims can result from betting and gaming.

2 The same applies to loans and advances, that were knowingly given to support the game or the bet, as well as to differential transactions and delivery transactions on goods or financial instruments, which have the character of a game or a bet.

Contrary to what could be surmised from the wording in Art. 531 para. 2, financial futures transactions in Switzerland are often not protected by Art. 532 (OR), despite their speculative nature.

The Swiss Federal Court usually begins with the assumption that financial futures transactions are not carried out with the intention of betting. Only in individual cases examined by the Court can it be established that a game or bet was inherent in the transaction and therefore no legal claim can be made. The legal non-enforcement of differential transactions is only confirmed in exceptional cases.

The same argument is made in Switzerland that awareness-raising about the risks of transactions is sufficient investor protection. Here Art. 11 of the Stock Exchange Act is referred to, where stock brokers have care, trust and information obligations towards their clients.
Assessment
For all three countries it can be surmised that there was an original intention of the legislator to protect investors from financial transactions of a betting or gaming nature by introducing legislation that declare such transactions legally non-enforceable. The last 20 years has witnessed the drastic weakening of this protection. This has occurred through permanent decrees (Switzerland), through the introduction of new legislative regulations (Austria) or with the complete abolition of the relevant paragraph (§ 764 BGB) in Germany. The justification of these actions was in every case that the “responsible citizen” did not need state protection in his/her financial dealings if the business partners were legally obliged to provide information and elucidation of the risks associated with transactions. But the financial crisis revealed that this legally obligated provision of information was insufficient investor protection against the risks and complexities of financial dealings. The restoration of legal insecurity in relation to the enforceability of claims from complex financial instruments could be effective in protecting consumers from the over-selling of such products.

Legal non-enforcement as an instrument of financial market regulation
As demonstrated, the principle of non-enforcement, when legally established and applied, had a strong restrictive influence on the development and the sale of speculative “financial products”. This effective and proven mechanism can be used to re-regulate financial markets.

It would be advisable to create an additional legal non-enforcement provision based on non-transparency as well as the one focussing on betting and gambling. This could prevent the increasing complexity of financial products spiralling out of control. With such a provision, a damaged bank client could reclaim the invested capital if the contract was voided on grounds of lack of transparency.

It would also be advisable to compile a positive list of financial products whose legal enforceability are explicitly protected by law. Other financial instruments would then either be prohibited or fall into a grey zone of legal insecurity. A positive list of accepted and legally enforceable financial instruments would not only have the advantage of significantly increasing transparency but also of preventing banks, hedge funds etc. dodging legal regulations with ever-new “financial products” not covered by existing regulations.

The compilation of such a positive list could, through the collaborative work of sustainable banks (e.g. GLS in Germany) and independent financial experts become a basis for a campaign for improved financial market regulation.
A new regulation could look like this (German version):

1. The existing § 762 BGB remains and continues to state that:
   Claims resulting from bets or gambling are not legally enforceable.

2. A new § 762a BGB (Legal non-enforcement on Transparency) should say:
   Contracts about financial transactions, whose legal consequences are not transparent, are invalid.

3. A § 764 BGB (new version) should say:
   1. Financial transactions based on financial instruments that are not on the list of accepted financial instruments for futures transactions should be considered as a bet or a game in accordance with BGB 762.
   2. Claims resulting from contracts based on financial transactions which do not fulfil criteria of transparency to be stipulated are considered non-transparent in accordance with § 762a.

Sources
Grassl-Palten, Eva (2002); Zum Anwendungsbereich des § 1271 ABGB, in. Koziol, H; Bydlinski, F.; Rummel, P.; (Hrsg.), Im Dienste der Gerechtigkeit: Festschrift für Franz Bydlinski
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