Mr. Bishop then went on to explain the investment arbitration framework in greater depth, starting with the fact that investment protection under BITs only applies to foreign investors and/or foreign investments. A poignant issue therefore becomes who qualifies as an investor and what qualifies as an investment under the treaty. Mr. Bishop provided answers to questions by referring to pertinent investment cases. One of the questions asked was whether the foreign shareholders of a domestic company can qualify as "foreign investors" – yes they can. Another was whether investors from states that do not have BITs with the host state may channel their investments through a subsidiary in a country that has a BIT with the host state (so-called "BIT-" or "Treaty Structuring"). The answer was that arbitral tribunals have generally agreed that BIT structuring is a legitimate means of enhancing available investment protection. In the future, companies may consider the option of "BIT structuring" before making an investment.

When discussing the development of jurisdictional issues in investment disputes, Mr. Bishop addressed the impact of nationality, temporal issues under BITs and the controversial issue of whether parties may circumvent the so-called "cooling down" periods stipulated in several BITs – a period of several month where the investor and the state have to try to settle their disputes amicably – by relying on most favored nation (MFN) clauses.

In his presentation, Mr. Bishop also outlined the development in the interpretation of certain treaty standards, such as the standard of "fair and equitable treatment", and noted that the broad wording of this standard gives investors considerable scope for making a claim. He outlined how arbitral tribunals had construed and understood this standard in the past, and how today, it is widely acknowledged that issues such as the "legitimate expectations" of investors (*i.e.* the objective expectations that an investor had when making the investment) are protected by the fair and equitable treatment standard. In addition, he touched on the meaning of the "effective means provision", the development in the assessment of damages by arbitral tribunals, and the possibility of applying to tribunals for provisional measures, *e.g.* at times perhaps even involving the dismissal of criminal charges against an investors' employees.

In the last part of his presentation, Mr. Bishop addressed recent trends in the field. In particular the public policy concerns that have been at the center of recent debates – BIT claims often involve broader public issues than contractual claims. Also, he noted the quest to clarify applicable standards such as the relationship between the fair and equitable treatment standard, and the minimum standard in customary international law, the clamor for increased transparency, and the role of *amicus curiae* briefs.

He observed that Bolivia, Ecuador and Venezuela had denounced the ICSID Convention, in response to the increase in claims against them. Ecuador had gone further and denounced several BITs, as has Venezuela which denounced its BIT with the Netherlands. The denunciations of the BITs would not impact investments made prior to the denunciations as BITs generally have a so-called "tail" provision which ensures that they are applied to existing investments for 10 to 15 years following the denunciation. In Mr. Bishop's view, the fact that some states have denounced BITs should not be understood as the beginning of the end of investment arbitration as, in contrast, about 400 new BITs had been signed around the world in the past 6 years.

During and after the presentation, the attendees of the Jour Fixe took the opportunity to ask follow-up questions, discuss hot-button issues and exchange experiences. One of the main issues that came up in the questions was related to the enforceability of awards. Specifically, whether, in practice, states voluntarily comply with awards and what happens if they do not; how the enforcement against states works in practice; and whether home states are willing to support their investors at a certain stage by putting political pressure on the host states. Other questions related to Mr. Bishop's experiences in arguing the meaning of fair and equitable treatment standard before arbitral tribunals, and whether there was an option to consolidate several arbitral proceedings relating to the same state measure into a single proceeding.

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The Efficient Capital Market Hypothesis – Critical Thoughts After The Financial Crisis

Report of the Nineteenth Annual Meeting of the Harvard Law School Association of Germany e.V. on March 22nd/23rd, 2013 in Frankfurt a.M.

On March 22nd/23rd, 2013, the Harvard Law School Association of Germany e.V. held its nineteenth annual meeting in Frankfurt a.M. After arrival on Friday night, the Harvard Law School alumni met for a social get-together over food and drinks. Saturdays' official part of the annual meeting is traditionally hosted by a Frankfurt based law firm. This year, Jones Day kindly offered to host the meeting in their modern offices in Frankfurt's Nextower building. Upholding a cherished tradition, not only Harvard alumni are welcomed, but also members of the Harvard Club Rhein-Main, members of the Tönissteiner Kreis, and members of the German-American Lawyers' Association. The HLSA of Germany would like to thank its guests for participating and enrichening its annual meeting and is looking forward to continuing the exchange in 2014.

Following an introduction, HLSA of Germany's president, Professor *Gerhard Wegen* of Gleiss Lutz, presented two renowned and internationally recognized speakers to speak on sense and nonsense of the Efficient Capital Market Hypothesis (ECMH):

* Wissenschaftlicher Mitarbeiter bei Gleiss Lutz Hootz Hirsch in Stuttgart; Attorney-at-Law (NY). Der Verfasser dankt Dr. Leonhard Hübner, M. Jur. (Oxon.) sowie Marius T. Müller, M.A., für ihre wertvolle Unterstützung.

Professor *Reinier Kraakman*, Ezra Ripley Thayer Professor of Law at Harvard Law School, first held a speech on "Market Efficiency and the U.S. Mortgage-Backed Securities Crisis". In his luncheon speech, Professor *Rolf Stürner*, former Professor of Law at Freiburg University, Visiting Professor at Harvard Law School, and first honorary member of the HLSA of Germany, made the "attempt of a response" when elaborating on "The Continental Advantage – Market Efficiency through Regulation of Financial Products". Both insightful presentations were followed by lively and controversial discussions.

After shortly introducing the theory of market efficiency against the backdrop of the financial crisis (I.), this paper will – in a nutshell – present Professor *Kraakman's* (II.) as well as Professor *Stürner's* (III.) points of view. In conclusion, this paper will make an attempt to reconcile both approaches in a synthesis (IV.).

I. Market efficiency and the financial crisis

Simply put, the ECMH means "that in a well-functioning securities market, the prices […] of securities will reflect predictions based on all relevant and available information."[1] Thus, the ECMH asserts that the financial markets are efficient and one cannot gain positive abnormal returns from trading on public information – however, only based on the premise that market conditions are perfect.[2] Therefore, in a perfect world, market price will always reflect the "real" price, i.e. the fundamental value of a financial instrument.[3]

The U.S. Subprime Crisis clearly demonstrates that the real world and its capital markets are not perfect. The combination of different factors such as low interest rates and new mortgage products, which did not require high down payments, increased the demand and thus the price of homes.[4] By 2006/2007 the valuation of real property had reached unsustainable levels; homes were overvalued. The market price exceeded the fundamental value of houses and of the underlying mortgage backed securities. When the market reacted with rapid decreases in home prices, the mortgage debt became higher than the value of the secured property and inevitably the bubble burst.[5]

II. Professor Kraakman: "Market Efficiency and the U.S. Mortgage-Backed Securities Crisis"

Against this backdrop, Professor *Kraakman* sets out his "attempt to defend the ECMH" as it should be understood in real world capital markets. As a starting point, he introduces the prominent post-financial crisis claim that the mispricing of subprime mortgages and related securities, which have given rise to the financial crisis, demonstrates the bankruptcy of ECMH. According to this claim, an unjustified faith in market efficiencies was amongst the causes of the financial crisis. *Kraakman* objects to this claim. In his view, the ECMH itself was subject to an "intellectual" bubble when it entered the political arena. "Informational efficiency" became confused with "fundamental efficiency". Designed as "a narrow but important academic theory about the informational underpinnings of market prices", the ECMH was expanded "into a broad 'faith-based' preference for relying on market outcomes over regulation".[6]

Kraakman believes that the financial crisis does in fact support the ECMH as long as it is construed as scientific theory rather than as a broad declaration of 'faith-based' ideology. He outlines that one cannot necessarily apply all findings that are true for the equity market to the backed securities market. Different from the equity market, in the backed securities market there are actually three different layers (plus derivatives): (1) the real estate/mortgage market, (2) the market for residential mortgage backed securities (RMBS), and (3) the primary market in collateral debt obligations (CDO).[7] Only the middle layer, the RMBS market, had the capacity for efficient information aggregation. The financial products of the third layer, the CDOs, were not only very complex but also rather opaque so that they were almost impossible to value. Also, claims against the senior tranches of these CDOs were not traded but almost always sold to long-term investors. Hence, there basically was no market for CDOs. Therefore, much information necessary to price the instruments associated with the financial crisis was not available.[8]

According to *Kraakman*, a market's relative informational efficiency is a function of information cost. If information costs are too high the market will not be efficient. This assertion was confirmed by the subprime mortgage crisis. Consequently, *Kraakman* argues that not the ECMH should be abolished but rather the informational quality of prices should be improved. He wants the hypothesis to be understood as a diagnostic tool that suggests the importance of information costs and market structures to the regulators. *Kraakman* demands for an introduction of conduits through which information enters the market price.[9]

III. Professor Stürner: "The Continental Advantage – Market Efficiency through Regulation of Financial Products"

Professor *Stürner* points out to a longstanding tradition of a relatively strict legal regulation of real property and forms of tradable bonds, promissory notes, and other investment securities in Germany and in France. Such a strict regulation was intended to create bonds of very high and enhanced security and reliability. As a result, this legal model of covered bonds did not face one case of stay of payment for a period of more than one hundred years – including the worldwide economic

1 *Sharpe*, J. Finance 25 (1970), 418, 418.

2 Cf. *Fama*, J. Finance 25 (1970), 383 who developed three major forms of the ECMH: a weak, a semi-strong, and a strong form.

3 Other related theories of modern finance that seek to state how capital assets are priced – such as the Capital Assets Pricing Model developed by *Sharpe*, J. Finance 19 (1964), 425, *passim* and the Miller-Modigliani Irrelevance Propositions first introduced by *Modigliani/Miller*, Am. Econ. Rev. 48 (1958), 261 – also "obtain rigor by simplifying away from market imperfections", *Gilson/Kraakman*, in: McDonnell (Ed.), Research handbook on the economics of corporate law, 2012, p. 461.

4 For an insightful and thorough description of the financial crisis and its causes cf. *Schwarcz*, S.C. L. Rev. 60 (2009), 549, *passim*; also comp. *Gilson/Kraakman*, in: McDonnell (Ed.), Research handbook on the economics of corporate law, 2012, p. 458, 466 et seqq.; *Großfeld/Heppe*, DAJV-NL 2010, 5 et seqq.

5 Former Chairman of the Federal Reserve Board *Alan Greenspan* said in 2007: "We had a bubble in housing."

6 *Gilson/Kraakman* (Fn. 4), p. 456.

7 For an explanation and comparison of the different types of mortgage backed securities, including CDO, see *Schwarcz*, Minn. L. Rev. 93 (2008), 373, 376 et seqq.; also cf. *Gilson/Kraakman* (Fn. 4), p. 458, 467 et seq.

8 *Kraakman* assumes that the CDOs were still bought because buyers were a) "gullible" and b) relied on rating agencies and underwriters who in turn relied on the stable returns of mortgage backed obligations in the preceding years.

9 On a policy basis he mentions disclosure, no bans on short selling, and introduction of ABX indices, cf. *Gilson/Kraakman*, Securities & Exchange 2004-2005, 64, 70 (further elaborating on policy implications of the ECMH).

crisis of the 1920s. With some regrets, *Stürner* remarks that the Germans and continental Europeans became gradually attracted to the idea of financial products in the early 90s of the past century.

This break with the traditional regulatory limitation of financial products led to an increase of modern contractual bond models that promised higher profits than the traditional German bonds. Attracted by these profits, market participants purchased the new instruments without noticing their deficiencies regarding the reliability of full and due repayment of their capital. In fact, market participants could not actually have noticed these deficiencies because they were hidden in formally correct descriptions of voluminous prospects. Also, these deficiencies were not reflected in the ratings (e.g. as compared to traditional German bonds).

Stürner is puzzled that, after the crisis, a direct regulation of the individual financial products was avoided and only measures of indirect regulations have been taken.[10] He criticizes that the regulatory reform was merely based on two elements of the market philosophy of the last three decades: the idea of market efficiency through improved information and the idea of information-based improved risk management. These "two old topics" have not proven themselves to work in practice. *Stürner* identifies the informational overload, which is caused by the lack of standardization and limitation of financial products, as main impediment to market efficiency. As long as an analysis of new contractual covered bonds takes specialized analysts two or three days – rating agencies need up to several months – necessary information is not available to enable an investor to make a well-informed decision. In short: The more complicated, disharmonized, and heterogeneous the financial products, the higher are the information costs which inevitably result in inefficient markets.

To meet this serious problem of a disinformed market, *Stürner* regards the legal standardization and thus limitation of financial products as the "only really efficient legislative measure". Unlike market theoreticians, *Stürner* does not expect market mechanisms to generate similar results without regulatory intervention. Since the market mechanisms did not work in the past, he wonders, why should they work in the future? *Stürner* asserts that not even the present market society in the United States confidently believes in the renovated model of financial markets. He views the resurrection of the Volcker rule[11] with its attempts of a strict separation between traditional banks (savings and loan institutions) and investment banks as a result of "remarkable mistrust" of the model of well-functioning markets.[12]

Concluding, *Stürner* calls for a reflection of the relationship between financial markets and real economy. He is of the opinion that a deep conflict between continental European and Anglo-American legal cultures results in a poor reaction to the financial crisis on both sides of the Atlantic Ocean. This conflict is twofold: On a merely obvious layer, the continental European and the Anglo-American understanding of freedom and free markets differ. The continental Europeans believe in the necessity of legislative actions in order to safeguard their citizens' rights. The Anglo-American tradition is dominated by the idea that the free decision of the individual is, in principle, best for the society as a whole. This understanding leads to an aversion to preventive legislative measures. On a more hidden layer, economies with a dominating real economy sector, such as Germany and some other continental European countries, have no distinct interest in financial products that are designed to generate high profits, mostly at the expense of the profits in the real economy. In the end, *Stürner* appeals to economists and economy enthusiasts to consider "that states and societies are not only defined by economic success and welfare" but "need a public order which respects a certain indispensible level of equality".

IV. An attempt of a synthesis

On first glance, Professor *Kraakman's* and Professor *Stürner's* points of view are opposed diametrically. However, on a closer look, they just look at the problem from different, but not necessarily opposing angles. On the one hand, *Kraakman's* point of view seems deeply influenced – or in his own words "indoctrinated" – by the school of behavioral finance and its market theories; on the other hand *Stürner's* opinion is influenced by an analytical knowledge of the products which are subject to market transaction.[13] Also, their approaches unveil a different understanding as to the role of market participants. Whereas *Kraakman* partly blames the "gullible buyers from Düüüseldorf", *Stürner* stresses the need to protect market participants.[14]

Nevertheless, *Kraakman* and *Stürner* describe the same problem: Both acknowledge that the ECMH is not more – but also not less – than a scientific theory. Also, they are of the opinion that there is a need for regulatory reform. Finally, *Kraakman* and *Stürner* agree that the market must be furnished with the necessary information. *Kraakman* admits that he is not in the position to propose regulatory measures but detects the policy implication of ECMH to introduce conduits through which information enters the market. *Stürner* concedes that market efficiency through improved information and information-based improved risk management as elements of enhanced market efficiency do make sense. He then goes a step farther and offers a solution to *Kraakman's* problem of high information cost: His conduit to spread information is the reduction of information through limitation of financial products.

Ironically, market regulation in form of standardization might therefore help to make markets efficient and, in the end, strengthen the ECMH. The difficulty would be to draft the regulatory framework in a way that is not too narrow; market institutions must be given sufficient leeway to efficiently react to economic necessities. Of course, *Kraakman* would respond that the ECMH in the modest form he proposes is *the* tool to determine how much regulation is necessary in order to efficiently price financial instruments.

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10 As an example *Stürner* mentions and further elaborates on the US-American Financial Stability Act of 2010 that, *inter alia*, established a Financial Stability Oversight Council and an Office of Financial Research, extended the Board of Governors' supervisory competences to bank holding and non-bank financial companies, regulated advisers to hedge funds, improved credit insurance supervision, restricted capital market activities by banks, regulated swaps and derivatives markets, regulated credit rating agencies and their rating procedures, etc.

11 The rule is named after former Federal Reserve chairman *Paul Volcker*.

12 *Stürner* does not believe the model of strict insulation of risky transaction with derivatives from the traditional bank business to be realistic.

13 E.g. Professor *Stürner* has served as permanent legal adviser of the German Mortgage Bank Association for almost 20 years and co-drafted several German laws in this field.

14 However, *Kraakman* as well as *Stürner* criticize the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) as too complicated and loquacious; cf. *King*, DAJV-NL 2010, 113 et seqq. (elaborating on the Dodd-Frank Act).