

CONFLICTS OF INTEREST AND SECURITIES FRAUDS: INTERNATIONAL STANDARDS AND INVESTOR PROTECTION UNDER ITALIAN LAW

Recent corporate scandals have given rise to an intense international debate on the suitability of existing internal and external control mechanisms for the proper functioning of securities markets. Asymmetric information, agency/fiduciary relationships, separation between ownership and control and other factors inherent in modern finance revealed themselves to be inevitable sources of conflicts of interest, offering strong incentives for opportunistic behaviour.

The research analyses the issue of securities frauds originating from the exploitation of conflicts of interest, taking into account this international debate. The purpose is to develop a framework for evaluating the Italian regulatory (*ex ante* and *ex post*) devices to protect retail investors against such abusive practices.

Considering the increasing globalisation of financial markets, the starting point of the research is the study of the initiatives undertaken at the international level. In particular, it is considered the historical origins, sources and effects of the international standards elaborated by IOSCO and OECD, how these instruments have been promoted worldwide and the economic model they are meant to spread. The Italian regime is, then, assessed in the light of this paradigm, so much inspired by the Anglo-American, market-oriented type of financial systems.

The thesis investigates the circulation of legal transplants elaborated in international forums and in the absence of a common taxonomy and evaluates, in the light of the local peculiarities (e.g.: ownership concentration, high level of private benefit extraction, role of shareholders agreements and pyramidal structures as means to separate ownership from control, lack of efficient judiciary system). The analysis outlines the profiles which make the Italian discipline not consistent with this model.

The comparison focuses on conflicts of interest and financial frauds associated with: (i) securities intermediaries offering multiple services (financial conglomerates and universal banks), (ii) production of information by auditors, analysts and rating agencies and (iii) corporate governance failures in the Italian concentrated-ownership environment.

The methodology of research espouses the functional and dynamic approach offered by Comparative Law and Economics. The choice for this method is due to two main reasons. Firstly, financial frauds generated by conflicts exploitation are substantially economic facts. Thus, the economic analysis of law provides sophisticated analytical tools of investigation in this field. Secondly, the research compares sources of laws having structurally different geneses, characteristics and effects. One source expresses a peculiar universalistic model elaborated internationally: it is at the same time a compromise between different legal systems and the translation into technical norms of a political (neo-liberal) project, where efficiency is elevated as the main value. This source of provisions will be compared with the Italian local regime, which asserts to transpose such model internally. This exercise strongly requires the employment of a non-state-centric approach and efficiency based, functional analysis, typical of law and economics.

The thesis is organised in four chapters, as described in the following.

The first chapter introduces the international standards mostly relevant in the securities sector. I describe the function, characteristics and effects of such peculiar legal sources, providing insights on the historical origins (from the Washington Consensus to the New Financial Architecture) and on the more recent joint initiatives endorsed by the International Monetary Fund and the World Bank whereby such standards are utilised in order to issue recommendations in the ambit of the Financial Sector Assessment Programme (FSAP) and the Report on Standards and Codes (ROSC).

I consider, among others, the IOSCO Objectives and Principles of Securities Regulation and the OECD Principles of Corporate Governance and the relevant Methodologies. These instruments represent a sort of “constitutional principles” founding the financial law and corporate governance regulation, the basic points of convergence of international consensus.

The international standards are read in the light of the initiatives undertaken as a response to the recent fraudulent behaviours, expressed in the IOSCO report “Strengthening Capital Market Against Financial Fraud”, which identifies several areas that have figured prominently in many high-profile scandals and action for further work (including in the field of international cooperation for enforcement purposes).

In the second chapter I focus on the conflicts of interest in the relationship between the securities intermediary and its clients, being it an incentive to abusive appropriations. Considering the wide variety of relations between a multi-functional intermediary and its clients, I concentrate on the types of conflicts appearing particularly critical in the light of the recent Italian scandals (e.g.: Argentinean bonds, Cirio, Parmalat, Antonveneta), such as the conflicts between the activity of securities underwriting and provision of financing to the same issuer and between the managing (in a broad sense) of clients and own investment portfolios.

In particular, I analyse the following aspects:

- Taxonomy of the conflicts of interest related legal notions, fiduciary duties identifiable under the Italian legal regime, difference between the situation of conflict and its exploitation (fraud) and trade off between conflicts and economies of scope.
- *Ex ante* legal devices to prevent the rising of the conflict (e.g.: incompatibilities and other prohibitions, inducements and regulation of fees) and its exploitation (internal procedures; fire walls; disclosure and abstain mechanism) and the recent changes introduced after MiFID transposition. The analysis is carried out: (a) in the light of the relevant provisions set forth in the international standards; (b) outlining the specific conduct rules applicable to the securities intermediary in case of conflicts of interest. Through the comparison of the Italian law with the IOSCO standards, I explain the major problems in our current investor protection regime (i.e.: interpretative doubts as to the prevalence of the clients’ interest; employment of formalistic solutions; possible instrumental use of Chinese walls).
- *Ex post* legal remedies sanctioning the conflicts exploitation: (a) public enforcement; (b) private enforcement, in the light of the most recent Italian case law (reversal of the onus of proof, existing doubts on possible remedies available to the investors and proposal for an interpretation favouring the private actions exercise).

The third chapter is devoted to the conflicts of interest of the operators elaborating and distributing financial information, which vested such a major role in the US and Italian financial scandals, i.e.:

- Auditors; the issue is qualified in terms of independency, analysing the role of corporate governance to avoid collusion with the issuers directors. Reference will be made to: (a) the “*Principles for Audit Oversight*”; and (ii) the “*Principles of Audit Independence and the Role of Corporate Governance in monitoring Auditor’s Independence*”. The above provisions are compared with the recently amended Italian legislation on auditors’ independence.
- Sell-side financial analysts, studying particularly the Italian legal measures to address the competing pressures arising from relationships with investment banking and performance of non-research functions. The comparison of the Italian law is carried out with the following IOSCO instruments: (a) the “*Report on Analyst Conflict of Interests*” and (b) the “*IOSCO Statement of Principles for Addressing Sell-Side Securities Analyst Conflict of Interests*”. Following transposition of MiFID and MAD, Italian law is currently consistent with IOSCO recommendations.
- Rating agencies, focusing on the conflicts arising from the issuer fees, access to confidential information/insider trading risks and provision of ancillary advisory services, in the light of: (a) the IOSCO “*Report on Activities of Credit Rating Agencies*”, and (b) the “*IOSCO Statement of Principles Regarding Credit Rating Agency*”. At the moment credit rating agencies are self-regulated entities and more stringent legislation seems to be required.

The fourth chapter considers the conflicts of interest related issues in listed companies and the corporate governance as a possible mean to contrast corporate frauds. I assess, in particular, how the conflicts of interest of a member of the board of directors is dealt with in the Italian jurisdiction characterised by concentrated ownership environment. I will also cover the conflicts between the shareholder and the company. The analysis will be conducted in comparison with the approach and measures suggested in the OECD Principles of Corporate Governance, taking into account the influence of Anglo-American law. I address the following issues, taking into account the difficulties of importing models typical of public companies in Italy.:

- Purpose and taxonomy (ambiguous notion of conflicts of interest; trade off between separation of ownership from control and extraction of private benefits in the peculiar Italian context; concept of abuse by controlling shareholders).
- Changes introduced by the recent reform of the Italian company law to *ex ante* devises, outlining insufficient directors fiduciary duties of care and loyalty, lack of the monitoring role of the board, lack of a suitable disclosure and abstain procedure, opaque use of shareholders agreement.
- *Ex post* remedies applicable to directors’ and shareholders’ conflicts, including the annulment of the relevant resolution, current debate on the action for damages, onus of proof, other actions available to investors in case of abuse by controlling shareholders; criminal action.

Finally, I will analyse the issue of intra-group conflicts with reference to the following issues identified in the IOSCO report as being particularly problematic:

- Unsatisfactory protection of minority shareholders in group structure and liability of the holding company (theory of so called compensative advantages and legal provisions introduced in the recent reform of the Italian company law).

- Related party transactions (assessment of the rules set forth in the Italian civil code and issued by Consob).
- Use of complex corporate structures and special purpose vehicles located in off-shore centres (role of off-shore centres in the Italian financial fraud; international initiatives against non cooperative jurisdictions; provisions introduced by the recent Italian savings law).
- Failure to appropriately deal with the large use of stock pyramids.

The novelty of the research is in that Italian scholars have not carried out a systematic comparison between the international standards and the Italian securities law in the field of conflicts of interest, nor have they endorsed Comparative Law and Economics for studying the movement of peculiar international soft-law provisions to the Italian legal system. Moreover, the analysis on how such standards have been implemented in Italy gives significant insights for assessing how effective our investor protection regime is. Last but not least, the recent Italian financial scandals call for more attention to the issue of financial frauds originating from conflicts exploitation.