

# LAW AND ECONOMICS YEARLY REVIEW

ISSUES ON FINANCIAL  
MARKET  
REGULATION,  
BUSINESS  
DEVELOPMENT AND  
GOVERNMENT'S  
POLICIES ON  
GLOBALIZATION

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# LAW AND ECONOMICS YEARLY REVIEW

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The “Law and Economics Yearly Review” is an academic journal to promote a legal and economic debate. It is published twice annually (Part I and Part II), by the Fondazione Gerardo Capriglione Onlus (an organization aimed to promote and develop the research activity on financial regulation) in association with Queen Mary University of London. The journal faces questions about development issues and other several matters related to the international context, originated by globalization. Delays in political actions, limits of certain Government’s policies, business development constraints and the “sovereign debt crisis” are some aims of our studies. The global financial and economic crisis is analysed in its controversial perspectives; the same approach qualifies the research of possible remedies to override this period of progressive capitalism’s turbulences and to promote a sustainable retrieval.

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## FINANCIAL DERIVATIVES. REGULATION AND DISPUTES

### IN THE ITALIAN LEGAL ORDER

Mirella Pellegrini<sup>\*</sup>

**ABSTRACT:** *In this paper, the main features of over-the-counter derivatives are examined together with the rules applicable in case of so-called negotiation “per conto altrui” (that means as a simple seller of financial instrument on behalf of the issuer or owner). In this regard, the questions and following litigation on trading in derivatives concerned essentially the operations in direct counterpart not traded on regulated markets that have been characterized by evident problems of illiquidity and opacity.*

*As a consequence, the reference to the behavioral norms that the legal system requires to intermediary in the execution of investment services and that have been subject to revision as a result of the transposition of MiFID directive.*

*In the attempt to identify remedies that protect the investor from errors in risk assessment assumed on trading these financial instruments (remedies able to prevent a misuse of derivatives and able to come beyond the information transparency) it draws to the attention the behavioral finance and the probabilistic risk assessment.*

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**SUMMARY:** 1. Introduction - 2. Concept of derivatives, regulations and operational procedures - 3. Over-the-counter (OTC) derivatives - 4. Derivatives disputes - 5. The applicability of the adequacy principle to the transaction - 6. Additional measures against improper use of derivatives: behavioural finance and probabilistic risk assessment

1. The negotiation of OTC derivatives is considered by the majority of academics and financial operators as one of the causes that made the financial crisis explode with devastating effects both in the United States and Europe<sup>1</sup>.

Such financial instruments, at the heart of numerous (and not only the most recent) financial scandals<sup>2</sup>, have caused huge losses to the investing public as well as to companies in which they were traded<sup>3</sup>; it is logical in this context

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<sup>1</sup> See, among others, BORIO, *The Financial Turmoil of 2007-?: a preliminary assessment and some policy considerations*, 2008, [www.bde.es](http://www.bde.es); COLOMBINI, *La crisi finanziaria e la riforma Obama*, in *Riv. trim. dir. econ.* 2010, n.3, pp. 201 ff. See CAPRIGLIONE – SEMERARO, *Financial crisis and sovereign debt: the European union between risks and opportunities*, in this *Review*, 2012; FRIEDMAN, *Two Roads to Our Financial Catastrophe*, N.Y. Rev. Books, Apr. 29, 2010, p. 27; ROE, *The Derivatives Market's Payment Priorities as Financial Crisis Accelerator*, March 2011, on [papers.ssrn.com](http://papers.ssrn.com)

<sup>2</sup> The distribution of derivative contracts goes back in time (CHANCE, *A Chronology of derivatives*, in *2 Derivatives Quarterly*, 1995, p. 53); here we limit ourselves to remembering the succession of scandals related to negotiation in derivatives pushed the English legislator to prohibit negotiations at the end of the XVIII century (see Barnard's act): See OLDANI, *The financial derivatives*, Milan, 2010, pp. 47 ff. On American finance scandals in recent years see PARNOY, *Infectious Greed*, New York, 2009.

<sup>3</sup> In Italy, the third largest bank (Monte dei Paschi di Siena), due to some derivatives traded not in accordance with existing regulations, found itself in the well-known position of having to resort to state assistance. see RINALDI, *Derivati e crollo MPS*, *Radioie*, 23/1/2013.

that the same have been defined as "weapons of financial mass destruction"<sup>4</sup>. It is precisely because of the improper use of such financial instruments which has enabled a dispute without precedence, begun by companies (and local authorities) that have signed such contracts: the matter in question is, therefore, of considerable practical impact.

The common element of the scandals mentioned above is not their being attributable to the derivatives "as such" (i.e. financial products intrinsically difficult to apply) but rather the distorted use of the same that has been made (not in accordance with regulatory requirements), or the fact that the operators have ended by excessively taking advantage of the leverage that derivatives enable. From here a general orientation critical of derivatives, a position that cannot be accepted *tout court*, as derivatives can presumably play a role, even a positive one, on the financial markets.

It can certainly be said that the data developed on the distribution of derivative contracts in global finance have long been the subject of reflection and guide the recruitment of taking corrective action in the present matter<sup>5</sup>.

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<sup>4</sup> See BUFFETT, *Derivatives are Financial Weapons of Mass Destruction*, available at [www.investorwords.com](http://www.investorwords.com).

<sup>5</sup> Specifically, between 2008 and 2009, namely after the outbreak of the financial crisis, the notional value of derivatives negotiated over the counter, OTC, in the financial world continued to grow... The estimated value of financial derivatives is estimated to be 12 times higher than the global GDP somewhere over 600 trillion dollars). See *Rivelazione sui prodotti derivati over-the-counter*, on [www.bancaditalia.it](http://www.bancaditalia.it). This investigation carried out on the initiative of the Committee on the Global Financial System foresees the biannual disclosure of the statistics on OTC derivatives on the basis of a sample of banks and financial intermediaries working more in this sector. Such a disclosure is based on the recommendations of the Report

From the outset it was realized that more stringent rules were needed, designed to prevent risky behaviours (rules that are appropriate to ensure a fair distribution of resources in a competitive healthy environment)<sup>6</sup>. This has led to a tendency (particularly emphasized in the current historical moment) to abandon traditional forms of self-regulation of intermediaries<sup>7</sup>, in favour of an increase in public control and sometimes of a (“re”) adjustment that has the proposed object of encouraging an effective application of the regulations and to guarantee the protection of the diverse public and private interests that underlie the functioning of the financial markets<sup>8</sup>.

The real problem that arises in substance is the one relating to the distinction between good and bad in this category of financial instruments that should absolutely not be demonized, but evaluated case by case to make sure they do not assume a speculative function, in other words aimed at reducing or

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*Proposals for improving global derivatives market statistics*, presented by the above-mentioned Committee in July 1996.

<sup>6</sup> On the effect of the limits of regulations – and above all the lack of clarity of the latter on the recent crisis see SICLARI, *Crisi dei mercati finanziari, vigilanza regolamentazione*, in *Riv. trim. dir. pubbl.*, 2009, pp. 45 ff.; BERNANKE, *Speech at the Council on Foreign Relations*, Washington D.C. 10th March 2009; TRICHET, *The EBC’s response to the crisis*, Paris 20th February 2009; CAPRIGLIONE, *Misure anticrisi tra regole di mercato e sviluppo sostenibile*, Torino, 2010.

<sup>7</sup> See PELLEGRINI, *Autoregolazione e controllo*, in *Elementi di diritto pubblico dell’economia*, edited by Pellegrini, Padova, 2012, pp. 241 ff.

<sup>8</sup> See FERRARINI – GIUDICI, *Financial scandals and the role of private enforcement: the Parmalat case*, ECGI, in *Law working paper* n.40/2005, May 2005.

delaying the concrete realization of the loss caused by a contract previously signed<sup>9</sup>.

2. We need to move from the idea which according to the derivative contract takes as its object the transfer from subject A to subject B of a «risk» inherent in an «underlying asset». In the derivative – and here lies its essence – the “risk” is not a mere contract accessory (as each contract has its own risks), but rather identifies the main object of the same. So we can define the derivative as the contract whereby risk is given a price.

This category, which seems in itself very heterogeneous, has an element in common. The object of the derivative is represented by spread trading; not by chance, it has been highlighted in literature that “what the contracting party buys is not the underlying liability but the difference in value that this will acquire in time<sup>10</sup>.

Under Italian law (which, as is known, adopts Community legislation), the expression «derivative contracts» frequently quotes from art.1, paragraph 2 , section D), E), F), G), H), J) of Legislative Decree No. 58/1998 (from here on TUF), which essentially qualify them along the same lines of financial instruments. The Bank of Italy<sup>11</sup> defines them as “the contracts based on elements of other negotiations such as bonds, currencies, interest rates, exchange rates, stock

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<sup>9</sup> See CAPRIGLIONE, *I prodotti “derivati”: strumenti per la copertura dei rischi o per nuove forme di speculazione finanziaria?*, in *Banca, borsa, tit. cred.*, 1995, pp. 359 ff.

<sup>10</sup> See GIRINO, *I contratti derivati*, Milano, 2010, pp. 16 ff.

<sup>11</sup> Art. 3, *Istruzioni di vigilanza per le banche*. See CAPUTO NASSETTI, *I contratti derivati finanziari*, Milano, 2007.

indexes etc.” whose value ‘comes’, therefore, from that of the underlying assets. Derivatives are, for example, *future contracts, options, swaps, forward rate agreements*”.

It must be stressed that, in addition, such contracts are professionally traded exclusively with regards to the public by financial intermediaries; consequently, it does not amount to one type of contract, but rather a category of contracts.

In this respect, it is significant that, in the cited regulations, a definition of derivative contract cannot be found. Indeed, the TUF limits itself to a non-exhaustive list of the forms such instruments (contracts) can take, which – for their characteristics – are qualified as «derivatives» (art.1, paragraph 3, TUF)<sup>12</sup>.

Despite being open to criticism in terms of legal certainty, this regulatory option is significant in actual fact when one considers that derivative contracts are developed first in financial practice, and only later «transposed» into law.

Such option has specific importance if one considers that several different types of contract have been developed in international practice, in addition to those set down by law (which can certainly be included in the class of derivatives).

All in all, a rigid legislative definition of derivative contract is not compatible with the operational reality on which derivatives are usually based;

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<sup>12</sup> These are: options, standardized predetermined financial contracts (futures), swaps, agreements for future interest rate exchanges, other derivative contracts relating to securities, currencies, interest rates, yields, other derivatives, financial indexes or financial measures which may be settled physically or in cash etc.

in fact, such definition would inevitably be doomed to crash with the rapid changes in financial engineering and to be considered obsolete in a few years.

In addition, this already very large legal category is open. It is for this reason that the list of derivatives does not constitute a closed number. Indeed, art.1, paragraph 2 *bis* of TUF grants a proxy authority to the Minister of Economy and Finance to identify other potential derivative contracts. In this way, the operating system acquires flexibility: the new derivative contracts, created on the basis of advanced financial techniques, may be incorporated into the legal order without the need for further specific legislative provision, but only after recourse to ministerial regulation.

Finally, it should be noted that the derivative contracts in an international field often repeat predefined schemes and models from third-party organisations; in this regard, it is particularly relevant the action taken by ISDA (International Swap Dealers Association for swap contracts, established in 1985 by some American operators), which subsequently changed its name from “Swap Dealers” to “Swaps and Derivatives”. This change was made to focus more attention on their efforts to improve the more broad derivatives markets and away from strictly interest rate swap contracts.

This association (which in 1987 formulated the first *Master Agreement* aimed at regulating the operations in question) draws up standard agreements designed to regulate principal contractual aspects, leaving the task to the contracting parties to agree on the financial elements of the individual

contract<sup>13</sup>. In this way, space is given to the so-called OTC derivatives, which will be discussed in the next paragraph. The need to contain the implicit costs related to the establishment of any new OTC derivative transaction and, at the same time, to have an instrument that can mitigate the related risks, including systemic risks, has given a decisive impetus to the development of the ISDA *Master Agreement*. In this logical context lies the recent issue of the ISDA *Protocol 2013*, a document that contains information on specific operative modes to comply with the recent Emir Regulation (see below) and the relevant implementing technical standards<sup>14</sup>.

3. Problems in derivatives trading have essentially concerned direct counterparty transactions that are not negotiated on regulated markets and that are characterized by serious illiquidity and opacity problems.

It is necessary to point out that, in order to guarantee transparency, the orderly execution of trading and the investor protection, as well as to mitigate the spread of litigations between intermediaries and investors in Italy, in 2009 Consob, as national supervisory authority, issued a recommendation concerning

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<sup>13</sup> See CAPALBO, *Profili civilistici del rischio finanziario e contratto di swap*, Milano, 1999, p.23. On ISDA, see RADICATI DI BROZOLO, *Il contratto modello di swap del ISDA*, in *Diritto del commercio internaz.*, 1988, p. 539; DE BIASI, *Un nuovo master agreement per strumenti finanziari*, in *Banca borsa tit. cred.*, 2001, pp. 664 ff. In the case of swap contracts, as happens in that of new atypical contracts (not nominated yet), we see the emergence of models and forms being developed by multinational trade associations and international organizations, to facilitate the work of the economic operators.

<sup>14</sup> Referring to the publication by ISDA, respectively 8th November and 11th October 2013, of two new Protocols called ISDA 2013 ICE Brent Protocol and ISDA 2013 Discontinued Rates Maturities Protocol.

the obligation of the intermediary to behave correctly and transparently during the placement of “ illiquid financial instruments”<sup>15</sup> (i.e. instruments difficult to disinvest in a reasonable lapse of time) to retail investors.

At the same time it has been underlined that particular attention should be reserved to OTC derivatives trading (swap overall), because these instruments “usually do not allow the definition of a real price but rather the identification of a set of financial parameters defining the transaction value” which is hardly quantifiable.

In the absence of a legal definition (both in national and in European legal order), legal doctrine has tried to define the expression “*over the counter trading*”, taking into account that the changes provided by the transposition of the MiFID directives (39/2004/CE) seem to have redefined its contents<sup>16</sup>.

In the light of the research results, it can be said that this specific case (i.e. “*over the counter trading*”) is characterized by the following elements: parties involved in the transaction, trading platform, rules regulating the admission of securities to trading and the rules governing the negotiation.

Belonging to the first element is the financial intermediary (generally counterparty of the derivatives contract) who can trade “on own account” (as

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15 It refers to Communication 2 March 2009, no. 9009104 that can be consulted on the web site [www.consob.it](http://www.consob.it); as an example, it considers bank bonds, over-the-counter financial derivative instruments, financial and insurance products (united and index limited) as illiquid financial instruments, which present restrictions or limitations to the disinvestment, at significant price conditions. On this issue see PICCININI, *La trasparenza nella distribuzione di strumenti finanziari derivati ed il problema della efficacia delle regole informative*, in *Contr. e impresa*, 2010, pp. 505 ff.

16 See SEPE, *La contrattazione “over the counter”*, in *Riv. trim. dir. econ.*, 2011, pp. 45 ff.

issuer or owner of the offered financial instrument), or “on account of third parties” (as simple seller of the financial instrument on behalf of the issuer or of the owner). This explains why the intermediaries' activity (banks or investment firms) during the placement of over-the-counter derivative instruments (OTC) to local authorities or companies, is essentially that of providing a trading service on their account, that is playing the role of direct counterparty with costumers<sup>17</sup>.

With reference to trading platform, it should be noted that OTC trading is the one performed outside regulated markets (in particular the official stock markets), which are subject to specific authorization requirements and supervision.

However, the transposition of the MiFID directives has introduced relevant regulatory innovations in Europe in the direction of overcoming the distinction between regulated and non-regulated markets. In particular, in order to avoid competitive asymmetries, all available trading platforms (regulated markets, multilateral trading systems or MTF and systematic internalizers) have been rationalized and they are now under control systems (also authorization systems) which are, to a great extent, equivalent (best execution, written form, pre- and post trading transparency).

These operational innovations have remarkably delimited the OTC area. From such innovations, there remain excluded (therefore they must be considered as OTC) those trading operations taking place outside the above-

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<sup>17</sup> See ROSATI, *Indagine conoscitiva sulla diffusione degli strumenti di finanza derivata e delle cartolarizzazioni nelle Pubbliche Amministrazioni*, hearing, 18 March 2009, on [www.consob.it](http://www.consob.it).

mentioned platforms, which means realized in an informal way, through bilateral relations between the parties, both *in the presence of the parties* and *by telephone*, but also by electronic means (*i.e.* when specialized *providers* make *booking* systems available to financial operators who can use these systems to insert their bid-offer on securities quotations, which can be displayed and accepted by system users<sup>18</sup>).

The other identifying feature is usually the fact that, unlike trading platforms under supervision, OTC derivatives require neither specific rules regulating the admission of securities to trading nor rules concerning the trading mechanisms themselves.

This obviously does not mean that a set of rules to be observed is lacking. Indeed - also when referring to a direct OTC trading between an intermediary and a customer - during the negotiation the intermediary is always obliged to respect conduct rules concerning the provided service (on own account trading, orders execution, orders reception and transmission); rules that the Community guidelines have graded according to the status of the counterparty that can be retail investor<sup>19</sup>, professional investor<sup>20</sup> or eligible counterparty<sup>21</sup>. From such distinctions, different schemes of protection derive<sup>22</sup>.

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<sup>18</sup> See SEPE, *La contrattazione "over the counter"*, cit.

<sup>19</sup> Retail investors are neither professional investors nor eligible counterparties (art.4, paragraph 1, sect.12, MiFID directives). To these investors, the standard protection regulation established by MiFID directives applies. art. 19 and ff.

<sup>20</sup> In order to identify the category of "professional investor", see Annex II, directive 2004/39/EC

<sup>21</sup> Eligible counterparties (described as investors in recital n. 40 directive 2004/39/EC), thus defined in relation only to specific services, are divided into subjects classified as such by MiFID

Basically, the so-called “OTC trading” phenomenon applies to an extended and varied range of operations (including rather different cases)<sup>23</sup>, in which the key features are the “one-to-one” mode, in terms of trade negotiation (rather than a multilateral one) and regulations, and the absence of a “market” public regulation to regulate the transaction<sup>24</sup>.

This operational situation has apparently not been overcome by the provisions set out in the recent Regulation 648/2012/EU (European Market Infrastructure Regulation, EMIR), which identifies a European common framework concerning the regulation of derivatives traded outside regulated markets (through mandatory clearing and reporting of the OTC contracts to the central counterparties), in order to reduce the systemic risks connected to

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directives and subjects that, on the basis of a possible option exercised by Member States, satisfy pre-determined requirements (art.24, paragraph 3, MiFID directives and art.50 directive 2006/73/EC). This classification as eligible counterparty does not compromise the subject's right to request, in general terms or for every single operation, a treatment as a professional investor or, expressly, as a retail investor. In this case, the request is subject to intermediary's approval.

22 For example, according to the best execution principle, this system may be departed from (in addition to “execution only” cases) only with reference to those operations executed on behalf of investors characterized by an “eligible counterparty status” (art. 58, sect.3, Consob Reg.).

23 Within this notion fall operations ranging from the sale of financial instruments (either derivatives or not) by the bank to its customer to the so-called financial transactions between intermediaries of systemic importance.

24 See SEPE, *cit.*; MAFFEIS, *Intermediario contro investitore: i derivati over the counter*, in *Banca borsa tit. cred.*, 2013, pp. 779 ff.

derivatives, and in which certain limitations to the discretionary nature of the counterparties on OTC markets are introduced<sup>25</sup>.

However, it is of major importance to maintain the connection to the specific case (typical of OTC trading) that prevents a general and unambiguous regulation of this subject.

Beyond what so far mentioned, it is important to consider that, according to the recent provisions by the European Regulator, financial operators committed to bilateral OTC trading – where neither standardization nor mandatory clearing requirements from an appointed *clearing house* are involved – shall satisfy main capital adequacy requirements.

To summarize, also by virtue of the recent EU regulations, over-the-counter contracts are and may still be non-standardized contracts; at a practical

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25 See Regulation (EU) n. 648/2012, adopted on July 4th, 2012, formally came into force on August 16th, 2012. It intends to regulate “OTC” derivatives (i.e. derivatives individually traded between two counterparties and not exchanged on regulated markets), imposing new stringent requirements on all operators, whose effective entry into force is planned according to a schedule of staggered deadlines. The main point is the introduction of mandatory clearing to the central counterparty and a mandatory reporting to the companies called “trade repositories”. All financial counterparties must comply with these requirements, as well as non-financial counterparties whose operations exceed a certain monetary threshold . Entities/Subjects operating as central counterparty are companies authorized by the national competent authorities, after consulting a college that includes Esma (European Security and Market Authority) (artt.14 ff.). A new supervisory function is conferred to Esma, with particular focus on the activity carried out by trade repositories and CCPs. In particular, according to artt.55 and ff, Esma keeps a register listing all trade repositories operating on OTC markets on the regional European territory. Once registered, Esma can require from trade repositories (and related third parties) every information linked to their activities (art.61) and can carry out on-site inspections (art.63). It can also apply administrative penalties (ex art.65) in case of technical infringements (as provided for in Annex I).

level, the possibility of a complete standardization seems unthinkable, as they are often generated to meet the investor's specific requirements and therefore conceived as “tailor-made” products.

4. Particular attention should be paid to the problem concerning litigations which may arise in case the relationship between the intermediary and the retail investor presents elements invalidating the contract.

This is not the appropriate context to focus on the broad debate regarding the possibility admitted by law to consider retail investors as professional investors (the so-called upgrading) and to waive any form of protection granted to the former (thus also to waive any intermediary's obligation to comply with the conduct rules imposed by the EU secondary regulation on investment services) by simply presenting a self-certification, as permitted by the regulations in force prior to the Mifid directives<sup>26</sup>.

The present study is therefore confined to specify the constraints imposed on the intermediary by the assessment of the level of financial expertise and experience of the requesting party; being such assessment aimed at identifying the requirement whereby the operator can disapply conduct rules

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<sup>26</sup> For an overview into the opposing positions emerging in case law as concerns the evaluation of investors' self-certification as professional investors (and therefore evaluating such declaration as ground for potentially exempting the intermediary from checking the investors' competence and experience to include them among professional investors) see respectively, on the one hand: Milan Court, 12th october 2007 in *Nuova Giur. Civ.* 2008, I, p. 222, commented by RUGGIERI; Mantova Trib., commented by MOTTI; Novara Trib., 18th january 2007, in *Banca borsa tit. cred.* 2008, pp. 57 ff., commented by LEMMA, *L' "operatore qualificato", nelle operazioni in derivati.*

(which is only granted by the law when the investor can consciously take decisions in terms of investments)<sup>27</sup>.

Leaving aside in-depth analyses on derivatives litigations, we intend here to remind that public authorities and companies (but also private investors, yet within certain limits) have frequently been offered financial instruments by banks with the goal – at least originally – of providing hedging against risks.

It should be emphasized that the original operational objective of these transactions is to be considered a commendable one, even though an observer – yet only a keen one - might have envisaged a *dangerous* development of the relationships established to that purpose, due to several features of such financial instruments. Besides their riskiness, the shortage of liquidity characterizing this type of transactions is also relevant; hence the need for a negotiation (directly carried out by the bank) aimed at solving the difficulties of the so-called weak negotiating party.

Conversely, the circumstance negatively influencing the reconstruction of derivative operations is that these contracts – based on the protection needed by each single investor – do not have an organized secondary market and – as previously mentioned – are usually traded over the counter; that is in a context characterized by scarce transparency, illiquidity and prone to develop conflicts of interest (due to the intermingling of offer and counseling which characterizes

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<sup>27</sup> See Bari Trib., 15th July 2010, in *Banca borsa tit. cred.*, 2012, II, 786; Milano Trib., 19<sup>th</sup> April 2011, *ibid.*, 2011, p. 748, commented by GIRINO, *Sviluppi giurisprudenziali in materia di derivati over the counter*, pp. 794 ff.; Napoli Trib. 30<sup>th</sup> October 2011, n. 11706, available at [www.dirittobancario.it](http://www.dirittobancario.it).

them); being these preconditions capable of undermining the liability of the intermediaries to attend to the investor's interest.

It is fairly evident that, in the context of a written formal agreement, investors have often signed (without hesitation) a certification whereby they have claimed to have a certain financial experience without being aware of the protection they are renouncing by doing that.

This is where the wide-ranging dispute concerning the operations in question comes from; the details of which are well-known, as much as the significant contribution given by the Supreme Court of Cassation concerning the Italian legal order<sup>28</sup>. The guidelines set forth by the Supreme Court can contribute to solve the problem here at stake, if its invitation is accepted to give adequate relevance to the principle whereby integrity, transparency and good faith must be ensured to qualified operators too, as judicial proceedings have recently confirmed<sup>29</sup>.

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<sup>28</sup> The Supreme Court intervened on this matter in 2007 by emphasizing that the (*virtual*) nullity “of the contract subsequent to the infringement of the intermediary's conduct rules..., in the absence of any specific provisions, general principles or systematic rules, is not justified” (whereas, depending on the case, either a «pre-contractual liability» or a breach of «contractual» obligation can be assumed, which legitimizes a claim for compensation or even, in case of exceptionally grave breach, for a termination of the agreement). See Supreme Court of Cassation, Ss. Uu., 19th december 2007, nn. 26745 and 26725, in *Danno e responsabilità*, 2008, pp. 525 ff., commented by Roppo – Bonaccorsi. See Supreme Court 26th may 2009, n.12138, on [www.ilcaso.it](http://www.ilcaso.it).

<sup>29</sup> Case law has made clear that art.21 of TUF - claiming the “integrity of the market” - is a mandatory rule, therefore a binding one, which also applies to qualified operators. See Milan Trib., 23th march 2012, n.3513, on [www.dirittobancario.it](http://www.dirittobancario.it); and also previously Milano Trib., 19th april 2011, n.5443; Verona Trib., 20 settembre 2012, in *Il Corriere giuridico*, n.8-9, 2013, pp. 1094 ff.

In such context, it is clear that the defence of investors in litigations involving derivatives should proceed to a detailed reconstruction of the modes in which the transaction was carried out (also including to this purpose the negotiating phase), in order to identify suitable elements to represent the “deceptions” envisaged by art.1439 of the Italian Civil Code, and consequently a negligent behavior in terms of communication<sup>30</sup>.

Furthermore, it should be noted that - besides Civil Law – the rules of conduct imposed by the law on the intermediary in dealing with investment services are also relevant and, as known, they have been reviewed following the application of the Mifid directive.

It follows that selling 'derivatives financial instruments' to customers can be framed within the wider context of providing the public with investment services, which is regulated by primary UE legislation (in Italy art.21 ff., TUF) and completed by secondary legislation (implemented in Italy by Consob Regulation No.16190 of 2007 art.27 ff.). It is worth remembering that the cornerstone rule regulating the intermediary/investor relationship is art.21 of TUF, which prescribes some *general criteria* among which the principle whereby the intermediary must act diligently, correctly and transparently in the interests of customers and the integrity of the market (art.21, paragraph 1, lett.a) acquires particular prominence. Hence the intermediary's duty to receive the necessary information from customers, to operate in such a way that they are always adequately informed (art.21, paragraph 1, lett.b) and to ensure a transparent

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<sup>30</sup> See DE POLI, *Note minime su strumenti finanziari e mezzi di tutela dell'investitore*, in [www.dirittobancario.it](http://www.dirittobancario.it), June 2012, p.8.

conduct during each stage of the negotiation, namely pre-contractual phase, completion and implementation, by providing exhaustive, objective and clear information on the crucial elements concerning the transaction, the service and the financial instruments. The article also prescribes that the intermediary must have adequate resources and procedures, including internal control mechanisms, to ensure an efficient provision of services (art.21, paragraph1, lett.d). Still referring to conduct, it adds a final requirement, namely the adoption of “every reasonable measure to identify the conflicts of interest that may arise with the customers or between customers... (through)... adequate organizational measures, so as to prevent such conflicts from negatively affecting the customers' interests” (art.21, paragraph 1-*bis*, TUF).

In actual fact, recent experience has shown that financial intermediaries trading in OTC derivatives have *exclusively* acted like invertors' counterparty (*rectius*: they have behaved in conflict with them), whereas they should have *cooperated* with the investors, without renouncing to their profitability according to special provisions <sup>31</sup>.

This also emerges from the provisions set forth in articles 21 and 23 of TUF concerning intermediation contracts<sup>32</sup>, which apply to both the negotiating phase and the contract completion.

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<sup>31</sup> See MAFFEIS, *cit.*

<sup>32</sup> In accordance with art.23 of TUF, contracts shall be in writing. If otherwise, they are void. Furthermore no action lies for payment of a gambling/gaming or betting debt, nor can an action lie for recovery where the debt has been paid voluntarily following a game or bet not involving fraud (art.1933 of the Italian Civil Code).

In such regulatory context, there acquires particular relevance the requirement according to which intermediaries should not pursue their own interest disregarding the customers'. If otherwise, the intermediaries would infringe art.21 of TUF and would be consequently held responsible. The EU regulator has imposed a strict discipline on intermediaries as regards conflicts of interest<sup>33</sup>, considering that primary and secondary legislations already require them to refrain from such a conduct.

5. As regards OTC derivatives, Consob (already mentioned in the 2009 Communication) pointed out that intermediaries are required to observe the requisite of "adequacy" of the transaction; this thesis is based on the consideration that the activity of assistance that they provide to customers (i.e. at the stage of structuring transactions according to the investor's profile risk), is embodied in the provision of advisory services (Article 1, paragraph 5 *septies*, t.u.f., transposing Article 52 of Directive 2006/73/EC)<sup>34</sup>. Therefore, we can understand the obligation imposed by the Authority on the intermediaries to adopt procedures apt to assess the suitability of the transaction recommended,

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<sup>33</sup> See KRUIHOF, *Conflicts of Interest in Institutional Asset Management: Is the EU Regulatory Approach Adequate?* on [www.ssrn.com](http://www.ssrn.com); ANTONUCCI, *Regole di condotta e conflitti d'interesse*, in *Banca borsa titoli cred.*, 2008, I; ENRIQUES, *Conflicts of Interest in Investment Services: The Price and Uncertain Impact of MiFID's Regulatory Framework*, on [www.oxfordscholarship.com](http://www.oxfordscholarship.com), pp. 11 ff.

<sup>34</sup> On the new configuration, as a result of the EU Guidelines, the criterion of the adequacy of operations, see PELLEGRINI, *Regole di comportamento e responsabilità degli intermediari*, in *I contratti dei risparmiatori*, edited by Capriglione, Milano, 2013.

suggesting suitable financial products in terms of effectiveness and efficiency, taking into account also the cost of alternative opportunities<sup>35</sup>.

On a closer look, apart from the guarantees concerning profile information, it is mostly about guaranteeing the intermediary's organization and internal operations (commercial policy, pricing methods, monitoring of the operation over time); therefore, they are not in the perceptual availability of the customer, who is in a position neither to know and appreciate them, nor to monitor the actual compliance.

It is the Supervisory Authority's duty to control and possibly to take appropriate sanctioning measures, (being the *enforcement* the real test for the protection of the customer) also in order to avoid any possible recourse to civil and criminal courts.

However, repressive interventions may not be timely and investors may be damaged anyway. It is therefore necessary to identify preventive measures that go beyond the mere "disclosure" for the protection of the customer.

In this regard, case law has shown that transparency is not a sufficient protection for those investors who are not able to "critically evaluate" the information provided, beyond their supposed "expertise" (as they often lack the competence that only the intermediary has). This suggests that making the protection of the customer effective is not only a problem of "asymmetric information," but also of "cognitive asymmetries"<sup>36</sup>, i.e. the seller's knowledge

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<sup>35</sup> See the ESMA, Guidelines, 6<sup>th</sup> July 2012, on suitability requirements, on [www.esma.europa.eu](http://www.esma.europa.eu)

<sup>36</sup> See GREENWALD - STIGLITZ, *Asymmetric information and the new theory of the firm: financial constraints and risk behaviour*, in *American Economic Review*, 80, May 1990, pp. 160 ff.

of the product<sup>37</sup>; it is an obligation of the latter to assist the customers in consciously choosing investment products, in order to prevent them "unpleasant surprises".

6. Trading in derivatives in a context of recession - which is what characterizes some EU countries at present, such as Italy - poses the problem of finding additional measures for the protection of investors, as the economic recovery cannot occur regardless of it. As already pointed out elsewhere, there is a reciprocal relationship between intermediaries' fairness and proper functioning of the market, since the former represents a *condicio sine qua non* to gain savers' confidence in market mechanisms and, therefore, indirectly ends up being a condition for its proper functioning<sup>38</sup>.

As regards the need to identify corrective measures to prevent the occurrence of situations that can seriously damage (and sometimes beyond repair) the relationships between intermediaries and investors, the results of scientific research on "behavioural economics" can be useful; in fact, they provide an additional instrument to ensure a stronger protection of the investor, especially if retail.

Particularly, there emerges the possibility to use the information provided by social sciences (according to which the proper use of the *investor education* instrument can improve the investors' understanding of the financial products' characteristics) in view of an appropriate correction of the cognitive

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<sup>37</sup> See on this point SEPE, *cit.*, paragraph 3.

<sup>38</sup> See PELLEGRINI, *Le controversie in materia bancaria e finanziaria*, Padova, 2007, spec. Chap.V, wide bibliography *ibid*.

errors (debiasing) experienced by some customers who are either little cautious or unaware of the complexities they face in their actions<sup>39</sup>.

Behavioural finance<sup>40</sup> - which deals with the results achieved in empirical studies - provides important information on the subject, pointing out that the decision-making processes of individuals are frequently influenced by different factors, which are not only rational but also emotional<sup>41</sup>. Actually, dealing with investigations to verify whether the investor's decision-making process has been influenced by external factors (or at least if the will to negotiate has somehow been altered) means pursuing market balance in innovative ways, based on the reliability of negotiations freely carried out by the contracting parties.

It is more recent and still very limited the line of investigation concerning the subjective difficulties experienced by investors in making their own choices before a wide range of operational alternatives (with respect to the same type of risk).

To clarify the context in which the various operational options offered by the market are located, it is getting more and more widely believed that it

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<sup>39</sup> See LINCiano, *Errori cognitivi e instabilità delle preferenze nelle scelte di investimento dei risparmiatori retail. Le indicazioni di policy della finanza comportamentale*, in *Quaderni di Finanza - Consob*, 2010, n.66, p. III.

<sup>40</sup> Studies of behavioral finance date back to the 1970s (see KAHNEMAN - TVERSKY, *Prospect Theory: An Analysis of Decision under Risk*, *Econometrica*, 1979, 47, p. 263 ff.; SHEFRIN, *Do Investors Expect Higher Returns from Safer Stock than from Riskier Stocks?*, in *Journal of Psychology & Financial Markets*, 2002, 2, 4, pp.176 ff.). See also AA.VV., *La finanza comportamentale e le scelte di investimento dei risparmiatori. Le implicazioni per gli intermediari e le Autorità*, in *Quaderni di Finanza - Consob*, 2011, n.68, p.6.

<sup>41</sup> See ROSSANO, *Le "tecniche cognitive" nei contratto di intermediazione finanziaria*, Napoli, 2011, *passim*.

would be appropriate to make it mandatory for banks to report the information contained in the 'probabilistic scenarios' when selling financial products (including derivatives) to savers.

Hence the growing interest in the so-called *risk-based approach*, whereby risks are assessed and illustrated to the investors with the aim of enabling the latter to a correct risk perception; this goal can be achieved by providing a report that clearly and objectively represents how likely the derivative is to improve its situation.

To confirm the validity of this approach it is sufficient to think how easy it is to let the investor believe that a product can produce high profitability (which is sometimes true), but without specifying what and how much this is likely to occur (being such information in possession of the issuer who does not mention about it in order to sell a specific financial instrument)<sup>42</sup>.

This informative method shows its full effectiveness in gambling, whereby the probability of winning or losing the amount invested can be assessed.

Therefore the probabilistic method shows the exact extent of the risk taken (i.e. the possibility of loss)<sup>43</sup>.

Applying the probabilistic method to some derivatives (for example, with regard to the past, those traded by local authorities), it turns out that the probability (calculated at the date of contract subscription) for the derivative to

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<sup>42</sup> See PATRONI GRIFFI, *I contratti derivati: nozione, tipologia e peculiarità del contenzioso*, [www.dirittobancario.it](http://www.dirittobancario.it), October 2012.

<sup>43</sup> See PATRONI GRIFFI, *op. cit.*

perform financial coverage is very scarce, or even not non-existent in some cases.

On this point, we agree that assessing the instrument's conformity to its function in probabilistic terms can be a valid method of inquiry for legal proceedings involving derivative contracts. If the instrument is not “genetically” able to perform the function for which it is meant (i.e. financial coverage, as in the case of derivative contracts traded by local authorities), then we are faced with either an insufficient or an unlawful cause to enter into a contract; hence the nullity of the same<sup>44</sup>.

Let us now take into account the case of OTC derivatives placed to private customers. If, on the basis of the above-mentioned method, the contract does not seem to carry out any of the functions typical of the negotiations in question (with the consequence that the specific case cannot be identified as “derivative financial instrument”), the investor should be entitled to terminate the contract, or to rely upon the “exception of the gambling and betting” and to declare the contract void for lack of cause (resulting from a defect in the *alea* of the contract whose typical characteristic is in fact that of being aleatory)<sup>45</sup>.

In conclusion, the identification of techniques ensuring transparency – as concerns the risks faced by the investors trading in financial products - may represent a step forward in the search for solutions to progressively fill the informational asymmetries characterizing the intermediary-investor

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<sup>44</sup> See PATRONI GRIFFI, *op. cit.*, p.23.

<sup>45</sup> See previous note, *ibidem*.

relationship; hence the recovery of the confidence in the financial system and, therefore, the preservation of its good functioning.

It is therefore necessary to reserve increasing opportunities for financial education, considering the investors' frequent inability to make choices that prove to be optimal for them. At the same time, it is clear that increasing attention needs to be devoted to the methods of intervention developed by cognitive sciences (which are able to identify suitable instruments for measuring the reactions of individuals faced with potentially risky situations). In other words, special attention should be paid to the operating models developed by the sciences that – even if apparently distant from the scope of finance and economics - can make a contribution to the solution to the long-standing problem of the protection of savers-investors<sup>46</sup>.

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<sup>46</sup> We agree with those who claim that this should not take away from investors the entire responsibility on the choices made "even through the use of indiscriminate rules ...of compensation or personal liability"; see MORERA - MARCHISIO, *Finanza, mercati, clienti e regole... ma soprattutto persone*, in *Anal. giur. dell'economia*, 2012, p. 35 (on the inalienable right of the citizen to be wrong see LOSS, *Fundamentals of Securities Regulation*, Boston and Toronto, 1983, p. 36). In this way, as we have pointed out in the past (see PELLEGRINI, *Le regole di condotta degli intermediari finanziari nella prestazione dei servizi di investimento*, in *L'ordinamento finanziario italiano*, edited by Capriglione, Padova, 2010, II, p.856), we would give a too strict interpretation of the new regulations and this would possibly lead to an increasing number of measures to protect the weaker party. To such an extent, it would alter the market logic and its competitive mechanisms.

On the basis of the *antiantipaternalistic* approach to the regulation of financial markets see SUNSTEIN - THALER, *Libertarian paternalism is not an oxymoron*, *The University of Chicago Law Review*, 2003, p. 1159 ff.; according to this approach, public intervention should aim to correct errors by acting on the circumstances that favour their emergence (so-called *debiasing through law*, see Jolls - Sunstein, *Debiasing through Law*, in *Journal of Legal Studies*, 2006, 35, p. 199 ff.). On some "correction techniques" aimed at making individuals aware of the most

This may be the shortcut, though limited, that the authorities in the field (and the operators) should pursue in the attempt to reinterpret in an innovative and concrete way the "duty to act in the best interest of the investor", which has been present in the European regulations for quite a long time.

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common mistakes, see FISHOFF, *Debiasing*, in *Judgment under Uncertainty: Heuristics and biases*, edited by Kahneman, Slovic, Tversky, New York, Cambridge, University Press, 1982.