Conflicts of Interests in the Provision of Investment Services and of Collective Management Services under Italian Law

Raffaele Lener
Freshfields Bruckhaus Deringer LLP, Rome, University of Rome Tor Vergata

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The issue

It is normal for an intermediary that provides investment services to find itself in a situation where there is a potential conflict of interests. This can happen, for example, when the investment proposed to the clients involves financial instruments issued or placed by companies belonging to the intermediary’s group, or when the intermediary itself is acting as the direct counterparty to the client and effecting transactions with its own assets, or even when the services of other intermediaries within the group are used, or more generally in all cases where multiple services are provided since the intermediary is providing several potentially conflicting services.

Of course, one could propose a drastic solution and prohibit the intermediary from providing services to the client in such cases. In the 1980s, Italian legislation, jurisprudence and case law, and to a certain extent Law 1/1991, contained several such indications. Indeed, many conflicts of interest cases—although certainly not all—could easily have been identified in advance and an “overprotective” legislator could have listed them and strictly forbidden them.

However, in the 1990s the Italian legislator chose, in an irreversible manner, to do exactly the opposite: there would be no more prohibitions, just supervision and organisational rules. This led to an obligation of prior information—an area fraught with difficulties—which permits potentially conflicting transactions where the client has been informed in advance and has given his written consent. However, almost insurmountable difficulties have emerged. Financial markets require rapidity and cannot tolerate restrictions or bureaucratic excesses, such as the request for consent for each individual conflicting transaction. Therefore, an attempt was made to reconcile the market’s needs with the need to protect investors by permitting the prior consent of the client to be obtained once only, before the provision of any services, for a long, generic list of possible causes of conflict.

However, it is obvious that this sort of measure provides rather modest protection of the client’s interests and produces an excess of pre-contractual information. The more information is provided, the more useless such information becomes: the risk of a real conflict is buried in the never-ending list of non-risky conflicts and is inevitably not spotted by the client, who then gives his written consent with the same degree of attention (i.e. virtually zero) as that with which he signs the “unfair” terms clause envisaged by art.1341 of the Civil Code.

The legislator must now make a much greater effort and issue more “sophisticated” rules that are more suited to modern financial markets. On the one hand, it must restrict prohibitions to a minimum (while maintaining the prohibitions and obligations to abstain in cases of non-manageable conflicts, as we shall see). On the other, it has to introduce a requirement to provide selective, “intelligent” information that distinguishes between “conflicts” that may be authorised ex ante and “conflicts” that require ad hoc authorisation, together with internal organisational rules (e.g. Chinese walls) and specific rules of professional diligence.

Besides, even the EU legislator has chosen to manage and not to prohibit conflicts of interest.

MiFID Directives: levels 1 and 2

The Directive of April 2004 provides:

“Member States shall require investment firms to take all reasonable steps to identify conflicts of interest between themselves, including their managers, employees and tied agents, or any person directly or indirectly linked to them by control and their clients or between one client and another that arise in the course of providing any investment and ancillary services, or combinations thereof.”(Article 18.)

The Directive then specifies that where organisational or administrative arrangements made by the investment firm to “manage” conflicts of interest are not sufficient to “ensure, with reasonable confidence, that risks of damage to client interests will be prevented”, the investment firm is required to “clearly disclose the general nature and/or sources of conflicts of interest to the client” before acting on its behalf.

It is worth noting that the assessment whether the measures adopted by the firm to “manage” conflicts are “sufficient” is ultimately carried out by the firm itself, so that if the intermediary considers its organisational arrangements to be sufficient (e.g. the separation of

information through Chinese walls) and such assessment is deemed to be expressed in good faith or, in any case, not in a negligent manner, it will not be liable to the clients for any damage they may suffer as a result of any transaction involving a conflict of interests, nor will it be subject to administrative sanctions for breaching the code of conduct. As for the contents of the information to be provided to the client in the event that the organisational arrangements are deemed to be insufficient (by the investment firm), the EU legislator requires the investment firm to disclose: (a) clearly; and (b) before undertaking business on its behalf, the general nature and/or sources of conflicts of interest.

Although the expression used is unfortunate, it is clear that the investment firm may provide the client with a generic (the phrase “general nature” definitely means that there is no requirement to indicate the actual “specific nature” of the conflicting interest) indication of the conflict and may do so only once at the start of the contractual relationship.

Consequently, we may conclude that an intermediary that considers its arrangements for “managing” the conflict to be sufficient runs a greater risk—since there is a risk that a court or administrative authority may find such assessment to be negligent—than an intermediary that decides to assess its arrangements as insufficient and therefore includes a standard clause which provides its client with general information on all the conflicts of interests that could arise during the contractual relationship, but is careful only to specify the general nature and sources of such conflicts.

A brief examination of the 2006 directive confirms that the EU legislator intends to introduce a policy for the management of conflicts and not a series of prohibitions or obligations to abstain even in cases where the intermediary “confesses” that its organisational arrangements are (possibly) insufficient to “reasonably” eliminate the risk (not of the conflict, but that the conflict may have the effect) of “harming its clients’ interests”.

Article 22 of the 2006 Directive, which is significantly entitled “Conflicts of interest policy”, provides that investment firms have to “establish, implement and maintain an effective conflicts of interest policy”. It only states that such “policy”: (i) must be set out in writing; (ii) must be appropriate to the size and organisation of the firm; (iii) must also be appropriate to the nature, scale and complexity of its business. It then merely adds some measures dedicated to individuals who occupy positions of direction and control within the company or who perform “delicate” duties in potentially conflicting roles (defined as “relevant persons”).

In conclusion, there are very few prohibitions and these are contained in ambiguous and generically-worded provisions. This confirms the legislator’s decision to opt for organisational forms of conflict management that place minimal restrictions on the intermediary’s conduct, thereby inevitably relying on the ex post assessment of the “honesty and fairness” of the intermediary’s action by the supervisory and judicial authorities.

It is certainly possible that the legislators of the individual Member States will issue more stringent rules by imposing effective rules of conduct or duties to abstain on intermediaries in cases in which a conflict is not “manageable”; but this will be increasingly rare since, on the other hand, competition among the European financial markets will inevitably lead to national regulators competing to offer the least restrictions and, on the other, gold plating—i.e. supplementing EU provisions at a national level—is increasingly stigmatised.

The position of the CESR

The CESR has also decided not to suggest more stringent measures.

In its technical advice of January 2005, it left the EU legislator to decide whether or not to oblige intermediaries to pay particular attention in cases where several activities are carried out, with specific regard to dealing for own account, portfolio management and activities defined as “company finance”, which include placement with prior subscription. Once again, this is a general suggestion, which does not put forward any concrete measures to prevent the risks of the all-too-familiar conflicts arising from the provision of multiple services.

The Committee has also looked at possible concrete measures and has gradually changed its opinion. Initially, it recognised the central role of Chinese walls in preventing exchanges of information between business sectors with the greatest risk of conflicts of interests; then it stated that there could be alternative means that are “at least as effective”, but omitted to specify which they are; it finally concluded that information barriers may be useful, but that they have to exist alongside further organisational arrangements, such as, for example, the separation of supervision from internal control and measures that render the remuneration of staff in certain areas independent from the results in other areas of the intermediary’s business. These measures are taken, as we have seen, from the level 2 Directive.

It is clear from the technical advice that the CESR does not have complete confidence in these measures and that instead it prefers to rely on mechanisms for informing clients based on prior written disclosure with an obligation for the intermediary to obtain the client’s consent before acting on his behalf.

Although the CESR states that it is necessary to distinguish cases in which the intermediary’s counterparty is a “sophisticated” client from those in which its counterparty is a retail client, since in the latter case more attention would need to be paid to manner in which the
conflicts are disclosed, it does not adopt a clear position and does not object to an initial general disclosure even for “unsophisticated” clients, at least with regard to the most common conflicts which can, therefore, be standardised.

This confirms the EU policy which, with regard to conflicts of interests: (i) has not imposed prohibitions or obligations to abstain; (ii) has suggested that organisational arrangements should be adopted to manage conflicts, but has done so in a rather generic manner without imposing any such measures; (iii) has established duties of prior disclosure to the client as the mainstay of its policy, thereby opening the way to initial general disclosures which inevitably become standardised statements that are of little use to the client (if anything, they are useful for “diligent” intermediaries, as we shall see).

Italian rules on investment services

The Italian rules naturally follow the lines laid down by the EU legislator and are, therefore, on the whole open to the same objections. There are, however, some interesting and innovative solutions.

In general, conflicts of interests in the provision of investment services (including the management of individual portfolios) is regulated by art.21 of the Consolidated Finance Law (TUF), which lists a series of general principles. The intermediary: (a) must act diligently, fairly and transparently in the interests of customers and the integrity of the market; (b) must acquire the necessary information from clients; (c) must operate in such a way that the clients are always adequately informed; (d) must use advertising and promotional communications which are correct, clear and not misleading.

Where conflicts exist, it must: (a) identify the conflicts which may arise; (b) manage such conflicts; (c) inform clients in advance its arrangements are insufficient to prevent the risk of damaging the clients' interests; (d) in general, it must “perform independent, sound and prudent management” and take suitable steps to protect its clients' rights.

The principles that govern conflicts of interests in collective asset management (art.40) are essentially the same, except for the absence of the integrity of the market criteria (which is also mentioned by art.65 of the Consob Intermediaries' Regulation), the lack of any reference to fair treatment and the (obvious) added provision that the risk of conflict must be minimised, including conflicts between the pools of assets under management.

The system prior to the MiFID (article 21 TUF)

The system under art.21 TUF, which was completed by the provisions contained in Consob's Intermediaries' Regulation, uses a complex, strictly formalistic mechanism to implement the aforementioned principles.

It was the primary and secondary legislator's intention to adopt an innovative approach in replacing the model introduced by art.1341 of the Civil Code, but in practice the new formalism has not improved the protection of the client: indeed, it imposes a large number of written declarations and counter-declarations, which are inevitably standardised and inserted in or attached to the contractual terms and conditions.

Before the implementation of the directive, the system had become sclerotic and had given rise to a complex series of declarations and counter-declarations or declarations of acceptance, which, in extreme cases, could comprise the following: (i) written request by the intermediary for the client to provide information on his experience in the investment sector, his financial situation, his risk propensity and his investment objectives (art.21 para.1(a) TUF and art.28 para.1(a) Pt I of the previous Intermediaries' Regulation); (ii) written refusal by client to provide such information (art.28 para.1(a) Pt II of the previous Intermediaries' Regulation); (iii) intermediary's declaration regarding the nature and the risks inherent in the proposed transaction (art.28 para.2 previous Intermediaries' Regulation); (iv) intermediary's declaration that the transaction is not suited to the client's financial situation or objectives, taking into account the information provided or the fact that it was not possible to obtain such information (art.29 para.3 Pt I of the previous Intermediaries' Regulation); (v) written statement by the client that he intends to carry out the transaction in any case, even if it is not suitable (art.29 para.3 Pt II of the previous Intermediaries' Regulation).4

With specific regard to the conflicts of interests, two further declarations were possible: (vi) a written declaration by the intermediary that a conflict of interests existed (whether direct, indirect, within the group, arising from the provision of multiple services, etc.); (vii) a written declaration by the client that he intended to carry out the transaction in any case (art.27 para.2 of previous Intermediaries' Regulation).

Moreover, there can be no doubt that such declarations could be made on standard printed forms. The Intermediaries' Regulation admitted as much when, with express reference to such cases, it provided that the conflict of interests should be indicated in a "graphically highlighted manner" (art.27 para.3 of the previous Intermediaries' Regulation).

There is also no doubt that the regulatory system did not impose insurmountable obligations to abstain: in the event that there was a conflict of interests or that the

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4 On this point, see Sertori, Le regole di conduzione degli intermediari finanziari (Milano, 2004), pp.181 et seq.
transmission was not suited to the client, as we have seen, the client merely needed state in writing that he intended to go ahead with the transaction in any case.

Finally, there is no doubt that the declaration of the conflict of interests could—at least in principle—be made at the beginning of the relationship and not repeated thereafter, provided that it was worded in a sufficiently elastic and comprehensive manner.

It is easy to see that, if the intermediary is careful in its handling of the complex series of documents and the precise sequence of declarations, this system would, rather than help the client to understand the transaction, actually provide proof that the intermediary “acted with the specific degree of diligence required” and, as a result, it would overcome the procedural instrument that art.23 para.6 of the TUF provides to protect the client, i.e. the inversion of the burden of proof in actions for damages.\footnote{See Ausegost, “Commentario alla legge n.191” in Quaderni di documentazione e ricerca (Roma: 1991), no.7, pp.114 et seq.; G. Visentin, “La disciplina del conflitto di interessi nel mercato mobiliare” in Nuova giur. civ. comm. 2002, II, 485, who maintains that, since the provision requires proof of specific diligence, merely “formal compliance with the procedural rules is not sufficient”.

Based on a simplification of the legislation—which is often complex and contorted and full of references by the primary legislation to the secondary legislation and vice versa—we can say that qualified counterparties include all investment firms, banks, insurance firms, collective investment undertakings, SGRs, harmonised management companies, pension funds, financial intermediaries registered in the lists envisaged by arts 106, 107 and 113 of the Consolidated Banking Law (“TUB”), companies referred to in art.18 TUB, electronic money institutions, banking foundations, national governments and similar bodies, whether Italian or EU.

Professional clients are defined in annex 3 to the Intermediaries’ Regulation as clients which have the necessary experience, knowledge and competence to make their own decisions on investments and to properly assess the risks inherent in such investments.

The following entities are defined as professionals by law: (i) a series of intermediaries (investment firms, banks, SGRs, insurance firms, collective investment undertakings, pension funds and other institutional investors) that are required to be authorised or regulated to operate in Italian or foreign financial markets; (ii) large companies, defined as such on the basis of their assets or net turnover; and (iii) institutional investors whose main business is the investment in financial instruments. Furthermore, public professional clients are those identified as qualified counterparties (pursuant to art.6 para.2-quarter(d) TUF) and the regions. Other entities, such as large public bodies, may ask to be classified as public professional clients.

Finally, retail clients are clients that have less experience and competence in the investment sector and, therefore, need a greater degree of protection both during the pre-contractual phase and during the provision of the investment services. Therefore, the provisions contained in arts 27 and 56 of the Intermediaries’ Regulation are applied in full to these persons. Such articles concern the rules of conduct and the disclosure obligations applicable to intermediaries, which we shall discuss below. The retail client category is defined in a residual manner: in fact, art.26 para.1(e) of the Intermediaries’ Regulation merely specifies that a person can be classified as such when it is not a professional client or a qualified counterparty.

A point of possible intersection between the “professional” and “retail” client categories is the subcategory of “professionals upon request”, which can include any clients other than “statutory” professional clients, who may receive the treatment received for professionals provided that certain conditions are met and an express request is submitted.\footnote{In the event that a professional client or a qualified counterparty asks to be treated as a retail client, the rules only require a written agreement with the intermediary that identifies the services, transactions and products to which the more stringent protection is applied (art.35 para.3 of the Intermediaries’ Regulation).

The lower level of protection afforded to professional clients has meant that the exchange of information and consents required to change category is regulated in a
formally rigorous manner: (i) the client must inform the intermediary in writing that he intends to be treated as a professional client, either generally or with reference to a particular service, investment transaction, type of transaction or product; (ii) the intermediary must advise the client, clearly and in writing, of the rights he would be waiving in such case; (iii) the client must declare in writing, in a separate document, that he is aware of such consequences.

Consequently, there is an inevitable return to the “chain” of declarations.

However, before accepting the client’s request, the intermediary has to carry out an in-depth substantive assessment that takes into account the nature and the value of the transaction, the client’s capacity to make his own informed decisions regarding investments and to understand the risks inherent in such transaction. Moreover, it will have to ascertain whether certain quantitative and/or professional experience requirements, which are strictly listed, have been met.

This is undoubtedly a step in the right direction compared to the previous system: the self-referential chain of declarations is no longer sufficient and concrete proof that the statutory requirements are met is now required. This should be considered a positive change.

Consequences of the new classification

Some rules of conduct have a general scope of application, i.e. those regarding information, advertising and promotional notices (arts 27–28 of the Intermediaries’ Regulation) and information on financial instruments (art.31), although, in the latter case, the intermediary has to take into account the classification of the client.

Otherwise, the rules are gauged differently according to the “type” of client, to whom a certain set of rules is applied, bearing in mind the particular investment service provided.

The lowest level of protection is applied to the qualified counterparties, for whom all the rules of conduct are set aside, although solely for the following services: execution of orders, dealing for own account and receipt and transmission of orders.

The highest level of protection is, instead, envisaged for retail clients, in the form of a general rule which requires a written “framework agreement” for the provision of all services other than advisory services (art.37 of the Intermediaries’ Regulation) and “special” rules for portfolio management agreements (art.38 of the Intermediaries’ Regulation).

In particular: the new concepts of “suitability” and “appropriateness”

Article 21 para.1(b) TUF, which has remained unchanged following the implementation of the Directive, provides that the intermediary has to acquire the necessary information from customers and operate in such a way that they are always adequately informed. Therefore, even under the new rules, there are two flows of information: from the client to the intermediary and from the intermediary to the client.

Clearly, the information to be provided to the client necessarily follows the information on the client requested by the intermediary, which necessarily conditions the content of the information to the client and, in general, the frequency and the intensity of the intermediary’s obligations to provide information. The information provided by the client allows the intermediary, inter alia, to classify the client.

With regard to the information that the client has to provide to the intermediary, general principle set forth in art.21 para.1(b) TUF, which provides that the intermediary has to acquire the necessary information from customers, is specified in arts 39 and 41 of the Intermediaries’ Regulation. The main objective of the principle in question is to allow the intermediary to make an assessment as to whether the service or financial product it intends to provide is suitable/appropriate based on the characteristics of the client. However, such assessment is not required for execution-only services or the receipt and transmission of orders and the intermediary does not need to obtain such information or carry out any assessment of suitability and appropriateness, provided that (art.43): (a) the services are linked to “non-complex” financial instruments; (b) the services are provided on the initiative of the client; (c) the client has been informed of the execution-only nature of the service; (d) the intermediary complies with conflict of interest obligations.

It should be emphasised that the concepts of suitability and appropriateness do not coincide and that this distinction was introduced by the new system. In fact, art.29 of the previous Intermediaries’ Regulation only used the criterion of the suitability of the transaction for the client, regardless of which investment service was being provided, and prohibited the intermediary from carrying out transactions that were unsuitable for the client due to the type, object, frequency or value of the transaction. In such cases—as we have seen—the intermediary had to inform the client, but could proceed despite the unsuitability where the client issued a written order—or, if the order was imparted by telephone, such order had to be recorded on tape or an equivalent medium—which contained an express reference to the warnings given by the intermediary.

Under the new rules, however, the suitability assessment is only required for advisory services relating to investments and portfolio management, while the appropriateness assessment is required for other investment services. Therefore, it is clear from arts 39 and 42 of the Intermediaries’ Regulation that: (i) such assessment criteria have a different scope—the suitability

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"They were already considered to be insufficient by more "progressive" rulings: most recently Supreme Court No.17340 of June 25, 2008 (see Il caso v), Court of Appeal of Venice dated June 12, 2008 (see http://www.conast.it [Accessed May 4, 2010])."
criterion clearly has a more rigorous content that the appropriateness criterion and Consob has decided that the intermediary must adhere to more stringent parameters when assessing it; (ii) there are different rules for the exchange of information between the client and the intermediary.

Under art.39 of the Intermediaries’ Regulation, the information that the clients have to provide to the intermediary so that it may evaluate the suitability of the transaction concern their: (i) knowledge and experience of the relevant investment sector for the type of instrument or service; (ii) financial situation; (iii) investment objectives.

However, when advisory and management services are provided to a professional client, the intermediaries,

“may presume that, with regard to the instruments, transactions and services for which said customer is classified as a professional customer, he has the necessary level of experience and awareness”

to evaluate the suitability, in terms of understanding the risks involved (art.40 para.2 of the Intermediaries’ Regulation). Moreover, if the client is classified as a professional client by law, the intermediaries may also presume that the customer is financially able to face any investment risk compatible with his investment objectives (art.40 para.3). As a consequence, the suitability assessment for professional clients is reduced to the (assessment of the) compatibility with his investment objectives.

The information that the clients have to provide to the intermediary for the appropriateness assessment regards their knowledge and experience of the relevant investment sector. Moreover, the intermediaries may again presume that their professional clients have the necessary level of experience and knowledge to carry out the transactions in question.

Before retail clients can carry out a transaction, the intermediary has to be in a position to express a positive assessment—based on the criteria indicated in art.40 para.1 of the Intermediaries’ Regulation—on the suitability of the transaction (for advisory and management services). In fact, a refusal by the client to provide the requested information constitutes an insurmountable obstacle and, in such case, the intermediary has to abstain from effecting the transaction (art.39 para.6 of the Intermediaries’ Regulation).

However, a negative outcome to the appropriateness assessment—in the case of investment services other than advisory or management services—does not constitute an obstacle as it does in the case of the suitability assessment. Indeed, the third paragraph of art.42 of the Intermediaries’ Regulation provides that the intermediary is only required to warn the client that the instrument or the service is inappropriate for him and there is no obligation to abstain from the transaction.

The only significant change is in the rules on advisory and management services, where the exchange of formal declarations is not sufficient to overcome the absence of a positive outcome to the assessment of suitability of the investment. There has been no change, however, in the rules regarding the other services, where the written declarations and counter-declarations allow the parties to overcome any obstacles.

The “management” of the conflicts of interests under the new rules

The regulatory rules on conflicts of interests are currently contained in the Intermediaries’ Regulation and in the Joint Regulation issued by the Bank of Italy and CONSOB on October 29, 2007.

First, it is important to emphasise that the rules on conflicts of interests apply regardless of whether the client is classified as retail, professional or a qualified counterparty—although the level of detail of the information to be provided to the client varies—in the event that the organisational arrangements put in place by the intermediary are not sufficient to ensure with a reasonable degree of certainty that there is no risk of damaging the client’s interests (art.23 para.4 of the Joint Regulation).

Like the old system, the mainstay of the new rules is the intermediary’s autonomy, which is clear from the fact that the intermediary itself is asked: (a) to take reasonable steps to identify conflicts of interests; (b) to manage the conflicts of interests, including: (i) the adoption of suitable organisational measures; and (ii) by ensuring that, in the case of the provision of multiple services, persons engaged in conflicting activities can act in an independent manner, thereby preventing the conflicts from having a negative effect on the clients’ interests; and (c) to evaluate whether the measures adopted to manage conflicts may be insufficient.

In particular, some cases of conflicts of interests are listed and are referred to as relevant conflicts of interests. Pursuant to art.24 of the Joint Regulation, such conflicts may arise when intermediaries, a relevant person (i.e. a member of the company boards, a manager, an employee, a promoter or a provider of particular services to the intermediary) or a person linked to the intermediary on the basis of direct or indirect control: (a) may make a profit or avoid a loss to the detriment of the client; (b) have an interest in the result of the service provided to the client, which is separate from that of the client; (c) have an incentive to favour interests of clients other than those to whom the service is provided; (d) are engaged in the same business as the client; (e) receive an inducement from a person other than the client, in relation to the service provided to the latter, in the form of money, goods or services, other than the commissions or fees they normally receive.
The various incentives should be supplemented by the provision on inducements in art.52 of the Intermediaries' Regulation, which reproduces art.26 of the level-2 Directive. As the CESR emphasised, although art.26 is entitled "inducements", it does not list the cases which may incur sanctions and chooses instead to identify the characteristics of the "fees or commissions" which may legitimately be paid to the intermediary, since: (i) they are normally envisaged for the provision of the service; or (ii) they are designed to enhance the quality of the relevant service and are, even briefly, disclosed at the beginning of the contractual relationship or, in any case; (iii) they do not conflict with its duties to act honestly, fairly and professionally in accordance with the best interests of its clients. Consequently, the inducements will only be relevant with regard to conflicts when such criteria are not met.

Article 21 para.1-bis(a) TUF and art.23 para.2 of the Joint Regulation provides that the intermediary has to manage the conflicts of interests by, inter alia, adopting suitable organisational arrangements. In practical terms, this means that the intermediary has to put in place conflicts of interest management policies that meet the criteria and objectives specified in art.25 of the Joint Regulation.

In particular, conflict management policies have to be: (i) "effective"; (ii) in writing; (iii) in accordance with the principle of proportionality, which implies that the intermediary has to take into account all the factors of which only the firm can be aware, including being a member of a group (art.25 para.1 of the Joint Regulation); and have to (iv) highlight, for each service, the circumstances that may give rise to a conflict of interests that could damage the clients' interests (art.25 para.2 (a) of the Joint Regulation); and (iv) identify, for the purposes of managing these conflicts, procedures to be followed and measures to be taken, which should be structured in such a way as to ensure that the "relevant" persons carry on their activities with an appropriate degree of independence, taking into account the size and the activities of the intermediary (art.25 para.2(b)(e) para.3 of the Joint Regulation).

Moreover, para.4 of art.25 identifies some procedures that the intermediary may apply, if it deems them appropriate, in order to maintain such independence. The firm may amend these measures or supplement them with alternative measures according to its specific needs. These measures are generally designed to prevent any exchange of information between relevant persons, to ensure separate supervision of the relevant persons and to eliminate any direct connection between the remunerations of relevant persons whose main business is likely to give rise to potential conflicts of interests between them in accordance with the provisions of the level-2 Directive, in relation to which there are no important changes or additions.

In addition, the intermediary is required to set up a register listing the actual or potential conflicts of interest for each type of investment service which could seriously harm the interests of one or more clients (art.26 of the Joint Regulation). The obligation to keep and update the register is part of the new corporate function of compliance, which was provided for by the level-2 Directive and is implemented by art.16 of the Joint Regulation.

Finally, art.28 of the Intermediaries’ Regulation sets forth additional rules for intermediaries that produce investment research—as defined in art.27 of the Intermediaries’ Regulation—that they distribute or may distribute to clients or the public and for which they assume or a member of their group assumes responsibility. The introduction of additional protection measures to the management policies is intended to avert the risk that clients' interests may be damaged through imbalanced and unobjective assessments.

However, it is not clear what action the intermediary should take with regard to the information addressed to clients when there is a conflict of interests. Indeed, neither the EU nor the Italian legislation: (i) clarify whether the intermediary is required to inform the client that there is a conflict for each individual transaction it carried out on his behalf or whether such information can be provided once and for all at the start of the contractual relationship; nor do they (ii) expressly state whether or not the intermediary may use a standardised format.

With regard to point (ii), however, art.27 of the Intermediaries’ Regulation dispels all doubts in that it provides, inter alia, that the appropriate information may be provided to clients, so that they “can reasonably understand the nature of the investment service” proposed to them, “in standardised format”.

The efficiency of the new system is, in reality, not a foregone conclusion, especially since the assessment of the existence of the risk of conflicts is carried out by the intermediary and, in such cases, it is only under an obligation to inform the client of the nature and/or source of the conflict—and not to abstain from carrying out the conflicting transaction—which can again be overcome by the consent of the client. As for whether the new rules have strengthened the clients' protection, at most one could claim that, by expressly requiring the intermediary to evaluate and manage the conflicts of interests, the rules have introduced a criterion that can also be used in any subsequent assessment of the intermediary's conduct by the judicial or administrative authorities, even if the intermediary was authorised to carry out the conflicting transaction. In other words, only if the courts manage to use these new criteria to assess the intermediary's diligence will we avert the risk that clients are effectively deprived of any protection against intermediaries that choose to assess their organisational arrangements as insufficient and, as a result, choose to initiate the exchange of notices required by law for all transactions.

19 In Level 3 Recommendations on Inducements under MiFID—Feedback Statement (May 2007).
Procedural remedies for clients

There is no unequivocal indication in the case law as to the contractual consequences of breaching the provisions of art.21 TUF, and the implementing regulations11 although the two rulings by the Supreme Court12 should have sufficiently clarified the distinction between rules of conduct and rules of validity. Indeed, the prevailing case law from the lower courts—although different opinions have been expressed, ranging from termination due to default, voidability due to a lack of consent, pre-contractual or even contractual liability—has long favoured the inclusion of all the rules of conduct described above under the generic umbrella of “rules of validity”, based on the mandatory nature of the provisions, with the consequence that the agreement would be afflicted by virtual nullity, i.e. it would be null and void having breached a mandatory provision even in the absence of an express sanction.13

The Supreme Court has now stated that only the breach of mandatory provisions regarding the validity of the agreement can give rise to nullity and not the breach of provisions which are mandatory but which regard the conduct of the contracting parties and which can, therefore, only give rise to liability. Such liability would be pre-contractual or contractual depending on whether the breach took place before or after the execution of the investment agreement. However, the situation is not as clear-cut as it seems, since several cases of improper, negligent conduct by the intermediary during the phase preceding the execution of the agreement are then absorbed by the default, thereby giving rise to contractual liability.14

Even if one were to admit that the Supreme Court has now managed to give unequivocal guidance to the lower courts, the decisions of the plenary session have failed to broach the most delicate aspect of the investors’ procedural protection. The greatest difficulties lie, in fact, in the manner in which the provision that inverts the burden of proof in compensatory proceedings operates (art.23 para.6 TUF) and in the quantification of the damages.

Indeed, the provision that inverts the burden of proof, by requiring the authorised intermediaries to prove that they “have acted with the specific degree of diligence required”, has in practice been of little help to the investor. In fact, I have always been of the opinion (ever since its introduction in art.13 para.10 of Law 1 of January 2, 1991) that it is little more than a decoy which does not improve upon the general rule of law set forth by art.1218 of the Civil Code.15

Effectively, although the client is not required to prove the intermediary’s culpability, the provision does not exempt him from having to prove the damage and the causal link, under the general rules. This is a considerable burden.

With regard to the damage, the client may well have little difficulty in proving his actual loss, including the costs arising from the transaction and the partial or entire loss of the capital invested (i.e. the difference between the value of the financial instruments at the time of the investment and the value that they had when the claim for compensation was filed). However, proving his loss of anticipated earnings—i.e. the profits that the client could have made if, having received the correct information and a correct assessment of the suitability and appropriateness profiles from the intermediary, he had made a different investment with the same or another intermediary—is an altogether more complex matter. In light of the typical risks inherent in investment contracts, it is extremely difficult to provide proof of “loss of anticipated earnings”. Perhaps there is a role for the benchmark envisaged for portfolio management contracts by art.38 of the Intermediaries’ Regulation, which could become a sort of guiding criterion for the courts and replace the “equitable criterion” which is undoubtedly unsatisfactory.

Moreover, just consider cases of contributory negligence by the client, which now tend to arise where, having received information that is sufficient to warn him of the losses or even only of the dangers inherent in the investment—where the initial information provided by the intermediary was insufficient, the client fails to exercise his right of withdrawal promptly. The intermediary may use both the account statements and the periodic or extraordinary information required by the Consob regulations to reduce the amount of the compensable damage.16

Producing evidence of the causal link is even trickier. In fact, the client has to prove that there is a connection between the breach of the intermediary’s obligation, which is usually the breach of a disclosure obligation, and the damage he has suffered. In other words, the investor has to prove that if the obligation had been fulfilled precisely, he would have made a different choice regarding the investment. This is certainly not easy to prove, especially since it is difficult to imagine the investor’s choices.17

At this point, the data that the intermediary should have collected on the client’s investment objectives, pursuant to art.39 of the Intermediaries’ Regulation, could be used

14 Lebuono, Responsabilità degli intermediari finanziari (Napoli: 1999), p.120; Santarelli, Le regole di condotta degli intermediari finanziari (Milano: 2004), pp.144 et sqq.
15 See Assogestioni, "Commentario alla legge n.191" in Quaderni di documentazione e ricerca (Roma: 1991), pp.114 et seq.; “In the best-case scenario, the provision is a mere reiteration of article 1218 Civil Code”.
17 On this point, see Mastropolo, I servizi di investimento e gli intermediari professionali (Milano: 2003), pp.585 et seq.
as a point of reference (however, it is possible that such information was not provided, as in the case of services other than advisory or management services).

Even if, after an extraordinary effort, the client manages to provide proof of the damage and of the causal link, a skillful intermediary can still paralyse the claim for compensation and prove that it has acted diligently by filing the series of declarations, counter-declarations and consents described above.

In theory, the court could rule that the general declaration regarding conflicts issued ex ante is insufficient. However, this is unlikely to happen in practice as it is permitted by the primary and secondary (EU and) national legislation. It is reasonable to assume that only in extreme cases will a court find the intermediary liable for breach of art.21 TUF based on the fact that the initial information provided to the client was insufficient to allow him to comprehend and, therefore, to authorise the conflicting transactions.

Collective management under the Consolidated Finance Law (TUF)

Collective asset management deserves a separate section. In fact, although there can be a continuous flow of information between client and manager under individual management agreements—as, and more so than, in other investment services—so that it is always possible to ask for authorisations for conflicting transactions, both ex ante in a general manner and with specific reference to individual investments, this cannot occur in collective management where there is no “dialogue” between the manager and the client.

Alternative mechanisms of a “hetero-protective” nature are used in collective management, while the only forms of self-protection available to clients are the scrutiny of the management reports and the right to withdraw from the contract.

In theory, this increases the risk of conflicts, since the client can only evaluate them ex ante at the time of the investment on the basis of the management regulations and/or the prospectus.

Consequently, the legislator has introduced specific conflict management measures which prohibit the provision of multiple services, impose restrictions on the investments and require a custodian bank to carry out the investment/divestment transactions ordered by the management company. It is worth remembering that most of these measures are not imposed by the EU rules, which are, in this case, less “progressive” than the Italian rules.

In the first place, the TUF established Italian management companies (SGRs), which are intermediaries that are authorised to manage assets on an individual and collective basis, and it has prohibited them from engaging in any other business than asset management (whether collective, individual or pension funds), with the sole exception of related and instrumental activities (art.33 TUF). This was the result of a long debate as to whether management services may be delegated and whether the management services may be “concentrated” in only one entity. The solution adopted by the TUF is without precedent in Europe, not so much because both the services of asset management on behalf of third parties have been assigned to a sole intermediary, as due to the decision to permit SGRs to manage assets on an individual and collective basis, but then to prohibit them from providing other investment services.

In removing the risk of conflicts arising from the provision of multiple services, the legislator has also simplified the implementing regulations which can now concentrate on effective conflict issues. This has increased the transparency and the efficiency of the market.

In order to prevent conflicts of interests, although the legislator has permitted SGRs to manage assets on an individual and collective basis, their own pension funds or those set up by others (art.36 para.1 TUF) and the assets of SICAVs (art.43 para.7 TUF), it has decided not to allow SICAVs to manage assets on an individual basis or to manage investment funds set up by others or the assets of other SICAVs. This is because it is impossible to make a formal distinction between shareholder-managers and shareholder-clients in SICAVs, so that if the SICAV were also to provide services on behalf of third parties, other than the shareholders considered as a whole (even on behalf of shareholders as individuals, such as individual portfolio management), the clients would also be exposed to the business risks arising from the management on behalf of third parties and the risk of conflicts of interests would grow out of all proportion.

Prior disclosure and collective management

The rules on collective management are also based on the rules of conduct developed on investment services which have been adapted to take into account the fact that, as mentioned, conflicts in collective management cannot be dealt with through disclosure or by specific authorisation issued by the investor (see Annunziata, 2005, p.303).

In general, the TUF (art.40 para.1(b)) provides that managers have to:

“[O]rganise themselves in such a way as to minimise the risk of conflicts of interest, including conflicts between the pools of assets under management and, where a conflict of interest exists, act in such a way as to ensure the fair treatment of the collective investment undertakings.”

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18 With regard to the assessment as to whether the client has effectively understood the information provided by the intermediary, especially in light of the inevitable standardisation of the declarations in question, see, for example, with different findings, Court of Turin, April 12, 2006 in Cit. it. 2006, 1631, and Court of Turin, March 23, 2005 in Cit. comm. 2006, T1, 158.

19 See Enriquez-Volla, "Le gestioni mobiliari: profili giuridici" in Banfi and Di Battista (eds), Tendenze e prospettive del risparmio gestito (Bologna, 1998), pp.350 onwards.

20 See these issues, see Pasqueroiello, "Le deleghe di gestione nelle SICAV tra codice civile e legge speciale" in Contr. e impr. 2002, pp.1103 et seq.
There is not and nor has there ever been, except for a short-lived individual provision (art.9 of Law 262 of December 28, 2005, which was abrogated after a year), anything in the primary legislation which delegates to the government the power to regulate, by legislative decree, the:

“[C]onflicts of interests in the management of the assets of collective investment undertakings and of insurance and pension products and in individual portfolio management.”

The provision was badly worded and a source of possible confusion, especially in its desire to treat investment funds and “insurance and pension products” in the same manner, with no specification. Although often, but not always, the same procedures apply to the management of “insurance products” as to the management of investment funds—and in some cases it is difficult to justify any difference in the rules—it is also true that the two (in reality three) cases cannot merely overlap without the law at least providing some guidance.

With regard to the management of the conflicts of interests, it should be said that under the previous rules: (i) there was a general principle of *fair treatment* of the assets managed by the collective investment undertakings; and (ii) SGRs and SICAVs were not prohibited from acting where there was an effective or potential conflict of interests. Furthermore, there was a general obligation of supervision so as to identify potential conflicts and to adopt containment and disclosure measures (art.49 of the previous Intermediaries’ Regulation).

Following the implementation of the directives, the general principle contained in art.40 TUF—which remains unchanged—has a partially new scope of application, pursuant to arts 37 onwards of the Joint Regulation, which essentially coincides with the new rules of conduct for investment services.

In particular, conflicts of interests now have to be identified and managed to prevent: (i) the assets of the collective investment undertakings being burdened by otherwise avoidable costs or being excluded from profits which are due to them; or (ii) the conflicts from damaging the managed collective investment undertakings and the unit-holders. Moreover, in the event that the arrangements are insufficient to rule out any risk of conflicts of interests that could damage the interests of the collective investment undertakings, suitable measures to guarantee fair treatment are required.

Finally, SGRs and SICAVs have to adopt a *written conflict of interest management policy* and provide investors with information on this policy, even in the form of a summary description. The policy must be based on the principle of proportionality and must be suitable: (i) to ensure the fair treatment of the managed assets; and (ii) to guarantee the company’s *appropriate independence* relative to the investment transactions through arrangements and procedures that coincide with those envisaged by art.25 of the Intermediaries’ Regulation on investment services.

**The separation of assets as preventive protection against the collective manager’s conflicts of interests**

In reality, the most significant “protection” provided in relation to collective asset management is the existence of a *strong* custodian.

Indeed, the TUF has raised the rule on the separation of assets to the status of general principle, so that art.22 states that the client’s assets are *separate for all intents and purposes from those of the intermediary and from those of other clients* (para.1). This echoes the wording of art.36 para.6, which provides that:

“[E]ach investment fund … shall constitute an independent pool of assets, separate for all intents and purposes from the assets of the Italian management company and from those of each unit-holder.”

However, the identical wording of the two provisions does not mean that they have the same consequences with regard to the “intents and purposes” they both mention. In fact, only the rules for collective investment undertakings provide that the separation of the assets implies the assignment of the separate assets to a custodian, which—on the one hand—is under an obligation to verify the lawfulness of the transactions ordered in relation to the assets, based inter alia on the rules of conflict management and the ensuing liability, and which—on the other—not only holds the assets, but is also the only entity authorised to dispose of them, albeit on the basis of instructions issued by the management company.

None of this is envisaged for investment services, with regard to which, therefore, both the separation of assets and the possible presence of a custodian cannot constitute a “strong” protection of the client’s interests.21

In fact, para.3 of art.22 TUF allows investment firms to “use” “on its own behalf or on behalf of third parties” financial instruments belonging to customers which it holds in any capacity, provided the client (yet again) gives its written consent, which leads one to wonder whether such declaration of consent may become a standard clause in contracts relating to investment services, especially in standard contracts drawn up unilaterally by the intermediary, and whether in case systems for protecting the client should be found to guarantee that the intermediary fulfils its obligation of restitution.22

On the contrary, in the case of collective asset management, and only in this case, the custodian guarantees compliance with the conflict management arrangement.
criteria introduced ex ante, thereby avoiding any subsequent, and frequently tardy, assessment by the judicial or administrative authorities.

Consequently, conflict management is less problematic and more effective in collective asset management than it is in individual assets management: therefore, under the current system the hetero-protection arrangements work better than the self-protection measures.

Thus, one cannot complain if the rules on collective management services do not provide for the inversion of the burden of proof in actions for damages pursuant to art.23 para.6 TUF.\textsuperscript{23}