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Procedural battles concerning jurisdiction are playing out between the Courts of Italy and those of London: the dealer vigorously defends the jurisdiction of London, while the (Italian) investor argues for Italian jurisdiction.

In English case law, the dealer is typically the counterparty in an exchange (*caveat emptor*). If the dealer coaxed the investor, that action took place outside of a fiduciary relationship and there is no "common law duty of care." If the dealer gave misleading advice, in its own interest, there is no liability because "there is a clear distinction between giving advice and assuming legal responsibility for that advice." If the investor does not pay for a specific consulting service, he cannot complain about what took place as a result of what the dealer, spontaneously, communicated to him prior to the conclusion of the agreement.

Thus, there is currently an abyss between the Italian Courts and the London Courts, principally as regards the relevance of the rules of conduct for dealers, which as concerns derivatives are applied strictly by the Italian Courts, while they are neglected by the English Courts.

This represents not only a paradox - given that the rules of conduct for dealers originated in the United Kingdom - but above all a violation of EU law, because while in the Italian judgments there is a rigorous application of the rules of Directive 93/22, which - on paper - is also binding in the United Kingdom, those same rules are not found at all in the UK judgments.

In the English judgments regarding over the counter derivatives, the rules of the Directive - reproduced in the *Financial Service Authority Handbook* and the *Conduct of Business* (*COB*) – and the very existence and force of the Directive, are completely absent.

This is a serious absence. Just consider the fact that, in other areas, it is precisely the sensitivity of the national judges - who are true "instruments of EU law" - that during implementation allows for raising the level of harmonisation beyond that written on the paper of the Directive that is applicable in each case.

In both the Italian judgments and the English judgments that are referenced below, the reference regulation is (*ratione temporis*) Art. 11 of Directive 93/22/EEC of 10 May 1993.

As is known, this provision does *not* regulate the investment *contract*, but regards the *conduct* of the

dealer. However, since it regards the conduct *prior, simultaneous* and *subsequent* to conclusion, the regulation becomes, *above all*, a regulation *of the contract*.

Thus, Article 11 establishes that the "investment firm... acts honestly and fairly in conducting its business activities in the best interests of its clients and the integrity of the market; acts with due skill, care and diligence, in the best interests of its clients and the integrity of the market; has and employs effectively the resources and procedures that are necessary for the proper performance of its business activities; seeks from its clients information regarding their financial situations, investment experience and objectives as regards the services requested; makes adequate disclosure of relevant material information in its dealings with its clients; tries to avoid conflicts of interests and, when they cannot be avoided, ensures that its clients are fairly treated; complies with all regulatory requirements applicable to the conduct of its business activities so as to promote the best interests of its clients and the integrity of the market."

As can be seen, the principles contained in Article 11 are *not* vague, and characterise the very *nature* of the relationship with the investor. From this standpoint, the principles affect *the contract*.

It is true however, that an EU provision, which is also a minimum harmonisation directive, not yet confirmed by case law of the Court of Justice - which has been absent to date - is a regulatory provision whose effect is handicapped.

Nevertheless, the principles involved are not so vague that they can be annulled during application: to the contrary, their meaning is to be reconstructed in unambiguous terms for all of the countries and "taking account of the context of the provision and the objective pursued by the regulation."

As regards in particular the United Kingdom: the fact that the principles are applicable in the abstract by the oversight authority, pursuant to Art. 150 FSA, does not mean that they are irrelevant for the Court.

To judge from Italian and English rulings, the sensation is that we are dealing with a zero implementation directive; and this, not from the standpoint of the remedies, but of the principles, and at the root, of the identification of the most important typological marker on the matter, which is the nature of the contractual relationship, that may entail cooperation or exchange.

The terms of the question do not change, except to deteriorate, when we start from the assumption that the difference in solutions between Rome and London depends on a more or less broad exemption from application of the precepts of the directive, based on the classification of the client according to the experience as *stated* by the client.

In this regard, the judgment of the Court of Milan of 19 April 2011 definitively clarified that the question is not if an investor who has stated that he is an expert, actually is. The question is that the investor's experience is not sufficient to shelter him from the subtleties, shall we say, in which the financial industry loves to indulge, and does not affect the dealer's duty to act in order to pursue the client's substantial interest. Of this, we find no trace in London.

It is true that in following that same Article 11 of the Directive, the rules of conduct "must be applied in such a way as to take account of the professional nature of the person for whom the service is provided," and that pursuant to whereas provision 32 "it is appropriate to take account of the different requirements for protection of the various needs of investors and their levels of professional expertise," but precisely because the issue is to modulate the rules of conduct, the capacity of the investor, whatever it may be, cannot be such as to eliminate those rules, as happens though, if it is established that the direct negotiation with the counterparty of an over the counter derivative is a normal business exchange transaction, as the English judgments currently state.

The state of case law on derivatives in Italy, is indicated by the judgment of the Court of Milan of 19 April 2011 and now also by the judgment of the Court of Milan of 3 May 2013, which order the dealer to pay damages to the client - a large company, a so-called qualified operator, and a small firm, respectively – at a rate equal to the negative balance between the yields accrued and charged, in addition to a lump-sum as damages to image due to having been referred to the Credit Register of the Italian central bank, the *Banca d'Italia*.

The Court of Milan's judgment of 19 April 2011 reconstructs the nature of the relationship between the dealer and client in terms of cooperation - in line with Art. 21 of the Finance Consolidation Act (T.U.F.), a provision that is the direct implementation of Art. 11 of the Directive - and identifies in the conclusion and execution of the contract a situation of conflict of interests - based on the overlapping for the dealer of the two capacities of cooperator and counterparty - which binds the dealer to always give precedence to the substantial interests of the client over its own: both when it is to organise within

the company the unit assigned to negotiate the derivatives, and when it is to suggest or discourage the conclusion of a derivatives contract, choose its characteristics and degree of risk, decide whether or not to formulate *de facto* suggestions, suggest or support a renegotiation strategy, disburse an up-front payment, set so-called implicit costs, and so forth. If it is established that the dealer has violated its duty to protect the substantial interests of the client, it follows that the dealer will be ordered to pay damages, which is to be considered *in re ipsa*, and thus as a consequence of the non-compliance, without the client having the burden of proving the causal relationship.

The Italian Courts are aware that identifying a situation of conflict of interests in the negotiation of over the counter derivatives means prohibiting the dealer from negotiating derivatives in every circumstance where it is not appropriate for the client's interests. This is case law that we point out, with praise, due to a severity of judgment that above all rewards the *deterrent* function of civil liability, the need for which is felt especially in areas such as the financial brokerage market.

Naturally, to prohibit the "push" policy is not the best contribution that applied law can offer the over the counter derivatives industry; but this does not dissuade the Italian Courts from properly applying the legal rules, and this is understandable, given that over the counter derivatives are dangerous financial instruments, and from the standpoint of law, including applied law, it is rather normal for a market of dangerous good or services not to be broader than needed to satisfy a demand that corresponds to a real and reasonable need and what is actually socially useful (argument *pursuant to* Art. 2050 of the Italian Civil Code).

Here, the distance between the Italian Courts and the sensitivity of the English Courts - the true companion of the spirit of the City - is enormous.

The same framework of the grounds for the Court of Milan's judgement of 19 April 2011, can be found in the judgment of the Court of Udine of 1 July 2011, which examines in particular the situation of conflict of interests that is found when the dealer sets "implicit commissions," ruling that "it would have been necessary to explicitly state all of the reasons for the conflict, and thus also the presence of the implicit commissions (or margin in addition to the transaction)" and concluding for the responsibility and conviction of the dealer, since "the causal relationship must be considered *in re ipsa* given that the dealer violated the obligation to refrain [from carrying out the transaction]."

The judgment of the Court of Lecce of 9 May 2011 falls exactly in this trend line, because, in a case brought by a small firm, it reconstructs the relationship between the dealer and client in terms of cooperation, and confirms, in the preliminary stage, the order for suspension of the charging of the yields generated by an "open" derivative, with the observation that, in a situation of conflict of interests, the dealer, as a cooperator, is obliged to pursue the substantial interests of the client; we also read that "even in relationships with qualified operators the bank must still follow the fundamental principles established by Art. 21 T.U.F. and thus must "behave with diligence, propriety and transparency, to promote the best interests of the client." That aspect has been stressed repeatedly in scholarship and case law, with the further specification that, in the context of investment services, the "adversarial" logic of an exchange contract, even when the dealer negotiates with a client on its own behalf, must give way to cooperation in the interest of the other, a rule immanent to the provision of a service restricted only to certified subjects (art. 18)."

Court of Bari, 15 July 2010 – prior to the leading case represented by the Court of Milan judgment of 19 April 2011 - adopts a different perspective. The order examines the derivatives contracts concluded during "debt restructuring" (i.e. renegotiation) and characterised, as is known, by the initial disbursement of an up-front amount for the purpose of covering the loss generated by the derivatives contract by mutual consent, and simultaneously dissolved. The Court of Bari resorts to the notion of cause, and rules that a derivative, such as the one resulting from a renegotiation, construed not with a function of hedging, arbitrage, or speculation, but with the sole function of insuring the client against the loss through an up-front payment, and making it certain, without risk, that the dealer at least recovers the up-front payment, is not a derivatives contract. The Court finds that it is a contract *lacking a practical purpose*.

In my view, it is exact to say that derivatives contracts that are renegotiated, reconstructed, during renegotiation, around the up-front payment, are null and void. Indeed it is useless to argue here - as is properly argued for derivatives contracts that are *not* the result of a renegotiation – that the derivative is made par by the disbursement of the up-front payment. Because during restructuring, the *only* reason for the conclusion of the contract is, *for both* parties, the disbursement of the up-front amount. The statement that "the incorporation in the regulation of the prior liability and the additional implicit costs makes the form of negotiation incapable of fulfilling the function of hedging risk, at the root," also appears to be convincing.

A patient verification of the legal validity of each *individual* clause is necessary, and this includes the

clause that entails the disbursement of the up-front payment, due to its nature as a loan, that thus requires, *inter alia*, (i) the explicit indication *ex ante* of the interest rate, (ii) observance of the usury limit, (iii) the conclusion of a specific contract, provided with the requirements of form/content typical of investment contracts.

The crucial point is that of the implicit costs.

The judgment of the Court of Milan of 14 April 2011 regards derivatives of a local government (the Municipality of Ortona) in which the initial mark-to-market was negative for the Municipality, by 576,000.00 Euro, and there was no disbursement of an up-front payment. In its stated grounds, the Court summarises the dealer's defence as follows: "the defendant bank objected that in reality, in financial negotiations 'par' contracts do not actually exist" and "are utopian, whereas all derivatives contracts provide for an initial mark-to-market that is negative for the client, an expression of the commissions and consideration due to the bank for the operation."

Particular importance must be given to the specification, that we read in the Court of Milan judgment of 14 April 2011, stating that the "initial mark-to-market (...) [was] not explicitly stated in the contracts."

As if to say: investment contracts, individual contracts and secondary regulations outline the characteristic features of a contract, the swap, centred on the exchange of yields depending on the performance of an underlying item, but according to the Court of Milan judgment of 14 April 2011, the exchange is not actually an exchange when the yields are affected significantly, and often predominantly, by elements that have nothing to do with the performance of the underlying item. From this standpoint, the ruling of the Court of Milan of 14 April 2011 is consistent with the position of the EMA (formerly CESR) stating that "An investment firm acting as principal in relation to a customer order must inform the customer accordingly beforehand and must be in a position to justify the price at which the transaction is executed, with reference to the prices and volumes in the relevant market(s), where appropriate, or the presumed value determined on the basis of objective elements, e.g. *mark-to-market*."

Judging from the reconstructions of the facts found in the English judgments - which as always are very precise, and excellent - the practices and conduct of dealers found in the City does not seem to be so different from that of ours.

However, in the cases subject to the laws of the United Kingdom, and referred to the judgment of the

High Court of Justice, it is not the conduct of the dealers that is at the centre of attention, but rather the contract, with its clauses. There is nary a mention of the Financial Service Authority Handbook and the Conduct of Business.

As often happens in Italy, the contract corresponds to the model of the ISDA (International Swaps and Derivatives Association, Inc.).

The apparent questions, that are present before the English Courts, are the following: *(i)* if the obligations that derive from the derivative contracts are legal, valid and binding, enforceable in accordance with respective terms; and *(ii)* if the client, at the time of the conclusion of the contracts, was in a condition to evaluate and comprehend the meaning of the clauses of the contract, and its risks. The unambiguous solution to the questions leads to finding that disclaimers remove the grounds of any factual basis of the investor's claims, at the root.

However, the true question is different: whether the client acted for its own account and through its own independent decisions, and in particular, without basing its decision on any communications (written or oral) as investment advice or as recommendations. The clauses, considered as fully valid, are of the following type: "[the bank] is acting solely as principal and not as advisory or fiduciary."

This is the crucial issue: if the bank acted first as advisory or fiduciary, before acting as a principal, or if to the contrary, it acted "solely as principal and not as advisory or fiduciary."

London's response is the opposite of that of the Italian Courts. London firmly excludes an advisory obligation.

The Italian Courts consider the conclusion of over the counter derivatives to be characterised by a pathological situation of conflict of interests, because they consider the dealer an advisor to the client. This ruling, which has numerous consequences, is based on the provision of the Directive, which being centred on the conflict of interests, is applicable regardless of whether the investor is sophisticated or not.

Thus Milan states that "the conflict of interests between bank and client concerning second level over the counter derivatives exists (...) when the bank has identical or contrary transactions existing with other subjects. That potential function is exhausted purely at the financial level, without taking on

any civil law significance. Actually, it must be noted that this circumstance, at least in the abstract, leads to the emergence of additional aspects of conflict of interest, since the banks, which are used to operating with derivatives, can find themselves in a situation where they must work to "place" products on the market only for the reason of repositioning, and thus for hedging themselves (against other derivatives), in situations which may not always coincide with the client's hedging needs."

Fully to the contrary, London considers the conclusion of over the counter derivatives to involve a normal situation of conflict of interests, because it considers the dealer as the counterparty of a frank exchange with the client (*caveat emptor*): "the essential principle underlying these qualifications and disclaimers is one of caveat emptor. The buyer is meant to make his own assessment of the risks of the transactions and to make an independent decision as to whether to enter into it." This is the notion, adopted by English law, that "at common law it is very rare that a seller or supplier has any duty to take into account the legitimate interests of the other party." Therefore London excludes any duty of care on the part of the dealer, finding that the state of affairs is superseded due to the agreement between the parties, who attest to a different state of affairs, i.e. primarily that the investor does not require any protection, not even from coaxing or poor information from the dealer. The English Judge puts it this way: "I can see no reason in principle why it should not be possible for parties to an agreement to give up any right to assert that they were induced to enter into it by misrepresentations, provided they make their intention clear."

The foundation of the decision of the English Courts is the different importance assigned to the contract, in which it is stated that "each party (.,..) is acting for its own account, and it has made its own independent decisions to enter into that Transaction and as to whether that transaction is appropriate or proper for it based upon its own judgement and upon advice from such advisers as it has deemed necessary. It is not relying on any communication (written or oral) of the other party as investment advice or as a recommendation to enter into that transaction; it being understood that information and explanations related to the terms and conditions of a transaction shall not be considered investment advice or a recommendation to enter into that transaction. No communication (written or oral) received from the other party shall be deemed to be an assurance or guarantee as to the expected results of that transaction;" "the other party is not acting as a fiduciary for or an advisor to it in respect of that transaction."

The flat exclusion of a duty for cooperation generates disorientation, because the recurrent European

legislative formula, centred on the "care for interests," is entirely disregarded.

Londonstates that "parties to a contract may agree that a particular state of affairs is to be the basis upon which they are contracting, regardless of whether or not that state of affairs is true." The technique is estoppel, the duty of consistency: "such an agreement may give rise to a "contractual estoppel," precluding the assertion of facts inconsistent with those which have been agreed to form the basis of the contract."

Thus, London excludes any duty of care. Note that there is no trace of a reconstruction of the relationship between client and dealer in terms of agency, even though, as is known, in the Anglo-Saxon tradition informational asymmetries represent the origin of the reconstruction of the relationship in terms of an agency, with consequent traits of conflict of interests; to the point that a disloyal agent pays compensation for more than the loss caused, having to return the greater enrichment derived from his disloyalty. In derivatives, none of this is present. To the contrary, the English Courts deny that even only in the abstract the care for the substantial interests of others can be considered as an obligation: "the duty (...) to safeguard (client) interests or to have client best interests at heart (...) are not the appropriate subject matter of legal obligation."

According to the High Court Judge: "I would say that A and B can agree that A has made no pre-contract representations to B about the quality or nature of a financial instrument that A is selling to B."

More in general, these are very common rulings in English case law.

So, if the dealer told the investor that over the counter currency derivatives are conservative financial instruments, there is no resulting breach of fiduciary duty, because a fiduciary duty does not exist, and because the statement, which is clearly completely false, "has to be placed in [its] overall context." As if to say, it's an issue of *dolus bonus*. Thus, if sales said that over the counter currency derivatives are liquid instruments, there is no responsibility, because this statement "could not stand in the face of what was found to be [investor]'s understanding."

Londongoes even further, because it recognises that although in English law there is the freedom to declare false facts in contract, this freedom operates within the limit of a specific or more general rule of English public policy." But it does not see aspects regarding public policy in the brokerage of over

the counter derivatives.

The absence of any incidence of the Directive means that the investor has the burden to prove the fraud or misrepresentation ("in order to sustain an action of deceit, there must be proof of fraud and nothing short of that will suffice"). Yet this burden is impossible, because on the one hand, the evaluation by the English Courts of the evidence, which the investor may produce, is not at all lenient (it is normal for sales to coax, it is normal to speak of liquidity, and so forth), and on the other, the English Courts are firmly convinced - frankly it is hard to say whether correctly or incorrectly - that a bank that negotiates over the counter derivatives, which by definition is "extremely careful about what (it) says and about what reliance can be placed upon what may have been said," follows such conduct in its own interest, or that of the client.

The Court states that "any erosion [of the signature rule] would have serious repercussions far beyond the business community."

The English Courts, after having excluded the obligation for the dealer to act in the substantial interest of the client, carefully deal with the subsequent question: i.e. if the dealer, despite not being obliged to pursue the client's interest *ex contractu*, nevertheless must answer for having spontaneously provided information and explanations.

This involves another crucial decision.

And again, the response of the English Courts is different than that of the Italian Courts.

In Italy, the rule that the dealer - regardless of preferring to recall that it is a guardian of market integrity, the holder of a private law office - answers, in fact, for how it behaves: the "principles of conduct (...) have a mandatory character, in the sense that they are dictated not only by the interest of the individual contracting party implicated from time to time, but also in the general interest of the integrity of financial markets and they are unfailingly applied to the intentions of the contracting parties."

The solution from London is quite the opposite: that in the absence of a written advisory contract, it excludes at the root that a duty of care can be identified: "Where phrases such as 'trusted financial advisor' are used in internal documents, or even in correspondence between the parties, the court has to construe their meaning in the relevant context. Such words and phrases may be a mere 'slogan'

or 'buzzword… intended to encourage relationship managers to maintain close relationships with their customers and to understand their business as a whole.' (…) The absence of any written advisory agreement "is a significant pointer against the existence of an advisory obligation."

In London, dialogues, information, and coaxing, are essentially irrelevant: "there is a real distinction… between the investment advisor, properly so-called, who is retained to advise a client, usually backed by considerable research… and the advice or recommendations given by a bonds salesperson… as part of the selling process."

The High Court states that "there is a clear distinction between giving advice and assuming legal responsibility for that advice" and "In order to decide whether the advice given gave rise to obligations that went beyond the normal recommendations or 'advice,' given in the daily interactions between an institution's sales force and a purchaser of its products, so as to import obligations of the type owed by a fully-fledged investment advisor, one needs to look at all aspects of the objective evidence of the relationship between the parties" and "mere giving of advice, even specific investment advice, is not sufficient to establish a duty of care"and "the fact that (…) they were giving investment advice to a customer does not constitute an admission as to the existence of an 'advisory relationship' in the relevant sense of that phrase."

The High Court denies at the root the very possibility of recognising spontaneous and interested advice by the seller, if it is not proven that the client requested it: the Court observes that "it is difficult to see how a general advisory relationship to be inferred from conduct in which [the client] never actually seeks advice."

An interesting corollary of the distance between Italian and English case law is the significance attributed to the proprietary nature of the mathematical models for calculating risk. For Italian case law, the dealer, having to act in the interest of the investor, must explicitly state the mathematical formula and its applications (and in the precedents commented on here, the dealer did not do it, and thus lost). For English case law "it is correct that the complexity of the product meant that statistical modelling was the best method of assessing the risk of default. However, (the buyer) had the ability to have this carried out by independent experts."

For the English Courts, the fact that the renegotiation of the derivatives contracts is presented to the

investor by the bank as a "zero cost" transaction is not misleading, given that the "zero cost" means that for the investor "no cash payment was required," while it is not at all relevant that, despite being presented as "zero cost," the renegotiation will generate a profit for the bank, since "it is implicit that were the buyer told that there would be a bid/offer spread cost for (the bank) that there might be some profit for /the bank)." This is at the opposite pole from Italian case law, that considers the occult nature of commissions as a consequence of the conflict of interests.

The Directive places the attention squarely on the dealer's duty of organisation. It follows that there is liability for disorganisation, the heart of the reasoning of the Court of Milan in the judgment of 19 April 2011. This perspective is non-existent in recent English case law, for which "it is not possible for [the bank] to be held liable for fraud by combining the understandings of individually innocent people" or "there will be no inquiry in the present case into the internal decision making procedures of the [bank]."

Ultimately: in Italy it is about public order and the trust and integrity of the markets; in London it is what is written in the contract that the parties entered into.

The doctrine of conflict of interests (whose roots are Anglo-Saxon) is the foundation for the entire system of rules (which system, in turn, has Anglo-Saxon roots). However, today we read in the judgments of the High Court that it makes no sense to sustain that the dealer should care for the interests of the investor, and neither do we see even a glimpse of the doctrine of agency and reconstruction of the relationship between the seller and investor as a relationship between agent and principal.

In conclusion, we must ask if the Italian Courts can apply English law to cases that present elements of difference but also connections with the Italian legal system, with the impediment of the limit of compatibility with Italian laws "of necessary application," pursuant to Art. 17 of Act No. 218 of 31 May 1995, among which the leading features are, on the one hand, the indication of general public economic order in Art. 21 of the Consolidation Act on Financial Brokerage, and in particular the mandatory rules concerning conflict of interests, and on the other, the provision in Art. 23(6) that places the burden of proof for having acted with the specific diligence required on the dealer.

The recognition of English judgments, for the purposes of enforcement, can also run up against the limit of the provision, of public order, in Art. 21 T.U.F., pursuant to Art. 27(1) of Act No. 804 of 21 June 1971. In fact, when the law applicable to an offence is that of one State of the European Union, which

does not implement a correct adaptation to EU regulations, it is obvious that the national courts must not apply it; if the limit of public order were in effect, the choice of the friendly law, English law, dictated by the ISDA model, would encounter a very significant obstacle.

In particular, it can be considered contrary to Italian (and EU) public order to state that "The buyer is meant to make his own assessment of the risks of the transactions and to make an independent decision as to whether to enter into it."