Against All Odds: Investor Protection in Italy and The Role of Courts

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Abstract:

The dualism between private and public enforcement of investor related rights and its influence on the development of capital markets has drawn the attention by much of recent commentary. While opinions differ as regarding preference for private or public enforcement, scholarly analysis has so far been focused on the principal-agent relationship between investors and issuers, and has tried to depict the most effective enforcement system from a deterrence perspective.

In this Article we present some data regarding the Italian experience of enforcement. Rather than by lawsuit suits against issuers or gatekeepers, investor protection in Italy is mostly the result of lawsuits brought by individuals against investment services providers. Does such a model promote the public goals of securities regulation? Is it efficient?

By answering these questions, we aim at showing how the Italian experience may contribute to the international debate on the enforcement of securities regulation.

Key words: investor protection, public enforcement, private enforcement, securities regulation; Parmalat, Cirio, Argentina default, investment services provider, third-party enforcement strategy, protective gatekeeping.

1. INTRODUCTION

Much of recent commentary shares the view that "law in action" matters at least as much as "law on the books" for the development of capital markets. Substantive rules are critical, but they do not achieve their object unless an efficient system of enforcement is in place.

Although the distinction between “law on the books” and “law in action” has long been known[1] and the debate on the optimal structure of enforcement has a distinguished tradition,[2] research looking at the way in which enforcement specifically affects capital markets is rather recent. Over the last decade, academics have started to examine the different roles that private and public enforcement play in achieving the optimal level of investor protection, and how each impacts capital markets.[3]

According to the most cited studies on the effectiveness of private and public enforcement, Italy does not perform well. On the one hand, private enforcement appears to be undermined by the absence of appropriate liability provisions,[4] and of procedural mechanisms to vindicate collective interests;[5] on the other hand, public regulators seem

[1] R. Pound, ‘Law in Books and Law in Action’, 44 *American Law Review* (1910) p. 12.
[2] S. Shavell, ‘The Optimal Structure of Law Enforcement’, 34 *Journal of Law and Economics* (1993) p. 255; M. Polinsky, ‘Private versus Public Enforcement of Fines’, 9 *Journal of Legal Studies* (1980) p. 105; W. Landes and R. Posner, ‘The Private Enforcement of Law’, 4 *Journal of Legal Studies* (1975) p. 1; G. Becker and G. Stigler, ‘Law Enforcement, Malfeasance, and the Compensation of Enforcers’, 3 *Journal of Legal Studies* (1974) p. 1.
[3] H. Jackson and M. Roe, ‘Public and Private Enforcement of Securities Laws: Resource-Based Evidence’, 93 *Journal of Financial Economics* (2009) p. 207; J. Cox - R. Thomas, ‘Mapping the American Shareholder Litigation Experience: A Survey of Empirical Studies of the Enforcement of the U.S. Securities Law’, available at < http://ssrn.com/abstract=1370508 >; E. Ferran, ‘Capital Market Competitiveness and Enforcement’ (2008), available at: <http://ssrn.com/abstract=1127245>; J. Coffee Jr., ‘Law and the Market: the Impact of Enforcement’, 156 *University of Pennsylvania Law Review*, (2007) p. 229; R. La Porta, F. Lopez-de-Silanes and A. Shleifer, ‘What Works in Securities Laws?’, 61 *Journal of Finance*, (2006) p. 1.
[4] La Porta, Lopez-de-Silanes and Shleifer, *supra* n. 3.
[5] G. Ferrarini and P. Giudici, ‘Financial Scandals and the Role of Private Enforcement: The Parmalat Case’, in J. Armour and J. A. McCahery, eds., *After Enron: Improving Corporate Law and Modernizing Securities Regulation in Europe and the US* (Portland, Hart Publishing 2006) p. 159.

to be understaffed and without adequate resources to police the market aggressively.[6] These findings suggest that the deterrent threat is far from effective in Italy, and that Italian investors do not receive enough protection – or at least not enough to allow for the development of mature capital markets.

We believe that this conclusion is over-stated. A thorough examination of the Italian system of enforcement reveals a more complex picture deserving of more attention than it has presently received. Based on some empirical evidence, our analysis of the Italian model of private enforcement shows that this model is significantly different from the mainstream approach, which is traditionally focused on the principal-agent relationship between investors and issuers, strongly supported by collective action provisions, and aimed at deterrence. Specifically, in Italy, investor protection is mostly the result of lawsuits brought by individuals against investment services providers ("ISPs"). These actions are based on alleged violations of business conduct rules or on general principles of contract law, and are adjudicated by courts, which are strongly oriented towards compensation. Such findings prompt some important questions: Does such a model promote the public goals of securities regulation? Is it efficient? By answering these questions, this paper shows how the Italian experience may contribute to the international debate on the enforcement of securities regulation.

We proceed as follows. Section 2 summarizes the ongoing debate regarding the importance of enforcement for the development of capital markets. In section 3, we delve deeper into the Italian experience. To this aim, we describe both the legal approach adopted by Italian courts and present data from two empirical studies conducted by one of us, based on 392 decisions rendered by the courts of Milan and

[6] Jackson and Roe, *supra* n. 3.

Rome in cases arising from major financial debacles - namely the bond default by the Republic of Argentina, and the default of two well-established food companies, Parmalat and Cirio. The Italian model of private enforcement and the implications for the international debate on the enforcement of securities regulations are discussed in section 4. Section 5 concludes.

2. THE IMPORTANCE OF ENFORCEMENT FOR THE DEVELOPMENT OF CAPITAL MARKETS

2.1 **The private enforcement primacy**

Scholarship in the fields of both economics and law has increasingly concentrated its attention on the importance of enforcement for the development of capital markets. In broad terms, research has focused on the interplay between public and private enforcement in an attempt to determine which method protects investors most effectively and which correlates most strongly with developed securities markets.

Within this general framework, one stream of the literature contends that private enforcement is the key element.

In a well-known study published in 2006, Professors Rafael La Porta, Florencio Lopez-de-Silanes and Andrei Shleifer ("LL&S") examined the way in which securities laws of 49 countries regulate the initial public offering of securities and observed how different methods of addressing this issue affect the development of capital markets. They concluded that what really matters for a country's level of financial development is extensive disclosure requirements coupled with standards of liability facilitating private enforcement. At the same time, they also asserted that public enforcement does

not correlate with strong securities markets.[7] Further studies confirmed their conclusions.[8]

Not surprisingly, these results triggered several policy recommendations. The World Bank - addressing developing countries - recommended legal reforms that would improve the operation of private enforcement, thereby fostering financial development and economic growth.[9]

Narrowing the focus on Italy, Professors Guido Ferrarini and Paolo Giudici built on this literature and argued in favor of stronger private enforcement of securities and corporate laws.[10] In essence, they claimed that Italy had good "law on the books", but poor "law in action". Hence, in order to achieve a proper level of deterrence affecting issuers and gatekeepers, they proposed the introduction of U.S. style class actions together with *ad hoc* discovery and pleading rules.

2.2 **The public enforcement approach**

Needless to say, a significant debate has mounted around the argument of LL&S that the development of capital markets is best promoted by private enforcement.

The chief criticism hinges on the reliability of the indices constructed by LL&S in order to compare different jurisdictions. As a matter of fact, critics emphasized that those indexes have been structured considering formal rather than substantive elements,

[7] La Porta, Lopez-de-Silanes and Shleifer, *supra* n. 3; from a theoretical perspective, *see* also J. Hay, A. Shleifer, 'Private Enforcement of Public Laws: A Theory of Legal Reform', in 88 *American Economic Review,* (1998) p. 398.
[8] S. Djankov, R. La Porta, F. Lopez-de-Silanes and F. Shleifer, 'The law and economics of self-dealing', 88 *Journal of Financial Economics* (2008) p. 430.
[9] World Bank and International Finance Corporation, *Doing Business 2011: Making a Difference for Entrepreneurs* (2010), Washington, D.C.
[10] Ferrarini and Giudici, *supra* n. 5.

on both the private and the public enforcement side.[11] In other words, LL&S failed the reality check.

This criticism has caused some scholars to reconsider the importance of public enforcement in the general framework of investor protection devices.

In a recent study, Professors Howell Jackson and Mark Roe changed the proxy used to assess the relevance of public enforcement. Instead of looking at the formal powers of regulatory officials, they moved to measure the staffing levels and the budgets of several securities regulators (so-called "inputs"). Then, they correlated these data with specific indicators of financial depth. By doing so, they came to the conclusion that public enforcement mattered much more for the development of capital markets than was previously acknowledged.[12]

From a different perspective, these conclusions were confirmed by further studies concerning the experience of the United States and the United Kingdom. Professor John Coffee, in particular, has advanced the idea that, in order to truly assess the real value of public enforcement, one should consider not only regulatory inputs, but also regulatory outputs; namely, the number of enforcement actions initiated and the financial penalties imposed by the regulator. And, within the general category of inputs, one should specifically look at the percentage of budget devoted to enforcement. But even taking this methodological remark into account, the same conclusions hold. With specific reference to the United States, Professor Coffee concluded that, because private enforcement achieves "little, if any, compensation and only limited deterrence", "it

[11] Jackson and Roe, *supra* n. 3; Coffee Jr., *supra* n. 3.
[12] Jackson and Roe, *supra* n. 3. These conclusions are not completely new: *see* E. Glaeser, S. Johnson, A. Shleifer, 'Coase versus the Coasians', 116 *Quarterly Journal of Economics* (2001), p. 853.

makes sense to place greater reliance on public enforcement".[13] Analogous conclusions were reached by Professor John Armour in his paper discussing enforcement strategies in UK corporate governance, with the further mention of the strong role played by informal private enforcement through institutional investors.[14]

3. THE ITALIAN EXPERIENCE

3.1. **Financial debacles and the Italian system of enforcement**

Having outlined the main points of the ongoing academic debate, we now turn to Italy, and to its particular system of enforcement.

At the beginning of the new century, a very large number of investors, mostly retail, were affected by several financial debacles. It all began with the Republic of Argentina's bond default in December 2001. In that case, about 430,000 investors were involved and the total amount of defaulted bonds may have reached about 12.8 billion Euros.[15] The default of Cirio, a renowned food company, followed in November 2002. Approximately 35,000 investors were affected, for a total amount of defaulted bonds of 1.125 billion Euros.[16] The scandal connected to the financial product "My Way-For You" and the spectacular default of Parmalat were next, in March and December 2003, respectively. The former cost about 100,000 investors 1.35 billion Euros;[17] the latter,

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[13] Coffee Jr., *supra* n. 3, at p. 304.
[14] J. Armour, 'Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment' (2008), available at: <http://ssrn.com/abstract=1133542>.
[15] Consob, *Relazione per l'anno 2004* (2005), available at: <www.consob.it>.
[16] M. Di Staso, 'La tutela dell'investitore: i casi Lloyd's, TSB e Cirio' (2003), available at: <http://www.archivioceradi.luiss.it/documenti/archivioceradi/impresa/banca/Cirio_distaso.pdf>.
[17] Il Sole24ore, 'Pronta la Class Action sui Bond Argentini' (2007), available at: <http://www.ilsole24ore.com/art/SoleOnLine4/Finanza%20e%20Mercati/2007/12/tango-bond-classe.shtml?uuid=a4bd730c-a185-11dc-bcc2-00000e251029&DocRulesView=Libero>.

affected 85,000 investors and involved defaulted bonds worth approximately 2 billion Euros.[18]

These dramatic data confirm Italy's poor performance in the studies reviewed in the previous section. In the LL&S Article, the private enforcement index for Italy equals 0.44, while the same index for the United States and the United Kingdom is1.00 and 0.75, respectively. On the public enforcement side, Professors Jackson and Roe estimated that, in Italy, in 2005, the staffing level per million of population and the budget per billion US$ of GDP allocated to capital markets supervision were, respectively, 7.25 and US$ 61,239; while they were 23 and US$ 83,232 in the United States, and 19.04 and US$ 80,902 in the United Kingdom. The total amount of fines imposed by the Italian securities regulator in the year 2003 and 2004 (20.3 millions Euros[19]) does not even come close to the US$ 360 million in fines imposed by the SEC for approximately the same period of time.[20]

3.2 **A different pattern of investor protection**

A closer investigation of the "law in action" reveals, however, a different pattern for investor protection, which is largely neglected by the mainstream analysis.[21]

Instead of asserting action against insolvent issuers and gatekeepers – such an approach would have been unsatisfactory (Parmalat and Cirio),[22] or would have been

[18] Banca d'Italia, *Audizione del Governatore della Banca d'Italia* (2004), available at: <http://www.senato.it/leg/14/BGT/Schede/ProcANL/ProcANLscheda9271.htm>; M. Di Staso, Il caso Parmalat (2004), available at: <http://www.archivioceradi.luiss.it/documenti/archivioceradi/impresa/banca/parmalat.pdf>.
[19] Consob, *supra* n. 15.
[20] Coffee Jr., *supra* n. 3, at p. 271.
[21] For an exception, M. Tison, 'The Civil Law Effects of MiFID in a Comparative Law Perspective', Financial Law Institute Working Paper No. WP 2010-05 (2010), available at: <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1596782>.

barred by the sovereign immunity doctrine (Republic of Argentina)[23] or probably would have been too complex to pursue (auditors and underwriters)[24] – Italian investors sued ISPs on an individual basis, claiming violations of business conduct rules. These suits met with great success. Although an official estimate is not available, thousands of cases were initiated throughout the country. A few hundreds of these have resulted in published decisions.[25] In addition, the major banks, worried about potential liability, activated their own dispute mechanism,[26] which, as conventional evidence suggests, led to a large number of settlements.

More in detail, Italian investors based their claims on private rights of action stemming from securities regulation and general principles of contract law. They alleged violations of business conduct rules in the sale of bonds on the secondary market, with reference to both the formal and the substantive requirements governing provisions of investment services. Italian investors also relied on general doctrines of contract law, such as mistake, fraud or illegality.[27]

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[22] The insolvency procedures of the Parmalat and Cirio groups granted investors a very modest recovery: *see* M. Longo, 'Obbligazioni in default: su 9 miliardi 7 sono andati in fumo', *Il Sole 24 Ore,* November 13, 2009.

[23] The Supreme Court asserted the lack of Italian jurisdiction in civil actions against the Republic of Argentina with a decision *en banc* in May 2005: *see* Supreme Court, May 27, 2005, *Foro italiano* (2005), I, p. 3046.

[24] The only edited decision, which ruled in favor of 60 investors lack against Parmalat auditors is Trib. Milano, November 4, 2008, *Giurisprudenza italiana* (2009) p. 1979. A significant exception is, however, the civil action brought by 32,000 investors in the criminal proceeding against Parmalat auditors and underwriters under art. 185 of the Italian Criminal Code. The investors were grouped by a major Italian bank and according to the press recovered in an out-of-court settlement about 25%-30% of the invested money: *see* V. D'Angerio, 'Per i risparmiatori ingannati possibili ancora i risarcimenti', *Il Sole 24 Ore*, April 19, 2011.

[25] Even though decisions are published in several law journals, the richest source of judicial opinions may be found at <http://www.ilcaso.it>.

[26] C. Geronzi, *Audizione dei rappresentanti di Capitalia s.p.a.* (2004); C. Passera, *Audizione dei rappresentanti di Banca Intesa s.p.a.* (2004); A. Profumo, *Audizione dei rappresentanti di Unicredit s.p.a.* (2004), available at: <http://www.senato.it/leg/14/BGT/Schede/ProcANL/ProcANLscheda9271>.

[27] A. Voiello, M. Calchera and S. Carascon, 'Repertorio di giurisprudenza', in A. Perrone, ed., *I soldi degli altri* (Milano, Giuffrè 2008) p. 105.

3.3 **Recurring features of judicial decisions rendered against ISPs**

Court decisions are based on various technical arguments, but show some recurring features.

First, court decisions tend to be balanced. Case law inclined to voiding the sale contract between the client and the ISP because of a violation of business conduct rules - thus allowing restitution whenever the investor successfully alleged a violation of any rule of conduct - was quickly replaced by a liability rule providing investors with damages only to the extent that the alleged loss was causally related to the rule of conduct violation.[28]

A quantitative analysis of the decisions rendered by the lower Court of Milan - by far, the busiest and most specialized court in Italy - confirms this point. In 116 cases arising from the default of the Republic of Argentina, Parmalat and Cirio decided between January 2005 and December 2006 ("Period I"), the lower Court of Milan ruled in favor of the claimant investor in the 51.7% of the cases.[29] With striking similarity, in 195 cases arising from the same defaults decided between January 2007 and December 2009 ("Period II"), the same court ruled in favor of the claimant investor in the 51.3% of the cases.[30]

Second, the degree of investor protection provided and the legal doctrine employed by courts tend to vary according to the client profile. When dealing with inexperienced or vulnerable investors, courts are inclined to rule in favor of the client by stressing the obligation to disclose the risks of the investment and to assess its

[28] A. Perrone, 'Regole di comportamento e tutele degli investitori. *Less is more*', *Banca, borsa e titoli di credito,* (2010), I p. 542; Voiello, Calchera and Carascon, *supra* n. 27.
[29] A. Perrone, A Voiello and V. Dragone, 'La giurisprudenza sul c.d. "risparmio tradito": un'analisi quantitativa', in A. Perrone, ed., *I soldi degli altri* (Milano, Giuffrè 2008) p. 83.
[30] A. Perrone and M. Musitelli, 'La giurisprudenza milanese sul "risparmio tradito": alcuni dati recenti' (2011), forthcoming.

suitability to the client's risk profile. On the other hand, with respect to actions brought by experienced or risk-taking investors, courts are prone to reject the claim by emphasizing either the client's causal contribution - *i.e.* the relationship between returns actively sought and risks deliberately borne - or the unforeseeability of the default.

Even though the client profile is not always clear and its classification is somewhat discretionary, the quantitative analysis mentioned above confirms the point. In decisions where the client profile was identifiable (71 out of 116), in Period I the lower Court of Milan ruled in favor of inexperienced or vulnerable investors in 95% of the cases, while rejecting the claim of experienced or risk-taking investors in 83.7% of the cases. Similarly, during Period II in decisions where the client profile was identifiable (120 out of 195), the same court ruled in favor of inexperienced or vulnerable investors in 94.3% of the cases, while rejecting the claim of experienced or risk-taking investors in 77.8% of the cases.

Data related to the arguments and legal doctrines used by Courts are less clear-cut, but nevertheless quite meaningful. Decisions, which granted plaintiffs a remedy on the basis of substantive arguments, hinged initially on a violation of the obligation to disclose the risks of the investment (40% of decisions rendered in Period I; 23.9% of decisions rendered in Period II), but later shifted towards a violation of the obligation to assess the suitability of the investment in light of the client's risk profile (35% of the decisions rendered in Period I; 58.2% of decisions rendered in Period II). Decisions in favor of defendants were mostly supported by arguments based on causation (17.4% of decisions rendered in Period I; 38% of decisions rendered in Period II) and unforeseeability of the defaults (19.6% of decisions rendered in Period I; 27.8% of

decisions rendered in Period II), or on a mix of these and other arguments (37% of decisions rendered in Period I; 22.8% of decisions rendered in Period II).

Third, the statute of frauds mandated by Italian securities regulation for the purpose of ensuring transparency between investors and ISPs played a significant role in court decisions. Courts agreed that, when the contract for the provision of investment services lacks a writing, the sale contract between the ISP and the client is void, thus allowing restitution regardless of any other substantive factor.[31] Despite the opportunistic behavior - which this approach may determine both for investors "cherry picking" bad investments and for courts using formal requirements as a "shortcut" to avoid a substantial analysis of the litigated investment[32] - courts were very reluctant to grant estoppel based on fairness (*bona fides*), probably because of their traditional respect for the statute of frauds.

In quantitative terms, the impact of this case law is quite relevant. Both in Period I and in Period II, 33% of the decisions by the lower Court of Milan which granted restitution were based on a violation of formal requirements.

Finally, the measure of damages appears to be a major problem for Italian courts. The aim of avoiding the issue altogether may explain the widespread use of restitutional remedies, either by overemphasizing the violation of formal requirements[33] and granting rescission for violation of pre-contractual duties,[34] or, by finding illegality after a very intrusive - and uncommon - inquiry into the merits of the transaction, as in the For You-My Way cases.

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[31] A. Perrone, 'Tra regole di comportamento e regole di validità: servizi di investimento e disciplina della forma', in A. Perrone, ed., *I soldi degli altri* (Milano, Giuffrè 2008) p. 31.
[32] D. Semeghini, *Forma ad substantiam ed* exceptio doli *nei servizi di investimento* (Milano, Giuffrè 2010), at pp. 4-8 and 17-19; Perrone, *supra* n. 31.
[33] Perrone, *supra* n. 28.
[34] Perrone, ibid; A. Albanese, 'Violazione delle regole di condotta degli intermediari finanziari e regime dei rimedi esperibili dagli investitori danneggiati', in A. Perrone, ed., *I soldi degli altri* (Milano, Giuffrè 2008) p. 45.

4. THE GENERAL IMPLICATIONS OF THE ITALIAN EXPERIENCE

4.1 Differences between the mainstream approach and the Italian experience

Contrary to the mainstream approach, which focuses on the issuer-investor relationship and aims at deterrence, the discussion above supports the idea that Italian courts are centred on the ISP-client relationship. Further, Italian courts neglect deterrence and use the traditional tool box of legal doctrines to promote individual compensation. Such an approach may be explained as both a legacy of traditional tort law in continental Europe[35] and as a consequence of the Italian lawyers' attitude towards commutative justice, in opposition to a functional approach to law.[36]

To be sure, the Italian way to investor protection is not flawless. While on occasion it overcomes traditional legal doctrines for the sake of reducing the cost of decision, the approach used by Italian courts is arguably prone to a strong bias in favour of investors. The emphasis on the violation of formal requirements, the early case law which voided sale contracts, and a widespread practice of judicially re-characterizing the investor's cause of action as a means to avoid dismissal based on procedural grounds, are indicators of a possible deviation from judicial equilibrium.[37] Quantitative data confirms the point. In 81 cases arising from the defaults of the Republic of Argentina, Parmalat and Cirio decided between October 2004 and July 2006, the lower Court in Rome ruled in favour of the claimant clients in 79% of the cases, without distinguishing between the investors in the different cases, and by relying on the same

[35] P. Giudici, 'Private Law Enforcement in a Formalist Legal Environment: the Italian Sai-Fondiaria Case', ECGI - Law Working Paper No. 094/2008 (2008), available at: <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1103985>; W. Wurmnest, *Grundzüge eines europäischen Haftungsrechts* (Tübingen, Mohr 2003) p. 94

[36] L. Enriques, 'Modernizing Italy's Corporate Governance Institutions: Mission Accomplished?' (2009), available at: < http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1400999 >.

[37] A. Perrone, 'La responsabilità degli intermediari: tutela del risparmiatore incolpevole o "copertura assicurativa" per investimento sfortunato?', *Banca impresa società* (2008) p. 41.

argument in the vast majority of its decisions.[38] Moreover, some decisions reveal hindsight bias, and judicial incompetence.[39] Standards of fairness or professional care are sometimes used to trump ISPs' defense arguments based on strict compliance with formal rules.[40]

What are the implications of the Italian model for achieving effective securities regulation? Is the model efficient?

4.2 **The distinguishing feature: a "protective gatekeeping" model**

In the terms of a well-known taxonomy,[41] in Italy, investor protection appears to be achieved through a third-party enforcement strategy focused on ISP liability, rather than by a primary enforcement strategy centered around issuer liability. This model differs from the strategy employed with "traditional" gatekeepers, such as auditors and underwriters, insofar as ISPs are in the position of preventing misconduct by protecting victims rather than by thwarting would-be wrongdoers, with whom they ordinarily transact.[42] Under any other aspect, however, such a "protective gatekeeping" model shares the same features of the more common "preventive gatekeeping" strategy.[43] Therefore, standard analysis of gatekeeping strategies applies. In this perspective, the model may be considered efficient if it is able to prevent misconduct at an acceptable

[38] Perrone, Voiello and Dragone, *supra* n. 29.
[39] A. Perrone, 'Servizi di investimento e violazione delle regole di condotta', *Rivista delle società* (2005) p. 1016.
[40] A. Perrone, 'Obblighi di informazione, suitability e conflitti di interesse: un'analisi critica degli orientamenti giurisprudenziali e un confronto con la nuova disciplina MiFID', in A. Perrone, ed., *I soldi degli altri* (Milano, Giuffrè 2008) p. 1; similarly, with reference to corporate law: L. Enriques, 'Do Corporate Law Judges Matter? Some Evidence from Milan', 3 *European Business Organization Law Review* (2002) p. 765.
[41] R. Kraakman, 'Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy', 2 *Journal of Law, Economics, and Organization* (1986) p. 53.
[42] Kraakman, ibid; A. Hamdani, 'Gatekeepers Liability', 77 *Southern California Law Review* (2003) p. 53; J. Coffee, 'Reforming the Securities Class Action: an Essay on Deterrence and its Implementation', 106 *Columbia Law Review* (2006) p. 1534.
[43] Kraakman, *supra* n. 41.

cost, and more effectively than a strategy based only on enforcement against issuers or on market incentives.[44]

Whether the Italian approach meets these conditions is an issue with no clear-cut answer. Nevertheless, it seems reasonable to assert that after the financial crisis neither a pure market model nor a primary enforcement strategy may be enough. Furthermore, the Italian retail market – as well as other European markets - is "strongly characterized by intermediation in the form of investment advice and related product distribution services".[45] Hence, ISPs are in the best position to act as protective gatekeepers.

The crucial issue to be solved is, of course, whether the game is worth the candle. To the contrary, standard economic analysis suggests that the cost of ISP liability will be passed on to clients,[46] with possible cross-subsidization effects.[47] In addition, a gatekeeping strategy oriented toward protection of contractual counterparties, in derogation of freedom of contract, might encourage excessive litigation and opportunistic behavior. More generally, a protective strategy implies a paternalistic approach, which might be considered inefficient by definition in a free market context.[48]

However, none of these objections appears to be conclusive. While it is hardly deniable that the cost of liability is transferred into the price charged by ISPs, this very same mechanism might turn into a competitive advantage for "virtuous" players. All other things being equal, ISP compliance with business conduct rules enhances

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[44] Kraakman, ibid.
[45] M. Moloney, *How to Protect Investors* (Cambridge, CUP 2010), at p. 192.
[46] G. Benston, *Regulating Financial Markets: A Critique and some Proposals* (Washington D.C., AEI Press 1999) p. 61; R. Craswell, 'Passing on the Cost of Legal Rules: Efficiency and Distribution in Buyer-Seller Relationships', 43 *Stanford Law Review* (1991) p. 361.
[47] F. Denozza and L. Toffoletti, 'Compensation Function and Deterrence Effects of Private Actions for Damages: The Case of Antitrust Damage Suits' (2008), available at: <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1116324>.
[48] E. Glaeser, 'Paternalism and Psychology', 73 *The University of Chicago Law Review* (2006) p. 133.

reputation and lowers legal risks, thus allowing a lower price. Further, legal doctrines, such as contributory negligence, might hinder opportunistic behavior by protected parties.[49] Finally, paternalism does not appear theoretically irreconcilable with efficiency,[50] and, in the aftermath of the financial scandals, a protective approach may be seen as a tool to restore trust and reputation,[51] thus lowering the risk of adverse selection.

4.3 On the ISP's side: A comparison between the incidence of public fines and private damages

Even though an official estimate is not available, the monetary costs for ISPs stemming from lawsuits brought by individual clients claiming violations of business conduct rules is arguably not even comparable with the fines imposed for the same reasons by the Italian securities regulator. Between January 2005 and December 2009 the total amount of fines imposed on ISPs for violation of business conduct rules was 11.2 million Euros.[52] In the same period of time, the available data show that the lower Court of Milan granted a remedy in 160 cases, while between October 2004 and July 2006 the lower Court of Rome did so in 64 cases.[53] Assuming an average recovery of 50.000 Euros, which is consistent with the median amount of the money invested in the litigated transactions,[54] the overall amount of damages equals the overall amount of the imposed fines. Considering that those decisions constitute only a portion of the decisions rendered in the whole country, and considering the cases settled prior to a

[49] A. Porat, 'A Comparative Fault Defence in Contract Law', 107 *Michigan Law Review* (2009) p. 1397.
[50] R. Thaler and C. Sunstein, 'Libertarian Paternalism', 93 *American Economic Review* (2003) p. 175; E. Zamir, 'The Efficiency of Paternalism', 84 *Virginia Law Review* (1998) p. 229.
[51] Moloney, *supra* n. 45, at p. 85.
[52] Consob, *Relazione per l'anno 2009* (2010), available at: <www.consob.it>.
[53] Perrone and Musitelli, *supra* n. 30; Perrone, Voiello and Dragone, *supra* n. 29.
[54] Perrone and Musitelli, ibid; Perrone, Voiello and Dragone, ibid.

decision or within the context of dispute procedures sponsored by major banks, the impact of private enforcement clearly outweighs that of public enforcement. Such a conclusion is further strengthened by taking into account legal and reputational costs.

It would be too simple to conclude that damages awarded by courts are more important in determining incentives toward proper behaviour than fines imposed by the securities regulator. To be sure, in November 2009 the Italian regulator issued an injunction against a major bank in order to prohibit the sale of securities in violation of business conduct rules.[55] In addition, in May 2010 the Italian regulator required the five most important Italian banks to review their organizational model in order to achieve more substantial compliance with business conduct rules.[56] Analogous to the conclusions reached in the analysis of antitrust law,[57] a balanced view suggests, therefore, an approach which integrates private and public enforcement as mutually supplementing mechanisms, and advocates a strong interaction between regulators and courts.

It is also difficult to determine whether a private enforcement system based on individual lawsuits is more efficient than the U.S.-style securities class action. While the Italian model surely grants significantly greater compensation for claiming investors, and anecdotal evidence suggests that the decision of the Italian Courts had a deterrent effect by causing some ISPs to adopt new organizational models, the costs of private enforcement based on individual lawsuits are self-evident. These costs could be reduced by some forms of class action. The relevant provisions, which entered into

[55] Consob, *supra* n. 52.
[56] Consob, *Relazione per l'anno 2010* (2011), available at: <www.consob.it>.
[57] J. P. Terhechte, 'Enforcing European Competition Law - Harmonizing Private and Public Approaches in a More Differentiated Enforcement Model' (2010), available at: < http://ssrn.com/abstract=1638339>; W. Wils, 'The Relationship between Public Antitrust Enforcement and Private Actions for Damages' (2009), available at: < http://ssrn.com/abstract=1296458>.

force in January 2010 are, however, clearly unfit. According to art. 140, par. 2, of the Consumer Code, the class action *à l'italienne* "protects contractual rights of multiple consumers who are in the identical situation vis-a vis the same firm" and are, therefore, clearly unfit in the case at hand, where transactions take into consideration the investment profile of the client.

There is, however, an important lesson to be learned from the Italian model. The very easy access to courts, as demonstrated by the thousands of lawsuits filed all over the country, the significant degree of independence enjoyed by the courts, and the different political and cultural orientation among judges, make this model of enforcement very difficult to be captured, either by the industry or by the political system. The prohibitively high costs of capture and the impact of the decisions of each court - which goes well beyond the single case and is enhanced by the dissemination of information through specialized websites and newspapers - contribute to create a significant deterrent effect.

4.4 **A corrective justice approach?**

Both the legal doctrines used (and misused) by the courts and quantitative data about the strong protection provided to vulnerable investors, confirm the orientation of Italian courts towards corrective justice. Such an approach is not surprising. Traditionally, Italian legal culture understands damages as a mean to achieve compensation.[58] The decision of the Supreme Court, which denied enforcement in Italy

[58] M. Barcellona, 'Funzione compensativa della responsabilità e *private enforcement* della disciplina antitrust', *Contratto e Impresa* (2008) p. 120.

of an award of punitive damages entered by an Alabama court[59] is an authoritative confirmation of this approach.

At the same time, however, it is difficult to deny the existence of positive externalities associated with court decisions aimed at compensation. We have already noted the impact on ISP organizational models and the deterrent effect associated with high costs of capture and the widespread dissemination of the decisions. The restoration of investors' trust and confidence is arguably another social effect. The perception of the possibility to recover losses caused by fraud led investors to believe that they could rely on the legal rules supposedly written for their protection. Quantitative data also show that civil disputes were successful where public enforcement was not. Therefore, while fundamental divergences between the private and the social incentives to use the legal system still remain,[60] in the case at hand, corrective justice appears more efficient than it is often believed.

5. CONCLUSIONS

In the discussion about the enforcement of securities regulation, it has been argued that "much analysis focuses on corporate-governance-related enforcement, especially that connected with tunneling value out from the firm into controllers' hands. Tunneling and related party transactions are important and deserve the attention they have received. But deep public markets also require brokers and other securities-handling institutions that are often intensively regulated in the United States and other countries with deep capital markets. Trading channels have not been the focus of

[59] Supreme Court, January 19, 2007, no. 1183, *Foro italiano* (2007) p. 1461.
[60] S. Shavell, 'The Fundamental Divergence between the Private and Social Motive to Use the Legal System', 26 *Journal Legal Studies* (1997) p. 575.

analysis in the law and finance writing of the past decade, yet reliable trading channels might be critically important to building a strong securities market".[61]

Our research goes in this direction, and, in our opinion, shows the relevance of the enforcement focused on ISP 's activity.

By describing Italian civil litigation in the aftermath of major defaults, which occurred at the beginning of the century, we have identified a model of private enforcement focused on ISPs and on the rules governing their business conduct. While taking a significantly different approach from the mainstream, this model contains many features capable of promoting the public goal of securities regulation. Considering that incentives work only prospectively and that only anecdotal evidence is currently available, the actual impact of this model is yet to be proven. Thus, it is not possible to say whether a model of enforcement based on ISP business conduct rules will become a viable alternative to the "issuer-investor" model or an indispensable complement to it. Nevertheless, the Italian experience is a concrete example that this model may work. Future empirical research should definitely take it into account.

[61] Jackson and Roe, *supra* n. 3, at p. 4.