

C/M/S/ Adonnino Ascoli & Cavasola Scamoni

**Derivatives and local authorities
Financial legal and administrative aspects**

23th June - Bologna

25th June - Padova

9th July - Ancona

Paolo Bonolis

Introduction

- ! The regulatory framework
- ! The administrative background (from the 2002 Finance Act to the 2009 Finance Act)
- ! The Financial Consolidated Act, Consob Regulations and Consob Communications on illiquid financial products
- ! Contentious cases - outline
- ! The role of the expert (ATP, CTU)

The 2002 Finance Act (Law no. 448/2001 - Art. 41) and implementation Decree issued by the Ministry of Economics and Finance no. 389/2003 (the “Decree”)

- ! Types of derivative contracts which the local authorities are entitled to enter into (Art. 3 of the Decree):
 - a. Interest rate swaps
 - b. forward rate agreements
 - c. interest rate caps
 - d. interest rate collars
 - e. Any combination of the operations described by letters a) to d), which allow to switch from a fixed interest rate to a floating rate and vice versa, provided that a pre-defined threshold value is determined or a pre-defined period of time has elapsed
 - f. Other operations which do not imply, at the time of their execution, the increase in the actual value of any specific pay-off, with the exception of any possible discount or premium which shall be agreed at the time of the execution of the operations, which must not, in any case, exceed 1% value of the underlying liability notional

Ministry of Economics and Finance

The Explanatory Circular dated May 27 th, 2004 – Main contents

- ! The execution of derivative instruments which include leverages or multipliers of financial parameters, are prohibited
- ! Transactions in derivatives referred to other pre-existing transactions in derivatives are not allowed
- ! Should the underlying liability fluctuate, the local authority may re-arrange its position at different conditions which should not cause losses to the authority itself
- ! Shall the authority chose to close its derivative position, it is only possible to execute -with a new counterparty- a derivative with an exact contrary position
- ! It includes a description of the financial intermediaries with which the local authorities are entitled to execute derivative transactions (with a certified rating)

**Ministry of Economics and Finance
2007 Financial Act (Law no. 296 of December 27th, 2006) and
Explanatory Circular dated June 22nd, 2007**

2007 Financial Act, Paragraphs 736 and following:

- ! Transactions in derivatives instruments may be executed only for amounts corresponding to actual liabilities, taking into consideration the limitation of the credit risks which have been undertaken
- ! Derivatives transaction may be executed solely with hedging purposes
- ! From an accounting perspective, derivatives may not be treated as liabilities
- ! Derivatives should be considered as “instruments for the management of debt”, not as indebtedness

Legislative Decree no. 112 of 2008 - (Law no. 133 August 6th, 2008)

- ! Art. 62 limits completely the use of derivatives contracts by the local authorities, as long as the Minister of Economics and Finance, after the audition of the Bank of Italy and the Consob, will issue a regulation which describes the types of local authorities which are entitled to execute such contracts
- ! The Minister shall determine the criteria and the conditions at which the derivatives contracts can be executed
- ! Until the above mentioned regulation is issued (and in any case, for a year dating from the Decree) the execution of new derivative contracts is prohibited for the local authority

2009 Finance Act - Law no. 203 of December 22nd, 2008)

- Art. 3 amends Art. 62 of the Legislative Decree no. 112 of June 25th, 2008: it prohibits the issue of any obligations and other liabilities which require a reimbursement of the principal by way of a lump sum on the expiration date
- The duration of a single indebtedness transaction may not exceed 30 nor fall short 5 years, even if it consists in the renegotiation of existing liabilities
- The Ministry of Economics and finance, after hearing of the Bank of Italy and the Consob, shall determine -by the issue of one or more regulation- the type of derivative contracts which the local authorities are entitled to subscribe: should this not be the case, the contract shall be considered null and void
- The Ministry of Economics and finance shall identify, with a regulation, the minimum information that must be included -in Italian- in the contracts (in order to guarantee a certain level of transparency). *(Note: nine derivative contracts executed by Calabria Region which have been criticized by the Audit Authority, were drafted in English)*
- The person in charge for the execution of the contract on behalf of the local Authority certifies in writing his acknowledgement of the risks and features related to the contract itself
- No derivative contracts can be executed until the regulation to be issued by the Ministry of Economics and Finance comes into force and, in any case, for a period of time of at least one year starting from the date the Decree comes into force

(Follows)

- † The derivative contract can be restructured (renegotiated) only if there is a variation of the liability which the same contract is related to
- † The Ministry of Economics and Finance sends to the Audit Authority (Corte dei Conti) the documentation it has received in connection with the contracts executed by the local Authorities, on a monthly basis
- † The local Authorities in shall, in compiling their balance sheet, enclose an information note which highlights the financial obligations deriving from derivative contracts or originating from other financing agreements which include a derivative element
- † Early termination must be always allowed via payment of a “substitution cost” (the Audit Authority in the hearing at the Senate Commission on February 18th, 2009, specified that the contracts should provide the minimum and maximum parameters for the termination costs, where relevant)

Testo Unico della Finanza“TUF” (Legislative Decree no. 58/1998) and Consob Regulations

- ! The investment service provided by banks and financial intermediaries, which execute derivative contracts as principal qualifies as “*dealing for own account*”
- ! The (Italian and foreign) undertakings providing investment services are subject to specific obligations
 - Pursuant to art. 21 TUF:
 - a) Act conscientiously, correctly and with transparency, in order to serve clients’ interest efficiently and ’ interests and to preserve markets’ integrity
 - b) Acquire from the clients all the necessary information in order and act in a way to keep them always properly informed
 - c) Make use of advertising campaigns and information which are correct, clear and not misleading at any time
 - d) Arrange resources and procedures, including internal control methods, which are suitable to ensure that the services and activities are always carried out efficiently

(Follows)

- Articles 26 *et seq.* of the Intermediaries Regulation no. 11522 of 1998 (now abrogated and replaced by Regulation no. 16190 of 2007):
 - The intermediaries must acquire knowledge of the financial instruments which they offer (Art. 26)
 - The intermediaries must operate in order to get the best result from the offered service
 - The intermediaries must ask the client -or potential client- the level of his knowledge and experience in the investment sector and in relation to the level of his understanding of the proposed instruments or services
 - The intermediaries must check whether the client has a sufficient level of experience and an adequate knowledge of the instruments, in order to understand the risks that are implied in the proposed instruments or more generally in the service
 - The intermediaries must inform the client or potential client shall they believe that the instrument or service does not fit that client and, if the client no matter how aims to perform the transaction, this can be executed only provided that a written order is given by the client

(Follows)

- ! Intermediaries Regulation no. 16190 of 2007 (subsequent to MiFID)
 - Provides with a classification of the customers:
 - **Retail Client - *Cliente al dettaglio*** (the client which is not a professional or a qualified counterparty).
 - **Professional Client** (i) *de jure* professional clients- determined by the law and listed in Regulation no. 16190 or (ii) professional clients “upon request”, provided that they comply with the requirements referred to by Schedule 3 of Regulation no. 16190) and upon explicit request of the disclosure of specific details and information; or (iii) “public professional client”, which should comply with the requirements referred to by the regulation to be issued by the Ministry of Economics and Finance according to Article 6, Paragraph 2-sexies of TUF).
 - **Controparte qualificata** (according to Art. 6, c. *quater*, lett. d), n. 1, 2, 3, 5 TUF, as well as Art. 58 del Reg. 16190).
 - The conduct rules provided for by Artt. 27-56 of Regulation no. 16190 do not apply
 - A different classification may be requested (in order to obtain a higher level of protection)

(Follows)

- ! Information gathering from the client (Art. 39)
 - The intermediaries may rely on the information provided for by the client -or potential clients- except when these are clearly outdated, incorrect or incomplete
 - When the intermediaries providing service in investments or in relation to the management of investment portfolios, do not obtain the required information, they must refrain from providing any service

- ! Evaluation of the appropriateness (only for advising services in investments and in the management of investment portfolios)

- ! Evaluation of the appropriateness (Article 42)

Critical issues in litigation

- ! Violation of the general administrative law rules (in relation to the selection of the bank as counterparty, authority of the signatories of the derivative contracts on behalf of the local public authority etc)
- ! Violation of Art. 3, Paragraph 2 of the Decree, in the case in which the derivatives executed by local authorities are merely speculative rather than hedging or debt restructuring
- ! Violation of Art. 21 TUF and implementing regulations

Invalidity – Violation of Administrative Laws

- ! Execution of derivatives other than those referred to as “plain vanilla”
- ! Violation of laws coordinating public finance and administrative procedures regulating the exercise of public rights
- ! Violation of administrative rights:
 - Derivative instruments which are dissimilar to the types which are provided for by Art. 3 of Ministerial Decree no. 389/2003
 - up-front exceeding 1%
 - inclusion of a “digital” option

(Follows)

“**Autotutela**” (Law 241 of 1990, Art. 21 *nonies*; Law 311 of 2004, Art. 1 Para. 136) provides the following:

- † The right for the Authority to amend, even on its own initiative, unlawful or ungrounded documents (i.e. which go against the Constitutional principles of impartiality and good performance of the public service)
- † Peculiar features:
 - Its application should be respected at the highest degree in order to increase the overall performance of the administrative law
 - its exercise shall be granted at the widest extent
 - its exercise has no time limit
- † The financial authority, even on its own initiative, may revoke the administrative actions which are to be considered as adopted not respecting the regular procedure and the correct model
- † According to Ministerial Decree no. 37 of 1997, the right to revoke and/or cancel the acts, mostly concern cases of unlawfulness and groundlessness of the acts themselves, and not their merits (Artt. 1 and 2 of the Ministerial Decree)
- † Consequences (revocation/cancellation – indemnification/compensation)

Administrative responsibility and fiscal damages

- ! Liability in this case arises when the directors, officers and employees of the State (and, more generally public authorities) in exercising their public functions (capacity) commit violation of their duties and in doing so, they cause damages to third parties or to the authority for which they exercise their role.
- ! The Audit Authority has jurisdiction on these cases.
- ! The public employee may also incur in the following:
 - **Disciplinary liability:** for the violation of his duties now provided for by the collective agreement (contrattazione collettiva di comparto) and by conduct rules (the Court for Labour has jurisdiction on public employees, whilst in the other cases refer to the Regional Administrative Court – TAR)
 - **Criminal liability**, for which the ordinary criminal judge has jurisdiction, if the behavior causes an offence according to criminal Law.
 - **Civil liability:** when the employee causes a damage to another party he will be responsible according to Article 2043 c.c. and Art. 28 of the Constitution, regarding the direct liability of the State officers and employees for the actions he or she performs in violation of rights. The respective Authority will be jointly responsible according to Civil Law.
 - **Directors' responsibility** provided for by Legislative Decree no. 165 of 2001, as amended by Law no. 145 of 2002 and by Legislative Decree 286 of 1999 and by the collective agreements for the area managers. The Labour Court is vested with the jurisdiction on these cases.

Invalidity / termination for violation of the TUF provisions

Possible arguments in favour of the local Authorities:

- ! Legal qualification of the Authority: retail customer rather than “*professional investor*”
 - Ineffectiveness of the declaration signed according to Article 31, Paragraph 2 of Consob Regulation no. 11522 of 1998 (see Court of Applea of Trento 5/3/2009, Trib. Novara 18/1/2007, *contra* Trib. Verona 22/6/2007, Trib. Vicenza 17/8/2007)
 - Supreme Court Corte di Cassazione n. 12138 of May 26 maggio 2009: favourable to the banks: the local authority must prove that the declaration pursuant art. 31 comma 2° of Reg. 11522/1998 was untrue
 - The absence of a complete disclosure of risks (disclosure on these must be provided also to *professional investors*)
 - No evaluation of the suitability of the transaction (in the event that the local authority must be considered as a retail investor)

Possible topics of the intermediaries

- ! Legal qualification of the intermediaries as a professional investor based on their previous experience in the investment sector
- ! Activity of external advisors supporting the local authority
- ! Obligations provided for by Artt. 27 and seq. of Consob Regulation no. 11522 of 1998 do not apply for the *operatori qualificati*
- ! Mifid provisions and limits introduced by 2008 Finance Act are non-retroactive
- ! Compliance with the provisions of administrative Law (reports by experts)

Termination/Cancellation of the contract

- ! **Termination** of the contract according to Art. 1453 of the Civil Code for the intermediaries not respecting their obligations consisting in:
 - Informing the client on the nature of the financial instruments
 - Deliver the client the general risk disclosure information
 - Acquire information regarding the risk profile and the requirements of the client and assess the adequacy of the relative investment in consideration of the collected information
 - Obtain a specific written authorization to perform the transaction which is not considered as suitable
 - The non application of commissions (explicit or “implicit”) in case of direct negotiation of financial instruments

- ! **Pre-contractual liability** of the Bank/Intermediaries with consequent compensation for damage according to the provisions of the Supreme Court no. 26724 and 26725/2007, for violations of Law provisions and TUF regulations

- ! **Cancellation** of the contract even for a defect in the determination to execute the contract, if it is caused by a false representation of the effective features of the derivative and by the non-suitability of the same to achieve the proposed interests

The role of the experts in litigation

- ! Identify the nature, the type and the technical features of the contract
- ! Calculate the "mark to market" and verify that no mispricing is in place
- ! Qualitative analysis aiming to assess the appropriateness, effectiveness, efficiency of the derivative transactions in relation to the underlying risk factors
- ! Evaluate the appropriateness of the possible *upfront* due and received in relation to the 1% threshold