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Table of Contents

Open Review of Management, Banking and Finance

«They say things are happening at the border, but nobody knows which border» (Mark Strand)

STS Securitisations: New dispositions for a uniform European discipline

by **Patrizio Messina** and **Madeleine Horrocks**

Abstract: *European institutions have recently enacted a common and uniform legislation for securitisation transactions, which emphasises the importance of their simplicity, transparency and standardisation and which entered into force on 1 January 2019 (Regulation (EU) 2017/2401 and Regulation (EU) 2017/2402). Through a grandfathering period, certain aspects of the new regime will become completely applicable by 2020. As will be seen in the following chapter, the new regulation strongly impacts also other laws (in primis, Regulation No. 575/2013), giving a new strong imprinting of the main focuses and parameters that must be taken into consideration when operating with securitisation transactions.*

Securitisation is an important element of well-functioning capital markets. Soundly structured securitisation can be an important channel for diversifying funding sources and allocating risk more efficiently within the EU financial system. The securitisation of loans (and, in particular, of Non-Performing Loans (NPLs) or credits that are unlikely to be paid (UTPs), generally and specifically of SMEs receivables, represent other strategies useful for exploiting alternative sources that may allow to gain long-term capital.
This new regulation should create a higher number of transactions within the European territory, rendering the securitisation tool even more suited for financing companies of smaller dimensions through dispositions that can be applied in all European markets and are coordinated and easier to be applied.

1. Financial regulation presents some issues that European and national authorities across European Member States have to face constantly during the different economic cycles. These matters have become crucial for the European institutions in recent years, and in particular since the 2008 crisis[1]. In this

respect, a solid improvement to uniformity and integration among different national legislations has been achieved through amendments of existing regulations and the creation of new ones.
In order to reach this goal, the European institutions have agreed to carry out, over the last ten years, two major projects, the Banking Union (BU)[2] and the Capital Markets Union (CMU)[3], which represented at the same time the basis and the objective for European regulators. Indeed, the provisions contained in particular in the last one, presented a recognition of the legislation in force and the need of the European market in order to grow and improve its efficiency. This activity allowed the definition of the objectives (and relevant deadlines) in order to reach a common playing field and fair and convenient conditions for companies of different Member States.
As well known, securitisation transactions represent an important tool for well-functioning financial markets[4]. Certainly, soundly structured securitisations are an important channel for diversifying funding sources for companies and allocating risks more widely within the European Union Area financial markets. Indeed, it permits a more thoughtful management of the financial sector risk and can help to free up originators' balance sheets to allow for larger lending activities to companies, both large and smaller ones.
Indeed, given its ability to release reserves, which otherwise had to be retained for regulatory purposes, by replacing non-liquid assets included in portfolios of performing and NPLs with liquid financial tools, securitisation has established itself as one of the main avenues offered by the market to an immediate improvement in the liquidity of a bank's assets. Thus, it allows to convert assets which are illiquid by themselves into instruments that can be traded on the debt capital markets and that can be bought also by smaller investors[5].
Moreover, the solution of issues related to financial regulation across European Member States has been a crucial goal for the European institutions during the last years, especially since the 2008 crisis[6]. In this respect, a strong enhancement to uniformity and integration among different national legislations has been achieved through amendments of existing regulations and passing of new ones[7].
Evolving models that have been used in international practice have undoubtedly played a role of fundamental importance in the spread and further development of securitisation. These have inevitably influenced the practice on the European capital markets, admitting domestic securitisation as part of a process of de facto globalisation, in which interactions between global financial markets have driven the structuring of increasing complex deals, while also offering the possibility of organising such deals in various jurisdictions.
In addition, the securitisation framework has proved sufficiently elastic and malleable to allow it to take on an increasingly complex structure, further driving its evolution and expanding its boundaries[8].

2. Under Article 2(1)(1) of the Regulation (EU) 2017/2402 of the European Parliament and of the Council (the "Securitisation Regulation"), 'securitisation' is defined as a transaction or scheme, whereby the credit risk associated with an exposure or a pool of exposures is tranched, having all of the following characteristics: (a) payments in the transaction or scheme are dependent upon the performance of the exposure or of the pool of exposures; (b) the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme; (c) the transaction or scheme does not create exposures which possess all of the characteristics listed in Article 147(8) of Regulation (EU) No 575/2013.

Recital No. 1 of the Securitisation Regulation also assists to understand the term by stating that "Securitisation involves transactions that enable a lender or a creditor – typically a credit institution or a corporation – to refinance a set of loans, exposures or receivables, such as residential loans, auto loans or leases, consumer loans, credit cards or trade receivables, by transforming them into tradable securities. The lender pools and repackages a portfolio of its loans, and organises them into different risk categories for different investors, thus giving investors access to investments in loans and other exposures to which they normally would not have direct access. Returns to investors are generated from the cash flows of the underlying loans."

In is interesting to note that, according to Article 4(1)(61) of Regulation (EU) No. 575/2013 (the "Capital Requirements Regulation" or the "CRR"), which has been repealed and replaced by the Securitisation Regulation, securitisation means a transaction or scheme, whereby the credit risk associated with an exposure or pool of exposures is tranched, having both of the following characteristics: (a) payments in the transaction or scheme are dependent upon the performance of the exposure or pool of exposures; (b) the subordination of tranches determines the distribution of losses during the ongoing life of the transaction or scheme.

Therefore, it is excluded from the scope of application of the Securitisation Regulation the so-called 'Mono-tranche' securitisation transactions (in other words, when the structure provides for the issuance of a single class of ABS securities), as was the case also under CRR; in addition in general, any securitisation transactions with several classes of ABS securities with no subordination between the different classes of ABS securities (i.e. they are repaid equally to each other and pro rata among them) are excluded from the scope of application of the Securitisation Regulation. Finally, the 'Multi-tranche' transactions (that is to say transactions involving the issuance of two or more tranches of securities with risk segmentation) which create exposures classified as "exposures by specialised financing" falling within limb (c) of the definition of securitisation are excluded.

As a preliminary outline and as better explained in the following pages, securitisation begins with a normal sale of loans, typically by a bank, known as the 'originator,' to a third entity known as a 'special-purpose vehicle' (SPV), which in turn finances its purchase of the loans by issuing securities collateralised by the credit claims to which it has obtained title[9].

In terms of carrying out an economic activity, which can turn out to be profitable, on behalf of the SPV, its operations may appear to be to be classified as economic; however it is more difficult to hypothesise an SPV engaging in a professional activity, given that even the remote possibility that the organisation of the capital and of the labour inherent an SPV may go beyond its function of performing the obligations for which it has been incorporated, which is the issuance of the securities comprised in the securitisation transaction[10]. Thus, this however implies that an SPVs can be classified as an entrepreneurial undertaking not on a general and theoretical basis, but only considering its specific conditions of incorporation.

Considering its objective and business purpose, each SPV has to maintain a very low minimum capital level. Within the international practice, such condition is generally known as 'thin capitalisation' or even a 'capital-free' approach. Indeed, conferring an SPV with a high amount of capital, may endanger the achievement of the goal of securitisation, which clearly aims at freeing up capital reserves. Besides, technically speaking, a high level of capitalisation of an SPV could conversely represent a potential source of financial risk for this type of company and, consequently, for the noteholders of the SPVs, because of the relevant reduction of their outstanding collaterals.

While the above description may be taken as an outline of the basic deal structure, it must be considered that there is no single historical model for securitisation: each deal may differ from another in terms of the type of loans sold, the allocation of risk between the parties involved and the guarantees securing the sale[11]. Nonetheless, in most cases the structures adopted in European transactions to release capital placed in securitised assets – which also leads to their conversion into securities – are all based on one main model of reference[12].

For these purposes, on January 2018 two EU regulations entered into force and became broadly applicable on January 2019: (i) Regulation (EU) 2017/2402 (the "Securitisation Regulation") defines the framework of laws disciplining European securitisation transactions and contains the legislation applicable to simple, transparent and standardised ("STS") securitisations[13] and (ii) Regulation (EU) 2017/2401 (the "CRR Amendment Regulation") replaces some rules provided by Regulation (EU) No. 575/2013 (the "Capital Requirements Regulation" – "CRR") on prudential requirements for credit institutions and investment firms (jointly referred as the "European Securitisation Regulation Package").

Hence, the Securitisation Regulation represents the conclusion of a long legislative process and political debate, which lead to the approval of the European Securitisation Regulation Package. In legal terms, the Securitisation Regulation endorses two main goals: firstly, the consistent harmonisation and consolidation of some key regulatory elements of the already existing rules (for example, the provisions already in force on due diligence, risk retention rule, disclosure and transparency and notification procedures); secondly, the creation of a specific legal framework for simple, transparent and standardised long-term securitisations.

With regards to market efficiency, the European Securitisation Regulation Package aims at:

(1) restarting markets on a more solid and healthy basis, so that securitisations can work to improve effectively the funding channels to the economy;

(2) allowing for convenient and effective risk transfers to a broad set of institutional investors, as well as banks;

(3) allowing STS securitisation to function as an effective funding mechanism for some longer-term investors as well as, of course, for banks; and

(4) protecting investors and manage systemic risks by avoiding a recurrence of the flawed 'originate-to-distribute' models.

The goals set by the European Securitisation Regulation Package show how this type of transaction constitutes an indirect support for those banks that need to recover the higher standards for lending activities and adequate levels of credit risk by removing NPLs and Unlikely to Pay loans ("UTPs"), of residential and commercial nature, from their balance sheet[14]. These are the main drivers that have lead the European institutions in the last past years to draft and adopt a relevant legislation capable of managing the reduction of the total amount of NPLs that national banks have accumulated during the low level of market liquidity which has become recurrent since the 2008 crisis[15].

3. The CMU Action Plan included, since its first original version, the adoption of a package of legislative measures that would pave the way to a stable and profitable market for securitisation transactions[16]. In general terms, the package provides for:

(1) a regulation containing provisions applicable to all securitisation transactions;

(2) the introduction of a STS type of securitisation;

(3) amendments to the regulation on the banks' capital requirements that renders them more risk-sensitive and appropriate for the STS securitisation transactions.

According to the provisions of the CMU Action Plan, on 12 December 2017, the European Parliament and the European Council issued two regulations:

(1) Regulation (EU) 2017/2402 (the 'Securitisation Regulation'), laying down a general framework for securitisation directly applicable in every Member State and including due diligence, risk retention and transparency rules, together with a very detailed set of criteria that outlines the characteristics of STS securitisations. Its first part (Chapter 2) provides for a common set of rules that apply to all securitisations, including STS securitisations; the minimum requirements imply the maintenance of a minimum net economic interest in the securitisation transaction, enabling investors to carry out the necessary analyses in order to be able to make a well-informed choice with regards to their investments and ensuring that the information regarding the securitisation transaction are transparent (together with the possibility of assessing over time the status of the investment). The second part (Chapter 4) drafts the parameters that identify STS securitisations; and

(2) Regulation (EU) 2017/2401 (the 'CRR Amendment Regulation'), amending Regulation (EU) No. 575/2013 on prudential requirements for credit institutions and investment firms.

It is important to underline that there are two types of securitisation transactions excluded from the scope of the Securitisation Regulation: (a) the mono-tranche securitisations (or, in any case, securitisations where, in case of more than one class of securities, no subordination between the different classes of notes is present), as previously (i.e. before 1 January 2018) provided for by the regulatory framework of the CRR; and (b) transactions or schemes that create exposures classified as 'specialised lending exposures' (ex Article 147(8) of the CRR Regulation)[17].

Nonetheless, this category of securitisation transactions could be performed under the domestic European securitisation regimes such as the Italian Securitisation (Italian Law No. 130/1999). However, a securitisation transaction carried out pursuant to Italian law but not compliant with the European Securitisation Regulation Package, cannot benefit from the risk weighting factors provided for by the CRR Regulation.

The European Securitisation Regulation Package was published in the Official Journal of the European Union on 28 December 2017; it entered into force on 17 January 2018 and has applied to securitisation transactions where the securities are issued on or after 1 January 2019, since 1 January 2019[18].

Moreover, other regulations already in force that deal with securitisation transactions were amended so as to render them consistent with the European Securitisation Regulation Package, avoiding overlaps or lack inconsistency and ensuring the same level playing field for all the players of the market. The most important legislative interventions regarded the CRR Regulation, fund managers that are required to become authorised under Directive 2011/61/EU on Alternative Investment Fund Managers (the 'AIFMD Directive') and insurance and reinsurance undertakings as classified according to the EU Directive 2009/138/EC as amended (the 'Solvency II Directive').

4. A securitisation transaction can be classified as a STS Securitisation if it meets all the requirements of the Securitisation Regulation and only after the positive completion of the notification procedure with the European Securities and Markets Authority ("ESMA"), pursuant to Article 27 of the Securitisation Regulation, which presents a description of the activities to be undertaken in order to comply with the STS criteria and the relevant procedures. Investors, anyhow, should be aware that the "STS

classification" does not automatically imply the absence of any risks in the transaction, but solely that the compliance with some more specific prudential criteria has been required.

Once the notification procedure has been completed and the transaction is classified as "STS", the effective responsibility of being compliant with the Securitisation Regulation stays exclusively with the subject who applies for the inclusion in ESMA's register (for example, the originator, the sponsor or the SPV). ESMA does not take any responsibility for verifying the contents of the notification. The same rule applies when the responsible entity becomes aware that the transaction cannot be classified as a "STS" anymore since it no longer meets the requirements; in such case, it has to make a request to ESMA to be removed from the list.

The STS criteria identify three main pillars on the basis of which securitisation transactions should be structured, which are simplicity, standardisation and transparency. Each criterion is explicitly addressed in a specific provision of the Securitisation Regulation (from Articles 20 to Article 22).

Considering the usual complexity that characterises the structure of STS securitisations, the concept of simplicity requires the securitisation structure to have a clear and comprehensive explanation of the potential risks. Transparency, on the other hand, implies that current investors and subjects interested in such investment are capable of carrying out their own due diligence activities. In the end, standardisation means that the securitisation transaction is in line with high-quality standards with regards to the underlying assets (specifically their performance), to applied rates and formulae, together with transaction documents and servicer's expertise to manage the transaction. It is important to underline that the servicer must demonstrate knowhow and proficiency with regards to securitised loans and/or exposures.

Securitisations that can be classified "simple" should be included in the "traditional securitisations" category, given that the legal and economic transfer of the securitised assets should take place either through the transfer of ownership to an SPV or through a sub-participation on behalf of an SPV. Such scheme should give the investors recourse to the securitisation assets if the SPV does not comply with its payment obligations. It is important to underline that such recourse cannot be granted in all non-traditional securitisation transactions (for example, synthetic transactions), due to their nature and main features[19].

Also, another innovative aspect of STS securitisations derives from the requirement for homogeneity of the underlying exposures. Indeed, this kind of transaction should be structured on underlying exposures that are standard obligations, specifically with regards to rights to payments and/or income from assets, currency and applicable legal system.

A peculiarity of the STS regime, in addition to the above, is that the new provisions of the Securitisation Regulation expressly require that, at the time of the transfer of the underlying exposures, any borrower must have made at least one payment. The only exception is allowed when the transaction involves a revolving securitisation backed-up by exposures payable in a single instalment or that have a maturity of less than one year. Of course, the reason stays in the fact that the new regulatory framework is thought in light of protection of the final investor and tends to reduce the extent to which those ones are required to detect and judge potential frauds and operational risks. In this regard, the credit risk and cash flow analysis which investors must be able to carry out cannot involve atypical rates or peculiar variables which would need a more skilled market experience and practice (as would happen with complex formulae or derivatives).

In respect of the transaction documents, some particular requirements are established by the Securitisation Regulation. Thus, in order to provide investors with certainty over the essential information, the transaction documentation has to specify the contractual obligations, duties and responsibilities of all the parties involved (mainly trustee, servicer and other ancillary service providers), as well as processes and responsibilities. The transaction documentation must also contain provisions related to an 'identified person' with fiduciary responsibilities, who acts on a timely basis and in the best interest of investors in the securitisation transaction. Such identified person might be the trustee of the securitisation (including the noteholders' representative) who must take decisions to facilitate, for example, the timely resolution of conflicts between different classes of investors, in all circumstances and in accordance with applicable law; if necessary, by sub-delegating to third parties.

5. The Securitisation Regulation requires that the interests and goals of originators, sponsors, original lenders and all the other participants to the securitisation transaction are aligned and match one with the others. Indeed, the last few years have shown that this is a strong solution that permits the avoidance of misalignments and conflicts among these same parties, damaging the investors' interest and confidence in being part of this type of transaction. Thus, a directly applicable provision (Article 6 of the Securitisation Regulation) that requires the originator and the sponsor (or the original lender) of each transaction to retain a significant interest in the securitisation itself has been reconfirmed in the European Securitisation Regulation Package. Specifically, it represents a material net economic exposure to the underlying risks of the exposures securitised held on an ongoing basis and for the entire life of the securitisation transaction which amounts to not less than 5% ('Risk Retention Rule'). There are many different structures for accumulating exposures (differently from a securitisation scheme based on the so-called originate-to-distribute model), nonetheless every scheme has to be compliant with the risk retention structures provided for by the Securitization Regulation[20] as supplemented by the applicable regulatory technical standards (such as those contained in Regulation (EU) 2014/625).
As just mentioned, the level of risk retention at 5% and its relevant structural methods have not changed from the previously applicable regime, due to the existing practice that confirmed its efficacy. However, there are some significant differences if compared with the previous legal framework of the CRR Regulation, the Solvency II and the AIFMD.
Firstly, the Securitisation Regulation imposes a new direct obligation on originators, sponsors and original lenders to retain the risk through a so-called "Direct Approach" in addition to the previous existing so-called "Indirect Approach" through an obligation on each institutional investor[21] to verify – before investing in any securitisation transaction that the originator, sponsor and/or the original lender retained on an ongoing basis the material net economic interest in the securitisation in accordance with the Risk Retention Rule. This implies that entities carrying out securitisation transactions that involve also investors not residing in any European Member States or that cannot be classified as institutional investors have to (as they did previously) apply the Risk Retention Rule.
Secondly, the Securitisation Regulation requires that the originators may not select assets to be transferred to the SPV for rendering losses on the assets transferred to the same SPV for the whole span of the securitisation transaction (or over a maximum of four years if it lasts longer) higher than the losses over the same period on comparable assets held on the balance sheet of the same originator. This further condition appears to make the application of the Risk Retention Rule effective.

In addition, the strongest amendment concerns the breach of the Risk Retention Rule. Indeed, the Securitisation Regulation states that each European Member State has to put into force detailed sanctions directly applicable to the non-compliant originator, the original lender or the sponsor of the securitisation transaction.
Lastly, the replacement of the different fragments of legislation (as listed above, CRR Regulation, Solvency II and AIFMD) into one all-encompassing disposition contained in Article 6 of the Securitisation Regulation. This level playing field facilitates its application on the market.

6. The Securitisation Regulation, as an underlying theme, stresses the importance of monitoring and controlling risks deriving from securitisation transactions. The main risks involved are due first of all to the complexity of the transaction structure, together with the characteristics of the underlying securitisations, exposures, the underlying borrower, the guarantees and any applicable credit risk mitigation measure. In addition to agency risks, modelling risks, legal and operating risks, counterparty risks, servicing risks, liquidity and concentration risks. In order to prevent, as much as possible, the potential issues that could jeopardise the positive result of securitisation transactions and investors' confidence in the market, the Securitisation Regulation sets out a number of prudential criteria that require to carry out some due diligence activities, differentiated on the several parties in charge of the obligation, and the circulation of a 'continuous, easy and free' flow of information – regardless of their private or public nature – that allows the fulfilment of the mandatory transparency obligations. The goal is to improve awareness by the institutional investors in terms of the exposures in which they are evaluating a possible investment and the ability of institutional investors to better examine and recognise the risks.
However, the Securitisation Regulation does not provide for a complete and detailed scheme of the information that has to be disclosed, in particular in relation to the underlying exposures. Indeed, Article 7(1)(a) requires only that 'information on the underlying exposures' shall be made available on a quarterly basis (or, 'in the case of ABCP, information on the underlying receivables or credit claims on a monthly basis'). Recital n. 16 and Article 7(1)(e)(i) of the Securitisation Regulation require the disclosure of 'all materially relevant data on the credit quality and performance of underlying exposures', which include the originator, the sponsor and the SPV to disclose to holders of a securitisation position the potential investors; in addition it implies the disclosure to the relevant competent authorities' of the information relating to the securitisation (both before the pricing and, when required and/or appropriate, consistently during the whole transaction). These due diligence requirements are of considerable importance. As with the risk retention requirement, the due diligence obligations are introduced with both a Direct Approach and Indirect Approach. This obligation applies directly to the originator, sponsor and SPV to disclose and deliver the information related to the securitisation transaction and to institutional investors to verify that the originator, the sponsor and the SPV are compliant with their own obligations. The due diligence obligations that have to be borne by the institutional investors can even be delegated to a third party if this last one is an institutional investor as well and it is authorised to take decisions with regards to the management of the investments related to the securitisation transaction on behalf of the first delegating institutional investor.
In technical terms, the disclosing strategy depends on the nature of the relevant securitisation transaction and it is the result of a combination of the requirements on behalf of the investors and the ones pertaining to the subjects who have structured the securitisation transaction. Indeed, in order to

acquire a securitisation position, the investors have to carry out a due diligence on the underlying assets and on the other aspects of their own interest related to the securitisation transaction. Nonetheless, such activities can take place only if the originator, the sponsor or the original lender have provided the amount and quality of information needed. Thus, it seems that the depth and level of detail of the activities depend on the quality of the work presented by those who have structured the securitisation transaction.

Moreover, in case of a public transaction, the disclosure activities have to take place through a securitisation data repository (or, if it does not exist, the information has to be published through a website meeting according to some prearranged standards). Whereas, if it is a private deal, there are no official prescribed methods; in any case, the goal implies that the information becomes available to holders of securitisation positions, competent authorities and (upon request) potential investors.

In any case, according to Article 7(4), the Securitisation Regulation requires that ESMA, in close cooperation with the European Banking Authority (EBA) and European Insurance and Occupational Pensions Authority (EIOPA), develops regulatory technical standards – to submit to the European Commission – based on some specific standard templates, which provide for the crucial information according to the different types of underlying asset (for example, leasing, consumer credit, corporate, residential or commercial real estate, etc.), to specify the information that the originator, the sponsor and the SPV shall provide in order to comply with their obligations under Article 7(1), letters (a) and (e). It is easily foreseeable the innovative strong effects that this scheme can have on the markets' procedures.

In this respect, on 19 December 2017, ESMA issued a Consultation Paper on 'Draft technical standards on disclosure requirements, operational standards, and access conditions under the Securitisation Regulation', so as to match what required in the Securitisation Regulation and allow operators to fulfil properly their obligations. On 22 August 2018, ESMA published its Final Report on the securitisation disclosure technical standards; it consists of a adapted, updated and revised version of the already existing ECB reporting templates used for the 'ABS loan-level initiative' (which have broadly and successfully been tested on the market during the previous years) and it embraces 17 reporting standard templates. Nevertheless, on 14 December 2018, the European Commission informed ESMA that it would have been appropriate to amend part of the disclosure technical standards. Thus, on 31 January 2019, the relevant Authority released a new opinion concerning 'Amendments to ESMA's draft technical standards on disclosure requirements under the Securitisation Regulation' that shall be in line with the European Commission's view. As at the date of writing this article, no official version of the documents has been issued by any Authority, a framework which leaves the market's operators with a scheme of obligations and responsibilities technically inapplicable and almost deprived of the core contents until the final decision of the European Commission (in other words, the specific data and an authorisation that allows to communicate them to an authorised securitisation data repository is indispensable for being compliant with the Securitisation Regulation).

In any case, it appears that ESMA should set clear the scope and the contents (in this respect, institutional investors and industry associations are demanding to be aware of the specific items in data and reports both on the lender's and on the borrower's side, in order to be sure to be capable of handling the implementation of the new provisions) of the disclosure obligations, together with the format and all the other bureaucratic and logistic aspects related to the first (among others, setting out the procedure for the authorisation as a securitisation data repository).

References

[1] Engelen, W. & Glasmacher, A., *The Waiting Game: How Securitization Became the Solution for the Growth Problem of the Eurozone*, https://journals.sagepub.com/doi/pdf/10.1177/1024529418758579.

[2] The banking Union (BU) allowed the shifting of the responsibility of the banking policy from the national to the EU level of the European Union for a number of Member States, requiring though the consistent national application of EU banking rules. Due to the Eurozone crisis after the 2008, in 2012, the BU was approved mainly in order to create a more transparent, unified and safer market for banks management and to control and monitor the fragility of banks within the European Union. The Banking Union stands on two pillars: (i) the Single Supervisory Mechanism (SSM), a new system of banking supervision that comprehends the European Central Banks (ECB) and the national supervisory authorities of the relevant Member States; and (ii) the Single Resolution Mechanism (SRM) aims at ensuring the efficient and rapid resolution of banks with financial issues with minimal costs for taxpayers and to the real economy.

[3] The Capital Markets Union (CMU) is the European programme presented by the European Commission in September 2015, which aims at a full integration of the national capital markets. Specifically, it intervenes by providing new sources of funding for businesses (particular attention is dedicated to Small and Medium Enterprises), reducing the cost of raising capital, increasing options for savers across the EU, facilitating cross-border investments and attracting more foreign investments into the EU, supporting long-term projects and making the EU financial system more stable, resilient and competitive. The whole plan have undergone through a revision in 2017 and it is expected to be completed by 2019.

[4] A securitization is a transaction within which the credit risk associated with an exposure (or a pool of exposures) is tranched and that has all of the following characteristics:

(a) payments in the transaction are dependent upon the performance of the exposure (or of the pool of exposures);

(b) the subordination of tranches determines the distribution of losses during the ongoing life of the transaction;

(c) the transaction does not create exposures which will be classified as specialized lending exposures according to Article 147(8) of CRR.

[5] Association for Financial Markets in Europe, *High-Quality Securitisation for Europe* https://www.afme.eu/globalassets/downloads/publications/afme-high-quality-securitisation-for-europe-the-market-at-a-crossroads.pdf

[6] As it is well known, the most recent financial crisis related to subprime mortgages became evident among the actors of the market in the United States of America in 2006. However, its reasons run back even to some years before, when mortgages were commonly granted to clients who clearly did not match the requirements related to the relevant risks and reimbursement of the loan, for example due to the lack of adequate guarantees. Since the year 2000, indeed, securitization transactions offered the possibility for banks to transfer its rights and obligation related to mortgages contracts, as securities, to the selected SPV, thus recovering in a relatively short period of time a significant portion of its credit, which otherwise could have been collected only at the expiration date of the loan (holding the risk that the client could become insolvent while the obligations were still standing out. Therefore, banks easily disposed of important amounts of liquidity that allowed always new and more lending activities in

favour of borrowers who could be set outside the regular framework of these activities. Of course, the advantages of such investing strategy – in most cases – lead to high profits in the short-term period, but also to undeniable risks of strong losses during the same time lag. Through this mechanism banks could assign the borrowers' insolvency risk to third parties, a strategy which in many cases, allowed a less rigid assessment of the debtors' economic and financial merit. Under these circumstances, different types of banks agreement have been subscribed by investors who did not meet the most appropriate economic and financial parameters for receiving a loan. Such lending practice fostered the spreading of lack of adequate liquidity on behalf on behalf of banks and let the issue affect the European economy too.

[7] Carbó-Valverde S., Rodríguez-Fernández F. & Udell G. F., 2016, Trade Credit, the Financial Crisis, and SME Access to Finance, in 'Journal of Money, Credit and Banking', 48, pp. 113,143.

[8] Norton Rose Fullbright US LLP, *Structured Finance & Securitisation,* http://www.nortonrosefulbright.com/files/ca-structured-finance–securitization-167792.pdf. Norden, L., Buston, C. S. & Wagner, W., 2014, *Financial Innovation and Bank Behavior: Evidence from Credit Markets*, in 'Journal of Economic Dynamics and Control', 43(C), pp. 130–145. Baradwaj, B.G., Dewally, M. & Shao, Y., 2015, *Does Securitization Support Entrepreneurial Activity?*, in 'Journal of Financial Services Research', pp. 1–25.

[9] Global Legal Book, *Securitisation 2018 (England and Wales): A Practical Cross-Border Insight into Securitization Work.*

[10] The securities usually issued appear to be bonds (well known in English-speaking environments as ABSs).

[11] Baums, T., 1994, Asset Securitization in Europe. Kluwer Law and Taxation Publishers; Curtin, E. & Tanega, J., 2009, Securitisation Law: EU and US Disclosure Regulations. LexisNexis. Ramos-Munoz, D. & Ingram, K., 2010, The Law of Transnational Securitization. Oxford.

[12] The type of receivables that may potentially be used in securitization, over the past years, have been identified with those arising from mortgage lending, consumer lending, leasing and factoring. In addition, they also include other different kinds of receivables, such as trade receivables and healthcare receivables arising from arrangements between suppliers and national health service.

[13] The Regulation (EU) 2017/2402 creates also a specific framework for simple, transparent and standardized securitization, and amended Directives 2009/65/EC, 2009/138/EC and 2011/61/EU and Regulations (EC) No. 1060/2009 and (EU) No. 648/2012.

[14] https://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1490966616011&uri=CELEX:52016DC0601; Demsetz, R. S., *Bank Loan Sales: A New Look at the Motivations for Secondary Market Activity*, https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr69.pdf

[15] The Bond Market Association, *European Securitisation: A Resource Guide*, http://people.stern.nyu.edu/igiddy/ABS/resourceguide.pdf.

[16] Kayode, S. A., *Post Financial Crisis Securitization: Can (EU) 2017/2402 Make Any Diffference?* https://helda.helsinki.fi/bitstream/handle/10138/279432/Master%27s%20Thesis%20_Kayode.Asoro_2018.pdf?sequence=2&isAllowed=y.

[17] Specialised lending exposures are a type of exposure towards an entity specifically created to finance or operate physical assets, where the primary source of income and repayment of the obligation lies directly with the assets being financed.

[18] In any case, since 1 January 2019, securitizations that cannot be classified as "STS", but that are compliant with the requirements set by the European Securitization Regulation Package, can anyhow be structured.

[19] Kaya, O., *Synthetic Securitization Making a Silent Comeback*, https://www.dbresearch.com/PROD/RPS_EN-PROD/PROD0000000000441788/Synthetic_securitisation%3A_Making_a_silent_comeback.PDF.

[21] As defined by Article 2, c. 1, no. 12 of the Securitization Regulation and by Article 124-ter, c. 1, let. b), of Legislative Decree No. 58 Of 24 February 1998.

Authors

Patrizio Messina is a dual qualified lawyer (England and Wales, and Italy), a senior legal expert in International Business and Finance. Patrizio is member of the Banking & Finance Group, Partner in charge for Europe and a member of the Firm's Global Management Committee.

Madeleine Horrocks is a dual qualified lawyer (England and Wales, and Italy), a senior legal expert in International Business and Finance. Madeleine is member of the Banking & Finance Group.

Paragraphs 1, 2, 3, 4 and 5 have been written by Patrizio Messina; Paragraph 6 has been written by Madeleine Horrocks.

Open Review of Management, Banking and Finance

«They say things are happening at the border, but nobody knows which border» (Mark Strand)

The duty of care in the UK bank-customer relationship: An analysis of the recent regulatory developments

by **Martin Berkeley**

Abstract: *This article explores how stakeholders in financial relationships owe duties of care – not only as already established by regulation and case law, but also because of the impact they can have on individuals, businesses and the economy as a whole. Recognition of the current suboptimal effectiveness of bank duties led the Financial Conduct Authority to initiate a review of bank duties. In analysing this, it is argued that large banks owe a special duty of care as they receive state support which can create moral hazard and they also can cause catastrophic damage to the economy and there follows a discussion of potential new duties. It is further argued that there is room for moral obligations in financial relationships.*

1. Duties of care between banks and other financial institutions tend to be thought of as unidirectional in that duties are owed to customers by banks. This is of course over simplistic and customers also owe duties, albeit narrower, to their banks; for example the duty not to draw cheques so as to facilitate fraud or forgery.[1] While the drawing of cheques may sound archaic, the principle of not using banking facilities recklessly or for fraudulent purposes holds, though perhaps it is easier to understand more simply as the duty to operate a bank account honestly.

Similarly, the duty to inform a bank of any suspected fraud as soon as feasibly possible has taken on new urgency given the pace and apparent proliferation of financial crime committed electronically.[2] These customer duties have been used by banks to argue that customers should have taken more care with their banking facilities and should have informed the bank earlier of suspected fraudulent activity.[3] Cynically, this may be seen as an attempt to hold customers responsible for losses by a bank. Of course, customer behaviour is not always simple and raises the question as to whether the same uniform standard should be applied to an internet savvy millennial, as opposed to an octogenarian with only limited understanding of electronic commerce.

Despite being commercial organisations, banks do not operate in a moral vacuum. There are both external laws and rules as well as expectations placed upon them as well as by their own corporate culture. An example of when a bank neglects its core values and allows its moral compass to drift is

when the former Barclays Bank Chief Executive Bob Diamond appeared before the HM Treasury Select Committee and was asked by John Mann MP if he: 'could remind me of the three founding principles of the Quakers who set up Barclays? [4]' Mr Diamond was unable to assist Mr Mann who reminded the former Barclays CEO the founders of Barclays' values could be summarised, with some irony as 'honesty, integrity and plain dealing'.[5] This would seem a good starting point for any New Duty.

2. The Financial Conduct Authority (FCA) recognising the importance of bank duties and accepting that all was not well with them, undertook a consultation exercise in 2018 questioning whether any 'New Duty' was required of banks. The term 'New Duty' was used to encompass a number of potential outcomes.

Initiating the exercise, the FCA issued the document: 'Discussion Paper on a duty of care and potential alternative approaches',[6] in which it outlined its concerns and the range of views in respect of the duties of financial institutions. Specifically, the following questions were asked of consultees:

- *Do you believe there is a gap in the FCA's existing regulatory framework that could be addressed by introducing a New Duty, whether through a duty of care or other change(s)?*
- *What might a New Duty for firms in financial services do to enhance positive behaviour and conduct from firms in the financial services market, and incentivise good consumer outcomes?*
- *How would a New Duty increase our effectiveness in preventing and tackling harm and achieving good outcomes for consumers? Do you believe that the way we regulate results in a gap that a New Duty would address?*
- *Should the FCA reconsider whether breaches of the Principles should give rise to a private right for damages in court? Or should breaching a New Duty give this right?*
- *Do you believe that a New Duty would be more effective in preventing harm and would therefore mean that redress would need to be relied on less?*

The consultation process took the format of workshops hosted by the FCA which were attended by interested parties. Parties then subsequently could make written submissions. The FCA has thus far issued an interim response reflecting the broad scope of responses.[7]

3. Given the long history, extensive nature of the explanations and supporting material in respect of expected duties as expressed in the FCA's PRIN and the recent FCA's consultation exercise suggests that the current duties are insufficient or ineffective. Alternatively, they have been not been enacted, interpreted or enforced effectively by both banks and regulators. The recent financial crises, mis-selling scandals and the seemingly increasing workload of redress organisations (the FCA's apparently caseload is apparent at record levels),[8] suggest that whatever duties already exist, are not functioning as intended or being adequately enforced, lending weight to the view that perhaps action of some sort is needed to achieve the desired standards.

Without an efficient banking system commerce would effectively stop, payments would not take place and trade would be reduced to little more than barter, at least in the short term. It is manifest given the vital nature of the financial system that stakeholders who can impact the orderly function have obligations to run stable and efficient services as well as wider of duties of care to customers and others.

In the days of the traditional City of London, the principle of 'dictum meum pactum' (my word is my bond, which is still the motto of the London Stock Exchange)[9] was understood by all counterparties and a bank's duty to a client was implicit and understood by counterparties as a quasi-moral obligation.

Breach of this moral code would be seen as acting in an 'ungentlemanly' manner and would lead to swift rebuke by colleagues and peers. The fear of shaming and shunning may have also acted as a 'moral brake' on the worst excesses of the financial system. That being said, a rose-tinted view of the City is to ignore many of the problems that historically existed or became apparent after the 'Big Bang' deregulation. The Big Bang also lead to significant cultural and economic changes to the UK banking sector, a slew of new regulations were introduced, some of these originating in the UK's membership of the EU, for example Principle Based Regulation and more recently the Markets in Financial Instruments Directive II(MiFID II).[10]

The FCA's Principles for Business (PRIN) aims to capture the duties expected of market participants succinctly. Following the Lamfalussy process the more detailed Conduct of Business Rules (COBS) are an intelligent 'colouring in' of the regulatory intentions.[11] Furthermore, guidance by the regulator, speeches, advice notes, voluntary codes and even soft law guidance on conduct all add weight, clarity and direction to the regulator's view of what duties are owed, by whom and in what circumstances.[12]

While any bank duties would ideally apply to all stakeholders in the financial markets, certain institutions should perhaps have a higher standard required of them. For example, Global Systemically Important Banks (G-SIB)[13] receive state subsidies being 'too big to fail'. This creating moral hazard. Does this support create an obligation to behave in a responsible fashion given the impact of their potential failure (though mitigated through bail out)? Simply put, if a bank is state subsidised it could be argued that they owe a higher/greater duty to 'UK Plc'. Conversely, smaller financial institutions or IFAs do not receive similar state support and it would seem unreasonable to expect the same high level of duties as per G-SIB institutions.

The approach in the Netherlands is illustrative: the Dutch Supreme Court (*Hoge Raad*) has taken the view that banks have special duty of care due to their social function. (*maatschappelijke functie*).[14] This duty of care applies in any contractual relationship between bank & client – credit, payments and even extends to market making activities such as IPOs. The duty can apply to both retail and professional customers as well as unconnected but impacted third parties. G-SIB banks have to balance interests of all parties in their decision-making processes. Recent case law is clarifying the duty of care towards semi-public institutions in the Netherlands. Much of case law based on the impact of derivative transactions and the impact they have had on business and the economy as a whole.

Given the damage a G-SIB can do not only to the national, but also the global economy it is manifest that they owe duties beyond that of a 'simple' domestic bank. However, a 'simple' bank can also have a profound impact on the economy, a risk that can be amplified through contagion, the run on Northern Rock being an example. At a more personal level, bad investment advice can have a devastating effect on an individual, business or their family. The duty of a financial adviser as an intimate advisory business is more akin to that of a lawyer or doctor and their client/patient. This is reinforced in recent case law By Mr Justice Kerr in *O'Hare and another v Coutts & Co* [2016].[15] While a financial advisor action may not be life threatening as is the medical arena, it can be similarly life changing. In summary, duties are owed as a general principle, but there are institutions whose impact can be so profound they arguably should hold a special duty of care.

If the FCA concluded that there was a need to construct a New Duty or restate existing ones more clearly, any such expected duties would ideally make the expected behaviours unequivocally clear and also how they would be measured and quantified. During the consultation meetings, some banks argued that new duties may be 'too complex' or 'difficult' for bankers to understand. Financial transactions are

complex, so understanding a simple principle such as too effectively 'do the right thing' should not be a challenge.

Any New Duty could reduce the regulatory burden as in an ideal world as a high-level principle should suffice in showing the desired behaviours, without detailed rules explaining exactly what is acceptable or not, though example case studies may be helpful. Finally, avoiding mis-selling or market damaging event by adhering to any New Duty should result in less redress payments, fines or litigation costs. Similarly, bankers and financial advisors are often heard to complain that they are not respected or seen as a 'proper' profession. Subscription and adherence to a code of conduct, as well as professional censure as per a professional banking tribunal, akin to other professional bodies, such as the General Medical Council for doctors or the Solicitors' Regulation Authority for lawyers, may help in raising standards in the industry and increasing the levels of respect afforded to bankers and financial advisors. In the Netherlands a banker's oath has been introduced which aims to professionalise financial services and reduce misdemeanours.[16]

To this end, the introduction of the FCA's Senior Manager Certification Regime (SM&CR), aimed to 'raise the standards of governance, increase individual accountability and help restore confidence in the banking sector'.[17] Though this was initially aimed at senior levels within the banking industry, the approach will have application at the level of individual advisers as it is extended across the financial services industry.[18]

The SM&CR had its origins in the UK Parliamentary Commission on Banking Standards (PCBS), which considered the professional standards and culture in the UK banking sector with the aim of improving standards in banking and restoring public trust in the industry. The PCBS recommended 'making individual responsibility in banking a reality, especially at the most senior levels', as it believed that senior bankers had operated without culpability and with little real chance of being penalised or sanctioned. The PCBS also was of the view that senior bankers would hide behind collective decision-making or claim ignorance of events that happened on their watch. Without individuals as well as institutions having New Duties imposed on them, there is a risk of blaming the bank rather than those who actually potentially breached the standard.

The SM&CR has its flaws: the terminology implies that it only applies to senior staff and the recent decisions such as the perceived soft treatment of Jes Staley of Barclays,[19] do little to inspire confidence in the effectiveness of the SM&CR or its future enforcement. Furthermore, the effectiveness of SM&CR type regulation is questionable, not only because banks may 'game' systems, but also the use of judicial devices such as Deferred Prosecution Agreements give the appearance of letting errant bankers 'get away' with a crime. Even if a duty is owed and it is breached it is unenforced.

Any New Duty also needs to extend to the pre-sales processes and product design. Customers often believe they are owed a duty and/or they are being advised – much as in the doctor/patient or lawyer/client relationship. If this is not the case, this needs to be made explicitly clear up front and the bank needs to ensure the client understands this. The current simplistic contractual interpretation of the bank/customer relationship is at odds with reality experienced by many non-professional customers.[20] The use of contractual estoppel to limit liability and non-reliance clauses reduce the position of a customer to little more than a junior party to a transaction. However, the consequences of that transaction can be profound. The point that external advice is available is also to an extent specious, as it may not realistically be available or the situation may be so constructed by bank that the customer has no realistic opportunity to take external advice, if it even were available.

It is pointless to have any standards or duties if they are unenforceable, ineffective or inconsistently applied. The FCA's high level Principles (PRIN) are effectively unenforceable by anyone but the regulator and Section 138D of FSMA is only actionable by private persons, leaving many small enterprises unprotected. It would be straightforward for HM Treasury to redefine the meaning of 'private person' within FSMA 2000 (Rights of Actions) Regulations 2001.[21] Furthermore, any high-level New Duty needs to be enforceable by all stakeholders. That may be customers, regulators or even affected third parties. This last category is important: suppose a bank's activities seriously damage the UK economy, for example causing a failure of the payment system – arguably damaged parties should have the right of redress, as is the case in The Netherlands.

As others have noted, banks are well funded in terms of their litigation budgets and can pick or choose which cases to settle or litigate.[22] Simply put, weak cases will be litigated and the fear of precedent encourages confidential settlement, thereby stifling the exposure of wrong doing and keeping it effectively hidden from the regulator. The concept of a financial services tribunal has been raised by some parties.[23] How this would be structured and operate is unclear at this stage, however if it could have the effect of removing the ability for confidential settlement, as per perhaps the FOS model – this may help matters. If a special tribunal is binding, and public would help, also this would reduce the inequality of arms between customers and firms.

The regulator has a role to play as well in any New Duty. In addition to enforcement of the New Duty, it has a duty as parastatal to not only fulfil its objectives, but also be more transparent in its dealing with banks and in publishing decisions. The current system of reporting misdemeanours is inadequate and there is apparently a belief that there is no point in reporting poor conduct to the FCA as there is little or no feedback and that nothing may actually be done. This negative perception of the regulator allows firms to breach PRIN and COBS with apparent impunity.

What could a New Duty look like? In short to do the right thing. To treat customers as one would wish one's own parents to be treated, though this obviously needs to be formalised more eloquently. The bank customer relationship is a contractual one but given the importance and implications of when things go wrong, and the ongoing failures despite the regulations already in place, the need for a New Duty is overwhelming.

The tools required to achieve the outcomes of a New Duty may already exist. The transition from COB to COBS under MiFID in 2007, abandoned the requirement to give best advice, but the general duty of loyalty is still a requirement under MiFID II and potentially may fulfil the intentions of any New Duty.[24] This would also be a simple route in terms of legislation as no changes would be required, but just enforcement of existing regulation.[25]

It is my view that a New Duty is needed, but more difficult questions are what should this new duty look like, and who should decide this, also how is 'buy in' and compliance to be ensured? Would a meaningful oath for bankers (along the lines of the Hippocratic oath) help? Perhaps fitness to practice or disciplinary tribunals such as found in many other professions have a place as well.

4. Bank/customer duties are primarily grounded in law, but do the interpretations reflect the reality of the client/adviser relationship? Financial services are essentially based on trust and the interaction between a customer and adviser is normally (and perhaps naïvely) one of confidence and trust. Financial institutions often market themselves as 'trusted advisers', but the reality is different – it is a commercial arrangement. It is axiomatic that humans are irrational, and the profit motive can cause a

financial advisor to be less than fulsome in their risk disclosures or even deceitful. This is where hence financial regulation based on principles should be aids to interpretation of more detailed rules. This raises the wider question as to whether there is room for moral values, perhaps expressed as fairness in financial services. [26]

The FCA requires in its Principles for Business for firms (and by extension their employees) to act with integrity as well as having due regard for their customers interests.[27] It would appear that the FCA consultation is recognition that these basic concepts are not functioning as intended. Even with the extensive regulations that have developed it seems these concepts do not work in reality as is also evidenced by continued mis-selling scandals. Even where an adviser's conscience may suggest a course of action over another, which is less good for the customer, the pressure of targets and commercial reality make the idea of an equitable approach to regulation less than realistic. Awrey *et al* believe that with changes to the corporate governance and incentive programmes within firms, the limits of law and regulation may be overcome.[28]

Borg and Hooker take the view that relationship between firms and customers is a ultimately a moral issue, arguing that banks have a wider social responsibility, and suggesting the *pro-bono* model found in the legal profession as an admirable way of utilising their skills in a positive fashion rather than just deploying financial assets as part of their Corporate Social Responsibility programmes.[29] Such an approach could help rebuild trust by connecting with the wider public. Their suggestion that errant bankers should undertake a type of public remedial training to 'improve their moral sensitivity', is interesting, but the commercial realities of the financial advice industry risk that this would become just another 'tick box' exercise.[30] Hudson argues the concept of unconscionability in equity should be seen as measuring what ought to have occurred and creating just outcomes. [31]

The Treating the Customer Fairly (TCF) regime was introduced by the FCA's predecessor in 2006,[32] with the aim of improving customer outcomes. The initiative extended to not only how customers were treated but also how products were designed and sold. Essentially it sought to make customers central to financial services firms and their transactions. The concept of fairness is of course elastic and subjective. Notably the TCF approach is not based on any new rules but the correct application of existing rules as outlined in PRIN and COBS. While this is not the same as a moral approach to finance it should be seen as an attempt to change banking culture but given its existence of nearly one and half decades, and the persistence of issues, its effectiveness should be questioned.

It seems that there is a role for change in the culture and ethics of financial services. The concepts of trust, integrity and 'doing the right thing' are to some extent woven into the regulatory framework, but with limited effectiveness. However, balancing these with the transactional nature of financial services and realities of making a profit as is not straightforward. It may be aspirational, but the ethical and moral aspects of finance should be borne in mind by regulators, advisers, lawyers and their impact on customers when designing regulatory systems and judging their effectiveness.[33] The leadership of banks and other financial institutions should also regularly check that their moral compasses have not drifted like the hapless Mr Diamonds appear to have done.

References

[1] See *London Joint Stock Bank Ltd v Macmillan* [1918] AC777

[2] The key principles outlined in *Greenwood v Martins Bank Ltd* [1933] AC51 are just as relevant to modern banking problems

[3] The case of *Hing Cotton Mill Ltd v Liu Chong Hing Bank Ltd* [1986] AC 80, raised the possibility of customers owing wider duties to banks, but this rejected on appeal

[4] Evidence by Barclays Bank CEO Bob Diamond to HM Treasury Select Committee – 4 July 2012

[5] See https://www.home.barclays/about-barclays/history/our-quaker-roots.html.

[6] FCA, *Discussion Paper on a duty of care and potential alternative approaches*, DP18/5 July 2018

[7] FCA, *A duty of care and potential alternative approaches: summary of responses and next steps*, Feedback Statement, FS19/2 April 2019

[8] https://www.finance-disputes.co.uk/2018/09/fca-caseload-at-record-levels-despite-dropping-more-cases-than-ever/?utm_source=Squire+Patton+Boggs+-+UK+Finance+Disputes+and+Regulatory+Investigations+Blog&utm_campaign=14cebf4b17

[9] https://www.lseg.com/careers/graduate-and-internship-programmes/about-us/our-culture

[10] https://www.esma.europa.eu/policy-rules/mifid-ii-and-mifir

[11] Alexander Lamfalussy devised this approach, the methodology was adopted in wider financial regulation in the EU, see the "Lamfalussy" report: https:// http://www.esma.europa.eu/ sites/ default/files/ library/2015/11/lamfalussy_report.pdf

[12] For example, *Thomas v Triodos Bank* NV 2017 EWHC 314 (QB), where adherence to the British Banking Code was judged to give rise to an intermediate duty of care to explain a product beyond that not to mislead or misstate

[13] List of global systemically important banks (G-SIBs) http://www.financialstabilityboard.org/wp-content/uploads/r_141106b.pdf

[14] For example see Dutch Hoge Raad, NJ/1999/285, *Mees Pierson/ Ten Bos*, 9 January 1998

[15] *O'Hare and another v Coutts & Co* [2016] EWHC 2224 (QB)

[16] Richard Furlong, *Bankers' oaths or being nicer chaps? Banking reform in the Netherlands and the UK compared*, JIBFL, No.6 (2014) 383

[17] Financial Conduct Authority, Senior Managers Regime, 5 (2016)

[18] The FCA has signalled it plans to extend the scheme to all FCA registered firms, see 'Individual Accountability: Extending the Senior Managers & Certification Regime to all FCA firms', FCA Consultation paper CP 17/25 (July 2017)

[19] FT: UK Regulators criticised for fine on Barclays Chief, 20 April 2018, https://www.ft.com/content/f8a5160e-4482-11e8-803a-295c97e6fd0b

[20] For a helpful explanation of the current state of UK case law see Gerard McMeel, '*Every word you just said was wrong*' *Holding banks to higher standards*, JIBFL, No. 4 (April 2018) 218

[21] See Lloyd Maynard, *Holmcroft Properties: will a contractual phoenix rise from its ashes?* JIBFL Vol. 31 No. 6 (June 2016) 358

[22] Reputedly major banks have litigation budgets valued in billions of pounds.

[23] Richard Samuel, *Tools for changing banking culture: FCA are you listening?* Capital Markets Law Journal, Vol. 11, No. 2 (2016)

[24] MiFID, Art 19(1) and MiFID II, Art 24(1)

[25] For a fuller exploration of this, see Martin Berkeley, *Do the FCA's Principles for Business require a firm to give the best advice?* JBIFL, Vol 33, Issue 4 April 2018

[26] For analysis of how the concept of 'fairness' is problematic for regulation see Niamh Moloney, *How to Protect Investors: Lessons from the EC and UK*, Cambridge University Press (2010), 219-223

[27] FCA, Principles for Business, https://www.fca.org.uk/about/principles-good-regulation

[28] Awrey, Dan and Blair, William and Kershaw, David, '*Between Law and Markets: Is There a Role for Culture and Ethics in Financial Regulation?*' Delaware Journal of Corporate Law Vol. 38, 191 (2013)

[29] Emma Borg and Bradford Hooker, '*Epistemic Virtues Versus Ethical Values in the Financial Services Sector*' Journal of Business Ethics, ISSN 1573-0697 (25 April 2017)

[30] Ibid.

[31] Alistair Hudson, '*Conscience as the Organising Concept of Equity*' Canadian Journal of Comparative and Contemporary Law Vol. 2, 267 (2016).

[32] Financial Services Authority, *Treating Customers Fairly – towards fair outcomes for customers.* July 2006

[33] For a fuller discussion of these dilemmas see John R. Boatright '*Trust and Integrity in Banking*' Ethical Perspectives 18, no. 4 473-489 (2011).

Author

Martin Berkeley is Director of Corvinus Capital, guest lecturer at the Alliance Business School Manchester, ESCP, University of Reading Law School and module tutor for the University of London Global MBA. Email: martin.berkeley@corvinuscapital.com

Open Review of Management, Banking and Finance

«They say things are happening at the border, but nobody knows which border» (Mark Strand)

Banking contracts and Sharia rules within the European Union framework

by **Gabriella Gimigliano**

Abstract: *The paper deals with the application of Sharia rules within the European legal framework for banking contracts. It attempts to ascertain whether Sharia rules can be legally enforceable in contracts made between a Muslim client and a bank. The paper comprises five sections, all of which refer to the European legal framework. In section 1, the paper provides for the three catchwords of the analysis, "integration", "Sharia" and "contract"; in section 2, the paper focuses on the scope of the non-discrimination principle on the grounds of religion; section 3 aims to clarify who the parties of the contracts at issue are with a view to ascertaining whether a European credit institution is per se entitled to provide Sharia-complaint products; section 4 points to the principle of incorporation and how it might make Sharia rules operate as applicable law or contracting terms. Finally, section 5 draws some conclusions.*

1. The paper deals with the application of *Sharia* rules within the European legal framework for banking contracts. It attempts to ascertain whether *Sharia* rules can be legally enforceable in contracts made between a Muslim client and a bank.

The analysis is based upon three catchwords: "integration", "*Sharia*", and "contract" and argues that *Sharia* may be regarded as a factor in the European integration process, which is based on the values of democracy and pluralism; the main point is that the application of *Sharia* rules within the EU-based framework for banking contracts may be frustrated on the grounds of legal uncertainty.

The first catchword at issue is "integration". The EU is a legal order based upon a process of approximation of Member States' legal systems to pursue its own objectives, as laid down in the Treaties and clarified by the jurisprudence of the Court of Justice. Therefore, any attempt to accommodate *Sharia* rules within the European framework must be based upon articles 2 and 3 of the

Treaty on European Union (hereafter, TEU). Art. 2 establishes that «The Union is founded on the values of respect for human dignity, freedom, democracy, equality, the rule of law and respect for human rights, including the rights of persons belonging to minorities. These values are common to the Member States in a society in which pluralism, non-discrimination, tolerance, justice, solidarity and equality between women and men prevail».

Among the Union's objectives, art. 3, §3 TEU provides for combatting discrimination and social exclusion, as well as establishing an internal market, defined as «an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of the Treaties»[1].

The term *Sharia* may be translated as *Divine Law*; the word literally means «the road leading to water» or the «way to the source of life»: for Muslims, the Way was revealed by God through His most important Prophet, Muhammad. God's revelations were collected in the *Quran* (the Holy Book), while the *Sunna* contain the Prophet Muhammad's examples, which have been relayed as an authenticated report of His lifetime. They encompass all aspects of human life[2] and establish broad principles as well as specific models for the family, commercial activities, banking, and financial operations[3].

Generally speaking, *Sharia* may be characterised according to its approach to money and property. Indeed, money is considered as potential capital, because it needs human effort to make it productive, or as a «monetized claim of its owner to property rights created by assets» obtained either by combining individuals' creative labour and natural resources or by making exchanges[4]. In turn, property is driven by a "sharing" logic: it is argued «Being God the only Creator and Owner of everything in the universe, His order (*hukm*) guarantees per se the justice of any property right (*haqq*), which is not the "right" of a person against the "right" of another person (as in the Western tradition), but the "right" of a person with the corresponding "obligation" of another person, linked together in a constant unity (*tawhid*)»[5].

From this approach to money and property follow two basic *Sharia* principles: the prohibition of *riba* and *gharar*. Generally speaking, *riba* means "increase" and covers any excess in the principal that is not "justified" by the risk associated with the use of money, both in exchanges and investments. However, this risk is not the same as credit or liquidity risk. Rather, it is the risk that being a partner in an economic activity may end up resulting in lower profits than excepted or none at all; in addition, it is the risk that something bought is destroyed or damaged before taking title of it, while the price is being paid in instalments[6]. *Gharar* means risk and it covers the sale of risk itself and the transaction involving excessive uncertainty. Traditionally, scholars teach that «while it is not allowed to sell the fetus of a camel in the womb, it is allowed to sell a pregnant camel and for more money than a similar but non-pregnant camel»[7].

Lastly, the third catchword is "contract": according to the 2002 Principle of European Contract Law (or PECL), this is a multilateral or bilateral juridical act, namely an «agreement which is intended to give rise to a binding legal relationship or to have some other legal effects»[8].

The PECL code is a set of general principles of law drawn up by European academics and applied by the contracting parties on a voluntary basis, namely when the parties incorporate them into the contract, when the parties have agreed that their contract is to be governed by the "general principles of law", the "*lex mercatoria*", or the like, and, ultimately, when the parties have not chosen or agreed on any system of law to regulate their contract[9].

In addition, the institutional legislative process has laid down some binding law rules. By no means exhaustively, one may refer to the directives on e-money, the directive on distance marketing in the provision of financial services, those on payment services in the internal market, and so forth. Although they enjoy a different scope and level of harmonisation, they established a higher level of protection for consumer clients, laying down a set of compulsory rules[10].

However, this paper does is not concerned with contracts in general. It deals with the process of accommodation of *Sharia* rules in banking contracts, i.e., contracts drawn up between a credit institution and a client, either a consumer or an entrepreneur. It must be borne in mind that, within the European Union framework, credit institutions are licensed entities, and they may be authorised to provide not only the core banking business and those banking activities listed in the 2013 banking directive annex[11] but also investment services[12].

The MiFID 2 directive has laid down a series of contract terms and business conduct rules on the provision of financial services[13]. Indeed, MiFID 2, building on the MiFID 1 directive[14], maintained all its main principles, including the duty of credit institutions and investment firms to act fairly and in the best interests of their clients, their obligation to provide clients with information; the assessment of suitability and appropriateness of investment services and financial instruments for investors, the obligation to execute orders in the terms most favourable to their clients and in compliance with specific client order handling rules. In addition, amending MiFID1, MiFID 2 has laid down *a)* a harmonised regime for the access of investment firms and market operators of third countries (countries other than the European Union Member States) that seek to provide services to eligible EU counterparts, «specific rules on the product governance (creation and distribution of financial products), new duties of information on costs and charges in the service provider-customer relationship»[15], giving less or no leeway to contracting parties in the process of negotiation and drafting contract terms. This is the reason why this paper prefers to focus on *Sharia*-compliant contracts drawn up between a credit institution and a client with the banking business as their object.

The paper comprises four further sections, all of which refer to the European legal framework. In section 2, the paper will focus on the scope of the non-discrimination principle on the grounds of religion; section 3 aims to clarify who the parties of the contracts at issue are with a view to ascertaining whether a European credit institution is *per se* entitled to provide *Sharia*-complaint products; section 4 points to the principle of incorporation and how it might make *Sharia* rules operate as applicable law or contracting terms. Finally, section 5 draws some conclusions.

2. Good operation of the internal market and the construction of a European Union as a pluralistic and inclusive society depend also on the correct application of the principle of non-discrimination on grounds of religion or beliefs, as laid down in articles 10 and 19 TFEU, framing the *Sharia* accommodation process in the EU-based framework for banking contracts.

The EU-based framework contains no general definition of “discrimination”; by contrast, any directives aiming to combat forms of discrimination provide their own definition peculiar to the rules of the directive to be applied. Nor has European jurisprudence filled this regulatory gap. However, it has been suggested – and I agree with this solution – to borrow a workable definition from the Canadian Supreme Court case law, according to which discrimination is «a distinction, whether intentional or not but based on grounds relating to personal characteristics of the individual or group, which has the effect of imposing burdens, obligations, or disadvantages on such individual or group not imposed upon

others, or which withholds or limits access to opportunities, benefits, and advantages available to other members of society. Distinctions based on personal characteristics attributed to an individual solely on the basis of association with a group will rarely escape the charge of discrimination, while those based on an individual's merits and capacities will rarely be so classified» [16].

Art. 10 TFEU provides that «In defining and implementing its policies and activities, the Union shall aim to combat discrimination based on sex, racial or ethnic origin, religion or belief, disability, age or sexual orientation», while, according to art. 19 TFEU, «Without prejudice to the other provisions of the Treaties and within the limits of the powers conferred by them upon the Union, the Council, acting unanimously in accordance with a special legislative procedure and after obtaining the consent of the European Parliament, may take appropriate action to combat discrimination based on sex, racial or ethnic origin, religion or belief, disability, age or sexual orientation».

Considering articles 10 and 19 TFEU as the leading primary rules, there are at least three questions to deal with regarding the process of accommodating *Sharia* rules.

Firstly, one wonders to what extent such Treaty rules compel the EU institutions or the Member States to remove any legal obstacles that may make *Sharia*-compliant transactions more difficult or less convenient rather than conventional ones. In other words, does the Treaty prescribe a "duty of action"? One such issue might be the case of double stamp duty. Whenever a Sharia-compliant sale-based business operation is performed within a conventional legal system, an issue of double-stamp duty may arise.

Sharia forbids Muslims to pay (or receive) an increase on a sum of money lent; it is a form of *riba*. The Sharia legal tradition therefore provides for alternative legal instruments to achieve the same economic result, for example entering sale-based transactions, such as *murabaha*, literally, a mark-up sale with a commission to purchase. According to the *murabaha* model, a customer entrusts a bank with purchasing the goods and reselling them to him; the bank assumes ownership of the assets before transferring title to the assets to its customer, calculating the sale price as "an agreed mark-up over its own costs". This means that that there are two transferrals of assets, one from the supplier to the bank and the second from the bank to the customer[17]. This double step implies a double stamp duty making *murabaha*-based transactions more expensive than conventional ones[18].

There is another point worth mentioning: in the event of political inertia, can European citizens enjoy the effects of articles 10 and 19 TFEU directly? According to the principle of direct effect of European law rules, any individual is entitled to invoke a European provision before a national or European court with a view to ensuring the application and effectiveness of EU law throughout the Member States. Although it is a fundamental principle of European law, its application is subject to several conditions.

Closely connected to the direct effect principle is the vertical and horizontal application of articles 10 and 19 TFEU. These concern the relations between individuals and the Member States and the relations between individuals respectively. Thus, one wonders whether the principle of non-discrimination on the grounds of religion or beliefs enables the Union (or the Member States) to intervene in Sharia-compliant contract terms given that, according to art. 1.102 PECL, paragraph 1, «Parties are free to enter into a contract and to determine its contents, subject to the requirements of good faith and fair dealing, and the mandatory rules established by these Principles».

The first observation to be made is that the Treaty in force renumbered art. 13 of the Treaty of European Communities (TEC) as art. 19 TFEU, while art. 10 represents something new. Both of them lack a definition of "religion"[19], both outline the principle of non-discrimination as a cross-sectoral

principle[20], and both cover the negative and positive harmonisation processes in the internal market[21].
Under art. 13 TEC, there was no duty of regulatory action either on the national policymakers or on the European Community. This aspect illustrates the difference with regard to the non-discrimination principle on the grounds of nationality or sex[22]. The conclusions seem unchanged within the framework of art. 10 and 19 TFEU[23]. Interestingly, it has been noted that the legislative institutions enjoy a «broad power of appreciation» over appropriate action, which is considered as a political issue[24].
Concerning the direct effect (both vertical and horizontal the Court of Justice has stated the direct effect of non-discrimination as a general principle of (EU) law, both in vertical and horizontal terms, as far as primary or secondary rules are concerned. However, this approach has raised some doubts: a number of scholars have argued that the general principles of law are principles of interpretation and therefore do not confer rights on individuals. In addition, also those scholars who agreed with the Court of Justice on the direct effect above apply it only to the relationship between the individual and the State[25].
However, in *Egenberger*, the Court of Justice established that it is the Charter of Fundamental Rights (the Charter), rather than a secondary source of law, that justifies a horizontal application of the principle of non-discrimination on the grounds of religion or belief. This implies that «The prohibition of all discrimination on grounds of religion or belief is mandatory as a general principle of EU law. That prohibition, which is laid down in Article 21(1) of the Charter, is sufficient in itself to confer on individuals a right which they may rely on as such in disputes between them in a field covered by EU law». As the direct horizontal application has been stated, one wonders when the Charter is in fact applicable[26].

3. The banking contracts in question are those between a Muslim customer and a *Sharia*-compliant bank.
A customer is a consumer or a professional adhering to *Sharia* precepts[27]. In the European legal framework, there is a general definition of consumer and entrepreneur, but the 2011 Consumer directive provides that a “consumer” is a «natural person who, in contracts covered by this Directive, is acting for purposes which are outside his trade, business, craft or profession», while a “trader” is «any natural person or any legal person, irrespective of whether privately or publicly owned, who is acting, including through any other person acting in his name or on his behalf, for purposes relating to his trade, business, craft or profession in relation to contracts covered by this Directive» [28].
On the opposite side of the contract there is a bank. According to the European legal framework for credit institutions, these are legal entities with their head office and central administration in the same Member State, authorised to operate a banking business[29]. The status of legal person might raise some doubts according to classical Islamic law, which only provides for partnerships rather than limited liability companies. However, considering that it would be extremely cumbersome to organise a bank (or an investment fund) as a partnership, Sharia legal scholars have reached the conclusion that banks, investment firms, or investment funds, may be formed as corporations or stock companies, accepting the idea that they only adhere to the basic principles of Islamic partnership law, «not to all rules in details»[30].

It worth noting that if a conventional bank is authorised to provide, among other things, *Sharia*-compliant products and services, it is supposed to set up an Islamic window, namely, a business line financially separate from the rest[31].

However, it might also be an Islamic credit institution based within the Union, either a branch of a third-country Sharia-compliant bank or an EU-based Islamic bank. In the latter case, it is a legal entity authorised to carry on banking business in accordance with the European banking framework, with its head office and central administration in a Member State.

In economic terms, both *Sharia*-compliant and conventional credit institutions perform a maturity transformation function: indeed, they are legal entities collecting repayable funds from the public and extending credit. However, analysing the asset and liability sides, there is a creditor/debtor relationship between the customer and the bank in conventional banking business, while traditionally *Sharia*-compliant business activity is based upon a partnership model.

Within the EU framework, a credit institution is defined as an «undertaking whose business is to receive deposits and other repayable funds from the public and to grant credits for its own accounts»[32], where the link between the two prongs is of paramount importance[33]. The asset and liability operations have in common the transfer of ownership of the monies "borrowed" and "deposited". The borrower acquires title to the funds, and agrees to pay back to the bank the sum of money plus an interest rate on the expiry date; the interest rate is fixed in advance, whatever the degree of profitability the funds are used for. In turn, the bank assumes title to the funds deposited by the client and is entitled to use them to extend credit, acquire shares in undertakings, and make investments within the limits established by the 2013 Banking Directive and Regulation as well as by supervisory authorities' regulations. However, the bank itself will be ready to pay the deposited monies back on the client's demand or whenever the client issues a payment order.

On the asset side, the prototype operation lies in the deposit contract: the term comprises «any credit balance which results from funds left in an account or from temporary situations deriving from normal banking transactions and which a credit institution must repay under the legal and contractual conditions applicable, and any debt evidenced by a certificate issued by a credit institution»[34]. Indeed, there exists a broad concept of demand deposit. It also covers bonds and other repayable funds: not only the «financial instruments which possess the intrinsic characteristic of repayability, but also those which, although not possessing that characteristic, are the subject of a contractual agreement to repay the funds paid»[35].

On the liability side, European banking legislation contains no definition of lending activity. However, the Consumer Credit directive sets out the definition of "consumer credit agreement" as an «agreement whereby a creditor grants or promises to grant to a consumer credit in the form of a deferred payment, loan or other similar financial accommodation, except for agreements for the provision on a continuing basis of services or for the supply of goods of the same kind, where the consumer pays for such services or goods for the duration of their provision by means of installments»[36]. Likewise, the previous version of the Consumer Credit Directive defined the "credit agreement" as «an agreement whereby a creditor grants or promises to grant to a consumer a credit in the form of a deferred payment, a loan or other similar financial accommodation»[37]. The creditor-debtor contract relationship is not consistent with *Sharia* rules in more than one aspect.

Firstly, the paying out of interest on the sum of money borrowed or deposited[38]. This commercial practice does not comply with *riba* prohibitions. An ancient *hadith* states that any exchanges between

fungible goods belonging to the same class (for example, money for money, food for food, goods sold by volume and so forth) is forbidden unless the contracting parties perform their obligations immediately. Therefore, every exchange of debt for debt is deemed a gratuitous contract[39].

Secondly, *Sharia* provides for a partnership relationship between the client and the bank both in the extension of credit and in the collection of repayable funds. There are two leading models: *mudaraba*– and *musharaka*-type operations.

The former approach requires a capital provider ("silent partner") and an entrepreneur ("active partner") contributing either their own capital or their time and work to the venture. Therefore, both of them are entitled to a pro-rata basis return; conversely, all losses fall solely on the capital provider, while in the case of returns lower than expected or no returns at all, the entrepreneur has already lost his time and efforts[40]. The latter partnership model has the appearance of a partnership in ventures where the bank and other partners contribute capital or work to the venture together with their client: all of them participate in the business management as well as in the profits and losses according to a predetermined ratio proportionate to their stakes[41].

Both profit-and-loss sharing models may be applied to the asset and liability sides of the banking business. Taking, for example, the *mudaraba*-based approach, on the liability side, the client acts as the "silent partner" and the bank as the "active partner": however, in conventional terms, this contract relationship is more comparable to portfolio management on an individual basis rather than conventional sight deposits, where the depositor is a riskless creditor[42]. In turn, on the asset side, the client is the "active partner", while the bank is the "silent partner": however, the conventional borrower is a debtor and, most of the time, he/she has to reimburse the capital according to a predetermined interest rate either in instalments or on the spot, whatever the actual returns may be.

From the above observations, it would seem that the client-bank relationship in conventional banking business is not comparable to the *Sharia*-compliant one: the former is based upon a creditor-debtor relationship, while the latter is rooted in a partnership model. However, the legal analysis is far from being black and white.

Initially, legal analysis of the accommodation process may be relaxed by the enforcement of the teleological approach, typical of the European legal frameworks. As a general rule, the European Courts have provided the so-called *effet utile* doctrine, which reads as: «a corollary to the teleological method of interpretation adopted by the ECJ judges in order to apprehend the meaning of Community law in light of its purpose. Accordingly, once the purpose or end of a legal provision is clearly identified, the detailed terms shall be interpreted in order to produce the desired effect». This means that any comparison between activities and services provided by Sharia rules and conventional rules is a long way from being made on a formal basis[43].

Moreover, on the liability side, the conventional and Islamic models of banking business provide for comparable sight or demand (or call) accounts. *Sharia*-compliant sight deposits are demand deposits, repayable at par on demand, but the bank – as active partner – may use these funds to make PLS investments; the bank is enabled to use the deposit funds, but "guarantees the repayment of the entire amount of money at any given moment"; in turn, the depositor is entitled to place and withdraw funds on demand, as well as to execute and receive payment transactions[44].

This means that a Muslim customer entering a contract with a EU-based Sharia-compliant bank may enjoy the advantages of the monetary function of banking exactly like a non-Muslim customer entering a payment account or a deposit account contract with a conventional credit institution based in Europe.

On the asset side, Islamic banks can also provide non-PLS funding. Indeed, the provision of funding on a mark-up basis establishes a creditor-debtor relationship between the bank and the "borrower". One of the most common non-PLS financing modes is *murabaha*. In *murabaha*-based transactions, banks and customers enter into sale-based transactions. The bank finances the purchase of an asset by buying the item on behalf of the client and then resells it to the client adding a mark-up. It is a cost-plus profit contract: the mark-up is the service price. Moreover, the bank provides funds entering into an *Ijara* financing: this resembles either an operating lease or a financing lease. In the *ijara*-operating lease, the bank-lessor transfers the usufruct of the item to the customer, while the lessee is entitled to use it on payment of specified rentals over a certain period; otherwise, in the *ijara*-financing lease, the bank-lessor buys the asset and leases it to the borrower-lessor. If the latter opts to buy it, the monthly payments will cover both the rentals for their use and the instalments towards the purchase price. In the teleological approach, mentioned above, some non-PLS transactions – the *ijara* especially – show some functional-based similarities in relation to passported activities, i.e. financial activities other than banking business subject to the principle of mutual recognition and listed under article 1, para. 2, letter *f*[45].
In the end, being a *Sharia*-compliant credit institution in the EU may be more expensive, but this does not impede operating in the EU as such or entering a contract with a consumer or a trader.

4. The terms of banking contracts may be implied by statute: within the European legal framework they are governed by directives and regulations. This is the case of the 2007 and 2015 Payment Service Directives, which provide for preliminary information duties on charges, fees, and normative conditions; this information will form the backbone of the payment services contract. In addition, the 2009 e-money directives defines e-money as an electronic currency and regulates the main contents of an e-money issuance contract between an issuer (for example, a credit institution) and a holder (be it a consumer or a trader) from the points of view of the e-money issuance process the e-money issuer is in charge of performing, the paying-out of interest, and other benefits on e-money balance, or the main contents and costs of the right to redeem conferred upon the e-money holder[46].
With a view to using the same technique to incorporate Sharia rules within banking contracts, a supporting argument is that the parties' freedom to choose the law applicable is one of the cornerstones of the system of conflict-of-law rules in the field of contractual obligations. However, Sharia rules are generally not State-based rules, and neither the 1980 Rome I Convention[47] nor the 2008 European Regulation on the law applicable to contractual obligations support this construction[48]. While the 1980 Rome I Convention, that sets out the parties' freedom of choice, established that «The rules of this Convention shall apply to contractual obligations in any situation involving a choice between the laws of different countries»[49], the 2008 European Regulation confirms the choice of the law as the law of a country, but, provides that «This Regulation does not preclude parties from incorporating by reference into their contract a non-State body of law or an international convention»[50]. Which are the «non-State bodies of law»? What does this concept cover? According to the Commission proposal for 2008 regulation, the rationale behind the preamble (13) was to boost the impact of the parties' will and «would authorise the choice of the UNIDROIT principles, the Principles of European Contract Law or a possible future optional Community instrument, while excluding the *lex mercatoria*, which is not precise enough, or private codifications not adequately recognised by the international community»[51].

However, *Sharia* rules turn out to be more comparable to *lex mercatoria* than to Unidroit principles or PECL rules. Since the medieval age, the *lex mercatoria* has always mirrored the needs of the merchant community, developed through a bottom-up process, promoted by the mercantile corporations and the special jurisdiction of the mercantile courts with a view to supporting the freedom of contract and a fair-and-just (*ex aequo et bono*) decision-making process. In the modern age, the *lex mercatoria* is still recognised as a driving force in the creation of a uniform, «customary, spontaneous and thus non-statutory» legal order, while its development has been fostered by non-governmental institutions like the International Chamber of Commerce (ICC)[52]. Sharia rules: *i)* characterise the Muslim community, covering both religious and commercial activities, apart from the nation-State the community members belong to; *ii)* express the idea of «a theory of property rights centred on an "equal sharing" of economic resources» and postulating a primacy of real economy over finance, (b) a theory of obligations where money is more than a commodity, and works as a means of exchange and investment in real activities, and (c) where labour and investment are the only legitimate instruments for acquiring property»; *iii)* are the outcome of a bottom-up normative process, because the leading sources of law are the Quran and Sunna, the holy book and the Prophet's example respectively, together with Islamic jurisprudence, which has arisen through the interpretation of legal experts, the so-called *Sharia* scholars; *iv)* are based on the interpretative activity (*fiqh*): while the divine law is always perfect, the «human comprehension of that law» is merely a supposition of what God's law truly is; it explains that there are several schools of (*Sharia*) law, but they are not organised hierarchically; v) in the end, AAOIFI is performing a valuable task in the process of developing and disseminating accounting, governance auditing concerning the activities of Islamic financial institutions and its application, and harmonising the accounting policies and procedures adopted by Islamic financial institutions[53].

The second legal technique available is so-called incorporation by reproduction. It means that the contracting terms are drafted in such a way as to cover every aspect of the contracting relationship. This mechanism is consistent with the standard and one-sided nature of banking contracts. Furthermore, incorporation by reproduction seems to meet the information requirements provided by the European lawmaker for the need for legal certainty and the predictability of contracting rules. Indeed, once all relevant *Sharia* rules have been inserted in the contract since the beginning, no "*Sharia* risk" should arise from the contracting relationship: the "Sharia risk" is interestingly defined as «the chance that an Islamic financing transaction is challenged on grounds that it does not comply with Islamic law»[54].

Incorporation by reproduction seems to be a workable solution as long as the scope is quite narrow, like the framework contract for the provision of payment services, for example. By contrast, if the banking contract is of a broader scope, covering the provision of payment services, or deposit and credit transactions, it would not seem sensible to lay down any *Sharia* rules to be applied from the beginning, not least because it is difficult to foresee the nature of the banking operations that will be performed in either the near or more distant future.

As a third option, one might turn to so-called incorporation by reference. It entails inserting into the contract one or more clauses that refer to a set of non-State rules in order to lay down the rules on the contracting parties' obligations. The statement often reads as follows: «Subject to the principles of Glorious Sharia, this agreement shall be governed by and construed in accordance with the laws of ... (a Country)». Incorporation by reference may provide great advantages in terms of flexibility. Since it refers to either all the *Sharia* rules or only the relevant *Sharia* rules according to the main purpose of

the contract, a clause like this can cover all possible operations that may be performed throughout the duration of long-term contracts or framework contracts such as banking contracts. However, the flexibility of this clause may challenge the principle of legal certainty enshrined under the European Principles of contract law and the freedom of contract. Indeed, notwithstanding the doubts raised on the boundaries of the law of contractual lien, the ground rules of contracts must be highly foreseeable by the parties and clearly identified when such rules are to be enforced in national jurisdictions.

There is no case on this issue in the Court of Justice's jurisprudence, but there are interesting examples in English case law. In *Shamil Bank of Baharain v. Beximco Pharmaceuticals Ltd. and others*[55], *Musawi v RE International (UK) Ltd and others*[56], *Halpern and others v. Halpern and others*[57] the above-mentioned incorporating clause had been inserted by the contracting parties with regard either to *Sharia* rules or to *Jewish* rules, but referred to English law as the applicable law of the contract in all of them. Thus, the English courts were requested to ascertain the intention of the parties to be bound to a commercial contract containing the said clause.

It is interesting that although the English contract law legal tradition has largely refrained from burdening the contracting parties, in the above-mentioned proceedings the English courts ruled against *Sharia* as legally enforceable rules because it ran counter to the essential need for legal certainty and the predictability of contracting terms.

From the courts' reasoning one might infer that,

- the contracting terms should sufficiently identify "black letter"[58] provisions, i.e. the basic rules of the non-State law to be incorporated by reference, provided that the courts are not entitled to make the contract for the parties (*sub* a). Indeed, in Beximco case law, once it has been ascertained that the reference to the principles of *Sharia* was a reference to the whole body of *Sharia* law, the court of appeal held that «Thus, reference to the principles of Sharia stands unqualified as a reference to the body of Sharia law in general. As such they are inevitably repugnant to the choice of English law as the law of the contract and render the clause self-contradictory and therefore meaningless»[59];
- the doctrine of incorporation by reference is properly applied when the contract may be construed and applied by the court pursuant to the contract's governing law. This means that the court should call for expert advice only at the end of the interpretation process carried out according to, for instance, English law. Otherwise, as Mr Justice Clarke in Halpern *vs* Halpern stated, «(...) Those laws [i.e.: *the applicable laws*] would only be a shell in which to incorporate a different non-national law»[60];
- non-State rules are considered "apt" to be incorporated by reference when they are consistent with the secular role of English courts. With regard to *Sharia* rules, one might agree that there was a broad consensus on the general principles as they were expressed in the Holy Books but should also admit that their enforcement through specific rules would involve secular courts in controversial religious disputes[61].

The criticisms from the English courts raise, once again, the issue of the legality of *Sharia* rules. Following the third approach (incorporation by reference), which allows the contracting parties to enjoy some degree of flexibility, one may point to three possibilities:

- *Sharia* rules as trade usage[62]. Indeed, it does not appear persuasive that *Sharia* rules were treated as customs implied in the contracts. Customs, like *Sharia* rules, come from a bottom-up regulatory process because they are not the result of concerted agreements or bargains.

However, the European lawmaker addressed the legal certainty of contracting terms and their uniform application among its founding principles in the 2002 Principle of European Contract Law (or PECL)[63]. PECL principles cover trade usage and establish that «The parties are bound by any usages to which they have agreed and by any practice which they have established between themselves. Unless agreed otherwise, they are considered to have impliedly made applicable to their contract or its formation a usage of which the parties knew or ought to have known and which in international trade is widely known to, and regularly observed by, parties to contracts of the type involved in the particular trade concerned»[64]. However, trade usage is applied (when enforceable) only in transactions between businesses. This means that addressing Sharia rules as trade usage does not allow us to cope with contracts drawn up between a bank and a Muslim consumer or a micro-enterprise[65].

- *Sharia* as a legal system (or an «emergent legal system»). *Sharia* rules are legal precepts according to a pluralistic approach, as Santi Romano, a leading Italian jurist, puts it. In his construction, a legal system (or institution or legal order) is made up not only of rules of conduct, but first and foremost, of rules of organisation[66]. At the heart of Santi Romano's theory is the idea of community, regarded as an organisation embodying a social order. It means that where there is a group of persons with or without legal personality, displaying a more or less complex organisation, there is a legal system and, as a consequence, an institution. This means that the concept of legal system departs from any religious, ethical, political purposes pursued and becomes a matter of form: it needs organisational rules, namely rules addressing the authority entrusted with legislative power, the procedures to lay down and enforce the rules of conduct, and, in the end, the conditions of membership of the social organisation. At the same time, Romano's approach argues that any organised social force may be considered a legal order: «[T]here can be multiple legal orders, each corresponding to a different social force (variously embodied in, and represented by, an ideal, a common purpose or an aspiration)»[67]. However, EU law and the European jurisprudence tend to address the "legal system" as a State legal system due to the demand for legal certainty. This might explain why a contemporary legal scholar has cautiously addressed *Sharia* as an emergent legal system: «Looked at from a Western, positivist perspective, that legal system appears rather strange, for there are no signs of the usual Western sources of law, i.e. legislation and case-law. However, it does have norm-creating mechanisms. The institutional creation of "standards", the collecting of fatwas, the organic forces mentioned above, including such processes as the consensus of scholars, standard documentation, and the search for guiding principle: all are creating certainty and uniformity in legal rules»[68].
- *Sharia* rules as general clauses. They are all juridical prescriptions to be applied through reference either to other legal precepts or to notions falling outside the general legal framework, such as cultural, technical, or social rules. This is the case for the precautionary principle, good faith, fair trading, or the concept of artistic value. Thus, EU law and the European Court of Justice are familiar with this type of concept as seen in the directive on misleading advertising, the trademark directive, and the unfair terms directive, such as "good faith", or general terms such as "likelihood of confusion" and "significant imbalance". It is argued that there is no reason to conclude that those legal terms do not fall within the jurisdiction of the Court of Justice, or, in

other words, that the national courts are entrusted with providing the final interpretation of such terms of contract by reference to national private laws[69].

4. The Union aims to build up an inclusive and pluralistic community firmly based on the non-discrimination principle. At issue is the principle of non-discrimination on the ground of religion and beliefs, which suffers from legal uncertainties on the level of application, but is it only a question of vertical application? It goes without saying that full application of the non-discrimination principle is an essential pre-condition for making the "internal market" work properly.

The main objective of this analysis was to investigate the process of accommodation of *Sharia* rules in banking contracts when a contract is made between a Muslim customer and a bank providing Sharia-compliant products and services or being a fully *Sharia*-compliant bank.

Firstly, this process is challenged by the lack of a comprehensive European framework for banking contracts and, in general, the lack of a European contract law. This means having to deal with a puzzling framework: there are cases, such as the provision of e-money and payment services, that enjoy a framework harmonised under several (though not all) aspects, but there are some others where the national lawmakers have much leeway in regulating banking contracts, for example, deposits and other bank transactions associated with reimbursable funds.

Secondly, this process of accommodation is challenged by difficulty in establishing the nature of Sharia rules within a conventional legal context given that they do not officially represent the law of a specific country. In contract law, there is a widespread demand for legal certainty. This is the main argument presented by the English court in the *Beximco* judgment.

Among the accommodation options set out in this analysis, preference is goes to a process of incorporation by reference, where *Sharia* rules are considered to be like general contract clauses or terms. Indeed, although my personal preference is for the construction of *Sharia* rules as a legal system or, at least, an "emergent legal system", the EU rules and regulations are more familiar with general clauses, for example, the "good faith" clause in the unfair commercial practices directive. One might suggest a different legal construction if the same problem were to be analysed at the national level.

References

[1] Art. 26 of the Consolidated Version of the Treaty on the Functioning of the European Union (TFEU).

[2] See, G. Bilal, *Islamic finance: alternatives to the Western model*, in *Fletcher F. Aff., 1999 (23), 143 ff.* wrote that «Islam, according to believers, is a social system imparted by Allah (God) to mankind»; while according to M.K. Lewis–L.M. Algaons, *Islamic Banking*, Edward Elgar Cheltenham, 2001, 25, «In any case, the *shari'a* is essentially a complex of rules to which individual adherents must adhere if they are to meet the requirements of their faith, irrespective of whether the observance of these is enforced by temporal authorities».

[3] The legal literature on Islamic finance is too vast to be listed exhaustively. See, in addition to the references mentioned in the previous footnote, M. Fahim Khan – M. Porzio (eds), *Islamic banking and finance in the European Union. A challenge*, Cheltenham: Edward Elgar, 2010; M. Kabir Hassan – M. L. Lewis (eds.), *Handbook of Islamic banking*, Cheltenham: Edward Elgar, 2007; B.L. Seniawski, *Riba today: Social equity, the Economy and Doing business under Islamic Law*, *Colum. J. Transnati'l L.* 2001 (39), 701; C. Mallat, *Commercial law in the Middle East: between classical transactions and*

modern business, Am. J. Comp. L., 2000 (48), 81; A.L.M. Abdul Gafoor, *Islamic banking and finance. Another approach*, The Netherlands: Apptec Publications, 2000; J.F. Jeznec, *Ethic, Islamic Banking and the global financial market*, *Fletcher World Aff.*, 1999 (23), 161; F. Vogel – S. L. Hayes III, *Islamic Law and Finance: Religion, Risk and Return*, The Hague and Boston: Kluwer Law International, 1998*;* S. Chinoy, *Interest-free banking: the legal aspects of Islamic financial transactions*, in *Journal of International Law*, 1995, 10(2), 517-524.

[4] Z. Iqbal – A. Mirakhor, *Islamic banking*, IMF: Washington D.C., March, 1987, 1 – 8.

[5] V. Cattelan, *Introduction. Babel, Islamic finance and Europe: preliminary notes on property rights pluralism*, in V. Cattelan (ed), *Islamic finance in Europe*, Cheltenham, UK, 2013, 1-12.

[6] F. Vogel, *Islamic finance: personal and enterprise banking*, in M. Fahim Khan – M. Porzio (eds), *Islamic banking and finance in the European Union*, 40 – 60.

[7] F. Vogel, *Islamic finance: personal and enterprise banking*, in M. Fahim Khan, M. Porzio (eds), *Islamic Banking and Finance in the European Union: A Challenge*, 49.

[8] *Amplius*, Study Group on a European Civil Code and Research Group on EC Private Law (2009), *Principles, definitions and model rules of European private law*. Draft Common Frame of Reference (DCFR), Sellier, European Law Publishers.

[9] Art. 1, PECL.

[10] Dir. 2000/46/EC of 18 September 2000, published in OJEU L 275/39, of 27.10.2000 on the taking-up, pursuit of and prudential supervision of the business of electronic money institutions; dir. 2009/110/EC of 16 September 2009, published in OJEU L267/7, of 10.10.2009 on the taking-up, pursuit and prudential supervision of electronic money institutions; dir. 2005/29/CE, of 11 May 2005, published on O.J.E.U. of 11 June 2005, L 149/22; dir. 2006/123/EC of 12 December 2006, published on O.J.E.U. of 27 December 2006, L 376/36; dir. 2007/64/EC of 13 November 2007, published in OJEU 319/1, of 5.12.2007 on payment services in the internal market.

[11] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC.

[12] According to Annex 1, section a, MIFID 2, the investment services and activities are: (1) Reception and transmission of orders in relation to one or more financial instruments; (2) Execution of orders on behalf of clients; (3) Dealing on own account; (4) Portfolio management; (5) Investment advice; (6) Underwriting of financial instruments and/or placing of financial instruments on a firm commitment basis; (7) Placing of financial instruments without a firm commitment basis; (8) Operation of an MTF; (9) Operation of an OTF.

[13] Markets in Financial Instruments Directive 2014/65/EU (MIFID 2).

[14] Markets in Financial Instrument Directive 2004/39/EU (MIFID 1).

[15] More details: Yeoh, MiFID II opportunities and regulatory challenges, Business Law Review 2018 (39), 126 – 135. The so-called "passporting regime" allows the investment firms and the credit institutions based in a Member State to provide those activities listed as financial services throughout the European Union, either establishing a branch or providing services from abroad, and a further license is needed in the host country.

[16] Case law: *Law Society of British Columbia* v. *Andrews*, [1989] 1 SCR 143; DLR. (4th) 1. More details in: L. Flynn, *The implications of article 13 EC. After Amsterdam, will some forms of discrimination be more equal than others?*, in *Common Market Law Review* (36), 1999, 1127 – 1152.

[17] F. Vogel, *Islamic finance: personal and enterprise banking*, in M. Fahim Khan, M. Porzio (Eds), *Islamic Banking and Finance in the European Union: A Challenge*, 52 f.

[18] The United Kingdom, for example, has removed double stamp duty. *Amplius*, FSA, *Islamic finance in the UK: regulation and changes*, November 2007.

[19] L. Flynn, *The implication of article 13 EC – after Amsterdam will some forms of discrimination be more equal than others?*, 1130 ff.

[20] Commenting on the *incipit* of art. 13 TEC («without prejudice to the other provisions of this Treaty...»), Flynn (L. Flynn, *The implication of article 13 EC – after Amsterdam will some forms of discrimination be more equal than other?*, 1133) argues that «One reading of Article 13 is, therefore, that as a result of this phrase all other Treaty provisions take precedence over it. However, the formula used in Article 13 EC may be intended to allow non-discrimination clauses to be inserted in legal instruments adopted on the basis of other Treaty provisions whose subject-matter, while relevant in the pursuit of equality, does not have this goal as their objective». Therefore, the Union or the Member States are entitled to take regulatory initiative according to the area concerned: it might be an area of exclusive competence of the Union, an area of Member State competence or, in the end, an area of shared competence. See: art. 2- 6 TFEU.

[21] The negative harmonisation process aims to remove any legal obstacles raised at the European or at State level which may impede the full application of treaty principles; the positive harmonisation process is based upon soft laws and compulsory secondary acts, such as directives, regulations and decisions. While the former is performed by the Court of Justice of the European Union, the latter implies the institutional legislative process, as amended thanks to the Lamfalussy approach. Concerning the positive harmonisation process, the principle of non-discrimination may, due to its cross-sectoral nature, allocate legislative competence to the Member States, the Union, or both of them, as it depends on the sector actually concerned.

[22] See: L. Flynn, *The implication of article 13 EC – after Amsterdam will some forms of discrimination be more equal than other?*, 1133 ff..

[23] G. Zaccaroni, *Non-discrimination on the ground of religion: a fundamental element of the EU constitutional legal order?*, University of Milan-Bicocca School of Law, Research Paper Series, 2018, n. 18-01.

[24] L. Flynn, *The implication of article 13 EC – after Amsterdam will some forms of discrimination be more equal than others?*, 1136 f.

[25] L. Flynn, *The implication of article 13 EC – after Amsterdam will some forms of discrimination be more equal than others?*, 1136 f.

[26] L. Flynn, *The implication of article 13 EC – after Amsterdam will some forms of discrimination be more equal than others?*, 9. In addition, the principle of non-discrimination on the grounds of religion is established also in the European Convention of Human Rights (art. 9): see, Human Rights Handbook, n.9, https://www.equalityhumanrights.com/en/human-rights-act/article-9-freedom-thought-belief-and-religion

[27] There is nothing to say that the client may be a Muslim; s/he may also be a non-Muslim opting for rules of this kind.

[28] Art. 2, n. 1-2, 2011 Consumer Directive.

[29] There is also a further possibility: the Sharia-compliant credit institution may be a branch of a third-country bank.

[30] See: F. Vogel – S. L. Hayes III, *Islamic Law and Finance. Religion, Risk and Return*, 133 ff.
[31] On the experience of "Islamic windows" in the UK, see: FSA, Islamic finance in the UK: regulations and challenges, 7.
[32] Art. 4, reg. 2013/575/EU, of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, published on *OJ L 176, 27.6.2013, p. 338–436.*
[33] Cfm., Opinion of the European Central Bank of 5 December 2008 on the proposal for a Directive on the taking up, the pursuit and prudential supervision of the business electronic money institutions, published in OJEU C 30/1, 6.2.2009, § 1.3.
[34] Article 1, directive 1994/19 EC. *Supra* note 14.
[35] Case C-366/97. *See:* Opinion of ECB of 26 April 2006 on a proposal for a directive on payment services in the internal market, OJ C 109/10.
[36] Directive 2008/48 EC of the European Parliament and of the Council of 23 April 2008 on credit agreements for consumers repealing Council Directive 87/102/EEC.
[37] It is beyond any doubt that the concept of "granting credit (for its own account)" is not limited to the consumer credit agreement's object, and this paper is not the feasible place to make a comprehensive list of all lending activities. However, the Consumer Credit Directive helps us to figure out the type of relationship between the bank-lender and the client-borrower (creditor-debtor relationship).
[38] This was the *Caixa Bank* case (Case 442/02) where the European Court ruled out a French law preventing banks from paying an interest rate out on sight accounts because it forbade the rationale of the common market. The Court held that the freedom of establishment forbade national lawmakers (i.e.: French regulator) to lay down rules preventing domestic as well as subsidiaries of the credit institutions set up in Member States other than France from remunerating the sight accounts in euro with residents in France to lower the cost of banking services to the consumers. However, even though this regulatory choice was purported to protect consumers' interest, it went beyond what was necessary. In giving its reasons, the Court maintained that, despite the fact that French law made no discrimination between domestic and foreign banks, it ended up scaling down the range of banking products available to the customers by decreasing the range of remunerated and non-remunerated sight accounts they may make their choice upon (See § 22 Caixa-Bank France case). Some critical remarks in: G. Rotondo, *The remuneration of sight accounts and the feasible competition between Islamic and Western systems*, in M. Fahim Khan, M. Porzio (eds), *Islamic Banking and Finance in the European Union: A Challenge*, 158 – 163.
[39] F. Vogel, *Islamic finance: personal and enterprise banking*, in M. Fahim Khan, M. Porzio (eds), *Islamic Banking and Finance in the European Union: A Challenge*, 42. A *hadith* is a written report on the Prophet's life, contained in Sunna; Sunna, in turn, is one of the main Sharia sources of law (see, above paragraph 1). More details on the sources of law: F. Vogel – S. L. Hayes III, *Islamic Law and Finance. Religion, Risk and Return*, 23 ff.
[40] G.M. Piccinelli, *The provision and management of savings: the client-partner model*, in M. Fahim Khan, M. Porzio (eds), *Islamic Banking and Finance in the European Union: A Challenge*, 23-39.
[41] F. Vogel, *Islamic finance: personal and enterprise banking*, in M. Fahim Khan, M. Porzio (eds), *Islamic Banking and Finance in the European Union: A Challenge*, 51 ff.

[42] P. Abbadessa, *Islamic banking: impression of an Italian jurist*, in M. Fahim Khan, M. Porzio (eds), *Islamic Banking and Finance in the European Union: A Challenge*, 207 – 211. However, the provision of portfolio management on individual basis is deemed to be a financial service, therefore, a EU-based credit institution is entitled to operate this type of activity as far as it is provided with ad-hoc authorisation. As emphasised in section 1, the financial services are subject to a set of tailor-made EU-based rules and regulations as laid down in MiFID regulatory packages, which fall behind the scope of this paper.

[43] L. Charpentier, *The European Court of Justice and the rhetoric of affirmative action*, European University Institute, Working Paper RSC, 98/30.

[44] G.M. Piccinelli, *The provision and management of savings: the client-partner model*, in M. Fahim Khan, M. Porzio, (eds), *Islamic Banking and Finance in the European Union: A Challenge*, 27 f.

[45] The statutory list of passported activities includes: • taking-up activities: deposit-taking and other forms of borrowing; • lending activities such as consumer credit, mortgage lending factors, invoice discounting and trade finance, factoring, forfaiting, financial leasing, guarantees and commitments; • the provision of payment services; • the issue and administration of means of payment; • money transmission services; and • trading on one's own account or the account of the customers in money market instruments, foreign exchange, financial futures and options, exchange and interest rate instruments or securities.

[46] For example, the 2009 directive provides that electronic money issuers have to issue electronic money at par value on the receipt of funds and no interest or any other benefit related to the "length of time during which an electronic money holder holds the electronic money"[46].

[47] Dir. 80/934/EEC, OJEC of 9.10.1980 No L 266/1.

[48] In June 2009, Regulation n. 593/2008 of the European Parliament and of the Council replaced Rome I Convention for Member States. An interesting report in Z. Tang (2008), *Law applicable in the absence of choice – The new article 4 of the Rome I Regulation*, in *The Modern Law Review* 71 (5), 785-800.

[49] Art. 3, 1980 Rome Convention.

[50] Preamble (13), EU Regulation Rome I.

[51] COM (2005) 260 final, Brussels, 15.12.2005.

[52] More details in: G. Baron, *Do the Unidroit principles of international commercial contracts form a new lex mercatoria?*, in *Arbitration International*, 1999, vol. 15 (2), 115 – 130.

[53] AAOIFI is a not-for-profit organisation, based in Bahrain and established in 1991. It is responsible for the development and issuance of standards for the global Islamic finance industry. More details on: http://aaoifi.com/?lang=en

[54] K. Bälz, *Sharia risk? How Islamic finance has transformed Islamic contract law*, Occasional Publication (9), September 2008, Islamic Legal Studies Program, Harvard Law School.

[55] *Shamil Bank of Baharain v. Beximco Pharmaceuticals Ltd. And others* [2003] EWHC 2118 (Comm.), All ER (Comm) 849 and Court of Appeal [2004] EWCA Civ 19. See, N. Saleh (2004), *A landmark judgement of 23 January 2004 by the England and Wales Court of Appeal*, in *Arab Law Quarterly* 19, 1-2.

[56] [2007] EWHC 2981 (Ch), [2008] 1 Lloyd's Rep 326, [2008] 1 All ER (Comm) 607.

[57] [2006] EWHC 603 (Comm) and [2007] EWCA Civ 291.

[58] See, Court of Appeal [2004] EWCA Civ 19, at § 51.
[59] See, Court of Appeal [2004] EWCA Civ 19, at § 52.
[60] See, [2006] EWHC 603 (Comm), at § 74.
[61] See, [2003] EWHC 2118 (Comm.), All ER (Comm) 849, at § 36.
[62] «A trade usage may be defined as a general or at least widespread regular observance of a particular line of conduct amongst those engaged in a particular branch of international trade over at least a short period of time». See: https://www.trans-lex.org/903000/highlight_usage/trade-usages/#references
[63] PECL: Article I.2.2. Here it is also established that «The usage is qualified in three ways:1) it must be a usage which the parties knew or ought to have known; 2) it must be widely known and regularly observed in international trade (thereby excluding domestic or local usages) by parties to contracts of the type involved and 3) the usage must emanate from the particular branch of trade in which the parties are operating. If the parties conclude the contract in full knowledge of the usage, it may be regarded as deriving its quasi-normative force, which overrides other non-mandatory rules of the Lex Mercatoria, from the contract itself. If the parties ought to have known the usage, it is endowed with a type of de facto normativity».
[64] PECL: article 1:105.
[65] Within EU law, microenterprises may be legally treated as consumers.
[66] Santi Romano began by contending that a legal system amounted to a sum of norms and, consequently, objectivity and enforceability through sanctions were to be considered as the distinguishing features of the legal system as a whole.
[67] S. Romano, *L'ordinamento giuridico*, Sansoni, Florence, 1962. An interesting analysis in: F. Fontanelli, *Santi Romano and L'Ordinamento Giuridico: the relevance of a forgotten masterpiece for contemporary international*, in *Transnational Legal Theory*, 2015, 67 – 117.
[68] N. Foster, *Islamic finance law as an emergent legal system*, in *Arab Law Quarterly*, 2007, vol. 21, 170 – 188.
[69] I. Klauer, *General clauses in European private law and "stricter" national standards: the unfair terms directive*, in *European Review of Private Law*, 2000 (1), 187 – 210.

Author

Gabriella Gimigliano is a senior researcher in business law at the University of Siena, Business and Law Department, E-mail: gabriella.gimigliano@unisi.it

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«They say things are happening at the border, but nobody knows which border» (Mark Strand)

Risk Management through Corporate Governance: A Study of Public Sector Banking Institutions in India

by **Deepankar Sharma**

Abstract: *The financial instability in the banking sector of any country marks a beginning of broader existential crisis for the maintenance of economic growth rate which may lead to plethora of problems viz. mounting bad loans, un-availability of finance, instable economic ecosystem causing unemployment etc. The backbone of the financial crisis is often adduced to the crucial factor of rising bad debts (Non- Performing Assests) which hamper the governance and management of fiscal stimulus at micro level i.e. within banks and at macro level as well. The root cause of this giant going beresk is the non-compliance of corporate governance mechanisms within the banking institutions as mandated by the government and Reserve Bank of India.*

This paper discusses the key ingredients required for effective corporate governance in the banking sector and best practices. This paper highlights the corporate governance mechanisms followed largely in India in the banking institutions. In this backdrop this paper, refers to the arrangements that companies, including banks, have in place for their internal governance, including in respect of the identification, monitoring and management of their risks. Although the paper discusses corporate governance as it applies to any corporate entity, the principal focus of the article is on corporate governance within banks and other financial institutions thereby covering the major guidelines issued by Reserve Bank of India in this regards.

1. The main object of corporate governance in banks is to protect the interest of the stakeholders from risk. “Risk is effect of uncertainties on the objects which is followed by coordinated and economical application of resources to minimize, monitor and control the probability and/or impact of unfortunate events or to maximize the realization of opportunities” .Effective corporate governance helps in proper allocation of responsibility and authority to board and senior management who carry affairs of business. Board is responsible for identifying risk at early stage and thereby assess consequences of risk and ways

in which it can be avoided and therefore selecting best measures for avoidance of identified risk. Risk management in banking institutions and thereby bringing good corporate governance culture in banks is also governed by OCED Principles which are followed in various regulations of government. Types of risk involved in banks and regulations governing risk management practice in India and obligation under OCED Principles are focused for assignment.

2. It follows the types of Risk Involved in Banking Institution and ways to manage the Risk.
1) Liquidity Risk: It occurs mainly in the scenarios when a bank fails to honour its commitment due to unavailability of funds or inability to mobilize resources for conducting day-to-day operations.
Management of the risk: The banks try to mitigate this risk by fixing a limit on inter-bank loans and through the Board supervision by having timely information on the liquidity prospects of the bank.
2) Interest Rate Risk: It occurs when the interest rate changes unexpectedly thereby collaterally affecting the market equity of the bank.
Management of the risk: This risk is mitigated by refering to BCBS Principle, where the earning prospect becomes the benchmark parameter. In economic prospective impact is analysed on expected cash flow. The role of board here would be to setup the mitigating alternatives through policy driven mechanism.
3) Market Risk: This risk is prominent in India as in recent times the forex value of Rupee has been fluctuating on dynamic basis.
Management of the risk: For managing market risk ALM framework is used. Under this three pillars are set i.e. ALM Information System which includes management information system and information availability system, accuracy adequacy etc. ALM Organisation in which top management and structure and responsibilities are involved and ALM Process includes risk parameters, identification, measurement and management.
4) Credit or Default Risk: Credit risk refers to the inability of the bank to meet its credit supply obligations. It refers to trading concerns where the borrower fails due to market restrictions beyond his control.
Management of the risk: Effective risk management framework will comprise of:
• Policy and Strategy: Board of directors of bank have to review and approve credit risk strategy and polices on periodical basis. Policy approved by board has to be communicated to branches of bank so that all officials of bank could understand approaches for sanctioning of credit and ensure accountability. Responsibility of credit risk polices will be on senior management of the bank.
• Organisational Structure: In sound structure there board of directors must have responsibility of management of risk. Risk management committee will be board level committee in which CEO, head of credit, operation and market committees will be there which will be working in coordination with each other. It will have to accept recommendation of committee and in case of denial rational for same is required and then served to internal and external auditors.
5) Operational Risk: It refers more to the behavioural approaches where either the people or the process in the setup itself has failed the system. The elements of frauds and non-adherence to guidelines are the triggers for the same.
Management of the risk: Impact assessment and constant review & supervision of internal control systems may help in mitigating such kinds of risks.

Role of Reserve Bank of India: Grown complexities of banking due to deregulation and changes in behaviours of consumer resulted in ineffectiveness of control system. In order to deal with increasing level of risk RBI set guidelines to bank on risk management in 1999 under which banks are required to distribute the out flow and inflow in different maturity periods.

Reserve Bank of India has put responsibility of management of risk on board of directors who are required to take active part in risk management polices and also in setting liquidity limits, foreign exchange rate, equity price risk and interest rate. Assets Liability Committee (ALCO) has been introduced by the RBI as top most committee to oversee implementation system by ALM system. It carries out function of considering product prices for advances and deposits, desire profile of maturity of incremental assets and liabilities along with monitoring level of risk in banks. It also carries out function of articulation of current rate of interest and to make it for decision making for future business strategies.

CAMLE Model is also adopted in which there are six components namely Capital Adequacy, Asset Quality, Management, Liquidity and Earnings Quality which are focused for effective risk management in banking company. RBI realigned entire supervisory mechanism to Board of Financial Supervision. Supervisory and regulatory supervision of RBI has also been widened in which financial institutions as well as non banking financial companies. Onsite supervision system is also developed in which assessment of core nature is carried on as per statutory mandate i.e., liquidity, solvency, management prudence and operational soundness. Due to recent trends of competition, financial integrations and globalisation one site supervisions is replaced by offsite supervisions by Board of financial institution so that risk can be identified at early stage. Offsite system involves asset quality, large credit and concentration, capital adequacy, earnings and risk exposures viz., currency, connected lending, liquidity and interest rate risks. Financial analysis of stock of bank in secondary market is useful source used for knowing financial performance of bank.

Basel Committee: It is a primary global standard settler for regulation of banks on supervisory matters and it has issues guidelines on the basis of OCED Principles for effective corporate governance in banks. Basel Committee on Banking Supervision is focused towards making banks more sensitive towards risk since most important reason of risk are breakdown of internal control and corporate governance. Committee has identified major breakdown like lack of control culture by management, inadequate risk assessment of certain banking activities, lack of communication between different levels of management and inadequate monitoring and audit programme. Use of internal system is allowed in order to measure risk and thereby allocating capital accordingly. Three pillars are developed with as view to maintain financial stability in banks. These include Minimum capital requirements, supervisory review process and market discipline. Under pillar of supervisory review process necessity of exercise of internal assessment is recognised in order to ensure that the management is exercising the strong judgment and has kept the capital for various identified risk in advance. Board has been entrusted with responsibility of business strategies and financial soundness and they must in exercise of these responsibilities have to adopt duty of care and diligence. They must be engaged in actively in affairs of bank and must monitor implementation of risk measures effectively. Board must also set up good corporate culture by setting corporate values and by promoting the risk awareness in a strong risk culture. Board should ensure that professional codes of conduct are duly followed.

3. Role of RBI is indispensible in current risk management of banking institutions in India. It is true that risk cannot be eliminated from banking activities but same can be eliminated and for effective elimination of risk in banking institution RBI has introduced various regulations which apply to both public and private banks equally. With help of RBI only entire Indian banking system is professionally managed and proper risk management are adopted at individual banks levels. Above discussed regulations of Basel and its committee's role of board of directors have been explained clearly and they are put in centre of governance of banking system. There are various models that have been suggested for effective management of credit risk in bank like "Internal Rating Based" in which focus is to be drawn on various factors that causes threat of risk in banking system. So present in built risk control system are equally strong for both private sector banks and public sector banks.

4. RBI normally follows threefold mechanism of corporate governance in supervising the banks' compliance, which is:

1) Disclosure and Transparency System:

The most emphasized mode of governance used in Indian legal system for regulating the banks is seeking timely, uniform and transparent disclosures. According to the standard operating procedures, the RBI vests with the power of imposing and levying heavy fines in case of non-compliance with the disclosure norms. Most recently RBI used such power to penalize a co-operative bank based out of Hyderabad, Telangana under the section 47A (1) (b) read with Section 46 (4) of the Banking Regulation Act, 1949 (As Applicable to Co-operative Societies), for violation of Reserve Bank of India directives and guidelines on loans and advances to directors and their relatives and in other similar matters.

2) Surveillance Based System (Off-Shore)

The main object to be achieved from such surveillance is to analyze the financial health and position of the target bank in between two on-site supervisions. Therefore the idea of off-shore inspection was initiated by RBI in the year 1995.

3) Prompt Action Based Sytem

As is the case with most sectoral regulators even RBI is involved in the process of taking prompt actions based upon breach of trigger points like issues of rising NPAs (Non- Performing Assets) in form of bad loans. This action include the issuance of mandatory action plan to the entire sector in form of guidelines and discretionary plans which are issued to the target bank or specific banks depending upon the financial deterioration and lapse of the existing internal control systems like failure of board etc. Therefore, the special nature of banking institutions necessitates a broad view of corporate governance where regulation of banking activities is required to protect depositors. However, while maintain the effective supervisory role and compliance to internal control systems, excessive pressure on the banks would lead to slowdown of financial transactions and economic development. Hence the best way is to pull-up the responsibility ratio of the Board of such so that the internal autonomy and governance are simultaneously balanced.

5. The continuous breakout of frauds in banking sector in India has shown shabby nature of compliance with corporate governance mechanisms in Public Sector Banks (PSBs). The fraud patronage by PNB officials in irrational and fraudulent issue of Letter of Undertakings (LOUs) to companies controlled by Nirav Modi, has shaken investors'/depositor' confidence. This makes it imperative for us to analyze the

existing legal framework for governance and prevention of fraud/mis-management in banks in India. Numerous committees have put forward the recommendations on this pertinent issue:

P.J. Nayak Committe Report (2014)

Key Findings

• Public Sector Banks (PSBs) are bound by the directions issued on timely basis by Ministry of Finance in India.

• Reserve Bank of India remains the only regulator of all banks including PSBs.

Recommendations

• The private banks and PSBs are ideally designed to be put at equal pedestal if the governance and reforms are concerned thereby granting more autonomy to the Board.

• A Banking Investment Company (BIC) is designated to be incorporated which will hold all the shares of Public Banks.

• Till the formation of BIC, an autonomous recommendatory body called Bank Board Bureau should assume the functions of BIC.

It is further to be informed that BBB started its operational activities from April 1, 2016.

Bank Board Bureau's Compendium of Recommendations (2018)

Key Findings

• The concept of regulations without pertaining to ownership has to introduced where the government continues to have its holdings in the banks.

Recommendations

• The harmonious interpretation of banking statutes incorporating such banks with Companies Act, 2013 has to be drawn but in conflicting scenarios the Companies Act shall prevail.

• In the context of pure banking operations Banking Regulation Act, 1949 will remain the guiding force.

World Bank – Detailed Assessment of Observance—Basel Core Principles for Effective Banking Supervision (2018)

Key Findings

• RBI is the legal regulator as well for the PSBs.

• RBI has no say in removal of Board Directors.

• RBI continues to have little say over risk management, profile assessment and compensation procedures.

Recommendations

• RBI should be vested with full powers to act as effective regulator for PSBs which would in turn ensure parity between private and public banks.

The governor of RBI, Mr. Urjit Patel also emphasized upon the same in speech on the RBI's perspective of PNB loan fraud. In order to advise it on the matters of high divergence observed in asset classification, various incidents of fraud, RBI appointed a committee under the chairmanship of Mr. Y.H. Malegam which is due to present its report till the date of the writing of present research paper.

6. Risk is indispensible in banking sector and timely and proper assessment of risk can only be helpful in making effective risk avoidance decisions by board. Board is using magnitude of risk and thereby making strategies for good corporate governance in banks.

¬ Acceptance of Basel Accord II by the RBI is a move towards more effective risk management since it is focused on enhancing risk sensitivity of capital requirement, promoting coverage of comprehensive risk

and more flexible approach by board members. Board must follow consistently various principles that are stated there in Basel to bring good corporate culture in bank and mitigating risk in effective and efficient manner.

¬ In addition to this, in order to improve governance an ownership neutral law is supposed to be brought into place which brings both Public Sector Banks and Private Banks at equal footing which would inherently mean the application of stringent norms without exception which otherwise is granted to PSBs as a course of routine rather than exception.

¬ The Government of India should necessarily take a strategic decision of transiting its holdings of PSBs into Banking Investment Company as proposed by P.J. Nayak Committee at a faster pace which would in turn be governed by Independent Board for which an exception may be added in the Companies Act, 2013.

¬ The use of 'Prescriptive Approach' of corporate governance should be brought into the fold of banking sector which would require banking institutions, to prescribe as mandatory rule, the organizational structure, designated officers (which may help in fixing the criteria of Officer in Default as per the Companies Act, 2013) and secure the personal accountability of conduct and internal grievance redressal.

¬ Under the framework of risk mitigation, RBI should aim to reinforce the Master Direction on Frauds whereby the regulation 8.3 consisting of Early Warning Signals (EWS) and Red Flagged Accounts (RFA) be made integral part of Board's report and the loan accounts threshold for the same be lowered to Rs. 500 Million as the lower trenches of loan default make a huge chunk of NPAs in the current system.

7. The depositors should be made feel protected to sustain relation and rule based banking. The idea of prudential regulation may come to good rescue in this cause but all these criterias can be compromised in wake of ill-informed disclosures and mismanagement tendencies creating operational cartels. The nature of bank holdings and the strenuous relationship of the sector with the government also adds upon the existing conflicts and in such loomy scenario the RBI may come to its rescue by being the regulator and occasional mediator.

This paper in its length has targeted the aspects of continuous maintenance of high governance standards which was envisaged at the time of inception and referred by Mr. Rahul Bajaj Chairman of CII Task Force on Desirable Governance Norms. The plethora of problems are not present because of faulty system but the paper concludes by suggesting that they in fact remain in existence due to highly technical rule based process with equally less favourable compliance appreciation.

Author

Deepankar Sharma is Assistant Professor of Law at School of Law, Manipal University Jaipur. He is also designated as Visiting Scholar at City University of London (UK) & Visiting Research Associate at University of Hong Kong (HKU). He is also the member of International Editorial Council of BRICS Law Journal (SCOPUS Indexed & UGC Approved). He is also an Arbitrator at Dubai International Arbitration Centre (DIAC).

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«They say things are happening at the border, but nobody knows which border» (Mark Strand)

Introduction to the Italian law of public companies

by **Andrea Sacco Ginevri**

Abstract: *This introduction to the Italian law of public companies is the first chapter of forthcoming book on the same issue and aims at giving a general overview on the main issues and rules applicable to public companies operating in the Italian markets. This paper focuses on corporate governance issues, having regard to transparency and control principles as well as to the ESG (environmental, social and governance) factors. Concluding remarks highlight that fostering long-term shareholders' activism may be a tool for strengthening the long-term best interest of the corporation since it allows directors to manage their enterprises in a manner that emphasizes the long-term over the short-term.*

1. A company can find new equity and financial sources in order to support its industrial plans, among others, by listing its shares [1]. At the end of the listing process (*Initial Public Offering* – "IPO") a company becomes "public" (*i.e.* "listed") since a significant number of its shares becomes widely dispersed to the public (*minority shareholders*) [2].
This form of financing is particularly convenient for the public company (the issuer) when its shares are offered to potential investors in exchange for a capital increase. In this way, the sources injected by the investors (the new shareholders) are allocated to the share capital of the company (equity) and, therefore, can be used by the issuer to finance its industrial and strategic growth plans (*business plan*) without any obligation to reimburse such injections. However, the incumbent shareholders of the company typically have an interest in selling at least part of their shares to the investors in the context of the IPO process, in order to promptly monetize a portion of their equity investment [3] and, at the same time, maintaining a corporate control over the issuer even after the completion of the listing [4].
The circumstance that, through the distribution of its shares to a large number of shareholders, the listed company collects and then manages "public savings" (see Article 47 of the Italian Constitution) explains why the Italian rules on listed companies [5] are very rigid and, therefore, significantly limit the private autonomy and rights of shareholders, directors, statutory auditors, potential investors, etc. [6]. This also explains why issuers are subject to the supervision of CONSOB (the Italian Securities and

Exchange Commission) and their directors, officers and auditors are subject to material penalties and sanctions as well as to a deep judgment of responsibility [7].

The special regulation of listed companies is so dissimilar from the general laws applicable to the "closed" (private) companies that, according to certain legal scholars, the two corporate structures at hand should belong to different corporate models (*i.e* "types", pursuant to Article 2249 of the Italian Civil Code) [8]; if one adheres to this opinion, the going public or private process should both be classified as conversion (*i.e.* "transformation", pursuant to Articles 2498 *et seq.* of the Italian Civil Code), consequently granting the right of withdrawal to shareholders who do not agree with such a transaction (see Article 2437, paragraph 1, letter. b, of the Italian Civil Code).

This issue – although of extreme interest from a theoretical point of view – is less relevant from a practical perspective, given that, on the one hand, the exclusion from the listing (delisting) expressly triggers a withdrawal right for the dissenting shareholders (Article 2437-*quinquies* of the Italian Civil Code) and, on the other hand, admission to listing supposes the prior adoption of material amendments to the issuer's articles of association (aimed at aligning the corporate by-laws to the special regulation on governance matters applicable to public companies) that the incumbent shareholders are granted with the withdrawal right as a consequence of the alterations to the voting and participation rights caused by the IPO (pursuant to Article 2437, paragraph 1, letter g, of the Italian Civil Code).

In the course of its business, any listed company must ensure *equal treatment* for all the holders of its financial instruments (shares, bonds, etc.) who are in the same conditions (see Article 92 of the Italian Securities Act). This principle aims at ensuring that the "rules of the game" are the same for all the investors and justifies, among others, certain rules on public takeover bids – including the one requiring the bidder to offer the same consideration to all the shareholders solicited to sell their shares [9] – and the constraints limiting selective information flows between issuers and its related parties (such as its directors and controlling shareholder).

Since admission to the process of listing means opening up the capital to public investors, the management of the company must become transparent, efficient and protected by external influence [10]. This explains the existence of strict law provisions requiring issuers to disclose their operations (*e.g.* financial statements and inside information) and their internal structure, as well as the adoption of efficient governance measures (*e.g.* a minimum number of independent directors, a slate voting system for the appointment of corporate bodies, specific rules on related parties' transactions, etc.).

Furthermore, certain corporate conflicts are typical of "open" companies (agency problems) and change in presence of a controlling shareholder (concentrated ownership) or in case of shareholding dispersed among the public (dispersed ownership). In the former case, the relationship between the controlling shareholder and minority shareholders must be carefully monitored in order to avoid the management of the listed company being affected by the personal interest of the parent company. In the second scenario, on the other hand, a management body too "self–referential" should be avoided since such a structure could incentivize management policies oriented towards short term goals (such as an excessive remuneration caused by the separation between ownership and control) [11].

However, since many relevant shareholders of issuers are now, in turn, "institutional investors" – collecting public savings at the top of their corporate chain – such a phenomenon gives rise to a "dissociation of ownership from ownership" (so-called "agency capitalism") [12], which accentuates, and multiplies exponentially, the problem of the separation between ownership and control which is well-known in companies with a dispersed ownership structure.

It should also be pointed out that modern listed company aims at pursuing the corporate social responsibility objectives ("CSR") and ESG (environmental, social and governance) factors, as demonstrated, *inter alia*, by the fact that issuers are required to publish an annual non–financial statement containing environmental, social, personnel, human rights and anti–corruption information [13]. This confirms what will be said below about the progressive *institutionalization* that currently characterizes the organization and management of the Italian (and European) listed companies.

2. Article 92 of the Italian Securities Act inaugurates the regulation on issuers stating that Consob exercises its powers with regard to the protection of investors and the efficiency and transparency of the market for corporate control and the market for financial instruments.
These are the main interests protected by the regulations on listed companies, which aim at attracting public savings into the financial markets in order to channel them towards the financing of listed companies [14].
This form of public savings' allocation pursues constitutional goals, which are physiologically linked to the success of the entrepreneurial initiative, including, for example, the proliferation of jobs, the increase in tax revenues, the protection of the creditor class and suppliers, and so on.
However, in order to ensure that savings are efficiently allocated in favour of the most deserving issuers, and then diligently used and remunerated by them, it is necessary that an imperative regulation protects the correctness and transparency of the behaviour of the competent corporate bodies of such issuers, to guarantee the rights of the investors and, therefore, the good functioning of the capital market [15].
These objectives also require an efficient and transparent circulation of corporate control over the issuers, given that the controlling company directs the entrepreneurial management of the listed company by exercising a dominant influence on the operational and financial management of the same and, in this way, conditioning its economic performance and results.
Consequently, in the listed company, the personal data of the main shareholders (*i.e.* holders of more than 3% of the voting capital) and the contents of any shareholders' agreement concerning the listed shares (having a maximum duration of three years) shall be in public domain.
Furthermore, in case of purchase of shares exceeding 25% of the voting capital the purchaser is required to mandatory launch a totalitarian takeover bid (public tender offer) over the outstanding shares of the listed target company (see Article 106 of the Italian Securities Act); such a "mandatory tender offer" rule (MTO) aims at to discouraging the circulation of controlling shareholdings without allowing all the shareholders of the target company to monetize their shareholding selling them to the insurgent controlling entity at the same economic terms (creeping acquisitions) (see below).
In addition, a recently issued rule (Article 120, par. 4–*bis*, of the Italian Securities Act) imposes on those who purchase more than 10% of the voting capital of the issuer to promptly disclose the intentions underlying their acquisitions, including which are the sources of financing of their purchases and their future strategies.
Moreover, if a bidder launches an "hostile" takeover bid over the issuer (*i.e.* not appreciated by the incumbent directors of the target company), on the one hand, the management body of the target company cannot start or implement defensive measures and strategies (such as poisons pills and shark repellents) without the prior authorization of the shareholders' meeting (passivity rule) – given that it is up to the shareholders to make the final decision as to whether or not the offer addressed to them is

appropriate – and, on the other hand, shareholders bound to each other by a shareholders' agreement will also be free, pursuant to law, to adhere to the public tender offer, regardless of the provisions set forth by such agreement.
These are provisions aimed at encouraging an efficient circulation of corporate control, in order to allow a change in the top management of the issuer, which is welcome when the issuer's securities are listed at a discount with respect to the potential value of the company. Such a principle aims at ensuring an optimal allocation of the savings invested in the financial markets which should be easily allocated by the investors to the issuers which are most appealing for them, from time to time, depending on the evolution of the market as well as of the management strategies and business results of the specific companies (so–called wall street rule) [16].

3. In order to promote an efficient allocation of public savings coming from the investors, corporate information plays a fundamental role. For the above-mentioned purpose of allowing investors to make informed investment choices, the information made available to the public by the issuers must be updated, understandable and equal for everybody (symmetrical) [17].
In the years of greatest growth of the financial markets (before the crises of 2002–2005) the "sunlight" has been considered the best "disinfectant" against conflicts of interest and fraud. In those years, governance rules of the issuers were sporadic and of minor importance, given that –– on the assumption that the investors were able to address their investment choices –– an exhaustive and truthful information framework was considered enough, guaranteeing at the same time the equal treatment among them (protected also by the insider trading criminal sanctions).
In this respect, the regulation of the listed company subverted the logic of the anonymity of the shareholders, which is typical of the "closed" joint stock companies, imposing the transparency of the ownership structures of the issuer (*i.e.* significant, potential and reciprocal shareholdings), today further strengthened by the provisions on shareholders' identification introduced by the European directives on shareholders' rights. In addition, corporate transparency of listed companies includes the obligation to periodically publish accounting information, including *interim* reports (Article 154-*ter* of the Italian Securities Act), as well as, occasionally, detailed corporate documents, such as prospectuses and reports – as the case may be – on extraordinary operations (mergers, demergers, significant acquisitions/disposals, capital increases, etc.), on stock option plans, on significant transactions with related parties and on matters falling within the competence of the shareholders' meeting (see, for example, Article 125-*ter* of the Italian Securities Act).
Of particular importance is also Article 114 of the Italian Securities Act, which requires inside information to be disclosed by issuers to the public as soon as possible (in execution of the European regulation on market abuse -– "MAR" –, mainly contained in EU Regulation No. 596/2014). Inside information has precise nature, not yet public, concerning the issuer (or its financial instruments) which, if made public, could have a significant effect on the prices of such financial instruments (price sensitiveness); for example, the execution, by the issuer, of a binding agreement relating to the implementation of an extraordinary transaction of particular importance triggers an inside information relating to the securities of such issuer [18].
The main aim is to avoid information asymmetries whereby certain operators are in possession of information that could affect share prices without the general public being in possession of it.

Paragraph 7 of Article 114 maintained the rules on internal dealing, pursuant to which significant shareholders (with a stake of at least 10% of the share capital of the issuer) are required to notify to Consob and to the public all the transactions carried out by them on shares issued by such issuer. By doing so, the transactions in the securities of the listed company carried out by the most important shareholders are monitored in detail.

With the above-mentioned disclosure obligations, Consob plays a very important role in protecting the issuers' compliance. On the basis of Article 115 of the Italian Securities Act, Consob, in order to monitor the fairness of the information provided to the public, may, also in general, require issuers (as well as the subjects that control them and the companies controlled by them) to communicate news and documents, establishing the related procedures, as well as to obtain information from certain categories of subjects and to carry out inspections.

Finally, particular attention should be paid to the rules on the disclosure of shareholders' agreements. The need for transparency in the structures of listed companies requires their publication, under penalty of nullity of the agreement, within 5 days from their subscription. It is important to note that such agreements, even if null and void (*e.g.* because, for instance, they are not published), are in any case able to trigger the obligation of the parties to launch a public tender offer in concert over the issuer if such agreements aggregate a percentage of voting capital higher than the threshold of the mandatory tender offer (25%) [19].

More in particular, Article 101-*bis*, paragraph 4-*bis*, letter a), of the Italian Securities Act provides that shareholders' agreements give rise to an "acting in concert" which is relevant for the purposes of the mandatory tender offer (if the applicable conditions are met) without the possibility, for the parties of the agreement, to provide evidence of the contrary (presumption *iuris et de iure*).

4. As a result of the financial crises at the beginning of this millennium (in Italy the Parmalat and Cirio crashes), the autonomy of the issuers' by-laws – with regard to governance – has been significantly limited by the introduction of certain mandatory law provisions (mainly by Law No. 262 of 2005) [20].

First of all, the Italian legislator introduced mandatory and binding rules on the appointment and composition of the management body of listed companies. In this regard, in order to allow minority shareholders to designate at least one director, the obligation to appoint the management body on the basis of a "slate voting system" (voting list) has been introduced [21]. According to such a mechanism, shareholders holding, even jointly, a minimum share capital threshold [22] have the right to submit a list of candidates for the office of director, indicated in the list according to a progressive number (see Article 147-*ter*, paragraph 1, of the Italian Securities Act) [23]. The by–laws are then free to distribute among the various lists duly filed the number of new directors to be elected, provided, on the one hand, that at least one of them is taken from minority lists (*i.e.* not connected in any way to those presented by the majority shareholder/s) and, on the other hand, that the list ranked first in terms of number of votes appoints the highest number of new directors. In the market practice, generally the by-laws provisions grant a fixed number of directors to the list ranked first (*e.g.* 9/10 of the new board of directors), while only in few cases the new directors are adopted according to a principle of pure proportionality (*e.g.* with the "quotient calculation") which aims at assuring a wider representation of the shareholders' designees within the board of directors [24].

In order to further ensure a sound and thoughtful dialectic within the management body, a minimum number of independent directors shall be appointed (see Article 147-*ter*, paragraph 4, of the Italian

Securities Act) [25]. Those directors shall be independent from the listed company itself and from its controlling shareholders/executive officers [26]. In compliance with the recommendations contained in the Code of Conduct for Listed Companies [27], the independent directors are often members of the internal committees with investigative, proposing and advisory functions (nomination and remuneration committee, internal control committee, sustainability committee, etc.) [28].

Moreover, if a listed company is subject to the direction and coordination activity by its parent company (see Articles 2497 *et seq*. of the Italian Civil Code), all the internal board committees must be entirely composed of independent directors. In addition, if the parent company is also listed, the majority of the members of the board of directors of the controlled listed company must be independent. The purpose of these rules is to strengthen the protection of the management autonomy and independence of judgement of those who manage a listed company which is subject to the direction and coordination activity carried out by another entity, in order to further protect minority shareholders and other stakeholders of the subsidiary (company creditors, counterparties, etc.) [29].

However, the role of the independent director must not be overestimated, given that, on the one hand, all the directors of the company are required to pursue only the corporate interest, regardless of who appointed them and their personal or professional relationships (see Articles 2391 and 2391-*bis* of the Italian Civil Code), and, on the other hand, beyond formal independence, what really ensures autonomy of judgment is the circumstance that the value of the person is actually higher than the value of the office held [30].

In listed companies, without prejudice to the applicability of the principle of equal treatment among shareholders who are in the same position, even corporate rights are not always the same for all the shareholders. Following the "Lehman Brothers" crisis [31], also the Italian legislator began to distinguish between shareholders with a short-term investment perspective (in the negative meaning: "speculators") and shareholders interested in the sustainable growth of the company in a medium–long term view ("patient capital"), strengthening the governance rights of the latter in the listed company through a series of incentive measures, among which, the increase of the voting right and of the dividend in favour of the long-term shareholders (*i.e.* those shareholders holding their shares – on an ongoing basis – for at least two years – see Article 127-*quater* and 127-*quinquies* of the Italian Securities Act) [32]. These measures, by derogating from a pure plutocratic principle which normally governs joint stock companies, are intended to strengthen the role of shareholders who, by virtue of their long–term ownership of shares, show a greater interest than other shareholders in the sound and prudent management of the company in the long-term perspective [33].

Moreover, in order to reduce the rational apathy which generally causes the inactivity of minority shareholders [34], the Italian Securities Act (see Article 125-*bis et seq*.) and the European directives on the involvement of shareholders [35] encourage the participation of the latter in the corporate life of the company, and in particular in the meetings of shareholders, facilitating the use of proxies (see Articles 125-*bis et seq*. of the Italian Securities Act) – which can be requested and collected by those who aim at influencing the result of the vote (see Articles 136 *et seq*. of the Italian Securities Act) [36] – and strengthening the previous corporate information flows. Moreover, in listed companies, only those who are shareholders of the issuer at the end of the seventh trading day prior to the date of the meeting (the so–called record date) are entitled to attend and vote at the shareholders' meeting. This rule aims at preventing that the vote could be influenced by speculative intentions, such as in case of encumbered shares or other devices according to which the shares are exchanged immediately before the

shareholders' meeting (and then delivered back) for the sole purpose of altering the results of the vote (*e.g.* through securities lending transactions, or similar).
It should be also noted that the board of statutory auditors of listed companies [37] has the duty to inform Consob of any irregularity discovered during the course of its supervisory activities (see Article 149 of the Italian Securities Act) [38]. Even the auditing monitoring is particularly incisive in the issuers, considering the obligation of such companies to appoint – in addition to the statutory auditors (one of them to be elected by minority shareholders) both an external auditing firm in charge for reviewing their accounts (see Legislative Decree No. 39 of 2010) and an officer responsible for the corporate accounting documents (see Article 154-*bis* of the Italian Securities Act), as a further comfort, for the investors, on the truthfulness and accuracy of accounting information disclosed by the issuer.

5. In public companies a transfer of a controlling stake triggers certain obligation for the new controlling shareholders aimed at complying with the equal treatment rule. A change of control over a listed target company could affect the business perspective of the company, and therefore the potential value of the shares.
In addition, since the corporate control grants to the controlling shareholder the so-called "private benefits" of control (see below the paragraph on related parties' transactions), generally such a purchaser pays a controlling premium to the former controlling entity (the seller of the controlling stake) [39].
Therefore, according to the equal treatment rule, in public companies – in the European Union Countries (*i.e.* those subject to the EU Directive No. 2004/25 on takeover bids) – when a purchaser acquires a stake in the share capital of a public company higher than a fix threshold (in Italy the 25 per cent) of the voting share capital, in the absence of another controlling shareholder, such a purchaser is required by the applicable law (in Italy see Article 106 of the Italian Securities Act) to launch a mandatory tender offer over the remaining voting shares.
The mandatory tender offer shall be launched at a price per share not lower than the highest consideration paid by the offeror in the 12 months preceding the acquisition of the controlling stake. This is a rule which grants the minority shareholders with an exit right in case of a change of control (which may affect the business strategies of the companies) at the same terms and conditions agreed by the former controlling shareholder [40].
The same obligation to launch a mandatory tender offer is triggered even if the significant stake has been exceeded by several persons acting in concert [41]. In the recent years an increasing number of legal frameworks deal with the notion of "persons acting in concert" in the international financial systems. References to such concept are generally aimed at achieving different goals, ranging from the extension of the parties bounded by disclosure duties vis-à-vis either the public or the competent supervisory authorities – in case of acquisition of significant stakes in banks, insurance companies, investment firms and listed issuers – to the identification of the joint offerors under the applicable takeovers' rules. However, the lack of legal certainty provided by the current EU rules on this subject is perceived as an obstacle to effective shareholders' cooperation since equity-investors need to know when they can share information and cooperate with one another without running the risk that their actions may trigger unexpected legal consequences. For such a purpose, certain financial laws and regulations make a distinction between a "white-list" of permitted acting in concert conducts – that typically include initiatives promoted by minority shareholders (concerning the harmonized exercise of

their reciprocal corporate rights) – and a "black-list" of personal connections that generally trigger a presumption of joint-responsibility among the entities acting in concert [42].

6. In listed companies, also related parties' transactions are regulated by specific rules. Related parties' transactions mean all transfers (direct or indirect) of resources, services or obligations from an issuer to a related entity associated with it (typically, but not exclusively, its directors, the parent company and certain other parties considered structurally close to the company) [43].

The regulation at hand aims at protecting the minority shareholders of the listed company from the risk of an extraction of the so–called "private benefits of control" (tunneling transactions). Tunneling transactions might be dangerous for minorities since they can cause a transfer of financial sources in favour of related parties at unfair conditions. In other words, in order to safeguard the consistency of the equity investment made by minority shareholders, the legislator has introduced devices aimed at safeguarding the correctness of the transaction process as well as its economic convenience, to ensure that it would be carried out at fair conditions and at market standard [44].

Consob Regulation on Related Parties' Transactions deals with the subject at hand and assigns a central role, within the corporate process, to a special internal board committee composed of independent directors who are not related to the specific transaction. The "related parties committee" has the duty to issue an opinion on the convenience and substantial correctness of the related parties' transaction as well as on the compliance of such transaction with the corporate interest of the issuer [45].

If case of negative opinion, the board of directors may go forward with the decision–making process only provided that – in the most significant transactions (in terms of size) – also an approval by the shareholders' meeting is obtained. In such a case, the shareholders' meeting "authorization" could be duly adopted only if the majority of the minority shareholders votes in favour of the transaction (whitewash mechanism) [46].

However, considering that the terms and conditions of the most important related parties' transactions are disclosed to the market – through the publication of a specific information document on the main legal and economic terms of such transaction [47] – it is rare, in practice, the overruling by the shareholders' meeting of the negative opinion of the special committee [48].

The special rules on related parties' transactions make safe the general rules on corporate conflict of interests (Articles 2373, 2391 and 2497 *et seq*. of the Italian Civil Code) and therefore add new contents and procedure to them in order to strengthen their scope of application.

7. In the context of the regulation on listed companies, the organization and functioning of special shares classes (*i.e.* shares other than common shares) plays a significant role since the introduction of savings shares by Law No. 216 of 1974 [49]. These rules aimed at attracting investment from investors who were more interested in the remuneration of their investment in shares than in the governance rights attached to the shares [50].

Following the 2003 Italian corporate law reform – which considerably extended the set of financial instruments that a company can issue to attract new capital sources – the special shares issued by the listed companies remained subject to strict and mandatory rules (see Articles 145 *et seq*. of the Italian Securities Act) [51].

Traditionally, the issuance of special classes of shares aimed at achieving several goals, including a "customization" of shares offered to investors. With regard to savings shares, which constitute the paradigm of a special class of shares in listed companies, Article 145 of the Italian Securities Act does not lay down precise rules for the privileges to which they are entitled to, but leaves the identification of

the content of the economic privilege, as well as the conditions, limits, methods and terms for achieving and exercising it, entirely to the articles of association of the issuer [52].
The class at hand benefits from certain 'class' protections, represented, in particular, by the special shareholders' meeting and the common representative of the special class. With regard to the first device, Article 146 of the Italian Securities Act extends the scope of the rules concerning the powers and functioning of the special meeting with respect to the provisions of the Italian Civil Code regulation [53]. With regard to the second device, Article 147 of the Italian Securities Act grants the special representative certain mandatory powers (of impulse, execution and supervision) to protect the special class [54].
It is a shared opinion, and confirmed by practice, that in listed companies – despite the good intentions of the legislator – savings shares (and other special shares) have not received among the public of investors the success originally hoped for. The experience of recent years has shown, in fact, a progressive decrease in the number of special shares in circulation, deriving from compulsory conversion transactions [55].
In a nutshell, in public companies the claim of the preferred shareholders is typically limited to a fixed dividend and a fixed amount on liquidation, and this claim shall be satisfied before the common shareholders can receive anything. Their rights to a prior, but limited, dividend resemble the rights of creditors, who also must rely on their contractual rights and do not vote in the general shareholders' meeting. However, according to Italian corporate law, the preferred shareholders have a veto power against fundamental transactions such as, for example, certain mergers, demergers, charter amendments that jeopardize their preferred rights.
Therefore, notwithstanding their limited percentage of share capital, preferred shareholders on the one hand have the power to prevent a corporation from transactions that may increase the common shareholders' value, and, on the other hand, are not subject to any redemption right neither by the common shareholders nor by the corporation itself.
In light of the above, certain legal scholars argued that granting a redemption right *ex lege* to the common shareholders in case the preferred shareholders should vote against certain fundamental transactions may be a tool for strengthening the best interest of the corporation because it allows at the same time directors and common shareholders – representing, the latter, the majority of the share capital – to achieve the corporate benefits arising from such fundamental transactions, and the dissenting preferred shareholders to withdraw from the corporation at a fair market value [56].

8. The fact that the issuers collect and manage public savings has a significant impact on the conformation of the relative corporate interest. This concept, in particular, on the one hand, drives the entrepreneurial strategy and the ordinary management of the company and, on the other hand, limits the sphere of influence of the shareholders and managers, since neither the directors nor the shareholders can act in conflict with the corporate interest of the issuer [57].
Since in the modern listed company a plurality of interests come into contact, many of them theoretically classifiable as "corporate", the governance structure and rules of the company clarify how to weight the different positions at stake according to the decision–making criteria typical of legal persons (first, the majority rule) [58].

When some of the interests at stake are qualified as “extra–corporate”, then the rules on the conflict of interests settle the contrast. In such a circumstance, the legislator makes a selection of the legal goods in competition, generally privileging the objective of safeguarding the public savings.

This being said, it is a consolidated opinion that, in the management of a listed company, the interest of the shareholders will drive the action of the directors ([59]). But having identified the interest of the shareholders as the boundary within which administrative discretion can legitimately be explained, we do not have yet a clearly traceable line of demarcation, considering that the widespread heterogeneity of the positions (and therefore of the interest) within the shareholders is well-known. In short, we can distinguish, within the corporate structure, between *(a)* industrial and financial shareholders, *(b)* conservative and speculative shareholders, *(c)* act al and potential shareholders, *(d)* common and special shareholders, etc. [60].

Shareholders are, in turn, more often financial institutions (funds, banks, insurance companies) representing further and shattered upstream interests, giving rise to a phenomenon called “agency capitalism”.

Therefore, the goals of a company’s strategy driving the actions of the directors – including any determination regarding the resolution of conflicts of interest – do not have an abstract content but are affected by the initial and evolving structure of values under the corporate initiative and business, as expressed by the shareholders [61].

In other words, the business program that still seems to prevail today is the one oriented, even in listed companies, towards the promotion of the interest of the shareholders when the latter is in direct conflict with the one of other stakeholders (so called: shareholders’ value theory).

However, the shareholders’ interest should be necessarily abstract, referable to an ideal and virtuous corporate shareholding, which pursues objectives of sustainable profitability in the long–term view [62]. This notion of corporate interest reduces the possibility of extraction of private benefits of control by the majority shareholders (and their trusted directors) and strengthening the role of long-term shareholders aims at producing positive effects on the perspective value of listed securities.

In short, making certain shareholder rights dependent on continuous ownership is a good way of developing corporate governance because it helps the management to act in the long-term interest of the company. In a nutshell, fostering long-term shareholders’ activism may be a tool for strengthening the long-term best interest of the corporation because it allows directors to manage their enterprises in a manner that emphasizes the long-term over the short-term.

In this context, the recently introduced provisions aimed at enhancing ESG factors and corporate social responsibility within the listed company further support the above-mentioned vision of the corporate interest.

References

[1] As an alternative – or in addition – to the listing of its own shares, a company may increase its financial means by offering to the public instruments other than shares, including, for example, debt securities (bonds) or hybrid securities (participatory financial instruments) or even more complex instruments. Moreover, a company may expand its corporate structure without having to list its shares; in this case, when the qualitative and quantitative conditions indicated in Article 2-*bis* of Consob Regulation on Issuers are met. The company at hand shall take the status of “issuer of financial

instruments distributed to the public to a significant extent" and will be subject to the rules provided for these categories of company (see mainly Article 2325-*bis* of the Italian Civil Code and 116 of the Italian Securities Act). Without prejudice to the foregoing, this chapter focuses solely on the rules and problems typical of listed companies; therefore, in the following discussion any reference to the category of "issuers" or "listed company" shall be understood to be limited to the subjective class constituted by "listed companies with shares", which may be either joint stock companies or cooperative companies.

[2] According to the Regulation of the Markets organized and managed by Borsa Italiana S.p.A., the initial free float ought to be at least equal to 25 per cent of the share capital of the issuer (Article 2.2.1). Free float may be defined as the number of current shares issued by a company, not representing the portion of the share capital constituting the controlling interest, available for trading on the Stock Exchange. Also, the shareholdings bound by shareholders' agreements and those subject to restrictions on the transferability of shares (lock-ups) with a duration of more than 6 months are excluded from the calculation of the free float, as well as those shareholdings equal to or greater than 5 per cent of the share capital of the issuer.

[3] In order to reconcile the interest of the historical shareholders in partially monetizing their investment and in equipping the listed company with new equity (which is instrumental in realizing the latter's business plan) – and thus in making the issuer's shares more attractive to new investors – the listing procedures often provide that, up to a certain amount of subscriptions to the offer, the resources collected are allocated to the increase in the issuer's capital and, if the above threshold of subscriptions is exceeded (the achievement of which testifies the success of the IPO), the surplus collected is paid to the historical shareholders against the transfer of part of their shares to the new shareholders.

[4] The capacity of maintaining control over the listed company is considered a value – also in economic terms – for those who achieve it. Indeed, the holding of a controlling interest in a company with a widespread shareholding, allowing the parent company to appoint the majority of the administrative body and to approve the financial statements at the ordinary shareholders' meeting, enables to extract the so-called "private benefits of control" (within the limits currently permitted by the rules on related party transactions pursuant to Article 2391-*bis* of the Italian Civil Code and the relevant Consob regulation) and, more generally, to direct the activity and strategies of the issuer at will. This explains the frequent use by newly listed companies, especially abroad, of so-called "dual class shares", *i.e.* distinct categories of shares through which the historical shareholders preserve control by means of enhanced shares (*e.g.* with multiple votes, *ex* Article 127-*sexies* of the Italian Securities Act) and reserve to the market (*rectius*: to the minority shares) ordinary shares or even shares of a special category weakened in terms of voting rights (according to the paradigm of the shares without full voting rights). See Goshen and Hamdani, *Corporate Control and Idiosyncratc Vision*, The Yale Law Journal 560 (2016); Zingales, *Insider Ownership and the Decision To Go Public*, Rev. Econ. Stud. 425 (1995).

[5] The regulation of the listed company is mainly to be found in the Italian Securities Act and in the implementing regulations issued by Consob, but –although partially – it is also to be found in the Italian Civil Code and in the European Directives. *Amplius* see Costi, *La disciplina delle società quotate*, Torino (2018); Cera, *La società con azioni quotate nei mercati*, Bologna (2018); Blandini, *Società quotate e società diffuse. Le società che fanno ricorso al mercato del capitale di rischio*, Tratt. dir. civ. notar., Napoli (2005); Montalenti, *La società quotata*, Tratt. dir. comm., directed by Cottino, Padova (2004); Meo, *Le società con azioni quotate in borsa*, Tratt. dir. priv., edited by Bessone, Torino (2002).

[6] See d'Alessandro, *La provincia del diritto societario inderogabile (ri)determinata. Ovvero: esiste ancora il diritto societario?*, Riv. soc. 34 (2003).

[7] As a confirmation of what has been stated in the text, listed companies – like other supervised companies that collect and manage public savings (such as, for example, banks and insurance companies) – are defined as "public interest entities" by certain regulations of special law (Article 16 of Legislative Decree No. 39 of 2010 on auditing accounts).

[8] See Oppo, *Sulla «tipicità» delle società quotate*, II Riv. dir. civ. 483 (1999).; *contra*, Spada, *Tipologia della società e società per azioni quotata*, I Riv. dir. civ. 211 (2000).

[9] Such consideration, in case of a mandatory takeover bid, must be not lower than the highest price paid off by the offeror (or by those persons acting in concert with him) in the last 12 months for the purchase of the same securities. This is because it is assumed that the highest price paid in the last 12 months by the offeror incorporates the control premium (*i.e.* the consideration paid to the previous parent company for the purchase of the relevant share above the threshold of the mandatory tender offer). Therefore, in application of the principle of equal treatment, any control premium would be granted equally – even if proportionally – to all shareholders interested.

[10] See Capriglione, *Introduzione*, Aa.Vv., I contratti dei risparmiatori, edited by Capriglione, Milano (2013).

[11] Traditionally, see Berle and Means, *The Modern Corporation and Private Property*, New Brunswick and London (1932); Jensen and Meckling, *Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure*, J. Financ. Econ. 305 (1976).

[12] See Rossi, *Proprietà, controllo, mercato: una triade scomposta*, Proprietà e controllo dell'impresa: il modello italiano stabilità o contendibilità, Milano 15 (2008). See also Gilson and Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, Columbia Law Review 883 (2013).

[13] The primary regulation regarding the communication of non-financial information is contained in Legislative Decree No. 254 of 30 December 2016, which implements Directive 2014/95/EU into Italian law. See Angelici, *Divagazioni sulla "responsabilità sociale" d'impresa*, Riv. soc. 3 (2018).

[14] See Costi, *Tutela degli interessi e mercato finanziario*, Riv. trim. dir. e proc. civ. 769 (1999).

[15] See Sacco Ginevri, *Staggered Boards, Banks and Public Companies: Quo vadis?*, European Business Law Review 575 (2017).

[16] The principle of free competition in the exercise of economic activity is intended to ensure the triumph of the most efficient corporations; see Ascarelli, *Teoria della concorrenza e dei beni immateriali*, Milano 30 (1960).

[17] See Mignoli, *Vecchio e nuovo nel diritto societario*, Riv. not. 1043 (1973) and *La società per azioni, problemi-letture-testimonianze*, Milano, I, 75 (2002) et seq. More recently see Capriglione, *I «prodotti» di un sistema finanziario evoluto. Quali regole per le banche? (Riflessioni a margine della crisi causata dai mutui* sub-prime*)*, I, Banca e borsa 53 (2008).

[18] In the case of a prolonged, multi-stage process, the issuer may, under its own responsibility, delay public disclosure of inside information relating to that process (*e.g.* during advanced negotiations where, however, there is still no certainty that a binding agreement will be reached). See Article 17, par. 4, of MAR.

[19] It should be noted that, pursuant to paragraph 5 of Article 122 of the Italian Securities Act, the regulation concerning the shareholders' agreements refers also to those agreements (executed in any

form) having as object the exercise of voting rights in listed companies and in their controlling entity (voting syndicates), or the establishment of obligations of prior consultation for the exercise of such rights (consultation syndicates), or the limit to the transfer of the relevant shares or of financial instruments that grant the right to purchase or to subscribe them (blocking syndicates) or the purchase of shares or financial instruments, or to have as their object or effect the exercise, even jointly, of a dominant influence, or which are intended to favour or counteract the achievement of the objectives of a public tender offer, including commitments not to adhere to an offer.

[20] See Aa.Vv. *La nuova legge sul risparmio. Profili societari, assetti istituzionali e tutela degli investitori*, directed by Capriglione, Padova (2006).

[21] Slate voting is a statutory mechanism – introduced in Italy for the first time for privatized companies by Legislative Decree No. 332 of 1994 (converted into Law No. 474 of 1994) – which derogates from the general principle on the basis of which the majority formed in the ordinary shareholders' meeting appoints the entire board of directors (see Article 2369, paragraph 4, of the Italian Civil Code).

[22] The articles of association establish the minimum shareholding required for the submission of slates, not exceeding one fortieth of the share capital or a different amount established by Consob regulation, taking into account the capitalization, the free float and the ownership structure of listed companies.

[23] If the articles of association so provide, the outgoing administrative body, in competition with the legitimate shareholders, may also submit to the shareholders' meeting its own slate for the renewal of the body itself. This mechanism is increasingly used by large Italian listed companies, especially where there is no controlling shareholder and, therefore, the so-called "slate of the board" is able to coagulate the votes of the market.

[24] *Amplius* Ciocca, *Il voto di lista nelle società per azioni*, Milano (2018).

[25] At least one of the members of the board of directors, or two if the board of directors is constituted by more than seven members, must meet the independence requirements established for statutory auditors by Article 148, paragraph 3, of the Italian Securities Act and, if the articles of association so provide, the additional independence requirements set out in codes of conduct drawn up by companies that manage regulated markets or by trade associations. The independent director who, after his appointment, loses the requirements of independence must immediately inform the board of directors and, in any case, his office shall cease.

[26] See Regoli, *Gli amministratori indipendenti tra fonti private e fonti pubbliche statuali*, Riv. soc. 382 (2008).

[27] Reference is made to the code of conduct drafted and updated by the committee for corporate governance established by Borsa Italiana S.p.A. – a private body composed of operators in the sector – in order to allow a rapid and flexible ability to adapt to the practical needs that arise in the markets. The Code of Conduct provides for non-binding recommendations addressed to issuers subject to the comply-or-explain rule pursuant to Article 123-*bis* of the Italian Securities Act; see Bosi, *Autoregolamentazione societaria*, Milano (2009).

[28] See Stella Richter, *I comitati interni all'organo amministrativo*, Riv. soc. 260 (2007).

[29] Reference is made to Sacco Ginevri, *La nuova regolazione del gruppo bancario*, Torino, 54 (2017).

[30] See Ferro Luzzi, *Indipendente... da chi?; da cosa?*, Riv. soc. 207 (2008).

[31] See Capriglione, *Crisi a confronto (1929 e 2009). Il caso italiano*, Padova (2009); Masera, *La crisi globale: finanza, regolazione e supervisione alla luce del rapporto De Larosière*, Scritti in onore di Francesco Capriglione, Padova 1121 (2010).

[32] See Tombari, "*Maggiorazione del dividendo*" *e* "*maggiorazione del voto*"*: verso uno* "*statuto normativo*" *per l'investitore di medio-lungo termine?*, I Banca e borsa 303 (2016).

[33] Reference is made to Sacco Ginevri, *L'attribuzione di diritti particolari agli azionisti di lungo termine in una prospettiva comparata*, Riv. dir. soc. 231 (2012).

[34] "Rational apathy" of small shareholders means the lack of interest of the latter in the participating in the decisions concerning the issuers in whose capital they participate, which is considered economically efficient because a different (more proactive) approach would require the expenditure of resources, including economic ones, which are essential for proper monitoring and possible intervention in management activities.

[35] This is the Shareholder Rights Directive II, which amends the EU Directive No. 36 of 2007 (the so-called Shareholder Rights Directive I), both relating to the exercise of certain rights of the shareholders of listed companies which are functional to encouraging their long-term commitment.

[36] These are functional devices to avoid excessive absenteeism of members. See Marchetti, *D.Lgs. 58/1998. L'incidenza sulla disciplina delle assemblee: primi commenti*, Società 557 (1998).

[37] The board of statutory auditors, like the board of directors, is also elected through slate voting, with the specification that the chairman of the board of statutory auditors shall be drawn from the candidates included in the minority list (Article 148 of the Italian Securities Act).

[38] See Valensise, *Il "nuovo" collegio sindacale nel progetto italiano di corporate governance*, Torino (2000).

[39] In this respect see Dick and Zingales, *Private Benefits of Control: An International Comparison*, journal of Finance 537 (2004).

[40] See Enriques, *The Mandatory Takeover Bid Rule in the Takeover Directive: Harmonization without Foundation*, ecfr, 440 (2004).

[41] See Sacco Ginevri, *Sustainable Governance and Regulation of Banks and Public Companies: a study of the concept "Acting in Concert"*, Corporate Governance and Sustainability Review 42 (2017).

[42] An overview of such conducts is provided by ESMA, *Information on shareholder cooperation and acting in concert under the Takeover Bids Directive* – first update, June 2014, available at *www.esma.europa.eu* – in which the authority recognizes that shareholders may wish to cooperate in a variety of ways and in relation to a variety of issues for the purpose of exercising good corporate governance without, however, seeking to acquire or exercise control over the companies in which they have invested.

[43] Pursuant to Article 2391-*bis* of the Italian Civil Code, the rules on transactions with related parties set forth therein, and implemented by Consob Regulation on Related Parties' Transactions, as subsequently amended and interpreted by Consob, shall be applied to Italian issuers (pursuant to Article 2325-*bis* of the Italian Civil Code). The catalogue of related parties is contained in attachment 1 to the afore-mentioned Consob Regulation.

[44] See Miola, *Le operazioni con parti correlate*, Amministrazione e controllo nel diritto delle società, Torino 643 (2010).

[45] Moreover, in order to monitor the progress of the negotiations, one or more members of the committee specifically delegated are generally involved in the negotiation phase and in the preliminary

phase through the receipt of a complete and timely flow of information and with the right to request information and to make observations to the executive bodies and to the persons in charge of conducting these phases. See Article 8, paragraph 1, letter b), of the aforementioned Consob Regulation.

[46] See Article 11 of the aforementioned Consob Regulation.

[47] See Article 5 of the aforementioned Consob Regulation.

[48] See Enriques, *Related Party Transactions: Policy Options and Real-world Challenges (with a Critique of the European Commission Proposal)*, EBOR 1 (2015).

[49] Since their origin, savings shares have been featured by the lack of voting rights at the shareholders' meeting, which is balanced by the mandatory granting of financial privileges.

[50] In particular, the introduction of saving shares was aimed at separating, with greater transparency, the role of the control group from the one of the saving shareholders, so as to concentrate on ordinary shareholders any negative results arising from entrepreneurial activity and, at the same time, strengthen the equity position of shareholders without powers of management influence. See Ferri, *Il Decreto Legge 8 aprile 1974, n. 95 e le modificazioni apportate con la legge di conversione*, I Riv. dir. comm., 192 (1974).

[51] Reference is made to Sacco Ginevri, *Azioni di risparmio (voce)*, Digesto delle discipline privatistiche, commercial section, Update *******, Torino 20 (2015).

[52] See Sepe, *Sub Art. 145 of the Italian Securities Act*, Il testo unico della intermediazione finanziaria, edited by Rabitti Bedogni, Milano 768 (1998).

[53] See Maugeri, *Azioni di risparmio e assemblee di categoria: prime note sul coordinamento tra t.u.f. e nuovo diritto societario*, I Giur. comm., 1302 (2004).

[54] See Giampaolino, *Le azioni speciali*, Milano (2004).

[55] See Sacco Ginevri, *Attivismo degli azionisti di risparmio e operazioni straordinarie*, I Giur. comm. 1092 (2014).

[56] See Sacco Ginevri and Sbarbaro, *The Role of Preferred Shareholders in Fundamental Transactions: Preliminary Thoughts*, European Business Law Review 765 (2015).

[57] See Minervini, *Gli amministratori di società per azioni*, Milano 189 (1956).

[58] See Oppo, *Eguaglianza e contratto nella società per azioni*, Riv. dir. civ. 32 (1974).

[59] See Angelici, *La società per azioni e gli «altri», L'interesse sociale tra valorizzazione del capitale e protezione degli* stakeholders, Milano 56 (2010).

[60] See Sacco Ginevri, *Il conflitto di interessi nella gestione delle banche*, Bari (2016).

[61] See Oppo, *La tutela dell'azionista nel progetto di riforma*, Riv. soc. 1220 (1966).

[62] See Sacco Ginevri, *The Rise of Long-Term Minority Shareholders' Rights in Publicly Held Corporations and Its Effect on Corporate Governance*, EBOR 587 (2011).

Author

Andrea Sacco Ginevri is Full Professor of Law and Economics at the Law Faculty of Università Telematica Internazionale Uninettuno in Rome