Volume 1, Issue 2, 2015

ISSN 2058-7422

OPEN REVIEW OF MANAGEMENT, BANKING AND FINANCE

FONDAZIONE CAPRIGLIONE Onlus

in association with

REGENT'S UNIVERSITY LONDON
Centre for Banking and Finance

An editor, at any time, must be evaluating manuscripts for their intellectual content without regard to race, gender, sexual orientation, religious belief, ethnic origin, citizenship, as well as scientific, academic, or political orientation of the authors.

The editors and any editorial staff must not disclose any information about a submitted manuscript to anyone other than the corresponding author, reviewers, potential reviewers, other editorial advisers, and the publisher, as appropriate. Unpublished materials disclosed in a submitted manuscript must not be used in an editors' own research without the expressed written consent of the author. When the editorial board is notified or discovers a significant problem regarding errors/ inaccuracy, undisclosed conflict of interest, plagiarism, in a published article, the editorial board will promptly notify the corresponding author and the publisher and will undertake the necessary actions to clarify the issue and in case of need to retract the paper or publish an *Erratum*.

Peer reviewer's duties

Peer reviews assist the editor in making editorial decisions and through the editorial communications with the author may assist the author in improving the paper. Any selected referee who feels unqualified to review the research reported in a manuscript or knows that its prompt review will be impossible should notify the editor and excuse himself from the review process. Any manuscripts received for review must be treated as confidential documents. They must not be shown to or discussed with others except as authorised by the editor. Reviews should be conducted objectively. Personal criticism of the author is inappropriate. Referees should express their views clearly with supporting arguments.

Reviewers should identify relevant published work that has not been cited by the authors. Any statement that an observation, derivation, or argument had been previously reported should be accompanied by the relevant citation. A reviewer should also call to the editor's attention any substantial similarity or overlap between the manuscript under consideration and any other published paper of which they have personal knowledge. Privileged information or ideas obtained through peer review must be kept confidential and not used for personal advantage. Reviewers should not consider manuscripts in which they have conflicts of interest resulting from competitive, collaborative, or other relationships or connections with any of the authors, companies, or institutions connected to the papers.

Author's duties

The authors should ensure that they have written entirely original works and if the authors have used the work and/or words of others that this has been appropriately cited or quoted. Proper acknowledgment of the work of others must always be given. Authors should cite publications that have been influential in determining the nature of the reported work.

Authors of reports of original research should present an accurate account of the work performed as well as an objective discussion of its significance. Underlying data should be represented accurately in the paper. A paper should contain sufficient detail and references to permit others to replicate the work. Fraudulent or knowingly inaccurate statements constitute unethical behaviour and are unacceptable. Manuscripts submitted must not have been published as copyrighted material elsewhere. Manuscripts under review by the Journal should not be submitted for consideration by another publication as copyrighted material. By submitting a manuscript, the author(s) agree that, if the manuscript is accepted for publication, the exclusive right to use the article for any editorial exploitation, without space limits and with every modality and technology, will be transferred to the Law and Economics Yearly Review Journal. Authorship should be limited to those who have made a significant contribution to the conception, design, execution, or interpretation of the reported study. All those who have made significant contributions should be listed as co-authors. Where there are others who have participated in certain substantive aspects of the research project, they should be acknowledged or listed as contributors.

The corresponding author should ensure that all appropriate co-authors and no inappropriate co-authors are included on the paper and that all co-authors have seen and approved the final version of the paper, having agreed to its submission for publication. All authors should disclose in their manuscript any financial or other substantive conflicts of interest that might be construed to influence the results or interpretation of their manuscript. All sources of financial support for the project should be disclosed. When an author discovers a significant error or inaccuracy in his/her own published work, it is the author's obligation to promptly notify the journal editor or publisher and cooperate with the editor to retract or correct the paper.

Reviewing process

Double-blind Review Process

1. Manuscripts and case notes will be reviewed by at least two reviewers (chosen among the Editorial Board members) and, where necessary, by an external advisor.
2. Any manuscript will be submitted by the Editorial Board – anonymously, together with an evaluation form – to the reviewers for an overall assessment.
3. In case of a single negative evaluation by one of the reviewers, the Editor-in-chief may assume the responsibility to publish the paper having regard to highlight this circumstance.
4. In any case, the submission of the paper or its positive evaluation does not provide any right to the author to ask for the publication of the paper. Fondazione Gerardo Capriglione Onlus may reproduce articles published in this Review in any form and in any other publication.

Open Access policy

Papers submitted to the Journal should be authentic and original contributions and should have never been published before in full text, nor be under consideration for any other publication at the same time. Authors submitting articles for publication warrant that the work is not an infringement of any existing copyright and will indemnify the publisher against any breach of such warranty. For use of dissemination and to ensure proper policing of use, papers and contributions become the legal copyright of the publisher unless otherwise agreed.

The Open Review of Management, Banking and Finance is an open access journal which means that all content is freely available without charge to the user or his/her institution. Users are allowed to read, download, copy, distribute, print, search, or link to the full texts of the articles in this journal without asking prior permission from the publisher or the author. This is in accordance with the BOAI definition of open access.

Table of Contents

The voice of stakeholders in large corporations under the Italian legislation of the last 10 years.....7

Raffaele Lener

How motivation brings to healthy organizations: methods and incentives to increase satisfaction, efficiency and productivity.....19

Angela Domenica Frusciante, Mohammed Elshendy and Nunzio Casalino

Recovery plans in the context of the BRRD framework..... 32

Vincenzo Troiano

Gender Diversity and Financial Intermediaries..... 42

Mirella Pellegrini

Concluding remarks of a conference on 'Diversity and gender equality in the banks'..... 53

Francesco Capriglione

General Principles of Law 59

Guido Alpa

Hot Tips Turned Flops: Liability for Unsuitable Investment Advice – An Integrated Approach.....83

Hanns A. Abele, Georg E. Kodek and Guido K. Schaefer

Open Review of Management, Banking and Finance

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

The voice of stakeholders in large corporations under the Italian legislation of the last 10 years.

by **Raffaele Lener**

Abstract: Following the reform of 2003, the Italian company law system is very open and flexible and is one of the most modern in Europe. Indeed, the Italian legislator envisages, on the one hand, shareholders that play no part in the management of the corporation and, on the other, non-shareholders that are instead granted administrative rights. While the assignment of administrative rights, including the right to vote, to non-shareholders is a frequent (indeed, almost common) occurrence in common law systems, it is considerably less so in continental Europe and, when it is allowed, there is an effort to restrict the non-shareholders' weight in the management of the corporation. The author tries to illustrate the new categories of financial instruments that an Italian corporation can issue, the corporate rights attached to these new instruments and the role that non-shareholders can now play in the governance of large Italian joint-stock corporations.

Summary: 1. Introduction. The *società per azioni* as an open business structure. – 2. Different categories of shareholders. – 3. Non-shareholders with management powers. – 4. Holders of *participating* instruments. – 5. Meaning of the prohibition on voting in general shareholders' meetings. – 6. The "external" member of the management board. – 7. Attending the shareholders' meeting. – 8. *Hybridisation* of *participating* instruments: "*quasi debt instruments*" and financial instruments "for participating in the transaction" – 9. Brief conclusions.

1. Giorgio Oppo's well-known comment, which provides the starting point for these brief notes, is that the modern *società per azioni* (SPA) may be described as an "open business structure" with a variable organisation. An organisation in which shareholders and non-shareholders may co-exist, there may or may not be the "profit-sharing purpose" envisaged by article 2247 Italian Civil Code and persons other than the shareholders may share the profits[1].

Although the flexible model of SPA introduced by the 2003 reform maintains certain "contractual" aspects, it would appear to be the result of a (more or less conscious) legislative choice to *interpret* the corporation as an *institution*[2].

The new relationship between shareholders and non-shareholders, the administrative rights that may be assigned to the latter and the possible reduction of the former's administrative rights without a

necessary economic "readjustment" create a certain distance between the organisation and the *contractual model*.

Following the reform, the Italian system is very open and flexible and is one of the most *modern* in Europe. Indeed, as we shall see, the Italian legislator envisages, on the one hand, *shareholders that play no part* in the management of the corporation and, on the other, *non-shareholders* that are instead granted administrative rights.

In fact, the assignment of administrative rights, including the right to vote, to non-shareholders is a frequent (indeed, almost common) occurrence in common law systems[3]. It is considerably less so in continental Europe and, when it is allowed, there is an effort to restrict the non-shareholders' importance in the management of the corporation.

There are principally two, potentially alternative (in light of the experience in other countries), reasons for assigning non-shareholders such rights: either to allow stakeholders to play a part, where possible, in the management of the corporation or to grant them administrative rights as a way of protecting their investment. Both reasons apply in Italy and the law virtually gives articles of association *carte blanche* with regard to regulation. Articles 2346 and 2351 Italian Civil Code only reveal an intention to maintain the shareholders' primacy in the management of the corporation. However, as we shall see, the limits are not always clear.

2. We know that the articles of association are free to create any *categories* of shares and to attach different rights to them. The law provides no parameters and even the "limits" within which the articles are allowed to operate (pursuant to article 2348, paragraph 2, Italian Civil Code) are uncertain and not readily apparent[4].

Thus, *categories* of shares may be freely created. It is not, instead, possible to assign individual shareholders particular rights relating to the management of the corporation or the distribution of profits (as in limited liability companies). I would say that particular rights in SPAs must still be assigned on an *objective* and not individual basis. This is the manner in which the concept of "category" must be interpreted, even though the articles of association have an almost unlimited power to establish its boundaries.

As regards the "limits" imposed by law, there is a *quantitative limit* on the issue of non-voting shares, limited-voting shares (where the right to vote is restricted "to particular matters") or shares whose voting rights are conditional upon the occurrence of certain future events. The overall value of such shares may not exceed one-half of the share capital (article 2351, paragraph 2, Italian Civil Code).

Even the traditional prohibition on issuing shares with *multiple voting* rights (article 2351, paragraph 4, Italian Civil Code, prior to the reform) has recently been transformed into a *limit* – although this decision was adopted, with no careful consideration of the matter, under the emotive pressure of the government's emergency measures for the "growth of the country". Corporations may now issue shares carrying more than one vote, with a limit of three votes per share. However, listed corporations may not issue multiple voting shares (the *prohibition* still applies in this case), but they may, through their articles of association, *increase the number of votes* to a maximum of two per share for shareholders that have continuously held their shares for at least two years (new article 127-*quinquies*, Consolidated Law on Finance, introduced by the "growth" Decree, *Decreto Legge* no. 91 of 24 June 2014, converted into Law no. 116/14).

It is difficult to ascertain whether the system envisages additional limits or prohibitions.

Scholars (still) tend to rule out any possibility of shares with *particular rights to appoint* (outside the shareholders' meeting) corporate bodies[5], based – it would appear – on the assumption that votes expressed in the shareholders' meeting constitute the "typical and exclusive" way in which shareholders contribute to the management of the corporation's affairs[6].

There is also a debate on whether it is possible to issue categories of shares carrying the *right to veto* certain shareholders' resolutions. Those who argue against this[7] do so based on the principles which may be inferred from the prohibition on multiple voting shares and the restrictions on the issue of limited voting shares, which, they say, imply that the system wishes to prevent a situation in which control is given to a category of shares representing a minority quota of the share capital. However, this argument is not entirely convincing. If – as the more "liberal" scholars accept and as appears entirely reasonable[8] – it is possible to issue shares with the right to vote *on the authorisation of management decisions* pursuant to article 2364, paragraph 1, no. 5, Italian Civil Code, there is no reason why it should not also be possible to issue shares with *veto rights* on the same matter. At most, categories of shares having the right to authorise, or veto, the directors' management decisions could be equated to categories of shares with limited or conditional voting rights so that they would be subject to the overall limit of one-half of the share capital.

Article 145, paragraph 1, Consolidated Law on Finance does not appear to envisage any further limits on the creation of categories. This provision only allows the issue of non-voting shares ("*azioni di risparmio*") if the corporation has ordinary listed shares (on regulated markets, including in other EU countries) and provided that the lack of voting rights is *compensated* by economic benefits, although the law provides no criteria to define such benefits, leaving this task to the articles of association (article 145, paragraph 2, Consolidated Law on Finance). In effect, this article – which undoubtedly *goes against the current trend* – compensates for the rights which are taken away from shareholders (voting and associated rights) by giving them something in addition to the rights assigned to them by law (economic rights) and is, as such, an "old-style" provision that appears to have ignored the 2003 reform. Indeed, the question is whether, in light of the new article 2351, paragraph 2, Italian Civil Code, categories of non-voting shares can be created without any form of economic compensation and without any requirement that the ordinary shares be listed. The answer must now be affirmative: "*azioni di risparmio*" do not account for all the categories of shares which may in theory be defined as *not carrying voting rights*. One could merely have the foresight to give them a different name: "*azioni senza voto*", "*azioni non amministrative*" and so on. This would eliminate the listing requirement and the obligation to provide economic compensation, leaving only the quantitative cap envisaged by article 2351, paragraph 2. In other words, only shares named "*azioni di risparmio*" are protected to avoid confusion.

Finally, a "systemic" limit may be inferred from the *prohibition on leonine agreements* pursuant to article 2265 Italian Civil Code (i.e. the exclusion from participating in profits or liabilities)[9], on which case law has recently placed new emphasis (e.g. Court of Milan, 30 December 2011, in *Le società*, 2012, p.1158). However, it should be noted that article 2348, paragraph 2, Italian Civil Code allows different rights to be granted "including with regard to the impact of losses", so much so that there is an increasingly frequent use of subordination. Probably, the only practical consequence of the prohibition is probably that is possible to issue categories of shares which are entirely excluded from profit sharing.

It is clear, then, that there are very few "statutory limits" on the creation of categories. As a consequence, the principle, envisaged by article 2348, paragraph one, Italian Civil Code, that all shares are equal – which has been downgraded to equality *within* the category – ultimately has very little meaning. Indeed, it could even be removed entirely were it not for the fact that the market still requires that shares with the same content belong to a category with a certain *name*.
In conclusion, there may undoubtedly be shareholders who contribute to the capital, but have *no administrative rights* in the management of the corporation and do not necessarily receive enhanced economic rights to offset this loss.
As a result, it is increasingly difficult to think of shareholders – only or mainly – as parties to a corporate contract[10]. Indeed, from a contractual perspective, although there is no requirement for the shareholders to be absolute equal, there would have to be a causal justification for any inequality and, thus, a *reasonable equilibrium* between the shareholders which in return for the sacrifice of certain individual rights envisages the enhancement of other rights. This "need for equilibrium" is no longer recognised by the system that currently governs *SPAs*[11].
The final reason for allowing such contractual *imbalances* most probably lies in the legislator's desire to guarantee that corporations have access to as many sources of funding as possible, so that they are no longer exclusively dependent on funding from banks.

Corporations need funding and they are allowed to raise funds even by issuing shares with no administrative rights, just as they are also permitted to issue financial instruments other than shares which, as such, do not represent equity interests, but which may carry administrative rights.

Ultimately, the market will be the final judge. It is clear that there will be no market for an *imbalanced* category of shares, i.e. one in which the administrative penalisation is not offset by an adequate economic benefit – which, as mentioned, is permitted by law regardless of the reaffirmation of the principle of equality – and so it will not enable issuers to raise funds. Moreover, the protection offered by the special shareholders' meeting envisaged by article 2376 Italian Civil Code will not apply since this remedy only operates against the *worsening* of the terms of issue and is ineffective against inherent penalisations of the category.
These considerations appear to confirm that the general rationale behind the reform of 2003 is that (small) shareholders are viewed as *investors*, who use their savings to fund businesses managed by others. As a result, the emphasis is on the financial aspect of the contribution in light of the SPAs' *natural vocation* to raise funds on the risk capital market. Moreover, from this perspective, it is of *no interest* to the legislator whether an investment is defined as a contribution (*conferimento*) or as a consideration (*apporto*), or whether an investor is defined as a shareholder (although not a controlling shareholder, of course) or a creditor with a (limited) voice[12].

3. The contractual rights of shareholders are further reduced by the presence of third-party rights, i.e. held by non-shareholders, *with management powers*.
Article 2346, paragraph 6, Italian Civil Code allows corporations to issue financial instruments that carry economic "or also administrative rights, excluding the right to vote in the *shareholders' meeting*" against consideration, by shareholders or third parties in general, in the form of work or services. Such consideration "does not constitute a contribution and does not contribute to or increase the

corporation's equity"[13]. The articles of association regulate the procedure for their issue and their contents and, if transferrable, also the relevant law.
This provision opens the way to a panoply of cases, which are perhaps in some respects even more numerous or, in any case, more *flexible* than the *categories of shares*, whose limits do not apply to the instruments which we shall call "participating instruments".
There is no mention of *categories* of (participating) financial instruments, which suggests that it may be possible to issue *individual securities*.
Notwithstanding the great uncertainty arising from the meagre provisions of the Italian Civil Code, it would appear that individual issues are possible. Indeed, the rules on special meetings set forth by article 2376 Italian Civil Code also mention participating financial instruments, but the provision states: "*if* there are different *categories* of [shares or] financial instruments that carry administrative rights". Thus, it is reasonable to assume that, where a category of participating financial instruments exists, there must also be a (special) meeting of the category. However, if individual securities are issued, there will clearly be no meeting of the category. In this case, the (only) remedies available to individual financial instrument holders who are damaged by a corporation's decision will be the general remedies envisaged by statutory law.

4. It is not easy to identify the administrative rights that can be assigned to the holders of such instruments.
There can be no doubt that participating instruments may carry *information rights*; for example, the right to consult the corporation's books, request information, postpone meetings due to insufficient information and also the powers envisaged by article 2408 Italian Civil Code. From this perspective, holders may perhaps be allowed to *attend but not intervene in shareholders' meetings,* but this raises issues of compatibility not so much with article 2346 as with the new version of article 2370 Italian Civil Code and the apparently necessary connection between attendance and voting[14].
The issue of *rights of participation* is more complex.
In fact, as mentioned, the provision allows the generic assignment of *administrative rights*, which will be determined by the articles of the corporation, with the sole limit that such rights will not include the right to "vote in the general shareholders' meeting". It must be said that "administrative right" is merely an "*a contrario*" definition: any right that cannot (exclusively) be classified as an "economic right" will be defined as an administrative right. Actually, the law even fails to define the concept of general shareholders' meeting, but, once again, the definition can be inferred *a contrario* from article 2376 Italian Civil Code: a general shareholders' meeting is a meeting not intended for individual categories.
Financial instruments may be assigned administrative rights and economic rights, or even just administrative rights. The phrase used by the legislator is not particularly clear ["carrying economic rights *or even* administrative rights"] and suggests that such instruments must always assign economic rights and may, exceptionally, *also* assign administrative rights. However, I can see no systematic reasons for ruling out instruments that only assign administrative rights. In a case such as this – which is probably destined to remain in the realms of theory – it should be possible to transfer the financial instruments so that the holder can (at least) make a profit from their sale.

5. The prohibition on voting in general shareholders' meetings is not easy to interpret in light of article 2351, paragraph 5; indeed, there appears to be a clear lack of coordination between the two.

Article 2351, paragraph 5 provides that participating financial instruments may carry the right to *vote on specifically indicated matters* and, *in particular,* they may be assigned the right to appoint an independent member of the board of directors or supervisory board or a statutory auditor.
In effect, these provisions are irreconcilable without partially emptying the prohibition contained in article 2346 of *technical* meaning and transforming it, within the limits that we shall see, into a general statement of principle.
Indeed, any interpretation of article 2351 that limits the voting rights of financial instrument holders to special meetings is unacceptable[15]. When the law mentions "vote" without further specification, there can be no doubt that it is necessarily referring to the (general) shareholders' meeting. Moreover, there would be no reason to expressly assign the right to vote in the special meeting given the provision of article 2376 Italian Civil Code. Furthermore, since the right to vote in the special meeting serves to protect the rights of the *category*, there is no way it could be limited to "specifically indicated matters".
Similarly, voting cannot be reduced to a mere *declaration of an opinion*. If the intention had been to provide for consultation of the financial instrument holders, the legislator should not have used the word "vote".
Nor would it make any more sense to interpret the provision as if it referred to the *appointment outside the shareholders' meeting* of members of the corporation boards: article 2351 envisages the assignment of the right to vote, which is a right that is typically exercised at the shareholders' meeting.
Moreover, the fact that the holders of these instruments are not prohibited from taking part in the "general" shareholders' meeting is demonstrated by a – better-worded – provision which expressly states that even cooperatives may issue participating instruments. Indeed, article 2526, paragraph 2, Italian Civil Code provides that "financial instrument holders may not, in any case, be assigned more than one-third of the votes granted to the total number of shareholders present or represented *at each general meeting*".

As for the specific matters on which these persons may be entitled to vote, all that can be said at present is that such matters must fall within the competence of the shareholders' meeting and not within the remit of the directors.

Instead, it is correct to assume that the scope of the "specific matters" on which participating instrument holders may vote must not be such as to encroach *in general* on the voting rights which are *reserved in principle to the shareholders* (which is the *real meaning* that should be attributed to the provision of article 2346, paragraph 6): thus, it is *not* so much a prohibition on *voting in the – general – shareholders' meeting* as a *prohibition on attributing a general scope* to the voting rights of the participating financial instrument holders[16].

Therefore, the exclusion of voting rights in the "general shareholders' meeting" should be interpreted not with reference to the body, but to the general nature of its areas of competence, which is replaced by the specific indication of particular matters.

Lastly, it should be emphasised that the law does not introduce a rule of proportion with the vote of shareholders, so that where there are both voting rights attached to shares and voting rights attached to financial instruments during a "general" meeting, the articles of the corporation will have to adjust the "weight" that each carries (with criteria that are, however, difficult to establish since, as we have seen, the contribution of works or services is also freely permitted).

6. The member of the management or supervisory board who may be appointed by the holders of participating instruments[17] must be regarded as having full powers and not as being a "quasi director" or "quasi auditor". The only provision is that he or she be "independent", i.e. meet the statutory requirements of *independence* (those envisaged by article 2399 Italian Civil Code or any others applicable), but we also cannot rule out that she or he may have "executive" powers. At least, this is the case in the traditional and in the one-tier system, since the two-tier system does not envisage the appointment of a member of the management board. Once again, there is a certain lack of refinement on the part of the legislator.
The provision does not even clarify whether, if there are several categories of financial instruments, the articles may assign *each of them* the power to appoint an independent director or auditor; nor does it clarify whether, in such case, there is still a cap on members not elected by the shareholders. Again, a legislative gap of no little importance.

It is clear that the interpretation whereby the majority of the members of the corporation boards must necessarily be chosen by the shareholders is not fully convincing with regard to a flexible organisational model such as that of "modern" SPAs. Besides, it would not be easy to find a legal basis.

The only argument that may, perhaps, be used to define the scope of the power to appoint corporation bodies that may be attributed to financial instrument holders is the formal argument that may be inferred from a strict interpretation of article 2351, paragraph 5, where it provides that "the appointment of *an* independent member may be reserved to them, in accordance with procedures established by the articles of association, (...)". This would imply that the total number of such independent representatives could not exceed one, with the consequent need to establish unitary election mechanisms in cases in which there are several categories of financial instruments[18]. However, any argument based on a literal interpretation is undoubtedly somewhat weak when the provisions in question are so unclear and incomplete.

7. As mentioned, another issue is whether the financial instruments may be attributed the right to *attend* the shareholders' meeting, since article 2346 Italian Civil Code *only* excludes – in the manner specified – their *right to vote*. If this were the case, there would be a conflict with article 2370, paragraph 1, Italian Civil Code, which provides that only "those who are entitled to vote" may attend the shareholders' meeting. The issue is, naturally, of general relevance. However, in this case, one could even adopt the broadest interpretation, given the importance – from the perspective of their information rights – of the financial instrument holders' attendance.
There is also an issue as to whether the participating financial instrument holders are entitled to challenge resolutions, naturally only regarding matters on which they are entitled to vote. In fact, article 2377 *only* refers to challenges *by shareholders*, but one could perhaps try to overcome this formal limit based on the logical connection between vote and challenge. However, I believe that, *in general terms*, this suggestion should be rejected due to the insurmountable technical problems that would arise: if nothing else, just consider the practical impossibility of applying the minimum shareholding requirement envisaged by the third paragraph of article 2377.
Therefore, it is reasonable to assume that, where there is no provision in the articles, a financial instrument's voting right *does not imply*, by default, a right to challenge. However, there is no reason why the articles should not envisage such a right – indeed, the articles may certainly derogate from the

aforementioned quantitative limit – and, in this case, regulate the relevant procedure and, in particular, the entitlement criteria.

8. In addition to the general provision of article 2346, paragraph 6, Italian Civil Code, which has, as we have seen, an *open* content, Italian company law envisages other – what we might call – special participating financial instruments with a *partially predetermined* content.
I should specify that the financial instruments *assigned to workers,* envisaged by article 2349 Italian Civil Code cannot be considered *special*, as the only thing that differentiates them from the general type of financial instruments is that they are issued to employees of the corporation. Nor should financial instruments issued by cooperatives, pursuant to the aforementioned article 2526 Italian Civil Code, be considered *special* for our purposes, since they also fall within the general provision (which are expressly referred to in the first paragraph of article 2526), with the only specific provision being the withdrawal right of holders of instruments carrying voting rights, in accordance with the procedure envisaged by article 2437 Italian Civil Code (article 2526, paragraph 3).

There are two genuinely "special" types of special participating financial instruments.

The first is that envisaged by article 2411, paragraph 3, Italian Civil Code, which extends the rules on bonds "to financial instruments, howsoever named, which make the timing and extent of the repayment of the capital to the economic performance of the corporation". In this case, the provision clearly envisages *quasi debt instruments* and not "corporate" instruments[19].
The second special type is envisaged by article 2447-*ter,* paragraph 1, letter (e), which refers to financial instruments for "participating in the transaction", which the corporation may issue when it resolves to set up a dedicated fund, with a "*with a specific indication of the rights conferred by such instruments*".
It appears that the articles of association may only assign supervisory powers to such instruments and not – at least, in principle –administrative rights: holders should *not* be able to play a role in the management of the transaction (based on article 2477-*ter,* paragraph 1, letter (d) and article 2477-*octies*, paragraph 1, no. 1, Italian Civil Code). Even the special meeting envisaged by article 2477-*octies* is not that referred to in article 2376 Italian Civil Code, but is equivalent to the bondholders' meeting envisaged by article 2415 Italian Civil Code (the rules of which are expressly referred to).
The relationship between the general and special participating financial instruments is ambiguous. In particular, there is debate as to whether such instruments may also carry administrative rights. The simplest solution is that they may not, since the *relationship* between the two sets of rules is one *of mutual exclusion and not complementarity* (that of article 2411 and those of article 2346 and article 2477-*ter*)[20]. As we shall see, this is true in part.
There can be no doubt that "quasi debt instruments" have their own set of rules, which is that applicable to bonds, and this distinguishes them from the "general" participating financial instruments envisaged by article 2346 Italian Civil Code. The specific rules regard three aspects: (i) the quantitative limit on their issue (i.e. double the share capital pursuant to article 2412 Italian Civil Code), which only applies to *quasi debt instruments*; (ii) the procedure for their issue: a board of directors' resolution is sufficient for *quasi debt instruments* (pursuant to articles 2410 and 2411, paragraph 3 Italian Civil Code), while article 2346 requires provision in the articles of association, with no need for a subsequent shareholders' resolution if the articles already provide all the details (procedure, conditions, issue, content of the rights, specific provisions for non-fulfilment and, if transferrable, also the relevant law);

the articles could certainly delegate such matters to the shareholders' meeting or the board of directors, but the source would still be the articles themselves; (iii) the rules on special meetings, which are regulated by article 2415, and not by article 2376 Italian Civil Code

Notwithstanding these specific rules, it makes no sense to state that such instruments cannot in any case be assigned administrative rights. It makes no sense because article 2346 permits the creation of "hybrid" instruments.

In other words, the articles could envisage the issue of participating financial instruments against a cash contribution, which carry administrative rights (with the broad freedom permitted by article 2346) and economic rights essentially equivalent to those specified in article 2411, paragraph 3 (i.e. with total or partial repayment upon expiry, commensurate with the performance of the corporation's business). What must be avoided in a case such as this is the risk that the law may be easily evaded; as a result, the quantitative limits envisaged by article 2412 on the issue of such instruments must in any case apply.

In reality, the problem should be approached from a different perspective: the issue is not so much whether a certain administrative right can be assigned to financial instruments similar to bonds, but rather whether the bond issue limits should be imposed on *hybrid* financial instruments, issued under article 2346, which envisage either total or partial repayment of the capital contributed, even where i) such instruments in some way *share the business risk*, with the measure of the repayment being linked to the corporation's financial results and ii) they carry *administrative* rights. The *hybridisation* of *quasi debt instruments* cannot exempt them from the provisions that limit their issue.
Instead, I can see no problem with regard to the body responsible for deciding their issue or the organisation that protects the rights of the holders of such *hybrid* instruments. Indeed, article 2411, paragraph 3, Italian Civil Code generally provides that the rules contained in *Section* VII (on bonds) apply to all the financial instruments that we have defined "quasi debt instruments". However, this is *only* true for instruments without administrative rights, while for *hybrid* instruments (including participating instruments) there would clearly be problems of compatibility between the two sets of rules (as regards the body that may decide their issue – management board or articles/extraordinary shareholders' meeting – and as regards the holders' organisation – bondholders' organisation or participating instrument holders' organisation -). Indeed, in the case at hand, the "hybrid" financial instrument is part of the corporate organisation and (potentially) interferes with the shareholders' prerogatives. Moreover, the limited protection afforded to bondholders would make little sense in light of the powers of "self-protection" that the assignment of administrative rights provides for holders.
Thus, it must be concluded that the rules on bonds only apply *in their entirety* to *para-debt instruments* not carrying administrative rights, while such rules only apply in part (i.e. exclusively with regard to the quantitative limits on their issue) to instruments that carry administrative rights.
Although an intermediate solution – i.e. a case-by-case analysis of such *hybrid* instruments to ascertain the level of "contamination" by participating instruments – has been proposed in an intelligent manner by scholars[21], it is not wholly convincing. In effect, it would require the interpreter to verify whether the administrative rights assigned to the holder are sufficient to attribute an "organisational value within the corporation" to these financial instruments and only in this case would the rules on bonds be set aside. This interpretation is not acceptable because the parameter is too vague and uncertain.

In reality, it is a delicate issue of "establishing the boundaries", for which a clear solution would be preferable so as to prevent a race by financial engineers to create *hybrid* instruments, the logical conclusion of which would be that only the assignment of *minor* administrative rights would be compatible with the rules on debt instruments. What would such "minor" rights be?? The power to inspect the corporation's books[22]? Taking part but not voting in the shareholders' meeting (setting aside the often cited problem constituted by article 2370 Italian Civil Code, which means that it is now difficult to imagine a situation in which attendance and vote are separated)? "Atypical" generic powers of oversight/supervision? Moreover, the sole purpose of this effort would essentially be to ensure that it is the management board that issues the instruments. It would be much better to state categorically that if administrative rights are also assigned, the rules set forth in article 2346 and not those in articles 2411 *et seq*. will apply, subject to the quantitative limits envisaged by article 2412, which are – it must be repeated – applicable wherever there is a right to the repayment of the consideration, even if this is (in part) dependent upon the financial results.
Instead, financial instruments for participating in the transaction pose fewer regulatory problems: there are, in fact, fewer overlaps with the category of participating financial instruments in the case of *hybridisation* of the model envisaged by the Italian Civil Code. Here, as mentioned, the holder would, in principle, only have supervisory powers and not powers to "participate in the management". Therefore, additional rights – of supervision and information – could be assigned to him without resorting to instruments not envisaged by article 2447-*ter* Italian Civil Code
However, even in this case the *hybridisation* of the instrument would be possible, with the consequent application of the rules contained in article 2346 Italian Civil Code, including with regard to the special meeting, if one were to assign administrative rights that are not limited to management control. There would, however, be no mandatory provisions – as in the aforementioned case of the quantitative cap on the issue of bonds and similar instruments – except, perhaps, for article 2447-*sexies*, single paragraph, second sentence, which envisages an obligation to keep the book of financial instruments for participating in the transaction issued in a *nominative* form, which would be necessary in any case.

9. In conclusion, the holders of participating financial instruments may be assigned an extremely wide range of administrative rights. Despite the restrictions which must be recognised, sometimes even by "forcing" the new legislative provisions, the power to participate in the management of the corporation that may be assigned to third parties is considerable.
Nonetheless, although such third parties may be assigned greater administrative rights than those attributed to minority shareholders, they do not become parties to the corporate agreement[23].
In fact, participating instrument holders provide *consideration*[24], they do not make a contribution, and this gives rise to a different relationship to that of the corporate agreement. However, rather than a credit relationship – as in the case of corporate bonds – it would be preferable to define it as an associative relationship which may be equated to a partnership (*associazione in partecipazione*).
The consideration provided for financial instruments is in this case merely a *loan* to a business that continues to belong to *others*, regardless of which *administrative* powers are assigned to them. In essence, it would appear that, in this case, the legislator – which is not always clear in its choice of expressions – has purposely used the concept of "consideration" as a distinguishing feature.
This explains why the *substantive* limit on the issue participating financial instruments is that the issuer must not become an SPA *in the hands of non-shareholders*. However, since no quantitative criteria or

strict, clear limits have been introduced (as they have in other legal systems), one can only evaluate the articles as a whole to check that an *abnormal* corporation, institutionally controlled by non-shareholders, has not been created.

Reference:

[1] See Oppo, *Le grandi opzioni della riforma e la società per azioni*, in *Scritti giuridici*, VII, *Vario diritto*, Padova, 2005, p. 298.

[2] See Oppo, *Quesiti in tema di azioni e strumenti finanziari*, in *Scritti giuridici*, VIII, *Ultimi scritti*, Padova, 2013, p. 67.

[3] See in the US EASTERBROOK-FISCHEL, *Voting in Corporate Law*, in *The Journal of Law and Economics*, XXVI (1983), p. 399; in UK cfr. Davies, *Gower and Davies' Principles of Modern Company Law*, VII ed., London, 2003, p. 806; cfr. also Van Ryn, *Securities and Securities Holders*, in *Int. Enc. of Comp. Law*, XIII, 5, Tübingen, 1990, n. 181, 116.

[4] See Tombari, *Le categorie speciali di azioni nella società quotata*, in *Riv. soc.*, 2007, p. 972.

[5] See Tucci, *La costituzione e i quorum*, in Lener-Tucci, *L'assemblea delle società per azioni*, Torino, 2012, p. 142 ss.

[6] See Angelici, *La riforma delle società di capitali. Lezioni di diritto commerciale*, Padova, 2006, p. 71.

[7] See Pomelli, *Rischio di impresa e potere di voto nella società per azioni: principio di proporzionalità e categorie azionarie,* in *Giur. Comm.*, 2008, I, p. 530 ss.

[8] See Notari, *Le categorie speciali di azioni,* in *Il nuovo diritto delle società. Liber amicorum Gian Franco Campobasso*, I, Torino, 2006, p. 603.

[9] The prohibition on leonine agreements is, however, "too little" to limit the inequalities between categories of shareholders.

[10] See Oppo, *Spunti problematici sulla riforma delle società per azioni*, in *Scritti giuridici*, VII, cit., p. 275.

[11] See Oppo, *Sull'impatto sistematico della riforma del diritto societario*, in *Scritti giuridici*, VII, cit. p. 303 s.

[12] See the considerations in Oppo, *Principi (di diritto commerciale),* in *Scritti giuridici*, VII, cit., p. 163.

[13] See Oppo, *Patto sociale, patti collaterali e qualità di socio nella società per azioni riformata*, in *Scritti giuridici*, VII, cit., p. 322.

[14] See Lener, *L'intervento in assemblea*, in Lener-Tucci, *L'assemblea*, cit., p. 97 ss.

[15] See Desana, *Le categorie di azioni e gli strumenti finanziari non azionari*, in *La riforma delle società, profili della nuova disciplina*, Torino, 2003, p. 124 ss.

[16] Cfr. Cian, *Strumenti finanziari partecipativi e poteri di voice*, Milano, 2006, p. 107 ss.; in the US see Williamson, *Corporate Governance*, in *Yale Law Journal*, 93 (1984), p. 1206 ss.

[17] With the consequence that the management board will increasingly become a place of confrontation and discussion, including with the non-shareholders' representatives, and not just of management decisions.

[18] See Cian, *Strumenti finanziari partecipativi e poteri di voice*, cit., p. 105 ss.; Cossu, *Società aperte e interesse sociale*, Torino, 2006, p. 207 ss.; Lamandini, *Autonomia negoziale e vincoli di sistema nella emissione di strumenti finanziari da parte delle società per azioni e delle cooperative per azioni*, in *Banca, borsa*, 2003, I, p. 536. Cfr. also Pennington, *Company Law*, VIII ed., London, 2001, p. 648 s.; Davies, *Gower and Davies' Principles*, cit., p. 307; in Germany cfr. Schmidt, *Gesellschaftsrecht*, IV ed., Köln-Berlin, 2002, § 28, III, p. 832; for a different solution in Switzerland see § 709 OR.

[19] See Valzer, *Gli strumenti finanziari partecipativi e non partecipativi nelle società per azioni,* Torino, p. 306 ss.

[20] See Valzer, *op. cit.*, p. 353 ss.; Dentamaro, *Le obbligazioni*, in *Il nuovo diritto societario nella dottrina e nella giurisprudenza*, Bologna, 2009, p. 250 ss.; Giannelli, *sub Art. 2411*, in *Commentario*, directed by Marchetti, Bianchi, Ghezzi and Notari, Milano, 2006, p. 61 ss.

[21] See Cian, *Strumenti finanziari partecipativi*, cit.

[22] Under German Law see Hüffer, *Aktiengesetz*, VI ed., München, 2004, § 221, p. 1072; Lutter, in *Kölner Kommentar zum Aktiengesetz*, Bd 5/1, II ed., Köln-Berlin, 1995, § 221, Rn 220, 584.

[23] See Oppo, *Patto sociale*, cit., p. 324.

[24] On the different meaning of *apporto* (*consideration*) of the *contractual* view and of the *institutional* views of SPAs, see Oppo, *Le grandi opzioni*, cit., p. 287.

The Author

Raffaele Lener is Full professor of Financial Markets Law and Private Comparative Law in the Department of Law at the University of Rome Tor Vergata. He's also Lecturer in Commercial Law in the Department of Business and Management at the LUISS University. He is a partner at Freshfields Bruckhaus Deringer since 1998. He is member of the Italian banking A.D.R. "Arbitro Bancario Finanziario". He is a member of the Scientific Committee of AIPP-Italian Association of Payment Institutions and of UFI-Italian Union of Financial Intermediaries. He has been a member of the European Commission's Legal Certainty Group since 2005. He is also a member of the jury of Assogestioni (Italian Association of investment funds managers) and Assoreti (Italian Association of investment firms). He is the author of numerous publications (monographs, essays, articles, encyclopedia entries, commentaries) on securities regulation, company law, banks, financial markets, insolvency law and contracts in general. He is a founder member of the Associazione Disiano Preite. Editor of the Economic Law series, published by Giappichelli. Member of the editorial or scientific boards of the journals: Analisi giuridica dell'economia, Banca, borsa e titoli di credito, Il Foro Italiano, Rivista bancaria, International Banking Law and Regulations.

Open Review of Management, Banking and Finance

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

How motivation brings to healthy organizations: methods and incentives to increase satisfaction, efficiency and productivity

by **Angela Domenica Frusciante, Mohammed Elshendy** and **Nunzio Casalino**

Abstract: Motivation is a process consistent of several factors that make employees continually interested and committed in their job: it is done by stimulating their unique characteristics and their own needs/energies. Dealing with a managerial context, this article provides a wide discussion about the different keys that encourage motivation and empowerment; business well-being happens by adopting the appropriate strategies aimed at achieving satisfaction and productivity. There is a focus on intrinsic/extrinsic motivation and on how it is related to effectiveness, efficiency, productivity and performances. So monetary incentives are not always the right stimulus when the purposes are corporate healthy behaviors and high results. Furthermore, S.M.A.R.T. goals setting is explained: its implementation requires management-based theories and reinforcement procedures. In addition, leadership styles play an important role in this framework. The ones here discussed are participative, supportive and directive. The articles ends with a discussion on authors' findings and thoughts.

Summary: 1. Introduction. – 2. Role of motivation and organizational theories. – 3. The pyramid of needs and work dimensions. – 4. Goal settings and reinforcements. – 5. Leadership and motivation management. – 6. Research findings. – 7. Conclusions.

1. This article focuses on the useful factors for effectively motivating workers in their workplaces. A motivated worker generates value for the company. A good manager, therefore, is interested not only into the employees' physical health but also into the mental health, because this last is able to bring the highest results. The social changes of the 70s introduced an important new concept: health is not a factor to be taken into account when it is missing, but it is useful to implement policies in order to have a good climate in the organizations; this leads to study the psychosocial aspects of work [1]. It was increasingly evident the influence on health of both biological and psychological factors (as well as the importance of their combination and interaction). In the 90s the situation improved with the creation of the Occupational Health Psychology (OHP), an interdisciplinary topic aimed at optimizing the quality of the working life and safety. In this perspective, healthy work environments are characterized by high productivity, good employee satisfaction, good security, lower absenteeism, few turnover and no violence. The OHP intervened on three basic dimensions: the working environment, the individual and

the relation work/family. Raymond, Wood and Patrick (1990) [2] presented an assessment tool of organizational health-based indicators built considering two criteria: the time characteristic of the indicators (current, retrospective, and forecasting) and the availability/fluency of collecting data. A second study [3] aimed to a long-term view: a healthy organization is evaluated not only through the ability of working effectively but also through the ability to grow and develop. Consequently, the organizational health can be considered as the overall scenario and it is linked with studies on corporate culture and stress. The indicators of organizational "malaise" (symptoms) were spotted: this including the decrease in profits, the decrease in productivity, the absenteeism, the stress level of employees/organization and the overall well-being [4][5]. Avallone believes that the concept of organizational health is uncertain, generic and does not allow to identify the conditions by which an organization is in a good state and is able to keep it in time with motivation and productivity [6].

2. A lot of researchers addressed the aspect of motivation at work analyzing the factors that take place from job satisfaction and job dissatisfaction. The motivation at work can be defined as the inner drive that leads individuals to apply with energy and enthusiasm. It is a kind of internal strength [7] that stimulates, regulates and supports the major actions (taken by the subject involved) and can be described in a cyclic way: the individual searches for the tools in order to satisfy his/her own need, perceived as an inner tension; when it is satisfied, the subject checks for new and additional needs. Motivation is inside the individual and cannot be induced from the outside. Through external interventions it is possible to urge or, at most, to fuel it.

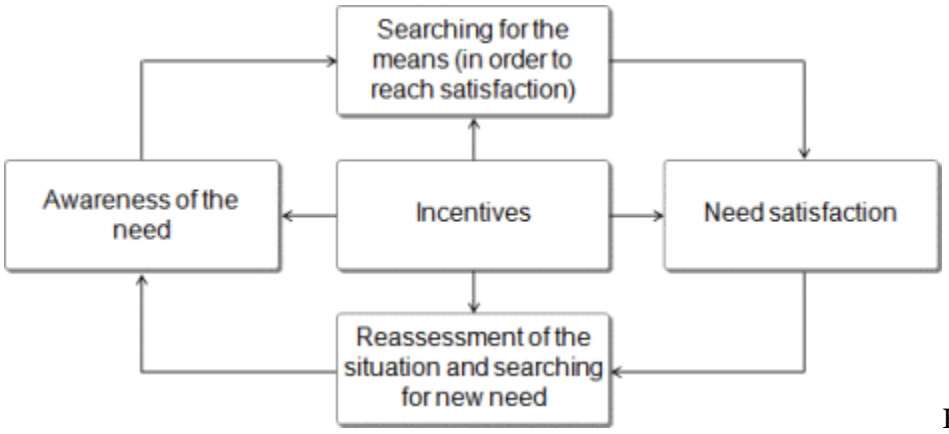

Figure 1: The life cycle of needs

The motivational system can be understood as the set of perceived needs and the links between them and the behavior. In order to define which are the elements that govern the motivation, several theories were formulated. For example Herzberg, in his studies, asked to the examined subjects to list what events in their professional life had caused satisfaction and what events had caused dissatisfaction [8][9]. The analysis of the results showed that the factors mostly contributing to generate satisfaction were related to the content of the work, while the factors of dissatisfaction were embedded in the working environment and remuneration. He took its cue from these analyses to develop a theory based on the distinction between two major classes of factors. On one hand there are those related to the external conditions of working such as the physical environment, social environment, remuneration (the ones that Herzberg calls the "hygienic factors"). On the other hand, there are the factors that affect

the internal content of the work, and therefore the ability to provide a psychological growth for the worker (the ones that Herzberg calls the "motivational factor"). Herzberg thesis is that hygienic factors cannot provide an effective satisfaction. The improvement of hygienic or environmental factors (i.e. more wages or more comfort) can only lead to a lower dissatisfaction. Therefore, with particular regard to the link between man and work, Herzberg said that people can be classified according to two different basic attitudes: there are "researchers of motivation" and there are "researchers of hygiene". The people in the first group are not only interested in economic well-being, safety, comfort of the physical environment or the pleasantness of the co-workers. Their aim is reaching a high level of satisfaction at work that will give them the joy of a psychological growth. Researchers of hygiene, instead, are captured only by the external aspects of working such as remuneration, environment, etc. Herzberg also said that only the researchers of motivation can experience a real job satisfaction. So researchers of hygiene, although may declare themselves satisfied, are actually "not-dissatisfied". According to Frederick Taylor (Monistic Theory) the motivation of the employee must be stimulated through systems designed to maximize productivity: the solutions he proposed concerned the introduction of piecework, the profit sharing and the participation in the savings. These systems are called monistic and the aim is to ensure that each employee uses, at work, all his/her energy in order to maintain and increase productivity [10]. By increasing productivity, the employee can increase his/her salary, his/her self-esteem and his/her status. Motivation procured by money however is questionable. In order to increase motivation, in an enterprise context, it could be useful to introduce [11]:

- empowerment;
- job enrichment & enlargement;
- job sculpting.

The term empowerment has had in recent years a significant resonance: it has Anglo-Saxon origin and a set of multifaceted meanings. Empowerment means "increased power". On an individual level, it is the ability of people to feel responsible/protagonists of their own tasks and to expand themselves; on an organizational level, it is the opportunity for the company to be more effective in operations and innovative challenges. In both cases, however, the assumption in that everyone has the resources that may be developed. Job enrichment, instead, is the approach by which the characteristics of the work are modified in order to make employees work with more autonomy and responsibility. This process is called vertical job loading and it introduces new and more enriched activities that do not belong to the daily routine. The horizontal job loading, instead, introduces an enlargement of the job, incorporating activities belonging to the same organizational level (in this way, however, the change is only quantitative and will lead to a greater load of routine activities). Some of the basic job dimension are [12]:

- variety of tasks;
- clear identification of tasks;
- significance of tasks;
- autonomy;
- presence of feedback.

Job sculpting is "the art of retaining your best people" [13]. It consists in making workers exactly do the tasks they really want and on which they perform better, satisfying so their deepest desires.

3. The Theory of Needs argues that the behavior of a person, even at work, tends to the satisfaction of needs arranged in a clear hierarchy, which he has shown in a pyramid. Starting from the bottom, the following categories are registered:

- physiological needs, linked to immediate survival (breathe, drink, eat, relax, move);
- security needs, physical and emotional, related to long-term survival (freedom from danger, threats and deprivation caused by physical damage, economic hardship, illness);
- need for love and belonging (emotional relationships, acceptance by peers, recognition as a member of the group);
- need for esteem and self-esteem (recognition by others and self-respect);
- need for self-realization.

The individuals' behavior is designed to satisfy the needs in the lower level, whose satisfaction leads to make them motivated and brings out the needs in the superior levels. This theory was very important in the management context during the last century, but it has some problematic sides: each individual, in fact, differs from the others and warns and meets the needs in different ways. For example, while some people are able to rest only a few hours' sleep, others need many more hours; while some people want to eat when hungry, others tend to satisfy higher needs. Salvemini has defined a different scale of needs that an individual can experience in the work contexts. The rank is:

- consumption needs;
- security needs;
- needs of sociability;
- esteem needs;
- power needs;
- needs of realization.

According to this author the satisfaction of a need, defined as the lack of a desired object, can be functional or dysfunctional to the satisfaction of other needs (i.e. the fulfillment of the desire for power can be functional to the needs for self-realization). According to Vroom (1964) [14], instead, motivation is related to two factors: the value, which is referred to the importance that one person gives to the achievement of a goal, and the expectation, which is represented by the probability recognized in order to achieve it. Motivation is so expressed in this formula:

Motivation = Valence X Expectancy

The value can be positive (when you want something) or negative (when you don't want something), while the expectation can only have positive value in fact, if the person doesn't recognize any chance of achieving the goal, the expectation is equal to 0. This theory was further developed and was enriched with an additional factor: the value of the reward, which refers to the reward of achieving the objective. The formula becomes the following:

Motivation = Valence X Expectancy X Value

According to this principle, the motivation of staff can be defined as a function of the work done, the objectives achieved and the behavior (i.e. if the behavior is considered positive, such as high performances at work, it should be subjected to a premium). The level of needs' satisfaction generates the organizational structure and the corporate climate/culture. The organizational behavior, that affect the individual performances, is the result of the interaction of four dimensions:

- extrinsic dimension (A);

- intrinsic dimension (B);
- dimension of sociality (C);
- dimension of solidarity (D).

A) *Extrinsic motivation* follows when an employee engages in an activity for purposes that are extrinsic to the activity itself, such as, for example, receiving praise, recognition, good grades or avoiding unpleasant situations, as a punishment or a fool.
B) *Intrinsic motivation*, in contrast, occurs when a worker engages in an activity because he finds it challenging and rewarding, feeling more and more competent. Intrinsic motivation is based on curiosity, which is activated when an individual meets environmental characteristics as strange, surprising and new; in this situation the person tends to explore the surroundings in order to search new information and solutions.
C) *The dimension of sociality* refers to the degree of friendship between the members of a community. There are many benefits: creativity is rewarded, work environment is pleasant, trust and mutual respect are produced. Pay attention to avoid the groupthink phenomenon, where consensus takes the place of the constructive debate and criticism.
D) *The dimension of solidarity* finally regards the actual interests / goals of the people. Solidarity determines a significant focus on the objectives, produces intolerance for unsatisfactory performances and allows you to respond quickly to threats. As disadvantages: the level of cooperation depends only by mutual interest and, if the roles are strictly defined, disagreements could arise inside the group.

Goffee and Jones' (1999) matrix [15] explains the relations between the last two dimensions.

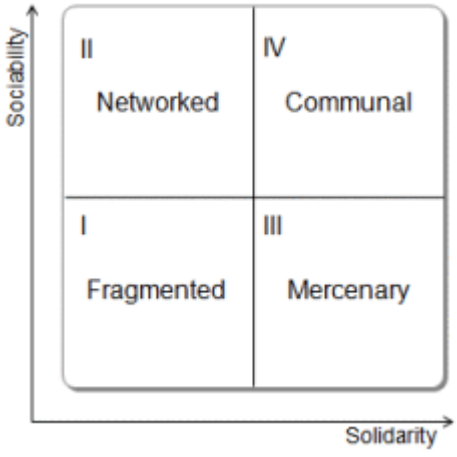

Figure 2: Goffee & Jones' Matrix

The box related to the "fragmented" concerns with the workers who interact with low sociability and little solidarity: goals are not perceived and interpersonal relationships are not present (sometimes it could happen that employees work remotely and they do not know each other). People in the "networked" box upgrade friendly relationships but are not so interested into sharing common objectives and tasks. The third box ("mercenary"), instead, has a strong focus towards the goals: typically these communities have short live and are highly motivated in the achievement of specific goals (i.e. Soldiers, Project Work Teams; even if the work experience is finished, during the time, the period spent together is remembered nostalgically and with pleasure). The ideal organization is the organization of citizens ("communal") [16] where the degree of sociability and the degree of solidarity are both high: the persons are strongly motivated into achieving their professional tasks, sharing

suggestions, observing deadlines, partaking into meetings and, in the same solution, into establishing social relationships rather hardly (sometimes co-workers become good friends and they also meet each other after work for informal drinks).

4. Goals are defined as the desired future conditions that the organization intends to achieve. Therefore, considering that these conditions are focused on company's purpose, the way they are being achieved is very important. Goal setting is a crucial dimension for labor relationships and it has been studied in fields such as Psychology and Economics [17]. According to the management and organizational literature, in order to motivate workers, one of the leader key-tasks is to promote clear purposes and ambitious goals for the whole team. A recent Fortune report talked about "Why CEO's fail" and estimated that projects execution failed in 70 percent of organizations, due to [18]:

- managers' disability to create a balance between strategic and operational tasks;
- unclear goal setting strategies.

Meanwhile, in Psychology literature, it is well recognized that goal setting is an effective way of achieving behavioral change in people. For instance, many psychologists argue that wage-irrelevant performance goals enhance employees' motivation and work performance [19]. Goals should be relevant (according to the person involved), challenging but realistic, achievable, specific and measurable [20]. According to this topic, in the last years one question arose: "How should goals be specified or written"? Locke and Latham carried out a case study explaining that employees are motivated when clear goals and periodic feedback (these last ones regarding performances) are provided. Their conclusion was that specific and precise goals have the highest motivational effect rather than vague and easy ones. Later, they developed five fundamental principles in order to create effective goal setting: the S.M.A.R.T. goal system [21]. S.M.A.R.T. goal setting drives towards efficacy. Instead of vague targets, SMART goal setting creates prosecutable path towards certain objectives, precise milestones and reliable results. Every goal, from the easiest to the most difficult one, can be made S.M.A.R.T. [22]. The acronym S.M.A.R.T. means:

- Specific – what is being pursued is exactly defined;
- Measurable – the achieved results are measured using recognized indices;
- Attainable – the goals are realistic to be achieved;
- Result – the goals are result-oriented;
- Timely – the milestones are exactly fixed in the timeline.

Reinforcement theory for motivation was proposed by Skinner and his colleagues. This theory said that the individual behavior follows the "law of effects". For example, individuals tend to repeat the actions that reproduce positive consequences and eliminate those ones that drive toward negative effects. Thus, according to Skinner (1953) [23], the organization must design its environment in order to encourage workers toward positive consequences. This theory is useful to control and analyze the different mechanisms concerning the individual behavior. The reinforcement is the submission of a certain kind of temporally limited stimulus which produces a response [24]. A reinforcing stimulus is defined by its power and by its ability to produce the desired changes. Some stimuli are able to produce changes, better than others are, and, consequently, they are classified as reinforcing or no reinforcing.

Reinforcement is fine when the positive behavior increases or maintains its frequency. In the organizational context, the employee desires the reinforced signal if he/she associates the outcomes to the behavior; in these cases the effect is stronger, more resistant and difficult to eliminate. In reinforcement learning, the procedure of selecting the best action is based on evaluating the results achieved during the observations (it could be useful to conduct many tests in order to individuate the best reinforced signals to use). The leader will choose the action, which maximizes the desired results [25]. Leaders use the following methods aimed at enhancing employees' behavior:

Positive Reinforcement – It implies giving a positive response when the worker shows the right and required behavior (i.e. immediately praising an employee for coming early at work). This will increase the probability by which the behavior occurs again. Rewarding, for example, is positive but not in all contexts. Only if the employees' behavior improves, rewarding can said to be a efficacious. The greater reinforcement happens when the intention of giving a reward is spontaneous.
Negative Reinforcement – It implies dealing with an employee by using action aimed at removing negative/undesirable consequences. Both positive and negative reinforcement can be used for increasing desirable/required behavior. Negative reinforcement is often used if positive reinforcement have not been effective in increasing the target skill/behavior [26].
Punishment – It implies removing positive consequences in order to decrease the probability by which an undesirable behavior befalls. In other words, punishment means applying undesirable consequence aimed at forbidding undesirable behavior (i.e. suspending an employee for breaking the organizational rules). In such contexts, considering the gained results, punishment can be equalized to positive reinforcement.
Extinction – It happens when reinforcements are absent. So extinction aims at lowering the probability of occurred-undesired behavior by removing all kinds of rewarding (i.e. if a worker no longer receives praise and admiration for his/her good work, he/she may feel unappreciated for his/her contribution). Extinction may unintentionally reduce desirable behavior.

5. Several studies have shown that leadership styles and motivation are strictly related: the most motivated followers have the most motivated leaders and vice versa [27]. According to this trail, the most important factors that an organization should use in order to preserve its effectiveness and its productivity are joined to the different leadership styles. Researchers have defined numerous and different leadership styles. The "style of a person" is created through the combination of his/her beliefs, values and preferences, organizational cultures and norms (encouraging one style and, even, discouraging others). As concerns Leadership Theories, there are three main key variables that affect the leadership styles: the leader's characteristics, the follower's characteristics and the environment's characteristics.

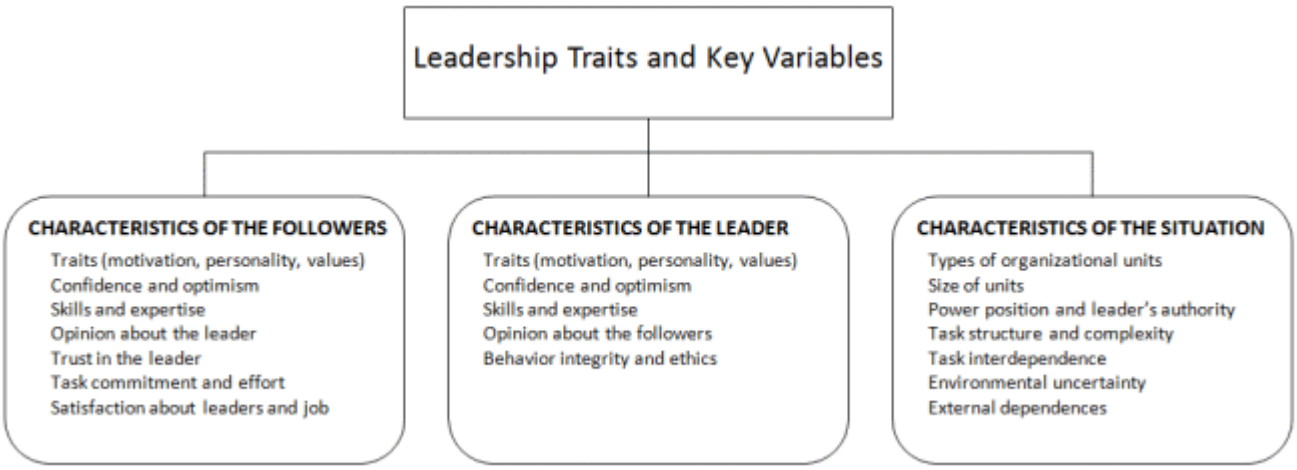

Figure 3. Key leadership components

Participative leadership style. It makes workers have high influence about their work decisions. This type of leadership leads to participative conditions where subordinates share a significant degree of decision-making power with their superiors. For example, if the workforce is smart, well-staffed and skillful, subordinates would prefer participative managers rather than directive ones. Instead of suppressing disagreement, aimed at appeasing the superior anger or ideas' divergence (as done in the recent past), the new generation of workers would definitely prefer to have a precise role in decision making. Supportive leadership style. It establishes a psychological support towards subordinates and this facilitate goal achievement, mutual trust and respect, helpfulness and friendliness. A channel leader with a supportive leadership style considers other channel partners' needs, looks after other partners' well-being, creates a pleasant atmosphere for interaction, encourages other units' accomplishments, looks out for their welfare, establishes mutual trust and builds a harmonious climate. Directive leadership style. It characterizes the leader that provides specific guidelines in order to drive his/her own subordinate work activities; this is managed by organizing and defining the task environment, assigning the necessary functions to be done, specifying rules and procedures to be followed (while accomplishing tasks), clarifying expectations, scheduling work, establishing communication networks and evaluating work group performance. Buble, Juras & Matic (2014) [27] said that motivation depends also on the following characteristics:

Demographic characteristics. They are relevant in order to configure managers' motivation and leadership styles. The most famous ones are those five: gender, age, academic degree, total work experience and work experience in the specific company.

Communication. It is commonly defined as the process of transferring information from one person to another. Interpersonal communication is not only the involvement grade of an individual in a group, but also the individual's self-realization level. Therefore, the communication development in the company significantly affects business performances and demonstrates the leadership style.

Interaction. It is the process of mutual and reciprocal influence regarding two or more people's behavior. Interaction has crucial importance for the management and it mainly bursts through the leader and his/her co-workers. It could be helpful to study the different kinds of interactions between the manager and his/her subordinates.

Decision-making. It is defined as the process of identifying the problems and the opportunities to resolve them [28]. It includes efforts before and after the decision is made. Who the decision makers are and how intensely the subordinates are involved in the decision-making process has a significant impact

on the solutions' realization. Therefore, it is very important to examine how this process takes place in the particular companies.
Controlling. It is aimed at monitoring employees' activities, determining the way the company uses towards the goals established; if needed, it supports corrective decision-making [28]. The management task is to ensure that employees are focused on achieving the goals fixed. In the context of graduated organizational changes [29], empowerment and trust are developed following new trends (the workers are less self-governed equalized to the previous classifications).

Therefore, the riddle is: "Which combination of leadership styles, motivation and followers' satisfaction results optimal for the organizational effectiveness?".

6. Multiple researches have shown the great influence of leadership on motivation. For example Mehta and other (2003) [30], studied the workers' performances subjected to multiple kind of motivation created by different leadership styles. The research showed that participative, supportive and directive leadership styles return all high levels of performance. Wright and Pandey (2010) [31], Bass and Riggio (2006) [32] and Storseth (2004) [33] found that the people-oriented leadership style is a key predictor for work motivation. Many other researchers have also confirmed these results leading to the thesis that the relation between leadership styles and employees' motivation is strong. So, as a result, the following model shows five principles in order to increase business productivity:

1) optimize human resources. A reorganization of human resources makes people do the activities they really "fit". Knowing the potential of each member in the company and entrusting the right responsibilities will enhance efficiency [34];

2) spur interpersonal relationships between employees. Quarrels and negative situations significantly harm the productivity. Suggesting corporate learning [35], creating a serene atmosphere and organizing events after-work (such as dinners or lunches) will help collaboration and tolerance among colleagues;

3) stimulate motivation encouraging members to do the best actions and to improve their position within the company (i.e. offering financial incentives or reward, such as travel, dinners, certificates, esteem, etc.);

4) improve the employees' welfare providing adequate break (i.e. coffee break to recharge the forces and make no mistakes) and allowing more flexibility (i.e. part-time or working from home, after a period of illness);

5) define priorities and delegation drawing up a list of things to do. It could be useful I) to delete – from time to time – the activities carried out, II) to get no distraction from colleagues and III) to delegate less pressing and important tasks.

7. A successful organization can reach its success by motivating employees. However, it can be difficult; there are no magic formulas or programs helpful to do this. Motivation is a personal dimension. While one employee may appreciate time off, another may enjoy new challenges. The basic rule is to discover what the workers want making it become reality or encouraging them to earn it. This is a success key for a department or a company [36]. Moreover, extrinsic factors are more significant compared to intrinsic

ones. So high salary, job security, etc., are more frequently required by employees and have the bigger impact on their motivational behaviors [37] but factors such as getting recognition for a job well done are more precious than the previous. Both categories of motivation enhancers, considered in different mixes, are always present in all type of leadership styles. The researches' results have confirmed that the relation is stronger between intrinsic motivation and leadership style rather between this last and extrinsic motivation. In conclusion, influencing managers' leadership style to motivational factors is very important [38] to avoid the drift towards the authoritarian leadership which is very dangerous. General principles to adopt and to support employees in their work are: know effectively the staff, give useful feedback, encourage people in achieving the goals, educate about the "business well-being", keep them informed and involved with the GAOS (in Italian: Grande Audace Obiettivo Sfidante) and adopt rewards (such as verbal recognition, professional development or money). Without motivation, nothing really gets started, as what you pay is what you get.

References

[1] Gabassi P.G., Psicologia del lavoro nelle organizzazioni, Franco Angeli, 7th Edition, Milan, 2007.

[2] Raymond J.S., Wood D.W., Patrick W.K., Psychology doctoral training in work and health, American Psychologist, 45 (10), pp. 1159-1161, 1990.

[3] Lyden J.A., Klengele W.E., Supervising organizational health, Supervision, Burlington, 2000.

[4] Avallone F., Bonaretti M., Manuale benessere organizzativo per migliorare la qualità del lavoro nelle amministrazioni pubbliche, Rubettino Editore, Rome, 2003.

[5] Casalino N., Draoli M., Martino M., Organizing and Promoting Value Services in Public Sector by a New E-government Approach, Proceedings of XIV Workshop dei Docenti e Ricercatori di Organizzazione Aziendale (WOA 2013), Università La Sapienza, Rome, 2013.

[6] Avallone F., Paplomatas A., Salute organizzativa, psicologia del benessere nei contesti lavorativi, Raffaello Cortina Editore, Milan, 2005.

[7] Maslow A., Motivation and Personality, Harper, Ney York, 1954.

[8] Herzberg F., One more time: How do you motivate employees?, Harvard Business Review 65 (5), pp. 109-120, 1987.

[9] Herzberg F., Mausner B., Snyderman B.B., The motivation to work, John Wiley & Sons, New York, 1967.

[10] Taylor F., The Principles of Scientific Management, Harper, Ney York, 1911.

[11] La Bella A., Capece G., Manuale di direzione d'impresa, Franco Angeli, Milano, 2012.

[12] Butler T., Waldroop J., Discovering your career in Business, Perseus Books Group, Ney York, 1997.

[13] Butler T., Waldroop J., Job Sculpting – The art of retaining your best people, Harvard Business Review, 77 (5), pp. 144-152, 1999.

[14] Vroom V.H., Work and Motivation, Wiley, Ney York, 1964.

[15] Goffee R., Jones G., What holds the modern company together?, Harvard Business School Press, Boston, 1999.

[16] Casalino N., Simulations and Collective Environments: New Boundaries of Inclusiveness for Organizations?, International Journal of Advances in Psychology (IJAP), Science and Engineering Publishing, USA, vol. 3, issue 4, pp. 103-110, 2014.

[17] Gómez-Miñambres J., Corgnet B., Hernán-Gonzalez R., Goal Setting and Monetary Incentives: When Large Stakes Are Not Enough, Chapman University Economic Science Institute, 2012.

[18] Forsberg K., Olsson P., Goal-Based Leadership, white paper, available online on: http://www.kristerforsberg.com/documents/WhitePaper_Goal-basedLeadership.pdf, 2008.

[19] Locke E.A., Latham G.P., Building a Practically Useful Theory of Goal Setting and Task Motivation, American Psychologist, 57 (9), pp. 705-717, 2002.

[20] Schmidt R.A., Wrisberg W.A., Motor Learning and Performance: A Situation-Based Learning Approach, fourth ed., Human Kinetics, Australia, 2007.

[21] Locke E.A., Latham G.P., Theory of Goal Setting and Task Performance, Englewood Cliffs, NJ: Prentice Hall, USA, 1990.

[22] Williams C., MGMT, 5th ed., USA: South-Western College Publishing, 2012.

[23] Skinner B.F., Science and human behavior, New York, Macmillan, 1953.

[24] Adams M.A., Reinforcement Theory and Behavior Analysis, American Psychological Association, Development & Behavior Analysis Special Interest Group of the Association for Behavior Analysis, 9 (1), pp. 3-6, 2000.

[25] Pandey P., Pandey D., Kumar S., Reinforcement Learning by Comparing Immediate Reward, International Journal of Computer Science and Information Security 8 (5), pp. 210-214, 2010.

[26] Neitzel J., Steps for Implementation of Negative Reinforcement, National Professional Development Center on ASD, 2009.

[27] Buble M., Juras A., Matic I., The Relationship between Managers' Leadership Styles and Motivation, University of Split Management journal 19 (1), pp. 161-193, 2014.

[28] Daft L.R., Management, Tenth Edition, Fort Worth: The Dryden Press, Harcourt Brace College Publishers, 2011.

[29] Casalino N., Ciarlo M., De Marco M., Gatti M., ICT Adoption and Organizational Change. An Innovative Training System on Industrial Automation Systems for enhancing competitiveness of SMEs, Proceedings of 14th International Conference on Enterprise Information Systems – ICEIS 2012, Wroclaw, Poland, Maciaszek L., Cuzzocrea A., Cordeiro J. (Eds.), INSTICC, Setubal, Portugal, pp. 283-288, 2012.

[30] Mehta R., Dubinsky A.J., Anderson R.E., Leadership Style, Motivation and Performance in International Marketing Channels: An Empirical Investigation of the USA, Finland and Poland, European Journal of Marketing, 37, pp. 50-84, 2003.

[31] Wright B.E., Pandey S.K., Transformational leadership in the public sector: Does structure matter?, Journal of Public Administration Research and Theory, 20 (1), pp. 75-89, 2010.

[32] Bass B.M., Riggio R.E., Transformational Leadership (Second ed.), Mahwah, NJ, Lawrence Erlbaum Associates, 2006.

[33] Storseth F., Maintaining Work Motivation during Organizational Change, International Journal of Human Resource Management 4, pp. 267-287, 2004.

[34] Casalino N., D'Atri A., Manev L., A quality management training system on ISO standards for enhancing competitiveness of SMEs, Proc. 9th International Conference on Enterprise Information Systems – ICEIS 2007, Cardoso J., Cordero J., Filipe J. Eds., INSTICC, Setubal, Portugal, pp. 229-235, 2007.

[35] Casalino N., Learning to Connect: a Training Model for Public Sector on Advanced E-Government Services and Inter-Organizational Cooperation. International Journal of Advanced Corporate Learning, iJAC, 7 (1), pp. 24-31, 2014.

[36] Casalino N., Innovazione e organizzazione nella formazione aziendale, vol. 10, Cacucci Ed., pp. 1-212, 2006.

[37] Casalino N., Piccole e Medie Imprese e Risorse Umane nell'Era della Globalizzazione, vol. 90, Wolters Kluwer, Cedam, pp. 1-273, 2012.

[38] University of Colorado, Guide to motivating employees, Department Of Human Resources, USA, 2012.

Authors

Angela Domenica Frusciante has achieved a master degree in Enterprise Engineering and she is a Researcher and PhD candidate in Business Engineering – DII at University of Tor Vergata, Rome. She is involved in research activities on management, social sciences and economy, business intelligence, finance, big data, social network and social media analysis *(e-mail: angeladomenica.frusciante@uniroma2.it)*.

Mohammed Elshendy has achieved a master degree in Mechanical Engineering and he is a Researcher and PhD candidate in Business Engineering – DII at University of Tor Vergata, Rome. His research activities are focused on economics of corporations, leadership, social network analysis and social media *(e-mail: elshendy@dii.uniroma2.it)*.

Nunzio Casalino is Associate Professor of Business Organization and Human Resource Management as well as Director of Master in Human Resources and Organization at Guglielmo Marconi University – Department of Economic and Business. He obtained the Ph.D. in Business Information Systems Management at LUISS Guido Carli University, Rome, Italy. His research interest areas are business organization and human resource management, SMEs opportunities and issues, entrepreneurship development, small business growing, innovation, enterprise resource planning. He is involved in several research activities in collaboration with national and international public and private partners on business practices, providing up-to-date contents to entrepreneurs, companies, manufacturers, organizational aspects and operative business processes through innovative managerial approaches *(e-mail: n.casalino@unimarconi.it)*.

The manuscript is the result of joint observations of the three authors. They contributed equally to this work.

Open Review of Management, Banking and Finance

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

Recovery plans in the context of the BRRD framework

by **Vincenzo Troiano**

Abstract: the BRRD contributes to the establishment of the new EU regulatory framework on the measures to be adopted for the prevention and early intervention in the event of financial instability of credit institutions, which is a matter that stands at the crossroad between prudential supervision and resolution interventions. This article focuses on the analysis of substantive and procedural aspects relating to the drawing-up and approval of "recovery plans" in their role of *preparation instruments* established under BRRD as well as *governance arrangements* of banks under the meaning of the CRD 4. The analysis aims also at highlighting the distinction and similarities of "recovery plans" with the "resolution plans", i.e. the other main *preparation instrument* provided for in the BRRD. Only time and practice will allow a detailed assessment of the relevance and effectiveness of the preparatory and preventative instruments provided for by the BRRD. However, at the moment it is already clear that "recovery plans" will play a key role in the improvement of corporate governance arrangements and will foster the development of a new culture of risk management in banks and financial companies.

Summary: 1. Preliminary remarks. – 2. Instruments for preparing for recovery and resolution: distinctions and continuity. – 3. Recovery plans as governance arrangements. – 4. Contents of recovery plans. – 5. Approval and assessment of the plan. – 6. Conclusions.

1. The area of *recovery plans* falls under the broader framework of prevention and early intervention in the event of situations of financial instability affecting credit institutions, which was subject to close attention in the wake of the 2008 financial crisis. This area, which serves as an interface, in light of its positioning within the system, between prudential supervision instruments and resolution instruments, is characterized by the latent ambiguities intrinsic in such framework: this applies with regard to both the link (that is established in this context) between competent and resolution authorities, as well as the identification of compatibility of injunctive measures which regulatory authorities may imposed during the plan assessment phase with principle of the freedom to conduct a business. I will first analyze recovery plans in the context of the *preparation instruments* established under directive 2014/59/EU, known as the BRRD, delineating distinctions and continuity with respect to resolution plans, another preparation instrument governed by the same EC legal base. Then I will analyze recovery plans as *governance arrangements* of banks, and later analyze more closely the *substantive aspects* of the

above-mentioned plans and *criteria for assessing and approving* such plans. As for the method followed in this article, reference will be made exclusively to the BRRD, since it is quite clear, in consideration of the authorities involved, that all of the rules deriving from the application of the Single Supervisory Mechanism (and therefore of the role of the ECB with respect to intermediaries exceeding the relevant threshold and eventually also those below the threshold) and the Single Resolution Mechanism (with regard to the structure of the resolution authority) will apply. On the other end, the matters subject to analysis will be addressed individually, given that the relevant legal framework sets forth distinct provisions applicable to group plans, without such circumstance giving rise to any substantive implications with respect to the analysis[1].

2. The directive, drawing from the experience of the financial crisis, aims at establishing a credible recovery and resolution framework for credit institutions, in order to prevent to the extent possible the need to intervene with rescues of credit institutions using taxpayer funds; it aims at preventing insolvency and, in the event of insolvency, to reduce its adverse impacts. The improvement of the capital adequacy and prudential instruments provided by CDR IV should reduce – in the hopes of European lawmakers – the likelihood of future crises; however, the risk that credit institutions may face difficulties cannot be considered eliminated. With this risk in mind, there was a need to endow authorities with a set of instruments that allow for interventions that are sufficiently early and rapid for intermediaries facing financial crises or instability[2]. The focus placed by the lawmakers upon the preparation and planning of interventions to be implemented in case of unfavorable circumstances is considerable. The early analysis of possible adverse scenarios and measures that may be taken if such adverse scenarios were to materialize, should serve as a safeguard to protect the functioning of the system as a whole (including various actors consisting of entities and competent and resolution authorities) to react quickly and early upon the emergence of situations of instability. While this, from a functional standpoint, constitutes the main feature of the "preparation phase", it should be noted that such phase will have to be structured differently depending upon whether it is aimed at preparing the recovery of the entity in difficult or the resolution of the crisis faced by the entity. The directive indeed identifies two separate measures comprising the preparation phase, revolving around recovery plans and resolution plans: the former contain measures aimed at restoring the financial situation of an entity after a significant deterioration of the same; the latter include resolution actions that the competent authority may implement when the entity meets the conditions for resolution provided under the directive.

The two instruments differ in several respects: the most important distinctions regard (i) the entities responsible for the drawing up of the plans; (ii) the authorities involved in the drawing up and approval process; (iii) more generally, the systematic role of the two instruments.

On the drawing up. Recovery plans are drawn up by credit institutions (it is true that the directive envisages dialogue during the plan preparation and assessment phase, but the plan remains an instrument that is drawn up and approved by the lending institution); on the contrary, the resolution plans are drawn up by the competent resolution authority, the entity subjected to the plan does not play an active role (at least in principle), but rather is explicitly subjected to significant obligations to report to and cooperate with the authority in charge of preparing the resolution plan. This differences in

structure with regard to the responsibility for drawing up the plans shows that, in the event of recovery, precedence was given to the autonomy of the concerned enterprise in assessing, in a forward-looking manner, the appropriate responses to deterioration in its financial condition; on the other hand, in the case of resolution, precedence is given to the public interest underlying the orderly management of crises, also considering the possible systemic impact of the same.
As for the authorities that take part in the plan adoption phase, the competent authorities of the individual entities that have prepared the recovery plan are the ones to carry out the assessment on the adequacy of the plan (in this regard, the role of the resolution authorities is limited to the possibility of formulating recommendations to the competent authority with regard to those actions envisaged under the plan that could have an adverse impact during a possible resolution phase); the resolution plan is – on the other hand – directly implemented by the entity's resolution authority (and, in this case, the competent authority's position is limited to cooperation with the resolution authority in gathering information necessary for the preparation of the plan).
It is clear from the foregoing considerations, with regard to the *systematic role* of the two instruments being compared, that recovery plans fall more clearly under the supervisory area, whereas resolution plans fall within the area of crisis management or resolution.
The recovery plans are positioned intrinsically within the ambit of *ex-ante* tools, as instruments through which a default may be prevented by imposing measures to be implemented in order to stabilize the financial situation of a bank; resolution plans are positioned conceptually within the ambit of *ex-post* tools, as corrective measures to be taken if a default becomes inevitable.

That said, it is worth noting that recovery plans, if they pertain to an entity that is not facing financial difficulties, nonetheless plan the measures to be implemented in order to overcome a hypothetical situation of deterioration; conceptually, they fall on the border between the areas of prudential supervision and crisis management. All of the foregoing occurs within and overarching context that does mark a clear line between the two areas and, in fact, tends to bring forward the assessments typical of a crisis situation to a much earlier moment, while from a different perspective, it creates authorities that have to remain separate, if not from a subjective standpoint, at least from a functional standpoint. The institutional and functional structure introduced by the directive (as supplemented by the Single Supervisory and Single Resolution mechanisms) must lead to the consolidation over time of roles and responsibilities, which to date has not been thoroughly defined.

A last remark, with regard to the system, concerns the significant role assigned to the EBA in this area. If we focus our attention solely on recovery plans, the EBA is called upon to prepare *draft regulatory technical standards*, for example, to define the criteria for the assessment of the systemic impact of the failure of an institution (which is relevant for purposes of eventually simplifying the obligations to prepare the plan), to specify the information to be included in the plans, to define the criteria for assessment of plans prepared by banks. It is also called upon to issue *guidelines* in order to define the range of stress scenarios to be considered in the preparation of plans. It results a varied and robust set of responsibilities aimed at achieving the objective of ensuring a uniform structure comprising the various authorities in charge of applying the new legal framework.

3. The directive indicates that recovery plans are to be considered a governance *arrangement* under art. 74 of CDR IV (directive 2013/36/EU). The provision of CRD IV just cited already envisaged the fact that the competent authorities ensured the drawing up by banks of recovery plans aimed at restoring their financial situation following a significant deterioration. The BRRD, moreover, expressly qualifies the plans in question as governance arrangements and, therefore, from a standpoint of prudential oversight, the drawing up of such plans, their implementation, monitoring periodic updating and so forth fall squarely under the legal framework of the CDR IV with regard to governance arrangements[3]. As known, governance arrangements consist of all those mechanisms, procedures, processes, technical means, organization of such factors, remuneration policies, aimed at collectively achieving and ensuring the governance and internal functioning of a bank. All of this is accomplished through an overarching structure that ensures the effective and prudent management of the bank and, in particular, the risks to which it is exposed. Considered from this perspective, namely as a governance arrangement, the recovery plan (*rectius*, its adoption) becomes a key instrument through which one of the main functions assigned by the EU to management body of credit institutions is exercised. The management body is assigned with general responsibility over the bank, approving and overseeing, *inter alia*, the implementation of its risk strategy (this has already led to the management body's exposure to the adoption of banks' Risk Appetite Framework). Within this context, the approval of the recovery plan, especially in consideration of the contents that such plan will have to have, constitutes an exercise in which the management body will have to demonstrate thorough awareness of the bank's position and all of the circumstances that may jeopardize its stability. In performing such exercise, the management body may also decide to adopt measures immediately, aimed at reducing the identified sources of exposure to potential risk and underlying the scenarios envisaged under the plan. Construed in these terms, the approval and update of recovery plans may constitute an element of discipline in the performance of the duties of the management body regarding the bank's policies on the control of the exposure to risks[4].

On another front, the particular depth of the analysis required during the assessment of recovery plans confirms the need, that has for some time been noted in the legal framework applicable to the sector, to enhance the qualitative composition of boards of directors: in this sense, the depth of knowledge and diversified areas of specialized expertise constitute, for the management body as a whole, a fundamental requisite in order to be in a position to effectively fulfill the management body's duties of examining and approving the plans in question.

4. The directive sets forth, in an Annex thereof, the information to be included in the recovery plans. Such information constitute the minimum set of indications for the preparation of plans by entities of systemic importance (*rectius*: for entities subject to direct supervision on the part of the ECB or those that represent a significant part of the financial system of their home member state).

The national authorities may supplement this minimum set of information, and may also proceed, with regard to entities other than those of systemic important, to simplify the information to be included in plans and the timetables for updates and revisions to the same.

This is a particularly broad power which is dependent upon the satisfaction of a number of general criteria set by the directive: this is in order to ensure that the obligation to prepare recovery plans is

applied *appropriately and proportionately*, minimizing the administrative costs related to the preparation of such plans[5].
In reality, the criteria identified by the directive are extremely broad in scope. In order to allow the simplification, competent authorities must assess the potential impact that the failure of the concerned entity could have on the financial markets, other entities and lending conditions as well as the economy in general. Such assessment, in turn, should be conducted taking into account, *inter alia*, the type of business pursued by the entity and the complexity of the same (including the performance or not of investment services), its shareholding structure, legal form, risk profile, size, legal status and interconnections between the entity and other entities or with the financial system in general, whether or not it belongs to an institutional protection system or other systems of mutual solidarity for cooperative credit institutions.
From a standpoint of contents, in addition to the disclosure set forth in the Annex to the directive, recovery plans (i) *must not* assume access to or receipt of extraordinary public financial support, (ii) *must include* any measures that the entity may adopt in the event that conditions are met for an early intervention within the meaning set forth in article 27 (and, in other words, the breach or risk of breach of one of the requisites established under the "CDR IV package": directive 2013/36/EU and EU regulation no. 575/2013); (iii) *must indicate* the procedures to ensure the timeliness of the recovery actions planned.
In addition, recovery plans must indicate the measures that entities will be required to take to restore their financial situation following significant deterioration; they must be detailed and *based upon realistic scenarios*, applicable in a series of (valid and rigorous) situations of serious macroeconomic and financial stress pertaining to the specific situation of the entity (and including event of a systemic nature and specific stress event for individual legal entities and groups)[6], and include the set of *indicators*, of a qualitative or quantitative nature, established by the entity and the circumstances in which the actions indicated in the plan may be implemented[7].
The breadth of simplification powers and the importance of detailed data needed in the definition of the required indicators and stress scenarios may theoretically lead to an effective risk of substantial fragmentation in the regime applicable to entities in different jurisdictions; this justifies the assignment to the EBA of the power to issue guidelines or draft regulatory technical standards, related to various aspects pertaining to the drawing up of the plans: this applies, for example, as regards the criteria to be used to assess the impact of the failure of one entity on the financial market, other entities, and lending conditions; or with regard to the scenarios to be used and the list of quantitative and qualitative indicators[8].

In cases in which the instrument to the used by the EBA consists of guidelines, the lack of binding value which is inherent in such instrument opens the door to the risk of an incomplete harmonization as regards the drawing up of the plans.

5. The recovery plan prepared by the competent bodies of bank, based upon its ordinary governance mechanisms, is subject to review and approval by the bank's management body, before being submitted to the competent authority[9]. The recurring reference to the fact that the management body

must *examine* the draft plan for approval is an indication of the need of its full involvement in analyzing the contents of the plan.

The management body's review is not merely procedural (i.e. for compliance with the internal process for the preparation of the plan), or aimed at assessing its completeness (i.e., to verify that the plan effectively contains the required information, the scenarios envisaged under the directive, the indicators, that will later be agreed at the time of its assessment), but rather also focuses on the matter of the various choices set forth in the document, with regard to both the establishment of the scenarios and the qualitative and quantitative indicators, and the measures that are planned to be activated upon the occurrence of the circumstances envisaged under the plan. From this latter standpoint, the measures may include instruments or initiatives (albeit merely planned) that also affect the bank's strategic decisions, which must necessarily be submitted to the board of directors for approval. In these terms, the configuration of the recovery plan as a governance arrangement of the entity is plain to see.

Once approved, the plan is subjected to a "complete assessment" by the competent authority which has to verify its thoroughness and capacity to restore the solvency of the entity in a timely manner, including during periods of serious financial stress[10].
In particular, the assessment performed by the authority is aimed, on the one hand, at verifying that the contents of the plan meet the content-related requisites established by the directive; on the other, it is aimed at certifying the *reasonable likelihood* that the implementation of the provisions proposed in the plan preserves or restores the economic sustainability and the financial condition of the entity (taking into account the preparatory measures that the entity has taken or intends to take), and that the operating options contained therein work quickly and effectively in situations of financial stress (avoiding to the extent possible material adverse effects on the financial system, including in scenarios that would lead other entities to implement recovery plans in the same period).

In making such assessment, the competent authority has to take into consideration the capital adequacy and the funding structure of the entity compared to the level of complexity of the organizational structure and the risk profile of the same entity.

The assessment phase is an interactive process: if the authority finds that the plan presents *material* deficiencies or that its implementation is subject to *material* impediments, it formally notifies such assessment and asks the entity to present (within two months) an amended plan that indicates how it is remedying such deficiencies or impediments. If the amended plan is also found to be inadequate to remedy the deficiencies and impediments, the competent authority may direct the entity to make specific amendments, setting a deadline for remedying the deficiencies or impediments to the plan's implementation.
In the absence of the foregoing, the competent authority may force the entity to take the measures considered necessary and proportionate, taking into account the seriousness of the deficiencies and impediments and the effect of the measures on the entity's business operations. Taking into account the principle of proportionality, the measures in question may, *inter alia*, concern a reduction in the entity's risk profile; the activation of recapitalization measures; the re-examination of the entity's strategy and structure; and the modification of the governance structure.
The inclusion of an obligation for an entity to modify its plan with interventions that may concern the structure or governance of the entity may have a general impact upon the freedom to conduct a business

guaranteed by article 16 of the EU Charter of Fundamental Rights[11]; it should be recalled in this regard that at the time of drafting the recovery plan, the entity in question is not in a state of financial deterioration, but is rather preparing and planning actions and remedies for the possibility that certain adverse events may occur, which are credible but not necessarily probable. The directive, indicates that such limitation would be in line with the provisions of art. 52 of such Charter: this is due to the fact that the limitation in question would be *necessary* (in order to meet the objectives of financial stability and, in particular, to reinforce the entities' business operations and prevent them from growing too quickly or assuming excessing risks without being in a position to address difficulties and losses and to restore a capital base) and *proportionate* (because it allows for preventative action of a nature and scope necessary to remedy the deficiencies) [12].
Obviously, such compatibility pertains to the introduction of provisions to the EU legal framework that enables the competent authorities to take measures of such type. The same criteria of *strict necessity* and *proportionality* must necessarily constitute the criteria for checking the lawfulness of the exercise by public authorities of the power to impose injunctions (as provided for in the directive), that in light of the compliance of such powers with the freedom to conduct a business guaranteed under art. 16 of the EU Charter of Fundamental Rights.

As for responsibility, it is fair to consider that the approval of supplementary and replacement measures required by the authority also rests with the management body, like the adoption of the plan.

One last remark has to be made on the role of the management body on this matter, drawing from the legal framework set forth in article 9 of the directive, related to the activation of the measures envisaged under the plan, upon the occurrence of circumstances covered by the qualitative and quantitative indicators included in the plan. In such regard, the directive expressly provides that the entity may take action in the context of its recovery plan also when the pertinent indicator has not been satisfied if the entity's management body deems it advisable under the circumstances or, alternatively, may refrain from taking action when the entity's management body does not consider such action advisable under the circumstances.

In the cases the management body's decision is doubtlessly highly important, since it is in practice deviating from what provided in the plan. It goes without saying that a decision by the management body not to implement what provided in the plan, resulting in a worsening of the entity's financial situation (eventually triggering even the adoption of early intervention measures), may end up exposing the management body to potential claims and criticisms from various sources (in addition to the authority, which could initiate supervisory actions even in the event of a decision not to proceed in accordance with the plan, shareholders and creditors may also have an interest in raising claims).

6. Concluding remarks regarding a legal framework that is still at such a preliminary stage must necessarily be limited to pointing out that only time and practice will enable an assessment of the relevance and effectiveness of the preparatory and preventative instruments in question; nonetheless it can certainly be concluded from the very outset that these are instruments that are destined to play a key role in the improvement of corporate governance arrangements and mechanisms for fostering a culture of risk awareness and control at the level of banking and financial companies.

References:

[1] See Recital (11) BRRD, according to which *"In order to ensure consistency with existing Union legislation in the area of financial services as well as the greatest possible level of financial stability across the spectrum of institutions, the resolution regime should apply to institutions subject to the prudential requirements laid down in Regulation (EU) No 575/2013 of the European Parliament and of the Council and Directive 2013/36/EU of the European Parliament and of the Council. The regime should also apply to financial holding companies, mixed financial holding companies provided for in Directive 2002/87/EC of the European Parliament and of the Council (3), mixed-activity holding companies and financial institutions, when the latter are subsidiaries of an institution or of a financial holding company, a mixed financial holding company or a mixed-activity holding company and are covered by the supervision of the parent undertaking on a consolidated basis. The crisis has demonstrated that the insolvency of an entity affiliated to a group can rapidly impact the solvency of the whole group and, thus, even have its own systemic implications. Authorities should therefore possess effective means of action with respect to those entities in order to prevent contagion and produce a consistent resolution scheme for the group as a whole, as the insolvency of an entity affiliated to a group could rapidly impact the solvency of the whole group."* See, *inter alia,* Babis, *European Bank Recovery and Resolution Directive: Recovery Proceedings for Cross Border Banking Groups, University of Cambridge, Faculty of Law Research,* Paper no. 49, 2013, p. 4 et seq.

[2] More in general, see Recital (5) BRRD: "*a regime is therefore needed to provide authorities with a credible set of tools to intervene sufficiently early and quickly in an unsound or failing institution so as to ensure the continuity of the institution's critical financial and economic functions, while minimising the impact of an institution's failure on the economy and financial system. The regime should ensure that shareholders bear losses first and that creditors bear losses after shareholders, provided that no creditor incurs greater losses than it would have incurred if the institution had been wound up under normal insolvency proceedings in accordance with the no creditor worse off principle as specified in this Directive. New powers should enable authorities, for example, to maintain uninterrupted access to deposits and payment transactions, sell viable portions of the institution where appropriate, and apportion losses in a manner that is fair and predictable. Those objectives should help avoid destabilising financial markets and minimise the costs for taxpayers*".

[3] See Art. 5 BRRD.

[4] See, *inter alia*, Amorello – Huber, *Recovery planning: a new valuable corporate governance framework for credit institutions,* in *Law and Economics Yearly Review*, 2014, p. 314; John – Litov – Yeung, *Corporate Governance and Risk Taking,* in *The Journal of Finance*, Vol. 63, Issue 4, 2008, p. 1679 – 1728 et seq.; Laeven – Levine, *Bank Governance, Regulation, and Risk Taking,* in NBER Working Paper No. 14113, 2008; Stulz, *Governance, Risk Management, and Risk-Taking in Banks*, in ECGI Finance Working Paper No. 427/2014, 2014.

[5] In particular, according to Recital (14) BRRD: *"Authorities should take into account the nature of an institution's business, shareholding structure, legal form, risk profile, size, legal status and interconnectedness to other institutions or to the financial system in general, the scope and complexity of its activities, whether it is a member of an institutional protection scheme or other cooperative mutual solidarity systems, whether it exercises any investment services or activities and whether its failure and subsequent winding up under normal insolvency proceedings would be likely to have a significant negative effect on financial markets, on other institutions, on funding conditions, or on the wider economy in the context of recovery and resolution plans and when using the different powers and tools at their disposal, making sure that the regime is applied in an appropriate and proportionate way and that the administrative burden relating to the recovery and resolution plan preparation obligations is minimised. Whereas the contents and information specified in this Directive and in Annexes A, B and C establish a minimum standard for institutions with evident systemic relevance, authorities are permitted to apply different or significantly reduced recovery and resolution planning and information requirements on an institution-specific basis, and at a lower frequency for updates than one year. For a small institution of little interconnectedness and complexity, a recovery plan could be reduced to some basic information on its structure, triggers for recovery actions and recovery options. If an institution could be permitted to go insolvent, then the resolution plan could be reduced. Further, the regime should be applied so that the stability of financial markets is not jeopardised. In particular, in situations characterised by broader problems or even doubts about the resilience of many institutions, it is essential that authorities consider the risk of contagion from the actions taken in relation to any individual institution."*

[6] See Art. 7 – 8 BRRD.

[7] See Art. 9 BRDD.

[8] In particular, see the final report by EBA on *"Guidelines on the minimum list of qualitative and quantitative recovery plan indicators"* (6 May 2015), identifying the minimum qualitative and quantitative indicators that institutions should include in their recovery plans.

[9] See art. 6 et seq. BRRD.

[10] In particular, according to Recital (21) BRRD*: "it is essential that institutions prepare and regularly update recovery plans that set out measures to be taken by those institutions for the restoration of their financial position following a significant deterioration. Such plans should be detailed and based on realistic assumptions applicable in a range of robust and severe scenarios. The requirement to prepare a recovery plan should, however, be applied proportionately, reflecting the systemic importance of the institution or the group and its interconnectedness, including through mutual guarantee schemes. Accordingly, the required content should take into account the nature of the institution's sources of funding, including mutually guaranteed funding or liabilities, and the degree to which group support would be credibly available. Institutions should be required to submit their plans to competent authorities for a complete assessment, including whether the plans are comprehensive and could feasibly restore an institution's viability, in a timely manner, even in periods of severe financial stress".*

[11] See Art. 16 of the Charter of fundamental rights of the European Union: *"Freedom to conduct a business in accordance with Union law and national laws and practices is recognised"*.

[12] See Recital (24) BRRD.

Author

Vincenzo Troiano is Full professor of Financial Markets and Intermediaries regulation and Insurance Law in the Department of Economics of the State University of Perugia. He is a partner at Chiomenti Studio Legale since 2006, where is the Head of the Regulatory Department. He is Academic Member of the European Corporate Governance Institute. He is member of the Editorial Board of "Law and Economics Yearly Review" and of the Scientific Committee for the Evaluation of "Rivista Trimestrale di Diritto dell'Economia". He is member of the Consultative Working Group of ESMA's Investor Protection and Intermediaries Standing Committee. From 1989 to 2000 he has been working at the Bank of Italy, initially in the banking supervision department and lately as a lawyer in the Legal Service. He has been Visiting Scholar at Columbia University, School of Law (2011) and Honorary Research Fellow at University College London, Department of Laws (2001). He is the author of numerous publications (monographs, essays, articles, commentaries, research papers) on EU and Italian banking and financial regulation, securities regulation, company law, insurance law and the regulation on payment systems.

Open Review of Management, Banking and Finance

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

Gender Diversity and Financial Intermediaries

by **Mirella Pellegrini**

2014/65/EU, called MIFID 2) oriented towards a modern financial management focused on people with great expertise and managing abilities, but at the same time diversified by age, sex, geographic provenience and experience. The goal is to identify ways to produce a strategic plan filled of the most different contributions to provide innovative solutions. The introduction of more diversified administrative organs is intended to contrast the "group mentality phenomenon", through the representation of "a variety of points of view and experiences". This research highlights the fact that women move in an under-confidence context (unlike men, who are usually overconfident) that often causes them to accept decisions even when not fully in agreement. Moving on to the identification of the reasons that justify a more appropriate placement of women in the banking and finance enterprises, the Author emphasizes the need for a particular technical qualification of the activity performed by the board of administration and control of the institutions belonging to this sector. Indeed, the various options (from organization to investment) for decisions oriented towards sound and prudent management require the ability to assess a balanced evaluation of information data remitted to the boards of directors and control in the reports that the structure periodically prepares.

Summary: 1. The need for an actual confrontation within the corporate governance mechanisms. – 2. Identification of the research field. – 3. New regulation on the governance for banking and finance. – 4. Gender policy as a macroeconomic answer to market crisis. – 5. Conclusions.

1. I'm delighted to participate to this convention on women and their (important) role in the financial world.*

This conference reflects a great transformation that's taking place in many countries (including ours) and that wants to give an insight on the actions taken by the European and National regulator to safeguard the existence of more efficient corporate governance mechanisms.

In fact *governance* is the topic of our discussion, since the quality of the decisions taken has a fundamental impact on the efficiency of the organizational bodies (*rectius:* of banking) and, consequently, on the performance of our financial market (that today more than yesterday needs

competition, seriousness and the ability to find innovative solutions to the actual and more and more social and participative context).

The financial crisis, the economic recession and the new legal criteria, have highlighted the difficulty in supporting the economy and, therefore, the Italian recovery. In light of the overcoming of these difficulties, Italian companies, especially bigger sized ones, highlight a regulative solution orientated towards a management made of people with great expertise and managing abilities, but at the same time diversified and complementary by age, sex, geographic provenience and experience, in such a way as to produce an opinion filled of the most different contributions and confrontations (as such, more open to innovative solutions). Hence the need to avoid in every possible way that within these there is a poor dialogue and confrontation, in order to ensure the correct and efficient functionality of the government bodies.

This is possibly the way to stimulate a *virtuous* development of the economic *agere* in line with the affirmation of an entrepreneurial type characterized by a greater transparency and attention for the (correct) risk management than before today, such as to organize the management accordingly to the decisional balance criteria.
In this introduction, I would like to start my observation from the considerations contained in some Directives previously mentioned by those who intervened before me (I am referring to Directive no. 2013/36/EU on credit and investment institutions; to Regulation 575/2013/EU so called CRD IV/CRR, and to Directive 2014/65/EU, on financial markets, so called MIFID 2).[1] These highlight the importance of "different abilities and points of view, and also the correct professional experiences", already stressed in the Green Book of the European Commission on corporate governance (2011); they confirm that "a greater difference fuels the debate, promotes alertness and the questioning of certain decision with the board of directors and, potentially, improves the quality of decisions."
The introduction of more diversified administrative organs is intended to contrast the "group mentality phenomenon", through the representation of "a variety of points of view and experiences"; in other words it has the objective of "improving risk oversight and the resilience of institutions", that is, their ability to cope with traumatic events and to reorganize their *agere* in a positive way (recital 60, Directive 2013/36/EU).
This is a significant guiding principle, reaffirmed in the transposing by the Bank of Italy of the European governance regulation[2], well known to scholars and professionals (including myself, I have often recalled this regulation in my past works) from which we should not deviate in the design of efficient firms and markets characterized by a high level of liquidity, transparency and proper operation; this criteria was intended to represent the best guarantee for investors that access the capital market, becoming essential for its proper functioning.

2. From what has already been said, I believe that it is not necessary for me to dwell and focus on the fact that gender parity answers primarily to the need to satisfy the principles of fundamental fairness between citizens, as stated in the Italian Constitution, in particular in articles 3 and 51.

Nor do I intend to reiterate the EU guidelines on gender balance in the government bodies of enterprises. On this topic one should also pay attention to the Directive Proposal (which I recall to be

stranded) aiming at ensuring equality and equal conditions between men and women, while leaving the Member States free to determine the ways and rules to achieve this policy target.

I also will not dwell on the assessment of the productivity levels that characterize the corporate structures in which there are some women (mentioned earlier by other colleagues); limiting myself to reiterate that gender inequality negatively affects management performance since in such structures, if there is a significantly low number of women, very little access solutions oriented towards equality logics, to be considered as necessary to optimize the redistribution forms.

This assumption is confirmed, moreover, by a recent study carried out by the Max Planck Institute in Jena by a group of experimentalists *of (the University where I come from)* the LUISS Guido Carli University in Rome (Laboratory of Experimental Economics "Cesare") that tested the hypothesis that women are more "suspicious" than men, while negotiating. This hypothesis is based on the evidence that people who belong to groups that have been historically discriminated, such as ethnical minorities and women, have less trust in their counterparties and consequently behave in a more strategic way[3]. This would be the reason why women have become more adverse to risk, but with greater ability to verify the reliability of others and to adopt strategic behaviors[4].
This research has, however, highlighted the fact that women move in an under-confidence context (unlike men, who are usually overconfident) that often causes them to accept decisions even when not fully in agreement.[5] In general, lab experiments, carried out in different countries and with different samples, have all highlighted some recurring characteristics: women are in average more adverse to risk, less self-confident and more willing to accept non-promotional tasks and lower earnings than men[6].
At the same time, it was found that – despite an under-confidence attitude on paper – women are more prone to change and learn to adopt "dominant" behaviors very quickly, being able to apply them with great success; there where, situations that express the result of appropriate training and integration/collaboration (e.g. when women "team up" with each other) show better results, such as to exceed the limit of an *agere* influenced by fear and by the suspicion of women who realize the weight of their belonging to a minority.

These characteristics tend to fade with experience and should often be attributed to influences and social and cultural gaps rather than genetic heterogeneity.

On this topic, the Generali Investments Europe Case should be analyzed: in2015 this company has decided to devote resources to enhance gender diversity, considered as a strategic project. Therefore, it has chosen to support female representation within the company[7], while deciding to actively participate to the promote women's professional growth[8]. This with the specific intent to build an inclusive model that supports the expression of all talents focusing on meritocracy: teamwork and the enhancement of diversity for the multiplication of quality, richness of ideas and solutions.

I will avoid any consideration on the predictable, desirable end of the phenomenon in which we are concerned, whose value in a limited period of time seems to be deduced from the remarkable numerical expansion of the presence of the female gender in university studies and, what is more important, their better performance in terms of preparation and results.

Instead, I would like to spend a few words to analyze and understand if the principle we are dealing with applies mainly to the financial and banking sector, field in which traditionally only marginal parts are left to women, preventing them from giving a constructive contribution to an activity that can take advantage of women's intellectual and cultural specific characteristics.

Therefore, the logical procedure to test the validity of the presence of women in banking and financial contexts must start from the consideration that the whole regulation of this sector involves the general principles of civil society in order to improve the explanatory modalities. Firstly, the protection of savings (art.47 Cost.) and, therefore, the submission to public scrutiny of the subjects who exercise banking and finance are considered as priority moments of a larger legal complex that has targeted the dignity, assessed in its man/woman unitary configuration, that is without discrimination[9].

Dignity, fairness, equality are social principals that are part of the banking system since the 1930s and that are offered to the clients, to those who benefit from the services offered, savers ... Naturally time goes by also affecting the interpretation rules for the values underlying a systematic construction of the financial reality. These principles are about to be brought within the organization, and gender equality and diversity become a garrison to ensure the sound and prudent management, almost equal to those already known, such as the Chinese walls on conflicts of interest , transparency, operative fairness.

It is clear that if gender equality is an intrinsic detail of the essence of banking activity, it does not seem feasible in any way to admit differentiated roles with regard to the identification of organizational models through which that activity is exercised.

This is the premise on which the debate on the legitimacy – or more precisely the justification – of the recognition of a more suitable location within the sector for women, should be based[10]; the crystallization of the organizational models focused on the admission of assumptions different from those analyzed is not acceptable.

3. Moving on to the identification of the reasons that justify a more appropriate placement of women in the banking and finance enterprises one should highlight the need for a particular technical qualification of the activity performed by the board of administration and control of the institutions belonging to this sector. Indeed, the various options (from organization to investment) for decisions oriented towards sound and prudent management require the ability to assess a balanced evaluation of information data remitted to the boards of directors and control in the reports that the structure periodically prepares.

Therefore, this is an activity characterized by an intuition not detached from the reference to the analytical data that characterizes the different circumstances under observation; all requirements which, in the collective, are considered typical of women as they are easily correlated to the psycho-physical qualities that characterize their personality[11]; to these requirements it is appropriate to add a careful and punctual way of viewing the reality under observation (but also able to move in different directions), as it is necessary to understand the complexity and, thus, to prevent any degenerative effects of the process examined by the border.

It goes without saying that an accomplished performance of that business requires dedication and commitment, and could prove itself to be difficult to combine with women's traditional role in society.

In terms of concreteness, this is an intrinsic spare factor and explains why sometimes "businesswomen" are victims of family isolation and, in most cases – especially in our country – can play primary roles only in old age.

That said, it seems appropriate to highlight that, in the latest knowledge techniques, the contribution of women, within the financial market (based primarily on tests that assess psychological correctness), in identifying appropriate remedies to market asymmetries is significant[12]; contribution that women are able to carry out thanks to their specific ability to relate to others, to their sensitivity in taking into account other people's demands.
In fewer words, the intuition – or more precisely women's natural ability to contrast men's deductive rationality with a decision-making guideline particularly sensitive to perceive the orientation of others – causes gender parity (and/or diversification) to become instrumental to the achievement of more profitable management, which thanks to women may benefit from their inclination towards mediation in conflict situations and from their natural limitation of risks, which is known as typical trait of the female personality (as shown by scientific analysis)[13]. This without giving up on listening to other people's advice, accepting innovative criteria for the *agere* evaluated in the entirety of their essence and, therefore, with special care to avoid that the same can be attributed to mere power logics (women are naturally ready for multitasking, they tend to be more cooperative in addressing problem solving situations and are motivators for working groups). In particular, gender parity is ideal to introduce suitable forms of balance within the management. These forms should be related to the peculiar independence of corporate officers and, therefore, related to the independence of the choices of the board from any interference arising from the lack of autonomy of its members[14].
In my opinion, this is the context in which we should place the interpretation of the interlocking and multiple directorships prohibition recently introduced in the banking and financial sector (art. 36 l.d. 201/2011, so called the "Salva Italia" decree)[15], in order to reaffirm – in different ways and on different levels, in reference to the CRD IV – the need of the non-existence of constraints or limitations in the identification of members of the administrative and control borders; both, in my opinion and obviously, are meant to encourage the plurality of approaches and perspectives in analyzing problems and in taking decisions, as well as rewarding professionalism, through a balanced composition of the bodies (avoiding the risk of behaviors of mere alignment to prevailing positions, internal or external to the bank).

The interlocking prohibition, seeks to prevent connections between competitors of the banking, financial and insurance market, organized through the presence of the same corporate officers. A healthy competitive market should avoid the crystallization of the list of those who may have management responsibility.

Instead, the CRD IV, for "internal" reasons aiming at the sound and prudent management of large banks, through diversification aims at ensuring time devotion (further guiding principle of the new rules of governance).

Therefore, we are in the presence of a *voluntas legis* aiming at affirming a meritocratic logic: avoiding the proliferation of charges in a few subjects ends up expanding the number of potential recipients of the boards and – at the same time – introducing a limit to the hoarding of these roles by persons who may be linked in various ways to the production centers or to empowering roles. Hence the expected benefit resulting from the policy of gender equality/diversity in redefining the composition of the board of directors in accordance with the parameters laid down by that regulation[16].

4. One last thought *in subiecta materia* can be drawn from the information provided by the recent financial crisis, which has shown the need to improve the efficiency of the organizational structures which reflect the optimality of financial services.

At the same time, the need to introduce balancing elements to management has appeared: on the one hand avoiding moral hazard behaviors, on the other suggesting the opportunity to re-analyze the matter of corporate officers' compensation.

The presence of women in boards of directors and audit committees will develop good behavior (and, therefore, a more transparent and balanced action of financial firms) and will allow potential savings on costs related to the reconfiguration of the wage system (thanks to the expansion of the number of recipients for the positions). For real, it is likely to witness a general inclination of women to the acceptance of lower wages since taking leadership roles for them is rewarding in terms of personal satisfaction, considering a generational release for this reason allowed to the female gender.

If this can happen at first, it does not have to represent the effects of a change, because a choice oriented towards reduced salaries that would create a new gender gap would be unacceptable ("Choose us because we cost less"). The result must and can only be "choose us women because we are very respectable".

Therefore a reflection in terms of equal pay as well as of representation in boards is necessary.

5. I'll conclude my thoughts with a further clarification on the distinction between the principle of gender parity and the broader concept of gender diversity. The first one (inferable from important European Documents, such as " Strategy for equality between men and women", and the "European Pact for Gender Parity"), has found expression in the Directive proposal on administrators without executive roles in listed companies; according to it by 2020, 40% of these will have to be exponents of the underrepresented sex, to which priority should be given over the candidates of the opposite sex, with the same qualifications.

The second one – on the diversification criteria within management bodies, according to "age, sex, geographical origin and educational and professional career" – is set out, as stated in Directive 2013/36/EU on credit institutions and investment enterprises (so called. CRD IV), and in Directive 2014/65/EU on financial markets (so called. MIFID 2).

In fewer words, while gender parity is achieved through an automatic mechanism connected to predefined percentages, the evaluation of diversity, including the gender issue here, requires transparent comparative evaluation of heterogeneous profiles, performed accordingly to company-specific needs. Such balancing, as a talent management practice aims at improving business efficiency, obviously invests equally in men and women and must be a gender parity objective.

More recently, Directive 2014/95 / EU on non-financial information and diversity in the composition of the governing bodies[17], went further, revealing the existence of a functional link between diversity and disclosure: the introduction for more adequate transparency in the management of the issue in question should encourage companies to consider the problem in question more carefully, directing them towards greater attention to the need to ensure higher levels of diversity in their boards[18]. This suggests that the establishment of a transparent system is needed not only to inform the market (about the corporate governance practices) but also to "create indirect pressure on companies to push them to diversify the composition of their board" (Directive 2014/95/EU)[19].
Hence the importance given to the so called saving clause, according to which large listed companies will have to disclose the management criteria adopted on diversity (extended to include the objectives, implementation methods and achievements), or their reasons for not doing so[20].

It is clear that this is a new impulse to accept the importance of diversification; for this reason, we come to a disciplinary system that allows (through the clarification and disclosure of the management rules) to achieve a systematic order increasingly characterized by the affirmation of real gender parity.

In the outlined context, we should also consider the provision contained in the Vigilance Regulation of the Bank of Italy (Circular 285/2013 as updated in the implementation of CRD IV) [21] of a link between diversification policies and transparency requirements. Considering carefully, this provision was already contained in the Recommendations of the Code of Conduct drawn up by the Committee on Corporate Governance for the Italian Stock Exchange; it is clear how sometimes self-regulation is able to anticipate the best solutions for the company's good performance. I feel obliged, however, to express my personal mistrust in a rejection of well-established professional statuses, managerial roles, remuneration and other satisfactions, left to the voluntary initiative of the market and its agents; this, especially when it comes to the financial market where us women, even if invited to participate in decision-making and management bodies of the industry, are sometimes forced to adapt to consolidated male logics.
Therefore, the regulative imposition (I'm referring to EU directives and national legislation, already in force with Law no. 120/2011) of diversification implemented through binding measures with regard to women's representation is well appreciated; unlike that which is given to deduce from the approach adopted by the international IOSCO, which calls for the initiative of a voluntary change (a cultural revolution) that should prove itself as historical[22]. This is the orientation that I propose here considering it fully justified by the fact that Member States have not shown so far any significant progress when left to their autonomous choice. Likewise I feel it is appropriate to fully agree on the temporary nature of the measures introduced, meeting the desires of those who – like me – believe in meritocratic system.

The important thing is not to fall in the misapplication of the rules, as was rightly highlighted a few years ago in the newspaper "l'Avvenire" stating "the false value of non-discrimination prevents thinking,

evaluating, discerning and expressing, as well as that of transparency that is often alien to the search for truth."

This is a modern version of what has already been supported by Tomasi di Lampedusa nearly sixty years ago, when he wrote: if we want everything to stay the same, it is necessary for everything to change. Let's try and prevent it..

*** Report of the Conference "Diversity e parità di genere nelle banche: dalla soft law all'attuazione della CRD IV", Rome, La Sapienza University, 17th April 2015**

[1] The Directive 2013/36/EU, also implemented in Italy, in defining the new EU regime on capital requirements of the banking system, has asked the Member States and competent authorities to require institutions and their nomination committees to stick to a wide range of quality and expertise in selecting the members of the management body and to prepare for that purpose a policy that promotes diversity within it. The competent authorities are therefore obliged to provide this information to the EBA, which will compare the records concerning Diversity within the Union in order to adopt, within the 31st of December 2015 orientations on "the concept of diversity to be taken into account for the selection of the members of the management body".

[2] See. Circular n. 285/2013 Bank of Italy, VI update of the 6th May 2014, section. Titolo IV, chapter 1 "Corporate Governance".

[3] See ALESINA and LA FERRARA, *Who trusts others?* , in *Journal of Public Economics*, vol.85, 2002, p.207 ff.

[4] See DI CAGNO, GALLIERA, GUETH, PACE e PANACCIONE, *Make-Up and Suspicion in bargaining with cheap talk. An experiment controlling for gender and gender constellation*, in *Theory and Decision*, currently printing, 2015.

[5] There is a extensive experimental evidence of gender differences both in the choices taken in risk condition and uncertainty (see ECKEL and GROSSMAN, *Men, Women and Risk Aversion: Experimental Evidence*, 2008, in *Handbook of experimental economics results*, Vol. 1, Ch.113, 2008, p. 1061 ff.) and in the bargaining (AYRES and SIEGEKMAN, *Race and Gender Discrimination in Bargaining for a New Car*, in *The American Economic Review*, Vol. 85, n.3, June 1995, p. 304 ff.; NIEDERLE e VESTERLUNG, *Do women shy away from competition? Do men compete too much?*, in *The Quarterly Journal of Economics*, August 2007, p. 1067 ff.

[6] See GNEEZY e RUSTICHINI, *Gender and Competition at a Young Age,* in *American Economic Review*, 2004, p. 377 ff..

[7] Here is some values on the female presence in the group: 15% of the first levels are women (3/20). On secondary levels women represent 35% of the total (29/84). Overall, the presence of women in the company is equal to 33% of the workforce (129/390). There are also 2 women in the Board of Directors.

[8] This is achieved through various initiatives: female empowerment training, with two targets: young women and those in career development; gender communication training; company meetings with role models, i.e. models to inspire; rethinking certain human resources processes (such as recruitment) aiming at encouraging a mix in genre, where possible. In this commitment the priority is to combine gender equality and meritocracy (to make sure that it does not become the first and only priority)

[9] See. Circular no. 285 Bank of Italy, amended May 6th 2014, Titolo IV – Chapter 1, Sec. 1, according to which " The corporate governance of banks, in addition to responding to the interests of the company, must ensure sound and prudent management conditions, the essential regulatory objectives and supervisory controls." Furthermore, in Sec. IV: In qualitative terms, the proper performance of the functions mentioned requires the following subjects in the organs with strategic supervision and management functions: with widespread skills between all the components and appropriately diversified, so as to enable that each of the components, part of the committees and of the collective decisions, can contribute, among other things, to establish and implement appropriate strategies and to ensure an effective governance of risks in all areas of the bank." The 1st note states that "An adequate diversification, even in terms of age, gender and geographical origin, among other thing promotes the diversity of approaches and perspectives in analyzing problems and in taking decisions, Furthermore, to Sect. IV: In qualitative terms, the proper performance of the functions requires that in the organs with the strategic supervision and management are present subjects: with widespread skills between all the components and appropriately diversified, so as to enable that each of the components, is to ' of the Committees of which a part in that collective decisions, will actually contribute, among other things, to establish and implement appropriate strate-gies and ensure effective governance of risks in all areas of the bank. " Note 1) states that "Adequate ade-quate degree of diversification, even in terms of age, gender and geographical origin, among other things promotes the diversity of approaches and perspectives in analyzing problems and in taking decisions, avoiding risk behaviors mere alignment with prevailing positions, internal or external to the bank. Diversification can lead to a more intense level of involvement of each component on matters or decisions related to their own characteristics and. This should not undermine the principle of the active participation of all members in the work and decisions of the Board; each component must then be able to analyze and judge all the matters dealt with and all the decisions taken.

[10] Sector in which, for too long, women have been intended for secondary tasks and not even called to exercise executive functions and/or responsibilities.

[11] See MACCOBY and JACKLIN, *The psychology of sex differences,* vol. II, Standford University Press, 1974.

[12] On this matter, see among others MORERA, *Sulle ragioni dell'equilibrio di fenere negli organi delle società quotate e pubbliche,* su http://www.associazionepreite.it/scritti/morera006.php

[13] See MORERA, *Sulle ragioni dell'equilibrio di fenere negli organi delle società quotate e pubbliche,* which quotes the studies by BRIZENDINE, *Il cervello delle donne,* Milan 2007; ID., *Il cervello dei maschi,* Milano 2010.

[14] See BIANCO, CIAVARELLA and SIGNORETTI, *Women on Boards in Italy,* in *Quaderni di Finanza della Consob,* 2011, p.7, on www.consob.it.

[15] Article 36 of L. Decree 201/2011 (so called "Salva Italia" Decree), implemented by Law no. 214/2011, has introduced the ban of accepting or exercising roles between companies or groups of competitor businesses within the credit, insurance and financial market (so called "interlocking ban"). If those who hold incompatible roles don't choose one of the possibilities within the set date, they lose both their positions. In the event of total indifference, the loss of their positions is pronounced by the Competent Authority. To clarify the rules for the application of the ban and resolve any doubts of interpretation emerged with the new standard, the supervisory authorities whose responsibility is to ensure its compliance (Bank of Italy, Consob and Isvap now Ivass, in coordination with the competition and market authority) have shared and made public the criteria which will be used for the examination the situations provided by art. 36 (see. Document of 20th April 2012, available on the Bank of Italy website at http://www.bancaditalia.it/vigilanza/att-vigilanza/accordi-altre-autorita/accordi-aut Italian /inte rlocking/Criteri_div_interlocking.pdf and the relative explanations). The same authorities have subsequently defined in a memorandum the criteria and modalities to coordinate the activities and procedures for the analysis of interlocking situations and the possible revocation of the incompatible offices, especially with regard to cases where crossed roles involve the responsibility of several authorities.

[16] And if it is true that the companies in question must commit to recruiting more women, it is equally true that the labor market must be able to respond adequately to this effort. In other words, the broad debate on gender parity from the perspective of the enterprise, must be accompanied by an adequate reflection on the fact that women are not always ready to respond to market demand. If the demand for labor does not change it is likely to witness a process that in recent times, more than ever, has been avoided for all (men and women), that is a combination of roles and the repetition of names and people in the various board of directors; eventuality that certainly must be avoided. And that's not good. One way to change the demand on the labor market could be, as in other fields, through information and training; see. RINALDI and TODESCO, *Financial literacy and money attitudes: do boys and girls really differ? A study among italian preadolescents*, in Italian journal of sociology of education, vol. 11, n.2, 2012, p. 143 ff.

[17] 2014/95/EU Directive of the European Parliament and of the Council, 22nd of October 2014, amending Directive 2013/34/EU for that concerning the communication of information of non-financial character and of information on the diversity by certain companies and large groups.

[18] Action Plan, 2012

[19] See AZZOLINI, *Dopo le quote rosa, la gestione dei talenti*, on http://www.lavoce.info, 2015.

[20] See ROSSI, in CALVOSA and ROSSI, *Gli equilibri di genere negli organi di amministrazione e controllo delle imprese*, in *Osservatorio dir. civ. e comm.* , 1/2013, p.7.

[21] The nomination committee supports bodies with strategic supervision and management functions in the following processes: – appointment or co-optation of directors as specified in paragraph 2.1. With reference to the need to ensure an appropriate diversification in the composition of the collective body, the Committee – without prejudice to the obligations set by the regulation of listed banks (12) – sets a target for the shares of the less represented gender and prepares a plan to increase this value up to the set goal (The identified gender target, the plan and its implementation shall be disclosed as part of the information that banks must give accordingly to the "third pillar" (see. CRR, art. 435). Section VII: Disclosure Obligations. Banks, in addition to the information obligations arising from the EU provisions and the prudential rules of the Bank of Italy, disclose in a clear and detailed way and see to the constant updating of the following information: … – Total number of components of the governing bodies in charge and motivations, analytically represented, of any excess revenue in comparisson to the guidelines of Section IV. Distribution of the components at least by age, gender and duration of charge. … The information to be published on the bank's website, including the information on the structural organization and corporate governance guidelines, can also be disclosed through the reference to other documents available on the website itself, including the Statute, provided that the information material is available and accessible through an accurate and clear link.

[22] See. Gender Quotas in management boards, 2012

Author

Mirella Pellegrini is Full Professor of Economic Law at the Department of Business and Management of LUISS Guido Carli University in Rome. She is member of the Editorial Board of "Law and Economics Yearly Review", of the Scientific Committee for the Evaluation of "Rivista Trimestrale di Diritto dell'Economia"; of the Editorial Board of the Journal Bankpedia-Assonebb; of the Scientific Committee of the serie "Ricerche giuridiche", ES (Editoriale Scientifica) editor; of the Scientific Committee of the Association "IGS" (Istituto per il Governo Societario); of the Scientific Committee of the Series "Diritto Pubblico e Diritto dell'Economia" (Giappichelli); of the Scientific Committee of the magazine Banche e Banchieri. She is the author of numerous publications (monographs, essays, articles, commentaries, research papers) on EU and Italian banking and financial regulation, securities regulation, company law.

Open Review of Management, Banking and Finance

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

Concluding remarks of a conference on 'Diversity and gender equality in the banks'.

by **Francesco Capriglione**

Abstract: Both academics and practitioners have been often involved in the long-standing discussion on gender parity. This paper – which reports the conclusions of a recent conference on such topic – sought to explore the main reasons why women remain under-represented in senior and middle management positions within the financial sector. Building on the idea that gender diversity may improve key performance indicators, the study focuses primarily on the argument that – even though several barriers are still restricting women's access to managerial roles – stereotypes and other bias must be overcome in order to enhance female contribution to the overall success of the business. However, as highlighted in the analysis, career progression needs to follow the basic principles of meritocracy since individuals must be evaluated according to their skills and competences – and so independently of their own gender.

Summary: 1. Introduction. – 2. The issue of gender parity. – Diversity and banking governance: the perspective of a review of business models. – 4. European guidelines on the active role of women in management. – 5. The need for equal opportunities in spite of gender diversity.

1. Wanting to begin these brief remarks with personal memories, distant in time but yet interesting with regard to the subject of today's meeting, the thoughts turn back to my first job started more than half a century ago, in the Bank of Italy, institution in which, at the time, women were not allowed into the managerial career, but only in the administrative one . Significant, also, was the fact that the female staff – according to the strict internal rules – was required to wear an dark apron , almost having to hide their appearance, in a logic of homogenization to standardize the female members, and clearly stress out their gender diversity.

There is no doubt – as nowadays reports show – that fortunately such a blatant female subordination (seen in the past even in the largest Italian financial institution), now survives only in the memories of those who, when young, , lived in a socio-economic context that is hopefully now definitely disappeared.

First, I'd like to highlight that the thesis supported today are far from easy rhetoric, which usually characterizes the remarks on issues related to the rights claimed by the women's movement; thesis that are also affirmed to overcome unjust discrimination related to diversity (religious or racial one, but also homophily, etc.). Indeed, the debate today wants to rely upon balanced and logical arguments (both technical and legal) in order to explore and clarify the issue under observation.

2. In particular, the debate focused on the topic of "*diversity*" in the EU framework, underlining how difficult the path towards satisfactory levels of "*gender equality*" has been in the recent years. It seemed significant, on this issue, the report regarding the increase (above the 20%) of the so called "*female quotas*" in the boards of directors of Italian firms (Parrella).

At the same time, it's worthy to consider also the convenience of whether delegating the identification of "*gender equality*" to the lawmaker's intervention; this tendency, ascertainable in the Italian legislation (see Law n. 120 of the 12th July 2011), while not appreciated by some countries, such as the United Kingdom, has been an incentive for others, such as Germany, to promote some legislative amendments in this field (Brogi, Perrazzelli, Sciarrone).

From previous observations and hypothesis, it has clearly emerged that "*gender diversity*" – and, therefore, the maintenance of unequal distinctions in the access to certain professional "careers" (as well as in the prospects for career progression- is a display of an *ideological conservatism* not annihilated yet, despite the relevant legislative amendments therein adopted, in compliance with the high levels of "juridical development" recently achieved. The solution of this problem has to be found by taking into consideration the specific cultural level of those countries engaged in its definition; hence the opinion according to which in countries like Italy it has to be deemed as opportune (if not necessary) the lawmaker's intervention in order to overcome a long-standing paralysis, that otherwise could have lasted even longer (Perrazzelli).

I do not want to focus any further on these debate's topics; nevertheless, I intend not to conceal an idea that seems to stem from today's reflections: I am referring, particularly, to the fact that a more complete (and hopefully ultimate) acknowledgment of "*gender equality*" is going to take a long time. This consideration is confirmed by the unequivocal observations made by some scholars (especially: Brogi and Zucchetti), as well as by the update, given to the audience, that among ABI's "Executive Committee" there are no women (Zaccaria).

That said, it is obvious that it will be necessary to proceed in the direction of improvement, as it seems to be emerged from the suggestions expressed in today's speeches. Defeating the blind logic at the basis of the situations here criticized since now is, therefore, the aim to pursue, knowing that its fulfillment is strictly connected with the solution of the more general problem of searching for an enhancement of the "quality of life" among Member States (Perrazzelli). Moreover, it is necessary to specify that this path is an uphill struggle, that has to be undertaken by being convinced that a a vast part of the civil society must not be exposed to the deprivation of freedoms and rights granted on a constitutional level to all the citizens equally (Pellegrini, Zaccaria).

3. In engaging the topic under consideration, most of the rapporteurs focused on evaluations regarding the difficult and recent financial crisis that, as is known, affected numerous countries of the

Western area, causing a recessive phase and economic stagnation that only now seems to come to an end It has been stressed, thereof, that in order to start a real reinforcement of the economic recovery, an action from the credit industry, especially responsible and professionally qualified, is needed.

Hence the necessity to search for a *management* composed of people with considerable technical ability and remarkable cultural sensitivity; a search that becomes the prerequisite of an *agree* which aims to guarantee the adequate and efficient functionality of the business organizational mechanisms (to which it is delegated the opportunity of improving the credit sector, making it more transparent and efficient than how it appears nowadays). It is become definitive, therefore, a context that requires, in order to achieve an effective management balance, administrative and supervisory bodies among which the gender differentiation could generate useful effects, improving the quality of the internal debate and posing on innovative basis the dialectical discussion between the business's members.

Upon this theoretical prerequisite accurate considerations have been engaged, in order to correlate *diversity* to the definition of a banking governance, which is functional to a closer cooperation between industry and finance (Bianco, Pellegrini, Ramasco, Sciarrone); thus, highlighting some of the most significant issues raised, at the European level, to identify adequate rules for optimizing managements.

This part of the debate, regarding the possibility of achieving higher forms of economic development through *diversity,* brings back the renowned thesis of Daniela Del Boca, according to which "women's work makes economy grow"; assumption that was used years ago for underlying the importance of female employment, with the intent of encouraging its appreciation. In conclusion, the observations expressed by today's speakers indicate that the aforementioned statement does not limit its impact with conveying – based upon an accurate economic analysis – a "*favor"* towards female participation in the labor market; the useful effects that can be deduced from this participation go far beyond a significant increase in the growth process, which is a conceivable result especially in those countries characterized by gender gaps in employment rates.

Right now, we are entitled to formulate an interpretation of the idea of women as participating to the productive model that allows us to attribute to the aforementioned formula the relevance of a "guideline", in order to reconsider the benchmark of business organizational structure. This formula, indeed, seeks for a new definition of business, different from the one that, until a recent past, characterized its essence. This is a first conclusion that can be deduced from this conference! It presents a specific topicality in the banking field, in which the principle of *gender equality* has been fairly recognized only recently; this, with the obvious negative consequence of having deprived, for a long period, the financial activity of the significant contribution that could result from women's presence in decision making and top management roles.

4. Then, the speakers (Bianco, Falci, Guglielmetti, Pellegrini) have quoted some EU directives (e.g.: 2013/36/EU dealing with credit and investment companies; and, more, Regulation 575/2013/EU – the so-called CRD IV/CRR; as well as the directive 2014/65/EU about financial instruments' markets – the so-called MIFID 2). It is literally inferred the orientation of the European lawmaker to give importance – above all in the regulation of corporate governance field – to the variety of 'capabilities' and 'points of view' of the members in the *administrative* and *audit boards*. Therefore, it outlines an evaluation

parameter acknowledging an active managing role of women, in keeping with their professional capabilities and work experience.

An acknowledgement comes from the European lawmaker, whose aim is to involve those willing to seek for building a 'common house', where the woman will, at last, have a central role, gained through an evolutionary process where a sort of cultural revolution, started more than a century ago, has been fulfilled. This is more significant in finance rather than in other fields; actually, in this field women have long been victims of a prejudice which has not allowed them to run for positions suitable to their intellect, to the peculiarity of their temper which makes them particularly fit to make decisions where rationality goes along with intuition in assessing risks.

Since the end of the 19th century up to now the Nora of Ibsen's 'A Doll's House' has gone through a way full of obstacles to reach her goal, not yet complete achieved in my opinion, although the woman's path – as it is coming out from the conclusions of this meeting (Amorosino, Siclari) – is acquiring a new perspective. Hope is being replaced by the certainty of achieving a goal, remarkably significant from an ethical profile as well, since the principle of equality among genders gains particular value if its grounds are ascribed to the aim of enriching society. The latter will, then, have the chance to benefit from an innovative cultural and practical input, featured by knowledge and techniques, which are not – or better, not willing to be – in contrast to the ones normally referred to man; rather, they aim at integrating their contents and improving their quality towards greater expectations to reach useful results for everybody (Bianco, Brogi, Pellegrini, Perrazzelli, Ramasco, Sciarrone).

The guidelines given in this meeting suggest that the path of woman's social and cultural emancipation (implied in achieving freedom from an age-old psychic and behavioural subjection to man) is going beyond the mere encouragement of female employment policies. It is no accident that a trend concerning gender equity issues converges on common interests. It is, then, clear that a school of thought limiting and compressing women' true and expanding power at work means refusing progress; indeed, it allows to identify a persistent deplorable custom of mental violence damaging those who have been abused by a selfish, surely blameworthy, domineering will. On the other hand, every action clearly addressed to disregard gender equality ends up with an outdated attempt to force the historical process.

The views here shown, which reaffirm the needs for enhancing women's role state the widespread belief that their progressively growing presence on the 'job market' is able to activate a virtuous circle ending up with advantages for the whole economic system. In particular, referring to finance, the empowerment of women's active role is likely to promote management practices shaped on higher levels of prudence, consequent to a peculiar care from those who, thanks to their moral integrity, avoid risky behaviour and pay special attention to complex circumstances.

5. Before closing these brief thoughts I would like to present you with some of the questions that I asked myself before participating to this seminar.

I am mainly referring to the identification of the reason why – especially in certain countries and in contexts characterized by delays in the economic development– women had to suffer a sort of penalization, becoming subject to the representatives of the male sex. The answer to this question must be found in the weak position in which women found themselves , starting with the biblical link to Adam's rib. Certainly, their peculiar physiological connotations and the fact that women are destined to

be mother and wife have eased the idea of their weakness in comparison to the power of men, intended in its broader sense (Brogi, Zaccaria); this convincement has contributed to woman's social placement (as previously expressed), negatively influenced also by the necessary balancing between family and work commitments (to which she was forced).

A deeper evaluation of the problem in question highlights that the specific *status* of women – and, therefore the unequal regime that they suffered through time because of the difference in gender – is essentially linked to cultural factors. It is not just a coincidence that women's statuses appear to be less important (in comparison to men's) mainly in undeveloped countries or ones dominated by religious ideas that are not afraid to accept logics in which women are configured as instrumental to the needs and desires of the exponents of the opposite sex, nearly in order to justify the influences that mortify their social role.

Another question, to which I have not been able to answer, concerns the influence played by the *technological progress* on the market's legal order. This progress highlights a new reality in which – as clarified by Giorgio Oppo a few years ago – a «depersonalization of relationships» reduces the historical identity of the individual. This dehumanization process – which mainly influenced the contractual term sand the delicate sector of financial operations –involves also the organizational profiles of businesses, since technology inevitably entails a *simplification* of the decisional schemes, a reduction of the *responsibility* in the presence of functions (such as *risk management, internal audit and compliance)* preordained for risk evaluating and containing risks and, therefore, limiting the riskiness of the financial intermediation.

In the light of this, in reference to an increasing orientation towards the acceptance of the operational forms that come to business results often not entirely shared, the question is: which implications (also prospectively) may arise from the future distribution of tasks between men and women? Will we also find the affirmation of a «physicality» connected to technology that, according to Natalino Irti, limits intersubjective encounters and reduces dialogue, consequently slowing down the development towards gender equality, of which we have deeply talked about today? Or is it that thanks to the increased ability of women to adapt to change, because of their natural sensibility that induces them to be wary of automatisms (and, therefore, to pay special attention to the verification of the results that affect strategic choices) they will deliver a better performance as compared to that of their male counterparts?

These are difficult questions to answer. . A solution to them may come from the adoption of measures aiming at rebalancing the subjective positions, organized consistently with the changes presented today.

Therefore, I would like to conclude by recommending special attention for *false problems*! And with that I do not want to label as 'false' the problem of «gender equality», but I would like to highlight that an excessive insistence (at times inadequate) on the need to find solutions to this topic is likely to make us forget that this equality cannot exclude the comparison between the skills of persons of different gender. Therefore, the equality that must be sought is that of «similar conditions» required for a job and for the progression in its performance; thus it seems that a correct intervention would be the one that instead of continuing to affirm the need for a homogenization between men and women reaffirms the need to ensure equal opportunities for all, despite "gender diversity".

[i] Concluding speech of the Conference on «Diversity *e parità di genere nelle banche: dalla* soft law *all'attuazione della* CRD IV», University Sapienza, Rome, 17 april 2015

Author

Francesco Capriglione is Full Professor of Banking Law and Financial Regulation and Dean of Law Faculty at Guglielmo Marconi University of Rome. Besides, he is President of Fondazione Gerardo Capriglione Onlus and Director of Master in Regulation of the Activities and the Financial Markets at LUISS Guido Carli University. His research interest areas are European banking law, institutional assets of financial top management, regulation of banking and financial markets, banking supervision and operations of financial intermediaries. He is author of over 300 peer-reviewed scientific public ations and fifteen books (*e-mail: fondazionecapriglione@luiss.it*).

Open Review of Management, Banking and Finance

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

General Principles of Law

by **Guido Alpa**

Abstract: this article identifies the functions performed by general principles is arbitrary, as is the categorisation, creation and identification of principles in the law in force. The findings of this research show that this arbitrariness, however, is coherent and is acceptable inasmuch as it is typical of all interpretive activity. What is important is that the interpretive activity responds to the canons of logic, common sense and practical utility.

The Author takes into account that, in general opinion and in general practice, principles thus perform a function that is much broader than that entrusted to them by Art 12 of the Italian prelaws. On this hinges a system of private law, consisting of positivist fact and the enrichments derived from its interpretation, manipulation, and construction in the legal system. Hence, principles therefore play a role as a "foundation" of the system. In uncodified areas, administrative law and international law, principles perform a yet more relevant function: that of a normative frame of reference.

This paper refers also to the jurisprudence, whereas principles obviously play the role recognised by Art 12 of the prelwas, that is, as rules applicable to concrete instances when a legislative text has gaps, is imprecise, or is in some way lacking. Consequently principles are often invoked in jurisprudence for the purpose of mere embellishment in that they corroborate the application of a positivist rule. They therefore serve to reinforce the crux of the decision and to assign the greatest possible internal coherence to the reasoning. Moreover, if they are created ex novo by the judge, they serve to legitimise the case law. In order to mask the arbitrariness of a decision, a judge will provide for the introduction of a legitimising shield, namely, the principles invoked.

The Author also consider that principles constitute the modern lingua franca of jurists belonging to different legal systems. This is the case whether for the positivist side of things, the formation of a uniform legal culture derived from the circulation of legal models, or whether indeed for the formation of uniform commercial practice and arbitration. In this context, the international positivist position tends to homogenise the legislation of member states (from time to time, though the setting up of parallel systems, as happens for the Community legal system, or by way of conventions, as happens for the Council of Europe, or indeed through treaties). Furthermore, the circulation of legal models occurs either as an effect of the uniformity of positivist data (as happens in the reception by internal legal systems of models from the Community, thmselves acquired from other internal legal systems and imposed on all member states) or as an effect of cultural exchanges and comparisons.

Undoubtedly, commercial practice tends to aspire to uniform principles; in the same way, international arbitral justice tends to follow principles collected from civil societies. Hence, principles today perform a function once performed by Roman law: they tend towards the fusion of systems that are diverse in their traditions and internal history. Despite this, principles perform the function of 'policy'; they express the legal policy of the legislator and, in general, of the interpreter, which more or less operates in a conscious way according to a table of values. This policy – understood as evidencing the optimal results that expressing and appling the principle would want to achieve – can either be clear, or indeed, obscure. In any case, principles appear as an unavoidable factor in the art and process of creating norms and interpreting them; or, which ultimately the same thing, they are indispensable instruments in the evolution of law.

Summary: 1. Uses of the term 'general principle'. – 2. Collections of general principles. – 3. The "common values of the west". – 4. Human rights and values of the person. – 5. Principles of EU Law. – 6. The Italian model: preliminary dispositions to the civil code of 1942. – 7. The identification of principles. – 8. The origins of the Italian codified formula. – 9. General principles in the Italian Civil Code of 1865: the statist thesis. – 10. The natural law thesis. – 11. "General principles of the legal system of the state." – 12. The legal realist thesis. – 13. The composite function of principles.

1. The different uses of the term 'principle' refer to different meanings, however similar they may be to one another. One can identify these meanings by taking into account the profession of the person interpreting the term, whether a scientist (doctrinal use), judge (jurisprudential use), or the legislator (legislative use). In Italian, although less frequently today, '*principio*' is used as a synonym for 'beginning' ("*In principio era il verbo*", or "In the beginning was the word"). Otherwise, the word 'principle' is used as a synonym for fundamental value ("It is a question of principle"), as an element of basic notion (the principles of ethics, mathematics, physics, and so on), or as a progressive abstraction generalised from a series of data and particular cases. Jurists use the expression 'principle' in different contexts: as an element of a discipline (principles of private rights), as a value (principle of correctness), as a tool (principle of contradiction), but above all as an abstract rule applicable to particular concrete cases.

In his treatment of the interpretation of law, Emilio Betti, accomplished jurist, lawyer, Romanist, internationalist, and philosopher of hermeneutics, used etymological arguments to demonstrate that 'principle' (understood in the technical legal meaning which we will discuss later) refers to the "beginning of a standard or of all standards and criteria in a country at a point in history." This defines 'principle' as beyond and outside of the legal system, but he concluded that 'principles' are at the same time both an external and internal source of law in a legal system.

We will dedicate a section to 'principle' understood as 'value' due to the significant role principles have in legal theory. In any case, principles exert a strong fascination: they are evoked by and allude to values. This causes us to be cautious, and as a result we assume a deferential attitude in this regard. If a principle is handed down and flows from one century into another, from one source to another, and from one system to another, it appears to have such an aura of prestige and authority as to seem almost indisputable and inevitable. In other words, 'principles' seem to achieve a legitimacy of their own. Their

existence, validity, and force are at the same time a weapon of persuasion and a tool of standardisation. And indeed, because a principle is often joined to or confused with an ethical rule (one thinks of "The Principle of Responsibility" by Hans Jonas), it may appear a bulwark of and prelude to civilisation. But one must pay attention; not all formulas that are presented as principles are truly such, not all principles have the same relevance, and not all principles are used in the same way.

How do jurists use this term? Normally they understand it colloquially as a synonym for "fundamental notion." In this case, however, one is not dealing with simple notions but with rather artificially complex notions that allude to the essence or to a part of the legal system. Giuseppe Chiovenda understands the term this way in his successful textbook on procedural law. George Edward Moore also used it this way in his "Principles of Ethics", as did Bertrand Russell in "Principles of Mathematics." However philosophers, sociologists, economists, and lovers of the exact sciences during the last century all created an architecture of knowledge in a systematic way, based scrupulously on a foundation of principles.

The principles of a legal system are also understood as the essential characteristics of the legal system, its way of being and appearing, its physiognomy, its soul or spirit. Locré first uses principles in this sense in his 1804 work '*Espirit du code civil*', and Rúdolf Von Jhering then uses them in describing the "spirit" of Roman law. Jhering saw Roman law as "a whole in and of itself", a phenomenon of the history of law, and a whole ensemble of techniques that were still useful in his day. In his introduction, principles are at the same time the points from which the formation and evolution of Roman law depart (original principles) and also the driving force behind the legal mechanisms of a legal system (unifying criteria). Jhering saw in that analysis the principles of the subjective will (the system of private defence), the principle of family (the origin of social aggregation), and the religious principle (from indistinction to the distinction between the sacred and the unlawful, *fas e jus*).

Other illustrious jurists such as Gustav Radburch and Roscoe Pound, in their efforts to illustrate the spirit of common law, understand this use of 'principle' as an expression of the spirit of the legal system. Fritz Schulz, an historian closer to us in time and culture, referred to Jhering in identifying principles. He lived in Germany until the Nazis came to power, at which point he moved to England where he continued to study the method of the Roman jurists with great acumen. Even Schultz placed himself in the proud tradition of those who connect principles to the spirit of a legal system.

2. As we can see, principles are used to accomplish many interpretative functions and operations. To paraphrase one of Damaska's assumptions, the world of principles "seems to be a collection of contrasting arguments waiting to be used in a dispute." We will discuss this further with regard to values underlying the reasoning of a decision, the ideology of the interpreter, and the weight of tradition.

If the craft of the jurist is "to do things with rules," then one can do many things with principles. Precisely because one can do many things with principles, jurists have armed themselves and have proceeded to gather principles into non-peremptory lists, ordering them according to various criteria. We are here dealing with unofficial lists. In Italy, lists were proposed at the moment the codification

entered into force, but the idea was appropriately abandoned. There are several reasons for this. On the one hand, there was the fear that an omission of these would result in an imprecise work, and on the other hand, the fear of an poor result since the list (that could not have been anything but peremptory) would have left the interpreter buried under a mass of written rules, denying him any active function.

In other epochs, attempts at official collections were not rejected. Justinian, as noted earlier, dedicated a book of his Digest (Book 50) to the collection of principles (*de regulis juris antiqui*). But that collection had another function. Justinian wanted to restore the authority of maxims expressed by the greatest jurists – that is, by the "official" jurists – and to give some order to material which, not being codified, could result in confused if not conflicting solutions to the same questions. The same need was also felt in Canon law, as the *Liber Sextus* demonstrates (that is, one of the *Decretals* of Boniface VIII, L. V., tit. XII, to which 88 legal dicta, the *regulae juris*, were added).

In the legal systems of every country, there have been lawyers, professors, students, and legal scholars in general who have devoted themselves to collecting principles. Some examples are easily found. In Italy, the collection of two thousand legal rules, compiled by L. De Mauri had some success and is still reprinted today.

In France, during the same period and even before, Boulanger refers to the success had by such collections. He points to the collections of Daguin and Jouanneau. Indeed, a new collection has appeared more recently, edited by Roland and Boyer, where principles expressed in the form of a 'brocard', or maxim, are considered "adages of French law."

In Spain, the catalogue put together by a historian, James Mans Puigarnau, was particularly thorough. He classified rules, maxims, and aphorisms, accompanying them with references to judgments of the Tribunale Supremo de Justicia.

Yet curious is the success that the maxims collected by Broom in the nineteenth century received and was still receiving in the 1940s both in England and in the United States.

To gather maxims, principles, and aphorisms is not difficult; it is enough to have some patience and a little luck. It is more difficult to understand what is effectively served by the quotation of a maxim and asking whether the maxim can act as a rule. To understand how often they are used, one can see the principles cited in the legal maxims prearranged by the editors of law journals.

3. Since the 1962 Hamburg conference dedicated to the 'general principles of law', there have been various different research projects undertaken by legal historians and scholars of comparative law regarding insights into the similar aspects of different legal systems. This elaboration has led to a very relevant conclusion: these values are currently expressed by general principles of law. The principles thus not only overcome historical phases and traditional cultures, but they allow transplants, osmosis, connections, approvals. Here is the proof.

Let us content ourselves with an overview of the theoretical models for the moment, without beginning the task of confronting the legislative texts and judicial decisions. Peter Stein and John Shand (1980)

have attempted to illustrate a panorama of these common values. They believed they had identified them: in the exclusion of violence and in the value of security; in the limits of interpretative discretion and Administrative discretion; in the responsibility breach of contractual obligation and illegal actions; personal liberty; in the right to life and privacy, property and protection of reasonable expectations; in the cooperation and limitation of economic policies for reasons of public interest.

For his part, Karl Larenz (1975), in discussing notions of just law and the fundamentals of judicial ethics, lists, amongst the principles of the individual sphere, self-determination and contractual autonomy; the principle of equivalence in synallagmatic contracts; the principle of trust and good faith. Within the principles inherent to the community sphere he notes: participation, equivalence and proportionality (here he adds the principles which govern political responsibility and procedural law – judicial impartiality and contradictory).

How is it possible not to share this classification and how can it not be found in our tradition?

In the great design of general principles/values, the first among all of them, not explicitly mentioned in the constitutional texts or civil codes but discernible within them is the principle of 'mutual respect': this lies at the heart of social cohabitation which is founded upon democratic bases (in so far as they express Kantian fundamental legal relations). It is precisely in the *Metaphysics of Morals* that Kant poses the rule of the free exercise of rights (limited by the freedom of others). It is easy to recall an antecedent to this rule: the evangelical precept: "*do not do unto others what you do not want others to do unto you*". The Kantian rule however is not dictated by love and the overcoming of selfishness but by rational rules of mutual respect. However it remains quite separate from that other evangelical precept, connected to the former: "*love thy neighbour as yourself*".

The natural jurist is invested with these Christian values, which, translated into rational formulas found the (free) exercise of rights on the part of the individual, in order to become compatible with the exercise of the rights of others.

But let us turn back to what was said at the beginning: those – like Karl Larenz – who move from the categorical Kantian imperative, cannot abandon the philosophical aspect. Thus they have to take account of the development, or rather, the critical construction that follows from this principle. From a religious point of view, it is only if one recognises in others a similar being to one's self that one can say that the 'recogniser is a person, like the recognised'. In other words, one is a person (in that one is free to express one's own will) only if one respects others as persons (Kant).

From this principle derives: the injustice of slavery, the illegality of 'corporal' servitude, the illegality of forced labour inflicted without necessity of penalty and, in a positive sense, the legal capacity attributed to all men. The principle which Larenz sees emanating from par. 1.1 of German Fundamental Laws, is that which states human dignity is intangible. It is precisely from this norm that the jurisprudential construction of the general law of the person is derived. Equally, there is derivation of the same principle of respect for a person's freedom of conscience and worship (art. 4 GG.). In other words, a solid body of the German legal doctrine holds that the principle of respect for the person (and reciprocal respect), even if not absolute, timeless and unchanging is a "natural right of the modern era" (Larenz, 1975, 64).

Freedom of will is thus reduced to the ability to do anything which is not prohibited and all that which does not hinder the equal freedom on the part of others.

The general right of personality as image, reputation, privacy is thus a value-principle accepted in all the Western legal systems.

Connected with this principle are the corollaries which concern the free exercise of profession and the prohibition on the entering into contracts which establish a total dependence of a person on another.

On this conclusion, Stein and Shand are also agreed; they place protection of privacy in the ambit of fundamental values.

With regards to the principle of self-responsibility, we will return to looking at this value during the examination of the principles in the field of civil responsibility.

The prohibition of emulative acts (as prescribed in art. 833 of the Italian civil code), the rules of good neighbourliness (article 872 and ss.), and the prohibition of insertions (art. 844 and ss.) are other examples of the principle of '*respect for others*'. Mutual respect entails restrictions to the right which is in fact by its nature the most selfish (the French revolutionaries called it the most '*terrible*'): the right to property. However we find examples of the application of this principle in contractual matters, where the model of commutative contract is the framework normally followed in the discipline of special contracts (*commutative contracts* are those in which the parties will exchange mutual benefits and in which they exchange between them risks and burdens). Likewise in the field of civil responsibility, he who causes harm bears the obligation to compensate, either in a specific form or in a numerical equivalent. In other words, he who does not respect the person, the goods or other protected interests of which an individual is the owner, must pay the consequences by compensating for the harm so caused.
More controversial on the other hand is the principle of '*rights abuse*'. In other legal systems, this is confirmed doctrinally and in jurisprudential practices: in the Italian system, this has a difficult life; however it appears to be a phoenix rising from its ashes in how many times it is highlighted by the system. This point will be returned to later, where 'concealed' principles will be discussed.
Other principles-values are the ban on retroactivity of the law and the presumption of knowledge of the law (*numquam legem ignorare censetur; ignorantia legis non excusat*).

Both the first and the second are however derogated and capable of derogation.

The second in reality codifies a conviction, namely that everyone is capable of knowing all the rules. Elaborated in a historical period in which there were few laws, they were promulgated through town criers, to a small circle of people, gradually from realistic consideration this became more symbolic but the rule was no less binding.

The number of laws will always increase: they will overlap the new and the old; from those of the rulers and the ruled (remember the call of Azzeccagarbugli?). These laws used to be written in a learned language (Latin), with most of the population being illiterate. Today, with this world having disappeared, the immensity of the number of norms has remained as well as their availability not being easy, etc. However not for this reason, the norm (which was once emanated with a regular procedure), is considered subject to the requirement that the recipients must have knowledge of it. This is

recognisable from legal provisions and the aforementioned principle quoted (Constitutional Court decision, 364/88).

As for effectiveness, it is has already been demonstrated that this is a question of Convention.

The principle of contractual autonomy is also considered a fundamental value.

Larenz observes that in all legal systems one can find the principle of *pacta sunt servanda*, even if in each of these, it is implemented in a different way. Each person can freely contract; and in obligating themselves, they perform an act of self-determination. Taluno (Binder, 1925, 479) holds that self-determination is the expression of personality: in the contract each party acknowledges the personality of the other contracting party. Others (Ghestin) underline that autonomy cannot be exercised without observing the principle of social solidarity.

4. In the Universal Declaration of Human Rights, the other table of values, we find a series of positions that reflect the aspirations and values of the West. These unite the situation of the individual with that of the collectivity, and therefore conform in part to the tradition of natural law. This is evident in the context of individual rights to life and security (Art 3), the prevention of slavery (Art 4), legal capacity (Art 6), equality and non-discrimination (Art 7), the right to an effective remedy (Art 8), property (Art 17), and freedom of association (Art 20).

Naturally, the use of these terms and the teleological interpretation of them is more developed now than in the nineteenth century; the social dimension has been made more important. But in individual constitutions, these individual and collective aspects are yet more precise.

In summary, one can trace, in the construction of a table of values common to the Western legal systems, a sort of progression or ramification which proceeds from the person to groups, to activities to be carried out within a society in an orderly manner, for the purpose of reconciling private interests and the collective interests.

- At the heart of this representation lies the principle of the protection of the person, with fundamental freedoms;
- Amongst persons, protected in this way, a relationship of equality in treatment is established, which entails a respect for difference (equality in difference);
- In order to survive, the individual needs goods and thus to be able to exercise on such goods a right to property; in certain systems the right to property is linked directly with protection of the person and appears almost as a 'natural' right; in many systems, the right to property is tempered, in its egotistical-individualistic dimension, by its social function, or more generally, from the limits deriving from collective needs. Economic individual interests, similarly to the general interest inherent in the dynamics of the market, require that goods be able to circulate freely or at least with a minimum of obstacles. The protection of possession however is affirmed and in certain systems (like the German), so is the circulation of goods through abstract bargains, whereas in other systems, this is done with simple expressed consent (such as in the French, Spanish and Italian systems), corollary of the protection of property and the liberal circulation of goods and the freedom of testation, tempered by the protection of legitimate heirs.
- The principle of protection of the worker, in its social and economic aspects;
- The principle of economic liberty, freedom of profession, freedom of competition; in certain systems one can identify a corollary of the principle of contractual liberty which in the Italian legal system does not seem to have constitutional 'cover';
- The protection of the person extends to family members of which the person is a member; within the scope of the family, one should remember: the principle of equality of the spouses, which is expressed in the principle of spiritual and material communion characterised in marital life. Also it is worth noting: the principle of equal power in the administration of goods; the principle of equal responsibility over the children; the principle of equal treatment of children, whether they are legitimate or not (in this regard, there are differences in the various systems with regards to right of succession of illegitimate children);

- The principle of liberty of association, of which its corollary is the principle of free economic association and the free exercise of collective businesses. With regards to the freedom to contract, here are its corollaries: the consensual principle; the principle of causa, for which every transfer of assets requires a lawful justificatory reason worthy of protection; the principle of contractual equilibrium, giving itself relevance to the corrispettività of performance, non-fulfilment and the sudden occurrence of unforeseeable circumstances; or foreseeable but such as to disturb the economic bargain. This principle formulated with different terminology and realised with different techniques in Germany (*Geschäftsgrundlage*), France (*imprévision*), England (*frustration of contract*) and in Italy (*teoria della presupposizione*) seeks to preserve the original balance of the contract and to balance the contingent with the economic programmes of the parties;
- The principle of responsibility, on the basis of which one undertakes an activity, natural or entrepreneurial, means that one must make good the damage caused; they are corollaries of this principle, or rather coordinated alongside, the principle of causality, the principle of fault and limitation of risks.

5. A recent reflection on the common values of the West is formulated in euro-sceptic terms of André-Jean Arnaud. He carries a broad examination of the historical nature of the development of fundamental themes in 'European' legal culture, arguing that, while being ambiguous, the meaning of 'European' is possible to identify a common end connecting them. The historical memory and thus the establishment of a 'promise': that of realising complete European integration. The historical experience finds its roots in the medieval period, in the canonical tradition, modern legal thinking which draws sustenance from rational jusnaturalism, by which voluntarism, legal positivism and subjectivism takes root. These values promote a discipline of international relations and they lie at the heart of the declarations of the rights of man as well as the first codifications. The emergence of national rights and the social dimension of law introduces censorship in this unitary and homogenous development, but this according to Arnaud, must not be considered as a brake on European unification, but rather a factor of growth and dialectic useful for the evolution of legal systems.

The process of European unification promoted by the two techniques of 'integration' and 'harmonisation', is based on the logic of flexibility which takes account of pluralism, the plurality of systems and the concentration of the application of law on the person. This complexity of the legal order can be overcome through the use of logic, with the contribution of doctrine, with the development of a legal system of compromise and resolution of internal conflicts.

Textual references to principles may be found in EU texts. For example, Article 340(2) TFEU provides that "In the case of non-contractual liability, the Union shall, in accordance with the general principles common to the laws of the Member States, make good any damage caused by its institutions or by its servants in the performance of their duties". Here the expression 'general principles' is employed in the sense of a norm that can be reached through provisions, contained in national legal systems, that are 'common', that is, that correspond. In other words, they are in force and are observed in the internal legal systems of member states.

As far as Community law principles are concerned, the Italian literature operates in the same way as interpreters from other areas of law. Different understandings of 'principle' (understood from time to time as 'notion', 'institute', or a 'rule' of a general character) are collated. Here we consider its meaning as a norm of a general nature, which can be obtained by way of induction from the complex of other rules and explicit statements in formal texts. In this sense they are extracted from the diverse affirmations of principle in Community rules: individual liberties, economic rights, the right of defence, the preservation of acquired rights, the principles of legal certainty and of legitimate expectation, the principle of equality, the principle of proportionality, the principle of exemption from responsibility due

to an act of God, the principle of good administration, the principle of extra-contractual responsibility, and interpretative principles. In a recent attempt to review the jurisprudence, Toriello leaves us with the understanding that even the Court of Justice employs general principles in the same way as Italian courts; these are integrative, corrective, and explanatory uses for provisions that appear unclear, incomplete or generic.

Among the principles collected together in the Community system, one in particular, often overlooked by internationalist and Community doctrine, appears within private law: the principle of consumer protection.

The existence and use of general principles of Community law remains the subject of some perplexity, notwithstanding that in 1964 Paul Reuter had attempted to establish that the Court of Justice of the European Communities voluntarily made recourse to general principles. Robert Kovar has recently confirmed that the Court uses principles from unwritten sources of Community law. In truth, the doubt exhibited today in France concerns not so much the existence as the 'necessity' of general principles of Community law.

Above all, we shed light on the fact that general principles are tied to the national laws of the individual member states, although one could immediately object that for some families, such as the Romanic-Germanic family, there are undeniable identities and affinities in the cultural and historical "humus" of these legal systems of which they form part. And some principles, together with many brocards, are also common to English law.

It is evident, however, that the principles of Community law that from time to time welcome different denominations have a pragmatic origin, and are therefore pervaded by a certain eclecticism. Besides, one must point out that the absence of fundamental norms in place at the base of the Community legal system deprives the judge of a point of reference for the construction of principles. On the other hand, in light of their specificity, the Community legal system cannot consider other legal systems closed, there being osmosis between the various systems and a notable circulation of juridical models.

The sources of Community principles must therefore be sought in international law, the laws of the individual member states, and, in particular, in the constitutional law of member states. Beyond these sources, one must take into account Community law itself, and therefore the complex of economic and legal values that are at the base of the Community. More precisely, we single out those principles that have a structural nature, including the principles of free movement, non-discrimination, free competition, and that of 'Community preference' and the unity of the Common Market.

What are added, over structural principles, are 'supreme' principles based on all the other principles, such as the rule of law (that is, the right to live in a community founded on a state of law and rights to justice). From the rule of law we can derive principles regarding so-called 'legal security', that is the obligation of institutions to observe a reasonable period of time for checks and notifications, respect for publicity, the need for a reasoned decision, non-retroactivity, the clarity and certainty of legal rules, good faith (including the brocard *patere legem quam fecisti*) and legitimate expectation. Chief among these are the principles of equality and non-discrimination on the basis of nationality of Community countries, sex, and so on. Also included is the principle of proportionality with reference to sanctions. Thus, the birth of a 'community of law' (*Rechtsgemeinschaft*) is theorised as completed by the 'right to

justice', that is, the right to a fair hearing consistent with Community law. We sustain, therefore, that in adherence to the characteristics of this Community, it is necessary that general principles are clear, expressed in a precise form, and knowable.

As regards the Community method of creating principles, one observes that it is no different from that of individual member states; it follows the inductive method. But above all, it uses a selection of principles extracted from international law and the internal legal systems of member states. This selection allows for the removal of principles that, in accentuating the autonomy or individuality of the individual legal systems, would lead to incompatibility with Community rights. This is the case, for example, with the principle of reciprocity. This selection has not always been possible. In fact, there have been times where the Community has not taken into account the fundamental rights of the person guaranteed by individual constitutions. It found itself in difficulty because national judges, even judges of constitutional courts, made internal constitutional law prevail over Community law. This was the bending of Community law, which had made the common principles its own, in order to make it fit with internal constitutional law.

Even comparative law has contributed its share to the construction of Community law and thus to its principles. The method followed has from time to time been to select, on the basis of value judgments, models considered worthy, even if only expressed by a single member state. The introduction of a system of liability, founded on enterprise risk, for the circulation of defective products bears witness to this. As has been noted, this could not be assimilated into Italian law, where at least formally liability founded on guilt (or the presumption of guilt) prevailed, and neither indeed could it be assimilated into English law (no liability without fault).

6. General principles are mentioned in the preliminary dispositions to the Italian Civil Code and in numerous other legislative texts in the national legal system (special laws, regional statutes, regional laws, city and provincial statutes). In the Community legal system, explicit reference is made to the general principles common to the legal systems of member states on the subject of extra-contractual responsibility (Art 340(2) TFEU). In the international legal system, reference is made to the recognised principles of the civilised nations (Art 38(1) of the Statute of the International Court of Justice). The compilers of the texts have not always employed the same formulas; one can speak of principles of the legal system, fundamental principles, and the principles of civilised nations.
Art 12 of the *preleggi* ('prelaws') merits more thorough comment for a variety of reasons. It contains the most well-known, widespread, and tortured text in Italian law. It is a disposition that fulfils the task of dictating the criteria for the interpretation and application of legislative texts. It is therefore placed on a different plane with respect to the other dispositions that refer to specific concrete cases. It is a norm about norms, and for that reason, it precedes all others from both interpretive and prescriptive points of view.

Art 12 of the prelaws presents a particularity with respect to the other provisons. It is the disposition regulating the interpretative process, and dictates (or claims to dictate) the behaviour of the interpreter and the limits of interpretation. This disposition has a complex history whose development must be known in order to fully understand it. It contains similarities with rules of other legal systems to which

we must refer in order to understand this peculiarity. Moreover, it represents one of the possible models for tracing the boundaries of the authority of the interpreter, and therefore it poses problems for the theory of law in general.

The heading of Art 12 is entitled "the interpretation of the law", and the text is comprised of two paragraphs. The first governs literal and teleological interpretation. The second adds "If the dispute cannot be decided by a provision, one will have regard to provisions that regulate similar cases or analogous subjects; if the case remains in doubt, one will decide it according to the general principles of the legal system of the State."

Above all, it is necessary to consider the existence of Art 12, and the need for a written rule that orders principles, as noted by drafters of the 1942 codification.

Let us pose the question in a different way. If the final paragraph of Art 12 had not been inserted into the preliminary dispositions, would interpreters have been equally able to have recourse to principles, and if so, with what limits and methods?

Not all systems of written law provide such a provision. It has already been duly noted that nothing like it can be found in the 'father' code (that is, the Napoleonic Code), the German code, or in the common law. This does not mean that the principles, or some interpretive technique, have not been noted or applied in France, Germany or in the common law. We can therefore go beyond this first elementary question, responding that the disposition is useful but not necessary. In an interpretative and systematic way, one arrives at the recognition and employment of general principles. Some hold that the disposition is superfluous because the interpretation of texts is exhausted by their 'analogous' application. However, this extreme thesis has no basis, as is revealed in the following discussion.

The provision was introduced into the prelaws for many reasons: for historical reasons (inasmuch as a disposition of a similar nature had already existed in the publication, interpretation and application of laws in general (Art 3) in the code previously in force since 1865); for political reasons (inasmuch as it was felt important to reaffirm, through law, the unity and completeness of the legal system and to render more precise discussion on the efficacy of natural law); and for ideological reasons (inasmuch as it was desired to give only those norms "established" by the state, the law in force, the task of governing Italian society in an exclusive way).

The location of this disposition within the prelaws is also for logical reasons. The world of principles is brought back into the interpretive dimension; a specific and circumscribed role is assigned to principles through laws that aid the interpreter in ascertaining the meaning and in applying the dispositions.

The legislator is not content to refer to principles and to determine their function; he is also given the responsibility to establish when recourse may be had to them.

Art 12 is formulated in the impersonal; commands are made in the third person ("one will have regard to", "one will decide"). They therefore concern all interpreters: the judge, the administration, or whoever in general has the task of applying the law. Principles are norms in the true sense and therefore must be respected by everyone, and in particular, by those who institutionally interpret the law.

However, the normative area of Art 12, second paragraph has boundaries that are more circumscribed because it is aimed not at the moment of interpretation, but rather at the point of deciding a dispute.

From this it is deduced that the 'judging' interpreter must make recourse to the principles in cases, within the limits indicated in the provision. It refers to the 'judge,' and thus not just the judge concerned with the dispute, but also an arbitrator who may make decisions in proceedings. In all other cases where one does not have to decide a dispute (that is, where the same judge makes pronouncements according to equity, or in the case of the arbitrator of equity or contract, or the case of a scientist-interpreter) there would be a freedom to use principles in the most appropriate and opportune way. Obviously, the judge of equity, the regular arbitrator of equity or contract is not allowed to decide in an illogical or unjust fashion; the interpreter assisted by scientific rigour cannot operate according to fantasy, but must concern himself with rules of doctrinal interpretation.

The letter of this provision seems to approve an order for these criteria: literal criteria (the true meaning of the words), psychological criteria (the intention of the legislator), teleological criteria (the will of the legislator and of the law), and analogical criteria (for similar cases or analogous materials '*analogia legis*'; for recourse to principles '*analogia juris*').

One notes that in this succession of criteria, principles can be applied to resolve doubtful cases only as a residual and last resort; the use of 'integration' is only residual, and is a surrogate to interpretation. The interpreter (the judge and other figures) therefore decides whether or not to turn to principles; the choice is up to him because it is he who decides whether a case is doubtful. If not, then it is not necessary to turn to the application of principles, as applying the written provisions would be sufficient.

The apparent crystalline and pyramidal structure of criteria for legal interpretation become, however, more opaque with regard to the practice that belies both legislation and also the technique of interpretation which would logically presuppose that the singling out of principles comes before any other criteria.

In practice, principles receive a very extended application that is not subordinate to hierarchical criteria, and that is wider than the role foreseen and prescribed ingenuously by the legislator. Yet more ingenuous still is the belief that gaps can be filled, and that these can be found in the text directly rather than as the fruit of an interpretative process. In the interpretative technique, the norm – fruit of verifying the meaning of the disposition as determined by the interpreter and filtered through his cultural baggage – is always framed and frameable as a principle.

But even the rule presupposed by Art 12, *in claris non fit interpretatio*, can be denied. The decision as to whether a provision is doubtful belongs to the same interpretative process. Whenever the interpreter prepares himself to fulfil his role, he performs an operation that is not (and cannot be) mechanical. The fact of distinguishing clear cases from unclear cases is already fruit of a pre-comprehension that leaves no doubt as to the active nature of his role.
Interpreted literally, Art 12 thus reveals the innocence of a legislator fearful of betrayal by interpreters. On the other hand, this is not new; Napoleon never liked commentary on the rules of his code. In fact, it is said that when he was brought the first work of interpretation and commentary, he is thought to have murmured, "*mon Dieu, mon code est perdu!*"

In conclusion, even if we wanted to conform strictly to the requirements of Art 12 of the prelaws, we would not be able to do so without turning to principles. This is because the use of principles is inherent in the interpretive process.

7. Since principles are mentioned in the scope of criteria for the interpretation and application of law, their legal nature can be founded on this textual argument: principles are also laws, and they are norms with different characteristics from written rules. We can consider the consolidated assumptions in light of the guidelines provided by Italian doctrine. The following characteristics are generally assigned to principles: they are vague and imprecise (yet it is not the case that written dispositions are, on the contrary, always clear and precise); they entail the use of an interpreter (yet neither is it the case that other dispositions do not require interpretive choices); they encompass a wider range of normative content than other dispositions (yet it is again not the case that equally broad dispositions are not found elsewhere in the legal system).

There are discussions as to whether principles obtained from written dispositions by the inductive method are directly applicable to specific concrete cases. The affirmative response is based on textual reasons (the formula of Art 12, paragraph 2), alongside logical reasons; if they are norms, then as with all norms, they are directly applicable to concrete cases.

With some authoritative exceptions, such as Betti, the doctrinal position agrees that principles are "norms".

On the other hand, if principles are extracted from rules by way of a process generalisation and abstraction, nothing but a norm is born from a norm. This, with greater reason, applies to the fundamental principles expressed. It is a positivist canon. However, modern supporters of natural law also agree on the legal nature of principles. He who holds that principles are founded on ethics and therefore have a meta-juridical origin, inspiring and shaping rights and therefore their epiphany (that is, the whole complex of rules which comprises the system), cannot but consider the observance of principles as binding. Otherwise, the judge who ignores them or directly violates them would produce a decision contrary to natural rights.

Legal realists, however, express doubts about the legal nature of principles: a principle would be observed not because it is binding in itself, but because it is held to be such in the collective imagination. A principle is a ductile instrument that serves to cover, legitimately, the work of an interpreter.

The impersonal formulation of Art 12, which would limit the task of applying principles to judges, clashes however with another logical need. Even before it is put into practice, the legislator has not enumerated the principles that one can or must apply. One wonders then whether principles are a 'source' of rights with characteristics similar to common law, as this would not be a written rule but a rule referred to and observed in practice, both in terms of interpretation and application. In contrast to common law, which in modern systems does not precede but follows the written norm and is subordinate to it, principles come before other norms (if one wants to go beyond the rigid scheme of Art 12) because other norms presuppose principles. However, while common law is observed, inasmuch as it is held binding (*opinio iuris ac necessitas*), principles are observed because in the mitigating of

interests, these offer the solutions that are most consonant with law – that is, to the culture and sensibilities of the interpreter.
Here, then, is the second illusion of the legislator: that principles would be a *numerus clausus*, operating within well-defined boundaries. This is because principles are inferred from the norms, and thus cannot exist (legally) if they do not have a foundation in these norms.

The legislator here has also forgotten, or has pretended to forget, the role of the interpreter, who can create principles and anchor them to norms.

There is not a closed list of principles, and therefore they cannot be catalogued. This is an ancient consideration that finds ample confirmation in practice.

The introduction of principles can have three origins: the legislator, the judge, and the legal scholar.

Examples of the first origin are: Art 1 (on the law on abortion) according to which abortion cannot be used as a means of birth control; Art 7 (on the law on administrative procedures), according to which the administration must operate effectively and efficiently; provisions on military discipline; provisions concerning workers and those contained in the laws on parity; and the other examples quoted in Ch 1, paragraph 4.

The majority of judgments deciding cases by applying a principle are examples of the second origin. It is enough to think of the application of the principles *pacta sunt servanda*, *rebus sic stantibus* and principles such as supposition theory in the employment context, unjust enrichment, acquisitive prescription, the protection of minors in custody cases involving parental separation, and all the other cases which are the subject of analysis in the second part of this work.

The legal scholar identifies principles, drawing them from practice, the politics of law as followed by the legislature, and drawing on elaboration and commentary, proposing principles that organise diverse and scattered norms in a systematic way or introducing new principles in adapting the legal system to new concerns (such as consumer protection, the protection of savings, transparency of contracts, etc).

Today, the legal nature of principles is universally recognised. It could appear contradictory to deny commentary and doctrine a role as a source of law whilst assigning doctrine with the task of describing principles. Legal positivists escape the contradiction by sustaining that the principles in force are those extracted from norms.

Can we place boundaries on the will of the interpreter which would ensure that principles are not transformed into an authentic Trojan horse, allowing interpretative subjectivity to reenter areas from which it had previously been banished, and transforming the judge into a legislator? Even those skeptical of constraining interpretation admit some limitation, such as logical consistency and the reducibility of the subject.

Principles can in fact be classified, ordered hierarchically and analysed historically. Since the fundamental values of a legal system are contained in its fundamental law, these serve to render the Constitution compatible with the rules in force. In this way, they can have a more general importance if found in the Constitution, the civil code, or in regional statutes, and a more circumscribed importance if expressed in special legislation giving rise to 'microsystems'.

8. A history of positivist fact requires us to consider the formulas prior to those codified in Art 12 of the prelaws. But it also requires analysis of the questions elaborated by the doctrine and jurisprudence surrounding that positivist fact.
A textual comparison apparently yields meagre results. As has been revealed, a disposition that makes reference to general principles as such, understood as a technique of stating values and guidelines that a interpreter must refer to in given situations, is not found in the Napoleonic Code, the 'father code' of legal systems belonging to the Romano-French family. *Individual* general principles are codified (such as the principle *alterum non laedere*, the principle of the bindingness of contracts, and so on).

This is an important fact in political history and the history of law. This is the period of time between the end of the eighteenth century and the beginning of this century, which we can define as the era of codifications and of the "positivisation of general principles".

In the Napoleonic codification as well as in the Austrian codification, evidence of natural law can be identified. In the latter, this is more distinct because it corresponds to rules in the code that explicitly reference the values of natural law. However, such values are 'encapsulated' in the code, and are thus rendered positivist rights in force, and translated into either explicit rules or general principles. Predating the code in permeating legal science, general principles in the new era that express a new way of conceiving legality are applicable in so far as they are referenced by the code. In short, general principles take inspiration from natural law, predate the legal system, and enters to form part of it only when called upon.

In the *code civil*, it is often said, principles are not spoken of explicitly. Napoleon's concern was to set out clear rules that the judge, as the "*bouche de la loi*", must apply in a literal way; not even comment was permitted, for fear that the legislative intent would be diminished or distorted.

It is not for this reason that doctrine dares to elaborate on general principles. This is instead due to the survival of Roman studies. It should be noted that the Italian translation of the civil code, that is, the civil code of the Kingdom of Italy for the Italian provinces conquered by Napoleon, entered into force in 1806, placing an obligation on university professors to comment in their courses and lectures on the civil code with the aide of Roman law. Even the typically French tendency towards classification and abstraction was a potent spur towards the identification, coordination, criticism and application of principles. In the private law textbooks of Laurent, Toullier and Zacharie, an ample use of principles is made, in contrast with the original legislative intent but in conformity with the doctrinal needs and logic of every legal system.

Conversely, an explicit mention of the expression 'general principles' is found in the Austrian Civil Code of 1811, in force in Italy from 1816 in the Italian provinces under Austrian control. Section 7 is formulated as follows: "whenever a case can be neither decided according to the words nor the natural sense of the law, one will have regard to other similar cases decided by the laws and to other analogous laws. If despite this the case remains doubtful, the case will be decided according to the principles of natural law, having regard to the relevant circumstances with care and consideration." Few references can be found in the legal systems of the other Italian states prior to the Napoleonic conquest. In some

states, as in the Kingdom of Sardinia, the situation after the fall of Napoleon and the Restoration was even more complicated.

In 1837, at the moment of unification of the civil laws of the states of Piemonte (Piemonte and Savoia, where Savoy constitutions were in force; Liguria, where the Napoleonic Code remained in force; and Sardinia, where particular laws were in force), the compilers of the code (then called the Albertine code) were beset by a problem: should they use the expression 'general principles'? And if so, should they copy the Austrian expression which made reference to natural law? The solution was curious yet at the same time illuminating: the subtle meaning in the phrase "principles of law" was preferred.

And it is this expression that was passed on to Art 3 of the prelaws to the 1865 civil that unified the civil laws of the new Kingdom of Italy. From that moment on, the history of positivist fact became the history of doctrinal techniques and jurisprudence whose purposes were to escape the literal and restrictive application of legal provisions, to enrich positive rules, and above all, to satisfy the needs and problems of reality and to find a response to these in positive rules of law.

This position is sustained primarily by scholars of commercial law, the area which, before any other areas of the legal system, is affected by the latest market developments among those coming from abroad and international relations. Here, principles – besides being the skeletal framework of the sector – are seen as tools that allow the rapid adaptation of the legal system to the new reality. It was in 'the nature of things' that rejuvenation of commercial code of 1865 was required; however, the code of 1882 also left the door open to principles, and therefore to new interpretation.

After the First World War, jurists warned that a turning point had been reached. The centuries-old empires had fallen, and the world of the nineteenth century had vanished with its exaltation of the individual and private property. The growing industrialisation, state intervention in the economy, and new social circumstances rendered the code, already grown old, inadequate for new realities.

9. Historians of Italian law have not yet deepened their analysis of the jurisprudence of the last century to enable us to know how principles were used in the reasoning behind decisions. Moreover, a work such as that of Broom, which would allow us to understand the role of principles in 'living law', does not exist in the Italian literature. But from an analysis of current legal scholars who have investigated individual sectors or institutions of private law, one can comprehend that these principles were applied in a manner not very dissimilar from the way in which they are applied today. Even the problems of a practical nature of general theory posed to the interpreter are very similar to those posed today. Retracing history then has a dual purpose: it serves to reconstruct the origin of texts, but also to avoid repeating errors of the past.

In an Italy divided by cultures and traditions very different from one another, the legislative unification that cemented the political unification had to be integrated by the uniform application of the law. Moreover, the victory of positivism (the modern technique of organising knowledge) in the natural sciences and the philosophical and social sciences led to the marginalisation, by the science and practice of law, of values not explicitly recognised by the law. Political reasons in conjunction with scientific reasons (beyond, obviously, the observance of Art 3 of the prelaws) thus militated in favor of a positivist

conception of law, and therefore one of general principles of law identifiable in the provisions of the code.

Vittorio Scialoja was the author of this conception. In his inaugural speech for the 1879-1880 academic year at the University of Camerino, Vittorio Scialoja, who had just been given the chair of Roman law and the civil code, enunciated a sort of manifesto for Italian jurists that would remain dynamic and persuasive for more than half a century. The speech bears the title "positivist law and equity", but its content was much more broad. In fact, the structure of the speech was as follows: the role of moral and physical forces in the creation of law; the consensual nature of law (that could be also expressed in terms of the original contract of the state); the necessity of legal forms; common law, written law, and the law of judges; and the tempering of written law (*strictum jus*) on the part of judge-made law and the legal force given to equity.

Following this structure, Scialoja focuses on the points of intersection in the speech, and these form the development of his thesis: there is nothing outside of law, and everything is within the legal system. Equity is not an 'alternative system'; equity is a (material) source of law. From this perspective, general principles (such as the principle of equality, the principle of citizenship, the principle of protection for foreigners) are constructed in the context of law. These do not derive from natural law, as though they were in a latent or unconscious state, but are the fruit of convention and of the will.

The idea of equity understood as a natural foundation of the sense of justice is to be refuted because it falls into subjectivity. It may be justified only as a response to formalism and the crude, thin, and insidious application of law, but not because it proposes an alternative system of rules with respect to the law in force. According to this illustrious jurist, this latter idea is dangerous because it encourages the judge not to apply the positivist rights considered unjust, and instead to choose a solution that no longer adheres to the positivist fact but that adheres to his own sense of justice. Since this sense of justice is subjective, the risk of falling into arbitrary interpretation is too high.

In the same way, he rejected the idea of equity as a "subsidy and correction of positivist law".

Here too the judge, unless authorised by the legislator, may not substitute the legislation with his own view. Equity, in compelling a judge to attend to the concrete circumstances of the case and to consider all the rules together, is not 'equity' in the true sense, but expresses the task of the interpreter. In other words, the judge is not free to interpret the rule but must seek out the intent of the legislator. He can modify his application of the rule only where he finds himself using expressions that the provisions define as having a relative meaning (and that we would call *clausole generali* or 'general clauses') such as public order, good faith, or correctness. In these cases, the legislative intention is that these norms are interpreted according to the ideas, sentiments, and conditions of various cases and various times. But here we are not dealing with a free choice, entrusted to the interpreter; the legislator is the one who explicitly authorises and makes use of 'general clauses', designed to survive for a century.

Scialoja here arrives at the conclusion of the speech, now pointing to general principles. Principles are not mathematical formulas and nor are they elastic formulas "such as to allow them to stray from the laws: a law does not propose principles, it dictates commands (…) from these commands one may extract principles, but the supreme difficulty consists in formulating them."

The legal positivist and statist credo regarding general principles is contained within these few lines. Laws are understood as an ensemble of commands. Consequently, a general principle is understood as a secondary norm that is extracted by way of abstraction from a written rule or from custom.

How, then, should we interpret Art 3 of the prelaws to the Civil Code of 1865, where it makes reference to 'general principles of law'? Currently, given what has been argued on this point, Scialoja excludes that such an expression alludes directly to Roman law, natural law, or to equity, as held by some of his contemporaries. Such formulas are suitable in legal systems where they are used in an explicit way and are directly relied upon, as was the case in the Ticino code (Art 5) that made reference to "common law" or the Austrian code that refers to "principles of natural law." The formula of equity as an expression that consolidates general principles is only to be relied upon (in so far as it is applicable by the judge) when the governing law permits it: the judge has the duty "not to exceed his powers."

Scialoja (in a note to the text) returns to the problem and gives his instructions to the interpreter. These instructions are directed more towards describing what we call today the technique of qualification than describing the technique of abstracting general principles from rules ("do not believe that every element of a fact is a legal element; do not forget to give their fair value to those elements of a fact that at first sight do not appear to be legal elements"). Taking nothing away from the moral imperative of life, Scialoja concludes with the summary: "to bend the private will and private judgment to the will of the State, whatever it may be, is the work of a good citizen."

The freedom of the interpreter, the uniformity of the legal system, and the consistent application of rights under law are the main points of this reading of norms, and the message of this jurist to other jurists.

10. The civil code of 1865 was beginning to show its first cracks: the growing industrialisation, changes in social structure and special legislation, which along with the dawn of the period of war were becoming ever wider, in turn colliding with work relations, local relations, and urban and agrarian relations. All these were provoking a rethinking of the role of the code, and therefore that of the interpreter. Moreover, the brief period of legal socialism at the end of the century had denounced the ideological options of a civil code that had been inverted on property, in the same way the commercial code was inverted on the microeconomics of exchange. The new times called for a modernisation that would take place without trauma. Plans for a new codification were not lacking, but most of these dealt with internal procedures, with progressive adaptations that above all bent existing norms to fit new needs. Even without reaching the maximum degree of autonomy entrusted to the judge, good results could be obtained. Swiss legislators had, in the same period, resolved the question in another way, allowing the judge who could not find a specific rule in the legal system that would resolve the case before him to make himself a "legislator of the individual case". Others, a few years before, had based interpretative freedom on analogy. The rules of logic, whether in the case of interpretation by analogy or in the application of principles, would naturally function as a restraint on discretion, tempering the creative power of case law.

In this climate of reform, waiting and dissatisfaction, models, trends, and directions that would eventually take hold in our legal culture began to take shape. These would be reproduced subsequently in the 1940s, again at the end of the 1960s, and finally in the present day. In our legal system, the history of general principles is one of phases, and these phases open up, normally, in periods of crisis or renewal.

In the 1920s, in the effervescent climate after the First World War characterised by the desire to install a new order, the positivist jurist began to doubt the established certainties that the past century had sculpted. Alongside those who still wanted an interpreter devoted to the letter of the law – deprived of any fantasy and a mere executor of a *voluntas legis*, obtainable without hesitation from a text allowing for neither nuances nor deviations – there were those who believed it to be possible to introduce meta-legal values into the legal system, entering by way of general clauses like equity, good faith and public order, making use of general principles of law.

In this environment, the beginning of a new phase, and therefore of a new discussion, first raised by the writings of Donati with his 1910 book on analogy and continued by Brugi with a work in 1916, is outlined by Giorgio Del Vecchio's broad essay, informed by a moderate and modern idea of natural law (1921).

In this essay, destined to become a pillar of the theory of interpretation, Del Vecchio begins from consideration of the inevitable incompleteness of the law in force, and therefore from the necessity of recourse to reason, or indeed to "natural reason that governs the creation and interpretation of rules" in order to resolve legal questions in a just way. Some principles have a logical nature (*nemo dat*, *cuius commoda*, etc); others derive from "the nature of things", that is, from evaluting the circumstances of individual cases. Others are postulated by the same civil code, referring to equity or to natural equity (Arts 463, 578, 1124, 1652, 1718; references to previous civil code).

Del Vecchio does not distinguish between a legal system and a system of equity. He does not consider the references made in the codes to 'equity' or to "the nature of things" to be expressions of values that are different and alternative with respect to legal references. For him, the law and equity are two reciprocally integrated sources; equity constitutes "a perennial source of renewal and reintegration for the whole legal organism."

There are, however, norms that reproduce principles, norms that only partly reproduce principles, and gaps that may be filled with the help of principles. The problem of the will of the judge does not escape Del Vecchio, and nor does he confuse the *jus coditum* with the *jus codendum*. Where there are rules, these must be applied even if they do not conform to criteria of rationality and equity. In other words, principles, "having a character of vitality and of absoluteness" cannot have the value of special norms that constitute the system, but can be placed "above and inside the norms." In applying the rules, principles make explicit the *ratio legis*. Where gaps are concerned, they regulate the subejct. Del Vecchio gives principles of natural legal reason an interpretive and 'corrective' function, since norms always receive an indirect application by the interpreter.

11. The second phase closed with the formula established by Art 3 of the prelaws (1939), which in the 1942 version becomes Art 12, to which reference is made in cases in which a decision cannot be reached using a given provision. Only subsequently, when doubts persist, is the judge directed to general principles "of the legal system of the State". In its most reductive intepretation, this formula would seem only to allow an interpretive and integrative use, and this would not extend to *all* principles of law, but only to those so general as to be part of the legal system "of the state". One could not invent a more rigid or positivist formula, and this was the fruit of a non-random choice, considering the rejection of other more bland formulas.
In reality, the content of the formula was more extended in the first version proposed by the Commission where "general principles of law" or indeed "general principles of the law in force" was planned. This was to exclude the risk of a judicial legislator (noted in Art 1, paragraph 2 of the Swiss code) in addition to satisfying "the reasonable needs of doctrine and to conveniently serve judicial practice". The formula had remained in the report of the Guardasigilli ('Keeper of the Seals'), which showed that in relying on the law *in force*, one could prevent the interpreter from reentering the legislative sphere of the legal system in force, and those norms that the system itself is connected to by its origins and historical development.

Transcending "excessive generalisations and abstractions, resorting to foreign laws and thus altering the particular lines of our national legislation" would therefore be prevented. Yet the text pleased no-one.

The underlying reasons behind the definitively accepted formula emerge from the report of the Guardasigilli. Indeed, we read:

"The specification introduced in the definitive project regarding general principles of law, in the sense that such principles must be sought within the sphere of the legislative system in force, has been met with the full favour of the Parliamentary Commission. Nonetheless, I believed it opportune to introduce a modification into the text of Art 3, not merely of a formal nature, to express more clearly and more completely this concept. In place of the formula 'general principles of the law in force', that might have appeared too limiting of the work of the interpreter, I held 'general principles of the legal system of the State' to be preferable, where the term 'legal system' is comprehensive, in its broad meaning, beyond norms and institutions, and even the state's political-legislative position and the national scientific tradition (Roman law, common law, etc) with which it is in harmony. Such a legal system, adopted or sanctioned by the state, namely our positivist legal system, whether public or private, will give the interpreter all the necessary elements for finding the applicable norm."

As we can see, the reference to the national scientific tradition, today considered mere tinsel, was the way of tying together to positive law the values dispersed in the system that lie at its base. Some represented this role under the guise of private law dogma.

That the interpreter would then have to extract principles from the rules of the law in force, and be bound by them, is another matter entirely. However, as is known, the interpretation of norms goes beyond the literal boundaries of the norms themselves.

12. Here we arrive at the current debate, whose echoes have already given warnings several times, which concerns the tension between formal interpretation and conceptual interpretation, along with criticism of the unconcious use of formulas. Of the valuable contributions elaborated gradually in the doctrine, we take into account above all the voices of the 'encyclopedists' and the Congressional acts. In this context, Giovanni Tarello stands out, with his research on legal interpretation.

The legal realist position of Tarello begins with the premise, shared by Betti among others, and shared also by analytical culture, that law does not only spring from laws: "not all of the regulation of social life can be found in the totality of the laws of a legal system". This is because the interpreter already makes additions the moment he undertakes a merely literal interpretation of the provisions; unless the laws themselves contain all the definitions of all the terms used, which rarely happens, the law cannot govern all the specific concrete instances that are possible in reality. The search for the rule to complete the system begins here. Tarello explains that this process is assisted by the ideology of completeness of the system. Art 12 of the prelaws begins with this premise because it seeks to use analogy and general principles to complete the system; it is therefore a norm of closure. The judge must give content to the analogical interpretation as well as (and above all) to the general principles. Still, completeness is belied by the existence of conflicting rules such that, if all law were the reflection only of laws, we would find ourselves faced with a contradictory system. The question is resolved with recourse to three criteria: the criterion of hierarchy (Art 1 of the prelaws), the criterion of 'posteriority' (Art 15 of the prelaws), and the criterion of 'specificity'. But these three criteria require the action on the part of the interpreter, in the same way that the application of the law requires systematic intepretation.

In this context, general principles are one of the various *techniques* utilised by judges in interpreting law. Tarello warns that principles mask the *analogia juris*; they mask a favour towards some interest (for example, the preservation of the contract, the protection of the debtor's interest, the interest of the employee, etc). Moreover, they mask the ideology of the interpreter, especially when he reproduces the values of the dominant regime (as happened for the principles codified in the "Charter of Labour"). The argument beginning from general principles is a blank slate that serves, from time to time, to cover disparate functions.

However, principles can be understood in a different way. This is as values underlying the system, used by the judge almost as though they were the fundamental material. This is the thesis of Ronald Dworkin.

In his critique of positivism, Dworkin distinguishes between *rules* and *principles*. Law is not a system of rules but of rules and standards, that is, principles, policies, and other standards. A principle is a standard that must be observed not because it provokes or maintains a certain situation (economic, political, or social), but rather because it expresses a need of justice, correctness, or some other moral consideration. For example, the standard that no-one should benefit from his own wrong is a principle. According to Dworkin, principles are therefore different from rules, but are a part of the law. The difference is above all a logical one. The written rule is expressed in a precise manner, wheras principles do not determine or set out conditions that render their application necessary. Another difference consists in the fact that principles have a dimension that rules do not have; this is the dimension is of weight or importance. Principles, then, serve to give content to 'general clauses' inserted into rules.

Furthermore, only rules impose results, whilst principles do not. In reality, principles can be recognised *ex post*, that is, after their application by a judge.

The fact that in common law systems the weight of precedent is much more relevant than in civil law systems weighs heavily on Dworkin's thesis. Moreover, there is the fact that beyond the influence of Roman law on common law, brocards, traditional principles and such techniques have never had dominant position in that culture, as conversely developed in the civil law countries and Italy in particular.

In any case, it is not possible to stop at the positivist conception. What one can do is take into account the positivist concern regarding control of judicial discretion and the consistency and logic of reasoning. Above all, this concerns awareness of the use of the expression 'principle' and the technique of employing a principle that is singled out whether out of prior recognition, out of carelessness, natural expression, or out of an *ad hoc* creation in order to resolve the question in issue.

Still in the context of this same theme of demystifying principles, considering also their historical function and content, we can place Francois Ewald, student of Michel Foucault. Ewal advanced his thesis moving from the premise that law is the fruit of a system of power allocation, and therefore that there exist concrete systems of positive law that from one historical phase to another express the values of the society that creates them. Ewald outlined the theory according to which general principles, here understood in the sense of foundation of the system, and unwritten rules latent in the legal tradition of civilised nations are, norms that the jurist follows. These comprise a kind of "empirical natural law" that, as distant from classic natural law theory as from dogmatic positivism, allows consideration of the legitimacy of legislative provisions and the enrichment of positivist fact. General principles are thus retraceable in the history of law and are the expression of the memory of our legal tradition.

This quite acceptable position, if only partially whether in defining the role of principles or in their historicisation, can nonetheless be placed within the range of positivist criticism. But it has provoked the criticism of those who hold that the natural law model is vital in the history of law, and that principles should be more circumscribed.

13. We can present the results of our research conducted so far in a comprehensive summary, and this deals with assertions noted in the preceding paragraphs.

References:

1) The identification of functions performed by general principles is arbitrary, as is the categorisation, creation and identification of principles in the law in force.

2) This arbitrariness, however, is coherent and is acceptable inasmuch as it is typical of all interpretive activity. What is important is that the interpretive activity responds to the canons of logic, common sense and practical utility. A fundamental function performed by principles is the role they play in legal

reasoning. As Struck has clearly brought to light, principles, and therefore the legal *topos*, assist in the application of norms the moment that no legal rule or value is considered absolute. There is always the case in which, depending on the circumstances, a rule must be limited and its value must yield to other more important considerations.

3) In general opinion and in general practice, principles thus perform a function that is much broader than that entrusted to them by Art 12 of the prelaws. On this hinges a system of private law, consisting of positivist fact and the enrichments derived from its interpretation, manipulation, and construction in the legal system. Principles therefore play a role as a "foundation" of the system. In uncodified areas, administrative law and international law, principles perform a yet more relevant function: that of a normative frame of reference.

4) In the jurisprudence, principles obviously play the role recognised by Art 12 of the prelwas, that is, as rules applicable to concrete instances when a legislative text has gaps, is imprecise, or is in some way lacking.

5) Principles are often invoked in jurisprudence for the purpose of mere embellishment in that they corroborate the application of a positivist rule. They therefore serve to reinforce the crux of the decision and to assign the greatest possible internal coherence to the reasoning.

6) Where they are created *ex novo* by the judge, they serve to legitimise the case law. In order to mask the arbitrariness of a decision, a judge will provide for the introduction of a legitimising shield, namely, the principles invoked.

7) Principles constitute the modern *lingua franca* of jurists belonging to different legal systems. This is the case whether for the positivist side of things, the formation of a uniform legal culture derived from the circulation of legal models, or whether indeed for the formation of uniform commercial practice and arbitration.

8) The international positivist position tends to homogenise the legislation of member states (from time to time, though the setting up of parallel systems, as happens for the Community legal system, or by way of conventions, as happens for the Council of Europe, or indeed through treaties).

9) The circulation of legal models occurs either as an effect of the uniformity of positivist data (as happens in the reception by internal legal systems of models from the Community, thmselves acquired from other internal legal systems and imposed on all member states) or as an effect of cultural exchanges and comparisons.

10) Commercial practice tends to aspire to uniform principles; in the same way, international arbitral justice tends to follow principles collected from civil societies.

11) Principles today perform a function once performed by Roman law: they tend towards the fusion of systems that are diverse in their traditions and internal history.

12) Principles perform the function of 'policy'; they express the legal policy of the legislator and, in general, of the interpreter, which more or less operates in a conscious way according to a table of values. This policy – understood as evidencing the optimal results that expressing and appling the principle would want to achieve – can either be clear, or indeed, obscure.

13) “Obscure” principles serve to elaborate decisions that are formally presented as consistent with clear principles, but are substantially inherent in the legal policy of the interpreter.

14) Principles expressed in a dialectical way, along with their reciprocal (or opposite), perform the function of mitigating the interests in play, orientating the social engineering and facilitating the mediating function of the judge.

15) Principles perform many other functions, as we have sought to demonstrate in this book, and as has been brought to light by many authors who at different times have taken them as the subject of their reflection. Just it is not possible to identify all principles once and for all, and that it is not possible to catalogue them once and for all either, so, in the same way, is it not possible to list all the functions which principles perform; and neither is it said that these functions are performed contemporaneously.

16) In any case, principles appear as an unavoidable factor in the art and process of creating norms and interpreting them; or, which ultimately the same thing, they are indispensable instruments in the evolution of law.

Author

Guido Alpa is Full Professor of civil law at La Sapienza University of Rome

Open Review of Management, Banking and Finance

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

Hot Tips Turned Flops: Liability for Unsuitable Investment Advice – An Integrated Approach

by **Hanns A. Abele**, **Georg E. Kodek** and **Guido K. Schaefer**

Abstract: This paper develops a new analytical framework for assessing losses from unsuitable investment advice, integrating both legal and economic aspects. First, a core of legal concepts for assessing losses is identified that is common to most jurisdictions. These include negligence in advice, causation as examined by the but-for-test, and the loss caused by the unsuitable advice.

Building upon these legal concepts, five economic tests are developed for analyzing the causal chain from improper advice to financial loss. If the tests show that the advice was unsuitable, the investor did not know about it, the investment violated his risk patterns, and the assets most likely chosen with suitable advice would have performed better, an economic proof for establishing liability is provided, thus supporting legal assessments of losses. Several new analytical tools are suggested to substantiate the analysis.

As a major conclusion, it is shown that proving liability for unsuitable investment advice gets more difficult, the more financially sophisticated an investor is.

Summary: 1. Introduction. – 2. Legal Framework. – 2.1. Legal Dimensions of Liability. – 2.2. The Legal Determination of Quantum. – 3. Proving and Quantifying Losses from Unsuitable Investment Advice. – 3.1 Foundations for an Economic Analysis of Damages. – 3.2. Financial Sophistication Test. – 3.3. Suitability-of-Advice Test – 3.3.1. Generally Accepted Investment Principles. – 3.3.2. Financial Profiles and Information Provision about Investment Recommendations. – 3.4. Ignorance Test. – 3.5. Risk Management Test. – 3.5.1. Assessing explicit risk management. – 3.5.2. Assessing implicit risk management. – 3.6. Asset Choice Test. – 3.7. Applying the five tests for assessing losses. – 3.7.1. Financially unsophisticated investors. – 3.7.2 Advice unsuitable for the asset. – 3.7.3. Advice unsuitable for the investor. – 3.7.4 Erratic investors. – 3.7.5 A testing scheme for assessing liability – 3.7.6 A gradually rising threshold for proving losses. – 4. Summary and Conclusions.

1. Because most households have very little financial knowledge[1], they often rely on advisors for guidance on financial decisions. Unsuitable advice can wreak financial havoc on investors as recent economic crises have amply demonstrated. When investments go awry, the question arises whether

financial advisors are to be held liable. A large legal literature examines this topic[2], but economic research has studied related questions only without addressing the issue upfront.[3] Hence legal analyses of unsuitable investment advice lack a solid economic framework for complex questions such as establishing liability, the causal influence of the advisor, or the quantification of the extent of losses, all revolving around the tricky economic issue of how the investor would have invested with suitable advice.

This paper suggests one approach to fill the gap in the existing literature by developing an analytical framework for assessing losses from unsuitable investment advice.[4] It tries to integrate legal and economic fundamentals and to provide simple, applicable tools to settle disputes in this area. First, a core of legal concepts for assessing losses, which is common to most jurisdictions, is identified. These include (i) negligence in advice, (ii) causation as examined by the but-for-test, and (iii) the loss caused by the unsuitable advice. Building upon these legal concepts, five economic tests are discussed to analyze the causal chain from improper advice to financial loss. If the tests show that the advice was unsuitable, the investor did not know about it, the investment violated his risk policies, and the assets most likely chosen with suitable advice would have performed better, an economic proof for establishing liability is provided, thus informing legal assessments of losses. Comparing the hypothetical performance to the actual performance provides an estimate for the amount lost.

It is shown that the threshold for proving prejudice rises gradually as the financial sophistication of an investor increases. Because sophisticated investors have broader financial knowledge and more experience with risky assets, unsuitable advice is less likely to have caused them losses. Also, the analytical tools for assessing the establishment of liability and the quantification of losses must account for the heterogeneity in financial sophistication. For unsophisticated investors, normative assessments of the suitability of advice are fundamental, whereas for sophisticated investors, positive analyses of actual investment behavior matter. The five tests developed in the paper account for these differences and demonstrate how economic analysis can support legal assessments of losses.

2. An investor may have claims against several persons or entities under a wide range of possible theories. While actions may be based on suitability, negligence, negligent misstatement, failure to adhere to rules and regulations governing the securities industry, or breach of fiduciary duty, the legal analysis in this paper focuses on losses from unsuitable investment advice. In particular, emphasis will be placed on aspects raising economic questions as analyzed later in the paper.

Claims for losses from unsuitable investment advice are becoming more and more common in many countries. While of course there are many differences in detail, at a very abstract level liability for unsuitable investment advice requires four prerequisites to be met: (i) the investor has to have suffered a loss; (ii) the loss has to be caused by the advisor; (iii) the advisor violated a duty of care. Often there is an additional prerequisite relating to the advisor's state of mind, that is, (iv) that the advisor acted "scienter"[5] , or some other subjective element. Sometimes the order of these elements is reversed. Thus, the elements of the tort of negligence are often described as (i) the negligent act, (ii) causation, and (iii) a loss. However, this difference in approach does not substantially affect the analysis. All of these elements may turn out to be problematic in specific cases. Even the first element, namely that the

investor has suffered a loss, although it seems pretty much straightforward, may present difficulties both as to the question of liability and as to the quantum.

2.1 Causation[6] is established by showing a link between the defendant's negligent act and the plaintiff's loss. The causation requirement is traditionally determined by way of the "but for"-test. [7] This aspect is usually described as transaction causation or cause in fact. Under this approach, a plaintiff has to show that he would not have entered into the relevant transaction or would not have entered into it on the terms he did.[8] However, once negligence is established, courts often are prone to resolve doubts about causation, within reason, in the plaintiff's favor.[9]

Obviously, the questions of whether the investor has suffered a loss and whether this loss was caused by the defendant are very closely, and sometimes inextricably, linked. This is particularly true if the investor claims damages for loss of opportunities, that is, for hypothetical investments he had made but for the unsuitable advice rendered by the defendant. In this case, the plaintiff has to prove that he would have made certain other investments if he had not received unsuitable advice from the defendant. The question of alternative investments poses significant difficulties on the factual level, that is, what alternative investments had the investor chosen in lieu of the unsuitable investment recommended by the defendant.

Even if the defendant caused a certain investment decision on part of plaintiff, this in and by itself is not sufficient to trigger liability. Rather, the defendant is only liable if he violated a duty of care.[10] Although this probably is true for all legal systems, the advisor's duties are most clearly expressed by the German concept of "*anlegergerechte*" and "*anlagegerechte* Beratung"[11], that is, advice suitable for the particular investor and for the particular investment. This approach, however, is by no means limited to civil law countries. Under US law, for example, to prove that a broker's investment recommendations were unsuitable[12], a customer must show that the broker recommended or effected transactions that were unsuitable in light of the customer's unique characteristics, including knowledge, financial situation, needs, investment experience, and account objectives, and made material misrepresentations with respect to the suitability of his or her investment recommendations, omitted to disclose that such recommendations were unsuitable where a duty to do so existed, or exercised control over the account. While this test relates to the suitability of the investment for a particular investor, the advisor can also be liable if the recommendation was not suitable for any investor, regardless of the investor's wealth, willingness to bear risk, age, or other individual characteristics.
An investor's expertise may be relevant on several levels: It may play a part in the determination of causation, that is, whether his decision was in fact caused by the unsuitable advice. Furthermore, the investor's expertise may be relevant for the determination of whether – but for the unsuitable advice he had obtained – he had sought advice elsewhere, whether he had followed that advice, and what, if any, alternative investments he had made. Also, an investor's level of expertise of course is important for whether and to what extent he needs certain issues to be explained. Thus, it is generally accepted that the specific nature of the duty of care of an investment advisor will vary, depending on the relationship between the investment advisor and the investor; hence specific facts are needed to assess what duty is owed under what circumstances.[13] For example, where the investor is uneducated with regard to financial matters, the investment advisor must define the potential risks of a particular transaction

carefully and cautiously. Conversely, where an investor fully understands the dynamics of the stock market or is personally familiar with a security, the investment advisor's explanation of such risks may be merely perfunctory. Thus, the investor's expertise is relevant both for questions of liability as such and for the determination of quantum.

2.2 Once the liability of the investment advisor is established, the question of quantum arises. This is one of the most difficult questions in this field. At least one court frankly admitted that the extent of liability may be arbitrary.[14] However, even if the court's task here is extremely difficult, the court has to come up with a figure.[15] Because of these difficulties, in many countries, the standards of proof are lowered. This is particularly important for civil law countries where the standard of proof tends to be higher than the common law's preponderance standard. Thus, for example, under German and Austrian law, the court can, under certain circumstances, depart from the normal standard (under which the court has to be "convinced" that something is true) and resort to an estimate.[16] Similarly, under English law (which of course applies the preponderance standard), it is well accepted that the court, in assessing damages which depend on the court's view as to what will happen in the future, or would have happened in the future if something had not happened in the past, must make an estimate as to what are the chances that a particular thing will happen or would have happened and reflect those chances, whether they are more or less than even, in the amount of damages which it awards.[17]

While in civil law countries an investor will often be able to recover lost return on investment, under the common law this will normally only be possible where liability is founded upon the breach of a contract to provide investment advice or skilled investment counseling services. Here again alternative investments come into play. Thus, the investment the investor had made "but for" the bad advice is important not only for the loss of principal but may become relevant also for the determination of lost returns.

Obviously, this paper cannot examine the complex legal requirements of liability for all legal systems in detail. Rather, the aim is to show how closely legal and economic concepts are connected in this case. In order to demonstrate this, reference is made to legal concepts from several countries. This is for purposes of demonstration only and does not aim to provide a full-fledged comparative legal analysis. Rather, it will be shown that economic concepts are compatible with, and indeed, although maybe often in a somewhat intuitive way, lie behind legal concepts of liability for unsuitable investment advice.

3. Proving and Quantifying Losses from Unsuitable Investment Advice.

3.1 The economic analysis of damages builds upon a basic model of the investment process relating information provided by advisors and other sources to investment decisions and portfolio outcomes. Each stage in this process corresponds to a test assessing the hypothetical course of events but for suitable advice.

The advisor is likely to be liable

- if the financial advice was unsuitable for the investor
  → 1. *Financial sophistication test* 2. *Suitability-of-advice test*;
- if the investor was ignorant about unsuitable advice → 3. *Ignorance test*;
- if he had avoided the risk with proper advice → 4. *Risk management test*;
- and if he had rather chosen better-performing assets → 5. *Asset choice test*.

The tests suggested are not intended to replace a conventional legal analysis of damages. Instead, the various prongs of the tests are designed to shed some light on essential elements of liability. Thus, the first and second tests basically relate to the investment advisor's negligence, and tests number 3 and 4 to causation. Test number 5 addresses the difficult question of the hypothetical course of events but for the unsuitable advice to assess the existence of prejudice and the amount of losses. Some insights gained by means of test #1 may also provide insights as to whether the investor would have avoided the risk with suitable advice.

Obviously, the above-mentioned tests presuppose that the investor suffered a loss.[18] While in some cases it may well be debatable what constitutes a relevant loss for this purpose (e.g., an actual financial loss or already an investment which fails to comply with the risks the investor is prepared to assume), this question need not be determined here. Rather, the present analysis can be employed regardless of the kind of loss or prejudice suffered by the investor.

3.2 The financial sophistication test identifies the investor's general ability to take sound financial decisions. Sophisticated investors are more likely to be held responsible for losses than less sophisticated investors.

Financial sophistication is a complex concept with multiple dimensions.[19] The assessment can either be made in an informal manner relying upon qualitative evidence or through some quantitative approaches as suggested by existing research (e.g., see Calvet et al., 2009). The general ability of an investor for making sound investment decisions is typically related to the following factors:[20]

- financial education,
- age,
- intelligence,
- interest in financial matters,
- wealth,
- investment experience, and
- track record.

Higher age, wealth, and interest in financial matters are positively correlated with financial sophistication. Education, intelligence, and experience have a direct bearing on it. The track record reveals how skillful the investor was at managing his financial affairs. Evidence from these sources can be combined to arrive at a comprehensive assessment of financial sophistication.

A major share of the population is financially unsophisticated. Such people lack financial education and relevant investment experience. Their past portfolios included only low risk assets. These investors at the fringe of capital markets are not hard to spot but are highly dependent upon advice. Therefore, advisors have a special responsibility to counsel them with care.

Financially sophisticated investors choose assets more independently. Therefore, proving causality is harder because one must isolate the relative contributions of investors and advisors to the actual investment outcome as examined in the following tests.

3.3 The suitability-of-advice test examines whether an investor received suitable advice. The analysis focuses on the risk factors triggering the losses. Unsuitable advice is required for the liability of the investor. This is probably the key factor in investment advice. [21]

The suitability-of-advice test is rooted in portfolio and household finance research. The aims and the scope of the test are different, however. Portfolio theory and household finance aim at providing general solutions to portfolio choice. The suitability-of-advice test focuses more narrowly on specific instances of unsuitable advice, identifying clearly inferior rather than optimal portfolios. This difference is fortunate because neither portfolio theory nor household finance give unequivocal, numerically exact answers to the portfolio choice problem of a retail investor. However, "generally accepted investment principles (GAIP)" capturing the robust core of these theories usually suffice to assess whether advice was adequate. Hence, more specifically, the suitability-of-advice test examines whether the advisor correctly applied generally accepted investment principles to the financial profile of an investor and provided all relevant information about the resultant investment recommendations. The final point also matters because the advisor must communicate the outcome of the portfolio selection conducted for the client in an appropriate form.

3.3.1 The concept of generally accepted investment principles was discussed in the finance literature by authoritative scholars[22], [23]. The principles are less established than the generally accepted accounting principles from which the term is borrowed. Still, they capture essential features common to superior portfolios backed by extensive research in finance. A violation of these principles constitutes clear evidence about unsuitable advice without having to resort to full-blown portfolio optimization. Generally accepted investment principles are an important supplement to existing legal rules about advisors' duties because those rules often define only formal criteria, thus remaining economically void.

While the body of generally accepted investment principles has yet to be codified, the following rules rank high:

- broad diversification of assets to achieve a better risk-return profile,
- a consideration of the covariation of returns between assets to assess risk in the context of the overall portfolio,
- lower shares of investments into risky assets for more risk averse investors,
- less portfolio risk for less knowledgeable investors,[24] and
- a preference for steady investment strategies over a frequent reshuffling of assets.

Gross violations of duty typically imply a violation of at least one of these rules, thus exposing the investor to too much risk or too high costs or both. For example, unsuitable advice is provided if

- an advisor recommends the purchase of a single security, thus overweighting the asset in the client's portfolio;
- he overloads on risky assets relative to the risk tolerance of the client and his ability to bear risk;
- the advisor neglects undesirable interactions of the recommended asset with the returns of other assets in the client's portfolio, thus creating pockets of highly correlated risks;
- he recommends the purchase of complex securities incommensurate to the financial sophistication of the investor; or if
- he recommends too frequent changes in the portfolio.

3.3.2 Sound investment advice must satisfy generally accepted investment principles as applied to an investor's financial profile. Profiles typically contain information about investment goals, investment horizons, risk tolerance, ability to bear losses, existing assets and corresponding risks, investment experience, and any additional constraints imposed by the investor upon the portfolio selection. Also, financial sophistication as analyzed in the first test is an important element. In most countries, financial profiles need to be provided in written form and have to comply with other legal rules.

Advisors may be tempted to exaggerate the willingness of the investor to take risk because they hope to use the investment profile as evidence shielding them later against possible lawsuits. Therefore, risk profiles should be cross-checked against the financial sophistication test for credibility. Information contained in the profile should be discounted if major deviations exist.

Applying principles to profiles may appear to be a complicated process. However, a broadly diversified portfolio containing risk commensurate to the risk tolerance and the financial sophistication of the investor and obeying any additional constraints will usually be acceptable. Many broadly diversified mutual funds satisfy the criteria if they constitute an appropriate share of total assets and if the advisor provided information about the premium paid for active management relative to lower cost passive funds. The specific investment philosophy of a fund is less important. Research about naïve diversification shows that spreading risks among at least a certain number of assets (usually around 20) is of paramount importance for performance. The exact weighting policies matter less because they are often plagued by a lack of robustness (see DeMiguel et al., 2009).

For investors with average risk tolerance, best practice advisors typically recommend a share of risky assets equal to 30 to 50 percent of the total portfolio (see Canner et al., 1997). Shorter investment horizons and lower financial sophistication tend to reduce the appropriate share. Note also that research about household finance suggests to under weigh high-risk assets in the risky part of the portfolio if an investor faces significant income risk that is correlated with overall economic activity (see Guiso et al., 2012).

By applying generally accepted investment principles to the financial profile of an investor, the advisor arrives at specific investment recommendations. An essential point to be considered in the suitability-of-advice test is the kind of information about these recommendations the advisor communicates to the investor. He should include all information about returns and risks of the assets relevant to his client. A misrepresentation of such features can trigger liability even if the application of the investment principles to the profile was correct. The investor might still have decided against the assets recommended if he had received proper information. Again, the emphasis lies on the risk factors causing the underperformance.

When considering the suitability of advice, a basic terminological distinction can be made. If advice was faulty because generally accepted investment principles were not correctly applied to the financial profile, the advice was “unsuitable for the investor.” If the advice was faulty due to deficient information about recommended investments, the advice is termed “unsuitable for the assets recommended.” This distinction matters because the assessment of damages crucially differs as will be shown in Section 3.7.[25]

3.4 Financial advice provides information to the investor. Properly provided advice must have the effect of liberating the advisor from liability. Therefore, the investor’s knowledge about unsuitable advice must preclude liability. An investor knowing about the unsuitability of the advice consciously takes on risks and must also accept responsibility for losses. For an informed investor, unsuitable advice was not causal for losses. Therefore, the ignorance test addresses the question of whether the investor knew about the unsuitability of the advice.[26]

The advisor must provide advice in a form that is understandable to his client, thus accounting for his financial sophistication. Unsophisticated investors have a limited capacity to digest financial advice. Legal analysis will usually start from the assumption that unsophisticated investors did not know about the unsuitable advice.

For other investors, assessing their knowledge at the time of the investment decision poses analytical challenges because the scope for direct observation is limited. Tricky problems of asymmetric information can arise. Still, the following pieces of evidence are useful for assessing the knowledge of an investor:

- manifest information provided by the advisor such as documents handed over and explained to the investor;
- other manifest sources of information such as the financial press, subscriptions to investment newsletters, documents written by the investor, emails etc.;
- topics covered in financial education obtained by the investor;
- financial experience; and
- evidence in the financial history of the investor about an unwanted increase in risk due to a lack of information provided by the advisor.

Manifest sources of information can provide direct evidence about the knowledge of the investor. Financial education and financial experience concern key points already discussed under the financial sophistication test. The ignorance test considers their relevance more specifically for the risk leading to the loss.

A major part of the financial experience of an investor is reflected in his financial history. It contains the kinds of risk the investor managed prior to the loss-making investment. An investor cannot claim ignorance if he learned about the risk under question from past portfolios. This insight is of far-reaching importance for the legal assessment of prejudice because it implies that an investor can only claim compensation for losses concerning risks that are essentially new to him. The portfolio history reveals which kinds of risk are ineligible for compensation. This fundamental feature of the ignorance test implies that more sophisticated investors holding bigger, better diversified portfolios face a higher threshold for passing the ignorance test because they are familiar with a bigger variety of risks. Conversely, for investors with low levels of financial sophistication, the ignorance test does not pose a big hurdle.

The financial history of the investor provides valuable information about his knowledge. Therefore, when assessing the suitability of an investment, courts also consider a client's trading and investment history. If the sophistication, or lack thereof, of the plaintiff is an issue, the client's trading history will usually be admissible into evidence.[27]

If the investor truly did not know about the unsuitable advice, he took on unwanted risk. This illusion must manifest itself as a surprise increase in the ex ante risk of his portfolio until he found out about the unsuitable advice. The issue can be analyzed statistically by examining structural breaks in the development of portfolio risk across time, accounting for changes in market risk. If such a surprise increase cannot be detected, it is not credible that the investor was not aware of the risk. The reverse need not hold true. A knowledgeable investor may deliberately "produce" a structural break in his portfolio risk by investing into the assets recommended, thus turning the liability of the advisor into a "put option." A high level of financial sophistication would be required for devising this strategy, however. Such a sophisticated investor is likely to stumble upon other points in the ignorance test. The

example shows that testing for a surprise increase in risk can be of great help for assessing ignorance. Results from such an analysis should not be interpreted in isolation though.

A thorough assessment of the knowledge of the investor must also account for different degrees of ignorance and unsuitable advice. It can make a big difference to whether the advisor actively tried to cajole the investor into choosing unsuitable assets or whether he simply omitted relevant information. Also the investor may have possessed some knowledge suggesting that he was offered unsuitable advice, but he may have been uncertain about it, it may have existed in latent form, he may have only partly understood the full implications of the investment, the unsuitable advice may have irritated him, etc. In such cases, the advisor and the investor may have to bear joint responsibility for the losses. The burden sharing will depend upon how actively the advisor biased his advice and how easily the investor could have reduced or avoided the losses by making further inquiries, limiting his exposure. Only more sophisticated investors are likely to be held jointly responsible though.

3.5 The risk management test examines whether the risk management of the investor would have responded to adequate advice by rejecting the loss-making asset. Any investor claiming damages asserts that he had such effective risk management in place. Risk management is understood in a very broad sense including all kinds of approaches to portfolio choice limiting risk. Had the investor still opted for the same asset, the advice would not have caused the loss.

The risk management test only addresses the question whether the investor would *not* have invested into the loss-making asset. It remains largely mute about which alternative investment the investor would have chosen. The main reason is that in many cases clear-cut answers can be provided to the first question by considering inconsistencies with existing risk management. However, precise answers are hard to come by for the second question focusing more on specific characteristics of assets. The asset choice test in the next section deals with these issues in depth.

Explicit risk management needs to be distinguished from implicit risk management for the assessment of damages. Explicit risk management is helpful because it allows simulating whether using proper advice as an input into the risk management process would have resulted in a rejection of the loss-making asset. Implicit risk management can only be inferred from past portfolio patterns. Due to the need for indirect reasoning, the conclusions tend to be less robust than for explicit risk management.

3.5.1 Explicit risk management is characterized by a structured process limiting portfolio risk depending upon the information provided by the advisor. Prime examples are investment algorithms or explicit risk criteria imposed by the investor such as in his financial profile. If an investment algorithm exists, one can simply feed the algorithm with the data from proper advice and observe whether the investment decision is changed. For retail investors such an algorithm is unlikely to be available. Their most important form of explicit risk management is the definition of risk limits in the financial profile. As discussed in Section 3.3.2, the financial profile includes explicit provisions about the risk tolerance of the investor, investment goals, or other asset criteria imposed by him. All these elements serve to narrow down the range of assets deemed acceptable from a risk perspective. Only assets fulfilling these risk criteria are suitable for the investor.

If an advisor violated the risk criteria explicitly imposed by the investor and recommended assets unsuitable for him, the risk management test can be conducted easily. Had the advisor recommended

assets adequate to the investor, it is highly unlikely that the investor would still have selected the loss-making assets from the large universe of possible assets against proper advice and his own stated intentions. Hence, it is practically certain that with proper advice, the investor would not have invested into the bad assets actually chosen. As a major conclusion, the risk management test will virtually never pose a hurdle if the advice was unsuitable for the investor.

3.5.2 In some cases, the analysis of explicit risk management criteria as included in the financial profile of the investor remains inconclusive. This may happen, for example, because the criteria were only loosely defined. Also, doubts may exist whether the document was distorted by the advisor towards higher risk as discussed in Section 3.3.2. The financial profile can be inconsistent, containing contradictory criteria. Particularly relevant is the case in which the advice was suitable for the investor, but unsuitable for the asset. Thus, the advice did not openly contradict the financial profile and generally accepted investment principles, but still the advisor failed to inform the investor about the relevant risk and return features leading to the losses. It is possible that the investor would still have decided against the assets recommended by the advisor if he had been properly informed.

In case there are no explicitly stated risk management criteria, one has to examine whether sufficiently stable risk patterns can be inferred implicitly from the portfolio history of the investor. If in the past the investor always adhered to certain risk principles, it is unlikely that he would have chosen assets inconsistent with these principles when obtaining proper information about them.

The reliable identification of risk patterns may be a tedious task. Yet, several analytical tools can be applied to this analysis. The clearest indirect evidence can be obtained if due to the unsuitable advice the ex ante portfolio risk of the investor significantly exceeded its global maximum in the entire portfolio history. If sufficient data is available, a statistical analysis of structural breaks can be conducted analogous to the ignorance test in Section 3.4.

A tricky issue to decide is which risk measure captures best the portfolio risk managed by the investor. Standard measures used in finance such as value at risk or the standard deviation of returns may be too difficult to obtain and interpret for a retail investor. Portfolio shares of certain asset classes or other more rudimentary measures may serve as a proxy capturing better actual portfolio behavior. Given a set of candidate risk measures obtained from this analysis, one can test statistically for structural breaks.

More often, retail portfolios will be either erratic or rather inertial, with infrequent transactions. Even if a lack of data rules out statistical analysis, informal examinations of stable behavioral portfolio patterns can still be meaningful and informative about risk limits followed by the investor. Erratic behavior is analytically harder to deal with than portfolio inertia. Section 3.7.4 will discuss this type of investors.

Violations of global risk maxima capture only gross instances of unsuitable advice. They have the benefit of being easily detectable in the data. However, it is possible that in less extreme cases the investor was still misinformed and would have decided against the asset with proper information even though global risk limits were not violated. Note that in these cases, recommendations are adequate to the investor, the size of the risk looks acceptable given past risks taken by the investor, and the actual risk management process is unobservable to outsiders. The advisor only omitted some information about the assets. In this case, the investor will have difficulty fulfilling the legal standard required for proving damages unless he can support his claim with additional, convincing evidence. Particularly, if

the standard of proof is high, it will not be possible to establish with high certainty that the investor would have decided against the loss-making asset. This observation is important because it shows that cases in which the advice was unsuitable for the asset are harder to prove than cases with advice unsuitable for the investor.

A final point worth noting about the risk management test is that the same logic applied to the identification of upper risk limits may also be applied to the identification of lower risk limits. The same kind of statistical tests can also be conducted to examine minimum risk levels. This point is of particular interest for the quantification of losses discussed in the following section. Investors may argue that they would have chosen safe assets but for the unsuitable advice. If the analysis of minimum risk limits suggests this choice to be unlikely, only riskier, potentially worse performing assets are to be considered for calculating damages.

3.6 The asset choice test examines which assets an ill-advised, ignorant, risk managing investor would have chosen if he had received proper advice. This is in line with the ultimate goal of the law of damages to place claimant in the same position as he would have been in if he had not sustained the wrong. While clear in principle, determining the hypothetical course of events as to what would have happened if the unsuitable advice had not been given can be extremely difficult.[28] Courts will generally be willing to accommodate for these difficulties. Thus, in the common law, once the injured client puts forward sufficient proof of a fiduciary breach, the onus shifts to the investment advisor to prove the loss would have occurred regardless of the breach.

The asset choice test draws upon the preceding tests; hence, it cannot be sensibly interpreted in isolation. The asset choice test poses a formidable analytical task because both investor behavior and financial markets are very complex. Usually, there is not just one likely course of events. Therefore, exact predictions of alternative behavior with suitable advice are impossible. Fortunately, legal analysis only requires tough standards of proof for establishing liability. Once liability is established, the standards of proof are lowered and estimates for approximating the extent of compensation are permissible. This same reasoning is applied in the asset choice test here.

The first step in the asset choice test is to collect all constraints narrowing down the set of eligible alternative assets as available from the case. The following pieces of evidence can be helpful for this analysis:

- Investment criteria derived from the financial profile such as investment goals, risk tolerance, preferred categories of assets,... The appropriate benchmark has to be determined in each case, depending upon the circumstances and risk aversion of the investor;[29]
- investment categories about which the investor is knowledgeable as derived from the ignorance test;
- upper and lower boundaries on acceptable risk resulting from the risk management test;
- and preferences revealed by the asset choice with unsuitable advice: if the investor believed to acquire a medium risk asset of a certain type and was actually recommended a high risk asset, the actually desired asset may be a good approximation for the alternative choice of the investor.

These criteria reducing the set of alternative eligible assets need to be categorized further into such criteria which are highly certain and into other, less certain criteria. For proving liability, only the highly certain criteria should be considered. If (almost) all assets in this set performed better than the loss-making asset, it is highly likely that damage exists. This conclusion completes the proof for establishing liability. Note that this proof does not require an exact determination of the quantum of damages.

If a substantial share of eligible assets performed at least as badly as the loss-making asset actually chosen, a high standard of proof cannot be satisfied. For lower standards of proof, it will matter how big this share of badly performing assets was and how likely the investor was to select these assets.

If liability can be established to the requisite legal standard, less exact estimations of the quantum of damages suffice from a legal perspective. Hence, the other, less certain criteria can also be used to narrow down further the set of eligible assets. An approximation of the value of the alternative investment with proper advice is obtained by taking some average across the value of the remaining assets. For example, an index may be constructed expressing the average value of the alternative asset holdings. Thus, in a 1985 case, the court based its decision on the performance of the TSX's main index over the relevant time period.[30]

Note that it is not a hopeless task to examine whether all the eligible assets performed better than the loss-making asset actually chosen. As, typically, the unsuitable asset recommended exhibited too much risk and the investor would have actually desired to hold lower risk assets, in many cases, the lower risk assets should have performed better than the loss-making high-risk asset. Hence, in clear-cut cases of unsuitable advice, the asset choice test should yield convincing results. On the other hand, the test implies that in a general market downturn also many of the alternative assets will lose value, thus, either making the proof impossible or at least limiting the amount of compensation.

3.7 The importance of each of the five tests for proving damages varies depending upon the type of investor and the kind of unsuitable advice considered. Four distinct groups of cases emerge: (i) financially unsophisticated investors, (ii) at least moderately sophisticated investors receiving advice unsuitable for an investment, (iii) at least moderately sophisticated investors receiving advice unsuitable for the investor, and (iv) erratic investors. Each of these cases requires a closer examination.

3.7.1 The financial sophistication test reliably identifies financially unsophisticated investors because a complete lack of financial education and financial experience is clearly discernible. Due to a lack of capacity to take informed investment decisions alone, an unsophisticated investor can only follow advice or gamble. However, financially unsophisticated investors are not habitual gamblers. With financial experience from past risky investments, they would not qualify as unsophisticated. Hence, unsophisticated investors basically follow the advice provided by the advisor or hold riskless assets. This behavioral feature of unsophisticated investors also implies a clear answer to the question of how the investor would have invested with proper advice: He would most likely have followed the recommendations as he did for unsuitable advice.[31] The economic content of the adequate recommendations matters for establishing liability and quantifying the extent of losses. The asset choice test needs to be conducted from the perspective of the advisor asking what assets would have constituted adequate advice and how they would have performed. Because an unsophisticated investor would usually have been recommended lower risk assets, the establishment of liability should be clear in most cases.

As a conclusion, for financially unsophisticated investors, the analysis of prejudice focuses on the normative question whether the investor received adequate advice. The financial sophistication test and the suitability- of-advice test particularly matter. The asset choice test needs to be conducted from the normative perspective of adequate advice. The ignorance test does not pose a hurdle because

unsophisticated investors are unlikely to be aware of unsuitable advice. The risk management test is also satisfied because unsophisticated investors largely delegate risk management to the advisor.

3.7.2 If an investor received advice consistent with his financial profile and with generally accepted investment principles, but was not properly informed about the relevant risk and return features of the asset leading to the loss, he received advice unsuitable for the asset. Investors have to be at least moderately financially sophisticated because otherwise they belong to the category analyzed in the preceding subsection.

The establishment of liability due to advice unsuitable for assets requires a thorough consideration of all five subtests. The main hurdles are posed by the ignorance and the risk management test. The more sophisticated an investor, the harder he will find it to prove that he did not know about the risk leading to the loss. Also, clear portfolio patterns must be identifiable in the portfolio history of the investor contradicting an investment into the loss-making asset. Again, risk-taking and fluctuations in portfolio values are more common for sophisticated investors. Hence, it becomes harder to show that the loss-making asset would have been rejected with suitable advice.

3.7.3. If an at least moderately sophisticated investor received advice inconsistent with his financial profile and generally accepted investment principles, the advice was unsuitable for the investor. Typically, the advice ran counter to risk constraints imposed by the investor. As discussed in Section 3.5, the risk management test becomes much simplified because such risk constraints are the most important form of explicit risk management for retail investors. Had the investor received proper advice conforming to his risk constraints, it is highly unlikely that he would still have invested into the loss-making asset.

As a conclusion, if advice was unsuitable for an investor, even a more sophisticated investor can convincingly argue that he would have avoided the loss with proper advice. The main challenge for such investors remains the ignorance test because still an investor cannot claim damages for risks he was aware of.

3.7.4. Many real-world retail investors follow suboptimal portfolio policies, moving in and out of assets. They are driven by unsound investment strategies, dubious information, individual passion, market sentiment, sometimes following advice, and sometimes deciding against it. They can be considered erratic investors. Such investors may have a hard time proving their case even if they were ill-advised and really would have rejected the loss-making asset with suitable advice. Due to their capital market experience, they do not qualify as financially unsophisticated. They face difficulties passing the ignorance test because they were exposed to many kinds of risks in the past even if their actual learning from past losses was limited. Their lack of consistent risk management also makes it hard to pass the risk management test.

The question for the law of damages is whether such investors should go unprotected. Evil-minded advisors could spot these investors and cajole them into buying risky assets, thus generating fee income without having to fear liability claims. It may be argued that erratic investors should obtain some, though not full, compensation. Sometimes they suffer true damages because proper advice would really have guided them to better investment performance.

A critical issue to be considered with erratic investors is the standard of proof. If near certainty is required, erratic investors face a low chance of successfully making a case in traditional tort law. A lower standard of proof increases their chance, but still the hurdle remains high. Joint responsibility may apply in some cases, leading to the result that the investor obtains partial compensation. However, joint responsibility generally has special prerequisites.

An alternative concept addressing the concern about erratic investors is stochastic causation. Stochastic causation applies if losses were caused to members of a group with some probability. However, whose loss was due to the damaging source under question and who suffered losses from other sources cannot be identified. The solution is to pay damages to each member of the group, but only proportional to the probability of having been affected. Stochastic causation addresses the problem of awarding compensation in complex cases with lots of uncertainty. Still, it may pose major conceptual challenges for traditional law.

The analogy carrying over to erratic investors is that in a certain percentage of cases the investor would have truly followed the better advice and thus avoided losses. It only remains unclear how in the case under question the investor would have decided due to his inherently stochastic behavior. Again, the investor would receive only part compensation for losses. It may be a tricky task to assess the probability that a given investor would have followed suitable advice to determine his due share. Still, the concept of stochastic causation deserves more consideration in the discussion about damages for unsuitable investment advice. It may provide a solution to the problem that an important group of investors miss out on compensation they should actually receive.

3.7.5. Summing up all subcases considered so far, a testing scheme emerges from the analysis. Financial sophistication (test 1) and suitability of advice (test 2) always need to be examined. If advice was unsuitable and the investor's financial sophistication is low, the advisor is likely to be liable and the quantum is determined by looking at suitable recommendations. For at least moderately financially sophisticated investors, their ignorance about the risk leading to the loss always has to be examined (test 3). Furthermore, if the advice was unsuitable to the at least moderately sophisticated investor, the risk management test (test 4) usually will be passed and one can proceed directly to the asset choice test (test 5). If the advice was unsuitable to the asset into which an at least moderately financially sophisticated investor had invested, all five tests need to be conducted to assess damages.

Each of the tests is supported by a set of analytical tools as developed in the preceding sections which mostly rely upon generally available information. Hence, the tests can be readily applied in practical cases.

3.7.6 The analysis above suggests that the correct determination of the degree of an investor's financial sophistication is critical for assessing liability. However, it should be noted that the threshold for proving damages rises only gradually. A moderately sophisticated investor will not find it much harder than the unsophisticated investor to prove his case. It will be credible that he did not know about the unsuitability of advice. Undesired high risk will pop out from a smallish portfolio of moderately risky assets.

At the other end of the spectrum, highly sophisticated investors face a lower chance of successfully claiming damages. They will find it hard to prove their ignorance and to prove for a broadly diversified

portfolio including high-risk assets that they would not have invested into the loss-making asset but for proper advice. Only if the risk was quite esoteric and if the investment explicitly contradicted their risk management, it may be convincing that they suffered damages.

4. Integrating concepts from law and economics, the paper aims at developing an applicable approach for a better handling of liability. First, important legal dimensions are spelled out. Then, five economic tests are developed to assess the suitability of advice, causation, and the foundation as well as the amount of losses. The tests examine each stage in the chain of events from unsuitable advice to underperformance. The motivation for the tests is derived from law, their intellectual foundation draws upon economic research, and their design is chosen with an eye on practical applicability. The tests are supported by a set of analytical tools developed in this paper to meet specific legal needs.

To provide a better economic foundation for legal assessments of liability for unsuitable investment advice, the tests suggest to

- assess suitability based upon generally accepted investment principles,
- assess the ignorance of the investor by looking at surprise increases in his portfolio risk,
- assess portfolio behavior by looking at inconsistencies between risk management principles followed by the investor and the assets recommended,
- assess asset choice with suitable advice by focusing on the most likely investment alternatives and building an index to gauge performance.

As a major conclusion, the paper emphasizes the role of the financial sophistication of an investor for determining liability. Financial sophistication marks the line between the responsibility of advisors and investors. The more sophisticated an investor, the less likely he is to pass all tests and to claim liability successfully. It also matters whether the advice was unsuitable for the investor or for the asset recommended, as the latter is harder to prove. Most protection is granted to unsophisticated investors. The paper takes an intermediate position in the discussion about liability for unsuitable investment advice, holding advisors and investors accountable depending upon their relative influence on the investment outcome.

Some questions alluded at in this paper, however, need further research, such as a more detailed analyses of past portfolio patterns, issues of asymmetric information complicating the proof of losses, the codification of generally accepted investment principles, or the adaptation of the framework to specific jurisdictions and cases. These issues at the intersection of law and economics need more thorough discussion which is beyond the scope of this paper.

References

Agnew Julie R., & Szykman, L. R., (2005). "*Asset Allocation and Information Overload: The Influence of Information Display, Asset Choice, and Investor Experience.*" The Journal of Behavioral Finance 2005, Vol. 6, No. 2, 57–70.

Bernheim, B.D. & Rangel, A. (2009). "*Beyond Revealed Preference: Choice-Theoretic Foundations for Behavioral Welfare Economics*", Quarterly Journal of Economics , 124, 51-104.

Blomvall, J. & Lindberg, P. O. (2003), "*Back-testing the performance of an actively managed option portfolio at the Swedish Stock Market, 1990-1999*". Journal of Economic Dynamics & Control 27, 1099-1112.

Bodie, Z. & Crane, D. (1997). "*Personal Investing: Advice, Theory, and Evidence*", Financial Analysts Journal, 53, 13-23.
Bolton, P., Freixas, X. & Shapiro, J. (2007). "*Conflicts of Interest, Information Provision, and Competition in the Financial Services Industry*", Journal of Financial Economics, 85, 297-330.
Brandt, M. (2010). "*Portfolio Choice Problems*", in Y. Ait-Sahalia and L.P. Hansen (eds.), Handbook of Financial Econometrics, Vol. 1, North Holland, 269-336.
Calvet, L., Campbell, J. & Sodini, P. (2009). "*Measuring the Financial Sophistication of Households*", American Economic Review: Papers and Proceedings, 99, 393-398.
Campbell, J.Y. (2006). "*Household Finance*", Journal of Finance, 66, 1553-1604.
Canaris, C.-W., *Die Vermutung aufklärungsrichtigen Verhaltens und ihre Grundlagen*, in Festschriftfür Walther Hadding (2004) 3 f.
Canner, N., Mankiw, N.G., Weil, D. (1997). "*An Asset Allocation Puzzle*", American Economic Review. Vol. 87, 181-191.
Cesari, R. & Cremonini, D. (2003), "*Benchmarking, portfolio insurance and technical analysis: a Monte Carlo comparison of dynamic strategies of asset allocation*". Journal of Economic Dynamics & Control 27, 987-1011.
Clarke, G., "*Liability and Damages in Unsuitable Investment Advice Cases*" (2005), http://www.investorvoice.ca/Research/LIABILITY_AND_DAMAGES.pdf,
Conaglen, M., "*Equitable compensation for breach of fiduciary dealing rules"*, 2003 Law Quarterly Review 246.
DeMiguel, V., Garlappi, L. & Uppal, R. (2009). "*Optimal versus Naïve Diversification: How Inefficient is the 1/N Portfolio Strategy*?". The Review of Financial Studies, Vol. 22, 1915-1953.
Elton, E. & Gruber, M. (1997). "*Modern Portfolio Theory, 1950s to Date*", Journal of Banking and Finance, 21, 1743-1759.
Gaivoronskia, A. A. & Stellab, F. (2003), "*On-line portfolio selection using stochastic programming*". Journal of Economic Dynamics & Control 27, l 013 – 1043.
Gorton, G. & Penacchi, G. (1990)."*Financial Intermediaries and Liquidity Creation*", Journal of Finance, Vol. XLV, 49-71.
Grifoni, A. & Messy, F. (2012), "*Current Status of National Strategies for Financial Education: A Comparative Analysis and Relevant Practices*", OECD Working Papers on Finance, Insurance and Private Pensions, No. 16, OECD Publishing. http://dx.doi.org/10.1787/5k9bcwct7xmn-en
Guiso, L. & Sodini, P. (2012). "*Household Finance: An Emerging Field*", CEPR Discussion Paper, No. 8934.
Hackethal, A., Haliassos, M. & Jappelli, T. (2012). "*Financial Advisors: A Case of Babysitters*?", Journal of Banking and Finance, 36, 509-524.
Hackethal, A., Inderst, R. & Meyer, S. (2010). "*Trading on Advice*", CEPR Discussion Paper, No. 8091.
Inderst, R. & Ottaviani, M. (2012). "*Financial Advice*", Journal of Economic Literature, 50, 494-512.
Jacobs, H., Müller S. & Weber M., (2010) *„How should private investors diversify? – An empirical evaluation of alternative asset allocation policies to construct a world market portfolio".* November 16, 2010, Electronic copy available at: http://ssrn.com/abstract=1471955.
Kelley, E. K. & Tetlock, P. C., (2013). *„How Wise Are Crowds? Insights from Retail Orders and Stock Returns."*, The Journal of Finance Volume 68, Issue 3, pages 1229–1265, June 2013.

Kock, B., "*Liability for unsuitable advice on investment funds (Austria)"*, Journal of International Banking Law and Regulation 2011, 26 (9), 461.
Kodek, G., "*Ausgewählte Fragen der Schadenshöhe bei Anlegerschäden"* (Selected questions of quantum in investor damages cases), Österreichisches Bankarchiv 2012, 11.
Krausz, M. & Paroush, J. (2002). "*Financial Advice in the Presence of Conflict of Interest*", Journal of Economics and Business, 54, 55-71.
Leupold, P., & Ramharter, M., "*Anlegerschaden und Kausalitätsbeweis bei risikoträchtiger hypothetischer Alternativanlage"* (Investor damages and proof of causation in case of high-risk hypothetical alternative investments), Österreichisches Bankarchiv 2010, 718.
Lusardi, A. & Mitchell, O.S. (2011). "*Financial Literacy Around the World*". Journal of Pension Economics and Finance, 10, 497-508.
Lusardi, A., & Mitchell O. S., (2013). *„The Economic Importance of Financial Literacy: Theory and Evidence"*. National Bureau of Economic Research Working Paper 18952 April 2013.
Manzini, P. & Mariotti, M. (2009). "*Consumer Choice and Revealed Bounded Rationality*", Economic Theory, 41, 379-392.
Parker, L., "*Stockbroker Litigation"*, American Jurisprudence. Trials. Database (updated April 2011).
Poole, J., and Devenney, J., "*Reforming damages for misrepresentation: The case for coherent aims and principles"*, Journal of Business Law 2007, 269.
President's Advisory Council on Financial Capability. *„Interim Report."* Washington, D.C., January 18, 2012
Romagnoli, A. & Trifilidis, M., (2013). *„Does financial education at school work? Evidence from Italy."* Bank of Italy, Questioni di Economia e Finanza (Occasional papers), Number 155 – April 2013.
Ryan, M., & Young, A, Springwell "*Are the English Courts the venue of last resort for complex investor claims?"* 2009 Journal of International Banking Law and Regulation 2009, 24 (1), 54.
Stapleton, J., "*Cause in fact and the scope of liability for consequences"*, 2003 Law Quarterly Review 288.
Thorsen, M.S., Kaplan, R., Hakala,S., "*Rediscovering the Economics of Loss Causation"*, 6 Journal of Business and Securities Law 93 (April 2006).
Wagner, G., "*Schadensberechnung im Kapitalmarktrecht"* (The determination of quantum in capital market law), Zeitschrift für Unternehmens- und Gesellschaftsrecht 2008, 495 ÖBA 2012, 11.

[1] See Lusardi and Mitchell (2011), (2013) for an overview on the international evidence about financial literacy. However, public awareness of the lack of financial affairs has grown as well and have led to increased efforts to remedy the situation; see Grifoni and Messy (2012) for OECD, or President's Advisory Council on Financial Capability (2012) for the US, or Romagnoli and Trifilidis (2013). The number of policies and/or empirically oriented contributions are increasing.

[2] For the United States, see, for example, Parker, Stockbroker Litigation, American Jurisprudence. Trials. Database (updated April 2011); for Canada, see Clarke, Liability and Damages in Unsuitable Investment Advice Cases (2005), http://www.investorvoice.ca/Research/LIABILITY_AND_DAMAGES.pdf; for the United Kingdom, see Conaglen, Equitable compensation for breach of fiduciary dealing rules, 2003 Law Quarterly Review 246; Poole, Reforming damages for misrepresentation: The case for coherent aims and principles, Journal of Business Law 2007, 269; Ryan & Young, Springwell – Are the English Courts the venue of last resort for complex investor claims? 2009 Journal of International

Banking Law and Regulation 2009, 24 (1), 54; Thorsen, Kaplan & Hakala, Rediscovering the Economics of Loss Causation, 6 Journal of Business and Securities Law 93 (April 2006), for Germany Wagner, Schadensberechnung im Kapitalmarktrecht (The determination of quantum in capital market law), ZGR 2008, 495, for Austria Kock, Liability for unsuitable advice on investment funds (Austria), Journal of International Banking Law and Regulation 2011, 26 (9), 461; Kodek, Ausgewählte Fragen der Schadenshöhe bei Anlegerschäden (Selected questions of quantum in investor damages cases), ÖBA 2012, 11; Leupold & Ramharter, Anlegerschaden und Kausalitätsbeweis bei risikoträchtiger hypothetischer Alternativanlage (Investor damages and proof of causation in case of high-risk hypothetical alternative investments), ÖBA 2010, 718.

[3] The household finance literature as surveyed by Campbell (2006) and Guiso and Sodini (2012) provides very useful positive and normative analyses of households' investment behavior. Research on financial advice focuses on the agency problem between financial advisors and individual investors. See the survey by Inderst and Ottaviani (2012); theoretical work by Bolton, Freixas, and Shapiro (2007) and Krausz and Paroush (2002); or empirical studies by Hackethal et al. (2009 and 2010).

[4] It goes without saying that the analysis has to concentrate on a small issue to achieve results. Quite a lot of interesting questions such as dynamics of investment, time horizons, asymmetric information, etc. have to be neglected; for introductions to these issues, see Cesari and Cremonini, (2003), Gaivoronskia and Stellab, F. (2003), Blomvall and Lindberg (2003), Agnew and Szykman (2005).

[5] This is the case in the United States under SEC Rule 10b-5. See, e.g., *Dura Pharmaceuticals v Broudo*, 344 US 336 (2005), at 341.

[6] In spite of the paramount importance of the concept of causation, there is surprisingly little legal authority on the question of causation. See Rt Hon Lord Hoffmann, "Common Sense and Causing Loss", unpublished lecture delivered to the Chancery Bar Association, June 15, 1999, noting that the numerous judicial citations of "common sense" in relation to "causation" often "conceal, or perhaps reveal, a complete absence of any form of reasoning" in the best tradition of English anti-intellectualism. See also *Fairchild v Glenhaven Funeral Services Ltd* [2003] 1 A.C. 32 at [53].

[7] See, e.g., *Barnett v Chelsea & Kensington Hospital* [1969] 1 QB 428.

[8] *Bristol v West Building* [1998] Ch 1.

[9] *Kwasny v United States*, 823 F2d 194 (7th Cir 1987).

[10] For purposes of this paper it is not necessary to distinguish between contractual and fiduciary duties in this respect since this distinction is irrelevant for the underlying economic questions.

[11] See, for example, German Federal Supreme Court NJW 1993, 2433.

[12] FINRA Rule 2310 requires the representative to only make suitable recommendations and to deal fairly with customers.

[13] For a discussion of the concept of fiduciary duty in this context from a perspective of Canadian law, see Clarke, Liability and Damages in Unsuitable Investment Advice Cases (2005) 32 et seq. However,

the elements discussed by Clarke are relevant for the determination of the nature and scope of duties of care under civil law as well.

[14] See, for example, the Canadian case of *Secord v Global Securities Corp*. (2000) 8 BLR (3rd) 238 (B.C.S.C.).

[15] Clarke, Liability and Damages in Unsuitable Investment Advice Cases (2005) 76.

[16] Section 286 German Code of Civil Procedure, section 273 Austrian Code of Civil Procedure.

[17] See, e.g., *Mallett v McMonagle* [1970] AC 166, 176.

[18] Historically, so few cases have gone to trial that no well-developed case law regarding the proof of loss exists. Nearly all of the case law regarding loss has arisen in the context of motions to dismiss summary judgment, class certification, evidentiary battles, or settlement. Thorsen, Kaplan & Hakala 2006, at 113.

[19] Financial literacy is a closely related concept that many researchers have scrutinized in recent years. See, for example, Lusardi and Mitchell, 2011, 2013. Apart from literacy, financial sophistication also emphasizes the practical side of investing, thus directing attention to actual investment performance; see i. a. Jacobs, e.a. (2010), Kelley and Tetlock (2013).

[20] Some (but not all) of these factors are recognized in the US Financial Industry Regulation Authority's Rule 2111 on suitability: "(a) A member or an associated person must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile. A customer's investment profile includes, but is not limited to, the customer's age, other investments, financial situation and needs, tax status, investment objectives, investment experience, investment time horizon, liquidity needs, risk tolerance, and any other information the customer may disclose to the member or associated person in connection with such recommendation."

[21] See, for example, *Rule 2111 (Suitability)*of the US Financial Industry Regulatory Authority (FINRA) (quoted in footnote 19).

[22] Optimal portfolio choice is a classical problem studied in financial economics. See Elton and Gruber (1997) for a survey. For a more recent account of optimal portfolio choice see Brandt (2010). The newly emerging literature on household finance argues that the classical approach only partly applies to households' financial decision-making. See footnote 2 for references.

[23] See Bodie and Crane (1997) for a list of generally accepted investment principles.

[24] See Gorton and Penacchi (1990).

[25] For a similar distinction between "anlegergerechte" und "anlagegerechte Beratung" (advice suitable for the investor and advice suitable for the product) in German law, see supra 2.1.

[26] For the sake of completeness, it should be mentioned that the knowledge of the investor may also be relevant for other questions, for example, for questions of comparative negligence or for determining

when the investor should have found out about the unsuitability of the advice and, consequently, should have taken steps to mitigate the damage. See, for example, Laflamme v. Prudential-Bache Commodities Canada Ltd., [2000] 1 S.C.R. 638: “In the case of injury resulting from mismanagement of a securities portfolio, a flexible approach must be taken in determining what constitutes a reasonable period of time for the client to act and mitigate the damages. In particular, regard must be had to the client’s level of experience and knowledge of investments, and to the complexity of the situation.”

[27] Clarke 24.

[28] On the evidentiary gaps faced in this context, see Stapleton 2003 at 401.

[29] Clarke 66.

[30] *Ryder v Osler, Wills, Bickle Ltd* (1985). While the decision concerned ill-management of a portfolio rather than investment advice, the method employed by the court, that is, using an index for a determination of damages, can be applied to the present context as well. See also Clarke 66.

[31] In German law, there is a presumption that the investor, had he been suitably advised, would have followed that advice. See German Federal Supreme Court BGHZ 61, 118; see also Canaris, Die Vermutung aufklärungsrichtigen Verhaltens und ihre Grundlagen, in FS Hadding (2004) 3 f . This presumption, however, may not reflect real life in all cases. For a case in which an investor was found not to have followed advice in any event, see *JP Morgan Bank v Springwell navigation Corp* [2008] EWHC 1186 (Comm) (QBD (Comm)); see also Ryan & Young, J.I.B.L.R. 2009, 24 (1), 54.

Authors

Hanns Abele is Professor emeritus, Department of Economics, Vienna University of Economics and Business, Welthandelsplatz 2, 1020 Vienna, Austria

Georg Kodek is Professor, Institute for Civil and Business Law, Vienna University of Economics and Business, Welthandelsplatz 2, 1020 Vienna, Austria, and Judge, Austrian Supreme Court, Schmerlingplatz 11, 1011 Vienna.

Guido Schäfer (Corresponding Author) is Associate Professor, Department of Economics, Vienna University of Economics and Business, Welthandelsplatz 2, 1020 Vienna, Austria