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Supervision and Class Action against Conflicts of Interest in “Universal Banking”: The US Experience *vis-à-vis* Recent Italian Initiatives

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**Supervision and Class Action against Conflicts of Interest in
“Universal Banking”: The US Experience *vis-à-vis* Recent
Italian Initiatives**

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Supervision and class action against conflicts of interest in “universal banking”: the US experience *vis-à-vis* recent Italian initiatives

*(S. Cappiello)**

ABSTRACT

The article focuses on US legal instruments that prevent and sanction abuses from conflicts of interests. It illustrates the guidelines of the US supervision system after the Gramm-Leach-Bliley Act (Par. 2) and the essential and most debated features of the US class action (Par. 3), to conclude with a number of remarks on Italian legislative initiatives concerning: (a) rules establishing organizational constraints in universal banks; (b) proposed procedural rules would aggregate lawsuits, aim at facilitating investors’ access to justice (Par. 4). The evolution of the US regulatory framework provides two useful indications. First, it shows the *rationale* underpinning the US flexible approach, according to which financial intermediaries are responsible for the selection and implementation of the governance system that they deem more adequate. Second, it urges to look for legal and market instruments that can help mitigate the risk that the collective action becomes an opportunity for the extraction of “private benefits” of various agents involved in the representation of investors’ interests.

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Introduction

The recent wake of financial scandals has prompted also in Italy a heated debate on how to regulate conflicts of interest emerging when banks simultaneously carry out deposit taking and loan granting activities (commercial banking) on the one hand, and provide financial services (investment banking) on the other. In particular, in the legal and economic literature, as well as in the press, attention has been focused on banks placing and dealing in securities issued by companies indebted to these very banks.¹

Among the many enacted or proposed legislative efforts to earn back investor's trust in financial markets, two appear to have a significant impact on the topic at hand. The first is Article 10 of Law no. 262/05 (the so called "law for the protection of savings") which establishes that - "*for the purpose of preventing the emergence of conflicts of interest in the provision of investment services, also in agreement with the other activities carried out by the authorised intermediary*" - the Bank of Italy, in agreement with Consob (the Italian Securities Commission), "*regulates which activities are required to be carried out by means of separate and autonomous bodies*". The second measure - which is currently being examined by the Parliament - would introduce a mechanism to aggregate lawsuits, making it "easier" for investors damaged by conflicts of interest within the context of the financial service industry to go to court.²

As it may be observed, these two legislative initiatives refer to different techniques to tackle conflicts of interest within "universal banking."³

¹ See F. Annunziata, "*Governance*" delle banche e conflitti d'interessi. Il difficile equilibrio tra disciplina bancaria e dei servizi di investimento, AGE, 2004, n. 1, 177; F. Bochicchio, *Dissesti finanziari e statuto soggettivo degli intermediari: ritorno al passato con vincoli e controlli comportamentali* ?, CONTR. IMPR., 2003, I, 26; M. Messori *La separazione fra industria e banca: il punto di vista di un economista*, AGE, 2004, n. 1, 43; E. Pagnoni, *Negoziare e collocamento "riservato" come modelli alternativi di offerta di prodotti finanziari*, SOCIETÀ, 2005, 159; N. Salanitro, *Gli intermediari professionali e la distribuzione degli strumenti finanziari*, BANCA, BORSA TIT. CRED., 2004, V, 555; F. Fimmanò, *I gap di informazione e controllo nei crac Cirio e Parmalat e le prospettive di riforma*, SOCIETÀ, 2004, 409 ss; F. Vella, *Nuove regole di corporate governance e tutela degli investitori*, BANCA, IMPR. SOC., 2004, 468. A list of the most recent securities placements with banks involved as underwriters and creditors of the issuer, see G. Dragoni, *Quanti conflitti per le banche nei collocamenti*, ILSOLE24ORE, 25 giugno 2006.

² The bill has been presented by the Government to the Parliament on July 27th 2006. It would apply to all kind of mass damages, not only to those pertaining to the financial sector.

³ I use the expression "universal banking" to refer to those banks that simultaneously carry out deposit taking and loan granting activities (commercial banking) and provide financial services (investment banking), regardless of the organisational solutions adopted (group *versus* multidivisional structure).

The provision contained in the “law for the protection of savings” establishes that supervisory authorities impose organisational constraints which, as a precautionary measure, are applied *a priori* to all financial intermediaries. The introduction of an aggregation mechanism for judicial claims by investors can, in contrast, be considered as an innovation which has an impact *ex post*, only on those situations of conflict that have led to abuses. Nevertheless, it is expected to have, *ex ante*, a deterrence effect for all intermediaries, without imposing any constraint.

As it will be illustrated in the pages below, in the United States both solutions have played an important role, and continue to do so – in the forms expanded on in the paragraphs below – with reference to the conflicts of interest that may arise in universal banking.

In general, the US system to limit abuses in the financial industry rests on three pillars: market discipline, public supervision, legal self-protection by investors.

A transparent and efficient capital market and a competitive banking and financial service market represent – are generally perceived as – a fundamental deterrence factor against abuses stemming from conflicts of interest.⁴

However, the market is not sufficient to address the problem. The US experience shows how actions taken by supervisory authorities on the one hand, and class actions filed by investors to recover damages, on the other, play an autonomous and complementary role in terms of prevention and deterrence to protect investors. The presence of such enforcement mechanisms is considered to be essential in the United States to ensure that investors trust intermediaries and markets, since market sanctioning may provide insufficient deterrence for management. In addition, the US experience proves that public and private enforcement play a significant “warning” role: they make it possible or easier to identify situations of conflict, and in this way amplify market discipline.⁵

In the light of the essential role played by supervisory authorities and legal self-protection of investors, it seems appropriate to analyze the guidelines on which the US supervision system

⁴ See C. Borio, W.C. Hunter, G. G. Kaufman e K. Tsatsaronis (edited by), *Market Discipline Across Countries and Industries*, The MIT Press, 2004; R.C. Smith e I. Walter, *Governing the Modern Corporation*, Oxford Univ. Press, 2006, 266.

⁵ See, e.g., S.J. Choi, e M. Kahan, *The Market Penalty for Mutual Fund Scandals*, NYU LAW AND ECONOMICS RESEARCH PAPER, 2006; R.C. Smith e I. Walter, *supra* note 5, at 267; C. Borio, W.C. Hunter, G. G. Kaufman e K. Tsatsaronis (edited by), *supra* note 5.

on conflicts of interests is based (Paragraph 2) and the class action that US investors have at their disposal (Paragraph 3).

The analysis carried out is the basis for a number of considerations on the current debate concerning: (a) rules establishing organizational constraints in order to prevent conflicts of interest in universal banks; (b) proposed procedural rules which, aggregating lawsuits, aim at facilitating investors' access to justice (Paragraph 4).

2. The supervisory system in the United States: from the Glass-Steagall Act to the Gramm-Leach-Bliley Act.

In the United States, the legal system providing for a clear-cut and rigid separation between commercial and investment banking – originally introduced by the 1933 Glass-Steagall Act in order to ensure the stability of the banking and financial system, albeit to the detriment of its competitiveness⁶ – was gradually changed beginning from the second half of the nineteen eighties.

Through secondary regulation and authorisations, the banking supervisory authorities have gradually allowed individual commercial banks also to operate in the investment banking sector, however only “indirectly”, *i.e.* through subsidiaries or companies belonging to the same group the relevant commercial banking is affiliated with (the so-called *section 20 bank affiliates*).

These companies were initially required by the Federal Reserve (Fed) to comply with a quantitative constraint⁷ as well as with organisational limitations (*firewalls*) aimed to prevent the mixing of investment banking with commercial banking activities could have negative repercussions on banks' stability and market efficiency.

However, the experience gained by the Fed caused it, during the second half of the nineteen nineties, to increase the ceiling for the so-called quantitative constraint,⁸ and to replace the twenty-eight *firewalls* with eight more flexible *operating standards* which – within the legal

⁶ For a discussion of the political roots of the Glass-Steagall Act see A. Crockett, T. Harris, F.S. Mishkin, E.W. White, *Conflicts of Interest in the Financial Services Industry: What Should We Do About Them ?*, ICMB International Center for Monetary and Banking Studies, 2004; M. Roe, *Strong Managers Weak Owners: The Political Roots of American Corporate Finance*, Princeton Univ. Press, Princeton, 1994.

⁷ Originally, the revenues from *ineligible securities* (*i.e.* securities which banks could not deal in) could not exceed 10% of the total revenues of each section 20 bank affiliate.

limitation established by the Federal Reserve Act to protect banks' stability⁹ – aimed at making coordinating various banking and financial activities easier.

The progressive mixing between the banking and the financial sector was eventually legislatively finalized by the 1999 Gramm-Leach-Bliley Act (GLBA), which marked the transition to a new legal architecture of the US banking and financial system.

The GLBA continues to forbid banks to directly carry out investment banking and insurance underwriting activities. However it has repealed those provisions of the Glass-Steagall Act which ruled out the cross-holding of shares in the case of commercial banks, investment banks and insurance companies. In relation to this change, the GLBA has introduced a specific regulation for financial conglomerates.

Under the GLBA, commercial banks may be part of a group headed by a company which, meeting the requirements to qualify as a *Financial Holding Company (FHC)*¹⁰, may carry out directly or by means of a non-banking subsidiary (the *Financial Holding Company Affiliate*) financial, insurance services and additional “complementary” or “incidental” activities¹¹. The GLBA therefore acknowledges the legitimacy of universal banking, but establishes that a legal “group” structure be adopted, requiring – by means of two different corporate entities – commercial banking activities to be kept separate from financial and insurance activities.

Two main guidelines seem to underpin the US system currently in force.

On the one hand, the GLBA provides for the separation by means of a corporate screen of commercial banking from the other activities carried out by the financial conglomerate. On the other, the system set by the GLBA distinguishes itself – even by comparison with the system resulting from the deregulation action carried out by the Fed during the second half of the

⁸ The ceiling for *uneligible securities* revenues has been increased, in 1997, to 25%.

⁹ See section 23 A of the Federal Reserve Act, which establishes quantitative and qualitative limits on “covered transactions” (i.e. transactions between a bank and its affiliates), and section 23 B of the Federal Reserve Act which carries four main rules, the most important being: (a) covered transactions must be carried out at market terms; (b) a commercial bank cannot purchase securities while an affiliate is a principal underwriter for those securities. For further details see J.R. Macey, G.P. Miller, R.S. Carnell, *Banking Law and Regulation*, Aspen Publishers, New York, 2001, 473-477.

¹⁰ First, each of the bank holding company's subsidiary FDIC-insured depository institution must be well-capitalized and well managed (the latter meaning that it needs at least a satisfactory composite examination rating and a satisfactory rating for management). Second, each of those institutions must have at least a satisfactory examination rating under the Community Reinvestment Act. For further details see J.R. Macey, G.P. Miller, R.S. Carnell, *Banking Law and Regulation*, Aspen Publishers, New York, 2001, 429-443.

nineteen nineties – by the ample contacts allowed between commercial and investment banking activities.¹² Having laid aside a rigid separation between banking activities and financial services, the system makes it possible to coordinate and share information between a FHC and its affiliates.¹³

From the existing literature and the debate accompanying the reform, it may be inferred that the corporate screen seemed to the Congress as the most appropriate solution to:

- (a) provide for the asset separation and autonomy, also from a legal standpoint, of the depository institution *vis-à-vis* the other group companies, so as to ensure the former's stability.
- (b) prevent the *subsidy* resulting from the insurance on deposits from being used within the multi-division universal bank context to support non-banking financial activities, this way causing financial intermediaries not affiliated with a banking group to suffer from a competitive disadvantage.
- (c) facilitate the supervision of the different activities carried out within the context of the conglomerate.

Nevertheless, with reference to the organisational and operational autonomy recognised within the group, the GLBA assumes that the *firewalls* against communication, information sharing and interaction may prove inappropriate not only because they do not guarantee that formal separation is actually mirrored by the operational and decision-making independence of

¹¹ For an account of the number of BHC and their activities, see the *2003 Report to the Congress on Financial Holding Companies under the Gramm-Leach-Bliley Act*, Federal Reserve Board.

¹² The GLBA has repealed the *Glass-Steagall Act* provisions forbidding affiliate companies to share employees or directors. Moreover, only two of the eight “operating standards” (still applying to “section 20 affiliate companies”) keep being in force as regards the FHC conglomerate. As the Fed (65 FR 14440, march 17th 2000) explain: “*the current section 20 operating standards, like the bills to repeal the Glass-Steagall Act that were considered in the late 1980s and early 1990s, contain detailed restrictions on relationships and settlements between depository institutions and securities affiliates. The Gramm-Leach-Bliley Act relies instead on requirements that each depository institution affiliated with a securities firm be and remain well capitalized and well managed. The Gramm-Leach-Bliley Act also relies on functional regulation of the securities firm by the SEC, full supervision of the depository institution by the appropriate federal banking agency, and umbrella supervision of the overall organization by the Board to identify and address potential risks to the depository institution associated with the securities and other activities in the organization*”.

¹³ Title V of the GLBA provides for the privacy issue. In particular, it requires clear disclosure by all financial institutions of their privacy policy regarding the sharing of non-public personal information with both affiliates and third parties. For the latter, consumers have the opportunity to “opt out”.

the different structures,¹⁴ but because they can be excessively strict, preventing economies of scale and diversification that result from universal banking.

On this particular feature, it should be pointed out that empirical studies on the effects of the gradual entry of US commercial banks into the investment banking sector have found evidence of a significant increase in market competition to the benefit of both commercial banks and investors.¹⁵ At the same time, one should not overlook the recent scandals in the United States, which have revealed various abuses stemming from situations of conflict of interest by leading US banks, subsequently exposed to serious penalties by the supervisory authorities, and to substantial claims for damages by investors.¹⁶ These cases do not lead to the conclusion that legal firewalls would be useful. Nevertheless they prove the specific importance of effective governance and internal controls systems within universal banks.

2.1. The division of jurisdiction between the Fed and the SEC with regards to the conflicts of interest typical of universal banks

Against the backdrop of the different types of conflict of interest that may result within a “universal bank,” the current system foresees different regulatory responses depending on the nature of the interests involved and the parties that may be harmed by the conflicts under consideration.

¹⁴ In a testimony before the Senate Banking Commission in 1990 the Fed chairman, Alan Greenspan, expressed “serious questions about the ability of firewalls to insulate one unit of a holding company from the funding problems of another...It is clear that high thick firewalls reduce synergies and raise costs for financial institutions...If they raise costs and are not effective, we must question why we are imposing these kinds of firewalls at all...”. Along the same lines, the FDIC president, Ricki Helfer, in 1997.

¹⁵ Cfr. A. Gande, M. Puri e A. Saunders, I. Walter, *Bank Underwriting of Debt Securities: Modern Evidence*, in 10 THE REVIEW OF FINANCIAL STUDIES 1175, 1997; A. Gande, M. Puri and A. Saunders, *Bank Entry, Competition and the Market for Corporate Securities Underwriting*, in 54 JOURNAL OF FINANCIAL ECONOMICS, 1999; S. Drucker e M. Puri, *The Tying of Lending and Equity Underwriting*, NBER Working Paper, 2004; D. Mullineaux, *Tying and Subsidized Loans: A Doubtful Problem*, Working Paper, 2003; C.W. Calomiris e T. Pornrojngkool, *Relationship Banking and the Pricing of Financial Services*, NBER Working Paper, 2006.

¹⁶ For an account of the role played by banks in the Enron and in the Worldcom cases see I. Walter, *Conflicts of Interest and Market Discipline Among Financial Services Firms*, Working Paper, 2003; R.C. Smith and I. Walters, *supra* note 4, 203 and 259. In connection to the Enron case, in July 2003, JP Morgan Chase and Citigroup reached with the Sec and the New York District Attorney General a settlement agreement: without acknowledging any of the charges, the two banks have agreed to pay respectively 192,5 e 126,5 million dollars. At the same time, the two banks have been involved in a class action on behalf of Enron investors, which has been settled for 2 billion dollar (Citigroup) and 2.2 billion dollar (J.P. Morgan Chase). The class action brought against 17 banks following their underwriting activity for Worldcom has been settled for around 6 billion dollar.

A first set of legal provisions falls within the regulatory and supervisory scope of the banking authorities, since it is aimed at preventing the commercial bank's stability from being affected by financial or insurance services. This category includes provisions which: limit and regulate intra-group funding operations;¹⁷ forbid the commercial bank to grant loans under especially favorable terms (*underpricing loans*) to an industrial company in order to obtain the fees resulting from underwriting/placing activities;¹⁸ impose the use of specific contractual forms clearly pointing out to investors the absence of all kinds of guarantees by the commercial bank on the insurance products sold through the same.¹⁹

A second set of regulations falls within the SEC's regulatory and supervisory scope, and pertains to those types of conflicts of interest that may be detrimental to investors making use of the financial services provided by the conglomerate. Indeed, pursuant to these legal provisions, whose reach goes beyond the abuses stemming from conflicts of interest in universal banking, the SEC can use its powers to impose penalties (while, at the same time, investors can claim damages) if an investment bank affiliated with a commercial bank participates – as an underwriter or broker/dealer – in the placement of debt instruments issued by an industrial firm with the specific aim of helping the affiliated commercial bank to get rid of its credit exposure toward that firm, without disclosing information to the market about the real economic and financial situation of the said firm.²⁰ Similarly relevant is the general provision according to which the SEC may impose penalties on those intermediaries providing a portfolio management service with reference to a mutual fund (investment advising)²¹ without making public the

¹⁷ See sections 23A and 23B of the Federal Reserve Act (*supra* note 10).

¹⁸ See section 23B of the Federal Reserve Act and section 106 of the Bank Holding Act.

¹⁹ Cfr. Sec. 305 del GLBA. Along the same lines, Section 214 of the GLBA, modifying Section 35(a) of the Investment Company Act, makes it unlawful for any person, in issuing or selling investment company securities, to represent that such securities are guaranteed by the federal government, are insured by the FDIC or are guaranteed by a bank. Furthermore, any person issuing or selling a fund that is advised by or sold through a bank must prominently disclose that the fund is not insured by the FDIC or other government agency. By repealing Sec. 32 of the Glass-Steagall Act, member banks have the authority to act as distributor for mutual funds.

²⁰ I refer to sections 11 and 12(a)(2) of the 1933 Securities Act, which target frauds in the registration statement and prospectus, and Rule 10b-5 promulgated by the Sec under section 10(b) of the 1934 Securities Exchange Act, which targets any “*fraud in connection with the purchase or sale of a security*”. On the wide reach of these provisions see, e.g., S.J. Choi and A.C. Pritchard, *Securities Regulation: Cases and Analysis*, Foundation Press, New York, 2005.

²¹ A commercial bank can act as investment adviser for a mutual fund through a specific advisory unit, registered as investment adviser, or through a separate affiliate company. To prevent conflict of interests Section 213 of the GLBA amends the Investment Company Act to modify the definition of “interested person” (Section 2(a)(19)(A)) relevant to be qualified as of independent director of an investment company.

existence of a situation of conflict that may jeopardise their ability to perform their tasks in the interest of the fund.²²

This division of jurisdiction between the SEC and the banking supervisory authorities is mirrored by the GLBA, which expressly draws inspiration from the functional regulation principle. However, the GLBA grants the Fed a residual supervisory function (*umbrella supervision*) over the entire conglomerate, with the aim of identifying and eliminating the risks that may affect the bank as a result of being part of the group. In particular, with reference to this provision, it should be pointed out that – besides the fact that from a regulatory and enforcement standpoint these types of abuses fall within the jurisdiction of the SEC in light of the harm to investors and markets – they may become relevant also with reference to the financial stability of the bank. Indeed, to the extent that these abuses involve *unsafe or unsound practices* of the commercial bank belonging to the group, the Fed may adopt enforcement actions against the bank (e.g. cease-and-desist orders) or against individual managers (e.g. suspension, removal and prohibition) whose liability has been ascertained.²³ In addition, such abuses may also authorize the Fed to adopt structural measures having an impact on the entire conglomerate. Indeed, according to the Bank Holding Company Act, if commercial banks belonging to a financial conglomerate do not have an adequate management and internal control system, the Fed “*may impose such limitations on the conduct or activities*” of the FHC and its affiliates as it deems “*appropriate under the circumstances and consistent with the purposes*” of the BHC Act.²⁴ The Fed therefore enjoys ample discretionary powers in identifying the necessary measures, and may – for example – establish that the activities carried out by the conglomerate be downsized, or prohibit further expansion until the an internal management and control system, adequate to its size and features, has been set up.²⁵

²² See section 206(2) of the 1940 Investment Advisers Act.

²³ On the various types of enforcement actions see J.T. Lynyak, *Responding to Proposed Enforcement Actions by the Federal Banking*, in 122 BANKING LAW JOURNAL 3, 2005.

²⁴ 12 U.S.C. Section 1843(m).

²⁵ See, e.g., the order approving the acquisition of First American Bank by Citigroup, where the Fed took a clearly negative position with reference to further expansion by Citigroup in light of its management system (“*Given the size, scope, and complexity of Citigroup’s global operations, successfully addressing the deficiencies in compliance risk management that have given rise to a series of adverse compliance events in recent years will require significant attention over a period of time by Citigroup’s senior management and board of directors. The Board expects that management at all levels will devote the necessary attention to implementing its plan fully and effectively and will not undertake significant expansion during the implementation period. The Board believes it*

The wide range of enforcement powers attributed to the banking supervisory authorities with reference to capital and management requirements represent the cornerstone of the financial conglomerate supervisory system, headed by the Fed.

Removal of the firewalls which (as previously pointed out) in the past kept commercial and investment banking separate, seem to stem from the idea that the capital and risk management requirements, accompanied by an effective and composite enforcement system at the disposal of the Fed and the SEC, represent a framework adequate to ensure bank stability and investor protection.²⁶ Hence, financial intermediaries are granted significant autonomy in defining the structure of the conglomerate, without the need for organisational constraints that might prevent *a priori* scale and scope economies stemming from universal banking.

3. Private enforcement: class actions.

It has been previously pointed out that the types of conflicts of interest which lead financial intermediaries to neglect their duties of diligence, fairness and transparency *vis-à-vis* investors, fall within the enforcement authority of the SEC. In the same context it was also mentioned how, in addition to the SEC's supervisory and penalty actions, these types of abuses expose financial intermediaries to claims for damages. In the United States, the latter are often brought by investors before the court through the so called "class action." This term indicates a specific procedural system whereby similar claims are pooled together and dealt with in the same lawsuit. Basically, and in summary, the class action starts with the filing by a single investor of a claim – for damages, or requiring the conviction for a different measure (such as a prohibition or an injunctive relief, or avoidance of a contract) – on behalf of a non-predetermined "class" of parties allegedly harmed by the same event. If the court approves the motion to certify the class, notice will generally be distributed to class members, who are given the right to "opt out" of the action by returning a form.²⁷ Class members who do not opt out are thereafter held to the

important that management's attention not be diverted from these efforts by the demands that mergers and acquisitions place on management resources."). With a letter on April 4, 2006, the Fed lifted the ban on Citigroup, giving account of significant progress achieved implementing the new risk management system.

²⁶ See *supra*, notes 12 and 14.

²⁷ On the disciplinary function of *opting out*, see J.C. Coffee Jr., *Class action Accountability: Reconciling Exit, Voice, and Loyalty in Representative Litigation*, in 100 COLUM. L. REV. 370, 2000 ; on its empirical irrelevance, see T. Eisenberg and G.P. Miller, *The Role of Opt-Outs and Objectors in Class action Litigation: Theoretical and Empirical Issues*, in 57 VAND. L. REV. 1529, 2004.

consequences of the litigation. Hence, class members benefit *pro quota* from the total award for damages judicially granted to the class or from the settlement of the lawsuit (which, however, must be approved by the judge, who has discretion to reject the settlement if he finds it to be unreasonable or unfair to the class, or if the attorneys fees are found to be excessive). In certain types of class actions (generally those not seeking monetary relief) class members are not given the right to opt out and are required to be a part of the class..

As it may be inferred from this brief description, during these complex proceedings, the judicial authorities carry certain functions: they ascertain that the special legal requirements to file a class action are met (the *certification* stage)²⁸; they preside over the investigation stage (the so called “discovery”), which may also be initiated before certification; they appoint the class member who will represent the entire class (lead plaintiff); they appoint the lawyer who leads the case in the interests of the entire class (lead counsel); they verify whether the settlement is correct and appropriate; they set the fee to be paid to the lead counsel.

The need for the class action stems from the “collective action” problem which occurs any time the harm caused by an illegal behaviour is shared among a number of parties so high that the legal and judicial expenses, to be borne individually, are higher than the benefits expected from each individual judicial action. When this situation occurs, it follows that, although the harm is significant at a social (aggregate) level, the injurer does not pay for it since harmed people tend to be passive. To overcome such “rational inertia”, the class action introduces an aggregation mechanism which achieves economies of scale so to make the filing of lawsuits economically feasible.

Therefore, while providing a means of redress for harmed people, the class action plays a public interest role, as it makes possible a private enforcement system with a deterrence effect alternative or – depending on the situation – complementary to the public supervisory action. This proves particularly true in the US financial system, where the “social function” of the class

²⁸ To pass the certification stage the plaintiff has to meet the formal requirements set forth by Rule 23(a) of the *Federal Rules of Civil Procedure*: *numerosity* (the number of parties involved is so high that joinder is impracticable or difficult), *commonality* (one or more questions of law or fact are common to the class members), *typicality* and *adequacy of representation* (both requirements refer to the representative parties’ ability to defend the class’s interests). Furthermore, the plaintiff has to prove that the class action falls within one of the categories of action listed by section 23(b) of the *Federal Rules of Civil Procedure*.

action is expressly recognised by courts and by the same supervisory authorities.²⁹ Even though, on this feature, one should not overlook recent criticism expressed by various scholars which have cast serious doubts on the ability of the class action in the financial sector to deter managers of listed companies from corporate wrongdoings that enrich them (such as manipulating financial information in order to profit from stock options held).³⁰

At the same time, the class action may also perform further social functions. From an administration of justice system standpoint, it concentrates in a single procedure a multitude of claims that would be otherwise spread up before different courts or in different procedures before the same court. It therefore helps to achieve economies of scale in the administration of justice, avoiding a possible jamming effect. Moreover, from the point of view of defendants in mass tort claim, concentrating all the cases in one procedure makes it easier to estimate the highest exposure for damages and reach a global settlement, speeding up the solution to the controversy.

3.1. Critical issues in class actions, and the Private Securities Litigation Reform Act.

If, on the one hand, there is a wide consensus in the United States on the social benefits of the class action, on the other hand different opinions have been expressed on how the class action should be legally structured so as to avoid its potential social downsides.

In particular, the class action discipline in general raises two main critical issues:

- (a) the opportunity to file a class action for the sole purpose of inducing the defendant to settle even in those cases where the claim is unfounded and would be rejected should the trial be decided by the courts;³¹
- (b) the lack of adequate incentives for the class members to monitor the lead counsel.³²

²⁹ In *Basic Inc. v. Levinson* (1988), the Supreme Court acknowledged that the class action is necessary to implement “the congressional policy embodied in the [Securities and Exchange Act of] 1934”. In a hearing before the Senate in 1995, the president of the Sec. A. Levitt, stated that “private actions are crucial to the integrity of our disclosure system because they provide a direct incentive for issuers and other market participants to meet their obligations under the securities laws”. For an empirical comparison between public enforcement and private enforcement in the US see J.C. Coffee Jr., *Reforming the Securities Class action: An Essay on Deterrence and Its Implication*, Columbia Working Paper, 2006, 18-19. For an account of the role played by class actions in the aftermath of the recent financial scandals see *supra* note 18.

³⁰ J.C. Coffee Jr., *supra* note 29.

³¹ From a theoretical standpoint see, e.g., L.A. Bebchuck, *Suing Solely to Extract a Settlement Offer*, 17 J. LEG. STUD., 437, 1988; R.D. Cooter e D.L. Rubinfeld, *Economic Analysis of Legal Disputes and Their Resolution*, 27 J. ECON. LIT. 1075, 1989; S.J. Choi, *The Evidence on Securities Class actions*, NYU WORKING PAPER, 2004.

3.1.1. The certification.

With reference to point (a), it may be empirically observed that the very high amount of damages involved (a consequence of the extremely high number of class members) generally make it more cost-effective for the defendants to settle rather than to be exposed to the risk of insolvency. This applies even for those cases where the probability of losing is *ex ante* low for the defendant.³³ In addition, the economic advantage of a settlement agreement for the defendant is increased by the complexity of the discovery process of the class actions, as a consequence of which companies may be exposed to high costs – in operational terms as well as from the standpoint of their image – for a long period of time.

In fact, the high number of settlements has spurred some law firms to specialize in soliciting individuals to file a class action³⁴, for the purpose of becoming lead counsel³⁵ and obtaining the related fee³⁶ following settlement. In other words, various class actions may be filed by lead representatives induced by law firms which, regardless of the case at hand, aim at forcing the defendant to settle.³⁷

³² On the agency relationship between the *lead plaintiff* and the member of the class see, e.g., J.R. Macey and G.P. Miller, *The Plaintiffs' Attorney's Role in Class action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, in 58 U. CHI. L. REV. 1, 1991; A. Klement, *Who Should Guard the Guardians ? A New Approach for Monitoring Class action Lawyers*, in 21 THE REVIEW OF LITIGATION, 2002, in particular fn 25 and accompanying text.

³³ See *supra* note 31. From the empirical standpoint, G. Priest, *Economics of Class action*, in 9 KANSAS JOURNAL OF LAW AND PUBLIC POLICY, reports that all mass tort class actions are settled. A study on class actions in the financial sector has calculated that 87,6% of those filed between 1988 and 1996 ended up in a settlement (see V. O'Brien, *A study of Class action Securities Fraud Cases 1988-1996*, 16).

³⁴ Technically, US lawyers are prohibited from soliciting clients under applicable ethics rules. However, it is commonly believed that solicitation occurs on a regular basis in class cases. US law firms cannot provide their clients with any form of compensation in exchange of being selected as legal counsel. Delaware Courts explicitly acknowledge the driving role played by legal firms in the promotion of law suits. The Delaware approach is criticised by E.J. Weiss & L.J. White, *File Early, Then Free Ride: How Delaware Law (Mis)Shapes Shareholder Class actions*, NYU Law and Economics Working Paper, 2004, which claim to provide empirical evidence of the abuses caused by it.

³⁵ In those class actions that are out of scope of the PSLRA judges tend to appoint as lead counsel the law firm which is hired by the class representative.

³⁶ Attorney's fee is set by the courts following the "percentage method" or the "lodestar method". Pursuant to the first method it is determined focusing mainly on the size of the fund awarded to the class (the fee awarded tends to be around 25-30% of the fund). The lodestar method is based on the number of hours spent on the case and other circumstances, such as the risk taken by the attorney with a contingent-fee agreement or the quality of work performed.

³⁷ The law firm "Milberg Weiss" has a dominant position as lead counsel in the financial market class actions: in 1996 it was present in 59% of the actions filed (83% in California). Two senior partners in the firm are now being

In order to prevent this kind of lawsuits, which hereinafter will be also termed as “frivolous suits”, a sort of filter is needed in the initial stage of the proceedings. In this connection, it has already been pointed out how the US system entrusts the judicial authorities with the task of “certifying” the lawsuit filed. Opinions strongly differ, both in legal practice and theory, with reference to the type of control to be performed in this situation by the courts. The solutions proposed are, indeed, influenced by the high probability that the plaintiff has, for the reasons illustrated above, to obtain a settlement once he/she has passed through this procedural obstacle.

The main orientation adopts a formal approach, and confines the courts’ role to ascertaining that the action meets the requirements set by the law,³⁸ without analysing whether the lawsuit is, even barely, grounded.³⁹ Part of legal practice departs from this approach: despite recognising that certification is based on the existence of formal requirements, it still considers courts entitled to examine – albeit *prima facie* – the facts on which the lawsuit is based, therefore recognising that in order to certify the class courts can take into consideration also the merits of the case⁴⁰.

The danger posed by indiscriminate access to class actions was explicitly addressed by a sector-specific piece of legislation, the 1995 Private Securities Litigation Reform Act (PSLRA). The PSLRA establishes rules in response to the widespread perception of an excessive and unjustified recourse to class actions for alleged violations of the financial market regulation (the Securities Act of 1933, and the Securities Exchange Act of 1934).⁴¹ As a consequence of the

criminally investigated for alleged payments, from 1981 to 2004, to induce filing of class actions and be appointed as lead counsel (see *Wall Street Journal*, January 19 2006; *Financial Times*, May 19 2006).

³⁸ V. *supra*, note 28.

³⁹ This is the approach followed by the Supreme Court in the *leading case* Eisen v. Carlisle & Jaquin et al., 417 U.S. 156, 94 S. Ct. 2140, 40 L. Ed. 2d 732 (1974). For discussion, see generally Geoffrey P. Miller, Review of the Merits in Class Action Certification, 33 Hofstra Law Review 51 (2004).

⁴⁰ The Seventh Circuit, in a decision by Judge Richard Posner (*In the Matter of Rhone-Poulenc Rorer*, 51 F.3d 1293, 1995), denied certification of a class action because only one out of thirteen individuals who had previously litigated the same claims to verdict had prevailed against the defendant. According to the court, this showed “a great likelihood that the plaintiffs’ claims...lack legal merit”, and thus demonstrated the unfairness that the class action jury “may disagree with twelve of the previous thirteen juries – and hurl the industry into bankruptcy”. From a normative standpoint, G. Priest, *supra* note 33, at 484, has proposed to modify the current rules of procedure in order to explicitly give courts the power “to examine whether the claims have sufficient potential merit to justify the creation of great economic power through class certification”.

⁴¹ As stated in the *Congress Report*, PSLRA was intended to solve inefficiencies deriving from: “(1) the routine filing of lawsuits against issuers of securities and others whenever there is a significant change in an issuer’s stock price, without regard to any underlying culpability of the issuer, and with only a faint hope that the

reform, in this category of class action: (a) the claim for damages must be accompanied by a detailed description of the facts on which the lawsuit is founded (the so called *pleading with particularity*); (b) the opportunity to ask for the documentation belonging to the defendant or the examination of witnesses (the so called *discovery*) is postponed to the motion to dismiss the lawsuit⁴².

These provisions represent “access barriers” to the class action which have a potentially ambivalent effect. On the one hand, by making certification more difficult (due to the need to meet the “pleading with particularity” requirement), and placing the costs of collecting elements of proof on the plaintiff, they reduce the probability of obtaining a settlement for frivolous class actions, and therefore represent a deterrent for their filing. On the other hand, by raising the costs of taking legal action, they hamper class actions which, despite being viable, require significant investigation, or produce an aggregate damage insufficiently high to make the decision to bear the costs of the lawsuit *ex ante* profitable, in terms of risk/return. Hence, these rules in fact jeopardise class actions dealing with offences which have not yet been made evident by accounting restatements or which result in a loss whose amount does not justify bearing the legal costs.

From US empirical literature on the PLSRA, evidence may be drawn of an effect in both the directions just outlined. On the one hand, according to the studies carried out, the reform seems to have reduced the number of frivolous suits. On the other, it seems that the PSLRA has introduced a barrier to class actions for offences that are not yet self-evident. It is currently impossible to say whether the social benefit resulting from the first effect (i.e. reduction of social waste associated with frivolous suits) exceeds the social cost (i.e. reduction of the deterrence effect of class actions for non-evident offences or regarding listed companies with a limited market capitalisation) resulting from the second.

discovery process might lead eventually to some plausible cause of action, (2) the targeting of deep pocket defendants, including accountants, underwriters, and individuals who may be covered by insurance, without regard their actual culpability; (3) the abuse of the discovery process to impose costs so burdensome that it is often economical for the victimized party to settle; and (4) the manipulation of class action lawyers of the clients whom they purportedly represent”.

⁴² In addition, the PSLRA provides that: (i) courts, on occasion of the final adjudication, to impose sanctions for frivolous litigation; (ii) each of the defendant is liable proportionally to its contribution to Rule 10b-5 actions, so that less culpable parties are relieved of a portion of the total liability (the so called *proportional liability principle*); (iii) a safe harbor procedure can be followed for the so-called “forward-looking statements”. S.J. Choi and A.C. Pritchard, *supra* note 21, at 259.

What can be said from the experience gained so far is that regulating the class action in such manner poses an inevitable trade-off between providing incentives (or lowering costs) to file class actions, enhancing its public interest deterrence function⁴³, and filtering out frivolous class actions⁴⁴.

3.1.2. The “agency relationship” between the class action members and the lead counsel.

With reference to the lack of adequate incentives to carry out monitoring activities, it should be first and foremost recalled that the class action is a system whose purpose consists in aggregating a significant number of parties, each one representing a small portion of the aggregate value of the lawsuit. The typical “agency costs” marking the relation between the lawyer and his/her client are, therefore, amplified in the class action due to a collective action problem: very rarely does the lead plaintiff or do the other members of the class have an adequate economic incentive to monitor the lawyer’s (the lead counsel) behaviour to ensure that he/she doesn’t put his/her personal interests before those of the class.⁴⁵

In order to downplay the leading role played by the lead counsel, the federal rules of procedure on class action, besides investing courts with the responsibility of appointing the lead counsel, entrusts the judicial authorities with the task of setting the fees to be paid⁴⁶ and of ascertaining whether the settlement, if any, ending the lawsuit actually promotes the real interests of the members of the class⁴⁷.

⁴³ On the doubts recently cast with reference to the deterrence effect of class action for some kinds of corporate abuses by managers, and on the reforms proposed to make managers accountable as class action defendants, see J.C. Coffee, *Reforming the Securities Class Action: An Essay On Deterrence and Its Implementation*, Columbia Law School WP, 2006; A.C. Pritchard, *Should Congress Repeal Securities Class Action Reform ?*, POLICY ANALYSIS, n. 471, 2003.

⁴⁴ See S. Choi, *The Evidence on Securities Class Actions*, UC Berkeley School Working Paper, 2004; Id., *Do Merits Matter Less After the Private Securities Litigation Reform Act ?*, NYU Working Paper 2005.

⁴⁵ See, e.g., A. Klement, *supra* note 32, at 34; J.R. Macey and G.P. Miller, *supra* note 32.

⁴⁶ To solve the problems of evaluation of the right fees, some courts have implemented an auctioning mechanism to assign the role of lead plaintiff (see M.A. Perino, *Markets and Monitors: The Impact of Competition and Experience on Attorneys’ Fees in Securities Class actions*, Working Paper, 2006; A. Klement, *supra* note 32, at notes 28 and 40).

⁴⁷ As R. Posner, *Economic Analysis of Law*, New York, Aspen Publishers, 1998, 5^o ed., 627, points out “*The lawyer for the class will be tempted to offer to settle with the defendant for a small judgment and a large legal fee, and such an offer will be attractive to the defendant, provided the sum of the two figures is less than the defendant’s net expected loss from going to trial*”. For further analysis on the dynamic of settlement, see G.P. Miller, *Some Agency Problems in Settlement*, 16 J. LEGAL STUDIES 189 (1987) and A. Klement, *supra* note 32, at 39.

Because of the doubts, raised by many, that courts have adequate information, competences and incentives to challenge the lead counsel⁴⁸, the PSLRA has introduced specific rules radically changing the process for selecting the lead plaintiff and the lead counsel.

The reform establishes that the lead counsel be chosen – subject to approval by the judge – by the lead plaintiff, and that this be a member of the class capable of – according to the judge’s opinion – best protecting the interests of the class itself. To this effect the law creates a relative presumption that the party most appropriate to become lead plaintiff, among those applying for appointment, is the class member holding the greatest financial interest in the lawsuit. The result is a system favouring the appointment as lead plaintiff of institutional investors. The system is based on the assumption that they have the greatest financial incentives, are in the best position to negotiate the fee to be paid to the lead counsel, have the ability to monitor the latter’s conduct during the proceedings. In this regard, the results of the reform are far from being clear. Empirical studies carried out so far show a limited participation by institutional investors in class actions⁴⁹, in particular in the position of lead plaintiffs⁵⁰. Different opinions have been expressed on the existence of a negative correlation between institutional investor participation and the amount of the fees paid to law firms⁵¹.

4. Final remarks: the Italian legislatives in light of the US experience.

During the course of the 20th century, the US regulatory pendulum made a full swing: from a system forbidding simultaneous operations in commercial banking and investment banking sectors, we have come to a regulatory scenario in which intermediaries are authorised to carry out those activities in a coordinated manner.

To get rid of the agency problem between the lawyer and the members of the class, J.R. Macey & G.P. Miller, *supra* note 32, have proposed to set up a system to auction off to the highest bidding legal firm all the claims deriving from the class action.

⁴⁸ See J.R. Macey & G.P. Miller, *supra* note 32, at 45; M.A. Perino, *supra* note 46, at 4; A. Klement, *supra* note 32, at 27 and 38.

⁴⁹ J.D. Cox, *Letting Billions Slip Through Your Fingers: Empirical Evidence and Legal Implications of the Failure of Financial Institutions to Participate in Securities Class Action Settlements*, in 58 STANFORD LAW REVIEW 412, 2005.

⁵⁰ S.J. Choi, J.E. Fisch & A.C. Pritchard, *Do Institutions Matter ? The Impact of the Lead Plaintiff Provision of the Private Securities Litigation Reform Act*, in NYU Law and Economics Research Paper No. 04-08, 2005.

⁵¹ M.A. Perino, *supra* note 46, at 3, posits to have found a positive correlation between the two factors. For a different conclusion see S.J. Choi, J.E. Fisch & A.C. Pritchard, *supra* note 50.

From an organisational standpoint, the GLBA has established that traditional banking activities on the one hand, and the rest of financial services on the other, may be carried out through affiliates in a holding company. This separation aims at making functional supervision of the different components of the group easier, and at preventing bank deposit insurance from being used to subsidise financial activities carried out within the same group.

The corporate separation between commercial and investment banking, therefore, refers to the protection of deposits as well as to the effectiveness of supervision. However, it does not focus on conflict of interests that lead to investors' detriment and it does not prevent the exchange of information between affiliate companies operating in the two sectors. On the contrary, the US system allows for shared management between commercial banks and investment firms belonging to the same group. The rationale underpinning the change brought in during the last two decades is that:

- (a) operational and information coordination within the same group may contribute to improve the effectiveness and competitiveness of the services provided, as shown by a number of empirical surveys on the effects of the gradual entry of commercial banks into the financial industry;⁵²
- (b) the introduction, by regulation, of organizational firewalls into the group could prevent achieving such positive effects, while however not preventing situations in which the information advantages resulting from the group's structure are abusively used, despite the fact that the above mentioned constraints are complied with.⁵³

Moving from this rationale, it can be easily inferred why also the evolution of the US regulatory system lead to question, from a cost-benefit perspective, the rigid firewall that article 10 of the "Law for the protection of savings" envisions to prevent conflicts of interest that might harm investors⁵⁴.

⁵² See *supra* note 15.

⁵³ A. Greenspan, *Insurance companies and banks under the new regulatory law*, 1999.

⁵⁴ Setting aside for the sake of argument the recent changes of the European regulatory framework: the European Directive 2004/39/EC (the so called MiFID Directive) and the subsequent implementing regulation do not prohibit any potential conflict of interest to occur within the same financial intermediary. They rather require the adoption of a set of procedural measures to deal with conflict of interest situations so to safeguard clients' interest and

In fact, the US system – along the same pathway so far followed by the Italian system⁵⁵ – does not prohibit *a priori* the occurrence of any situation of potential conflict of interest resulting from taking up the position of creditor and investment banker of the same industrial company. Rather, the protection of investors in such situations is entrusted to a composite set of instruments: the requirement of an effective system of governance and internal controls and the provision of duties of transparency, professional diligence and fairness which prevent intermediaries from exploiting their information-advantage to abusively shift to investors their exposure to financially distressed issuers (*i.e.* breaking the above mentioned professional diligence, fairness, and disclosure rules which they are bound to comply with *vis-à-vis* investors).

As for enforcement and deterrence characteristics of the US system, it is worth noting that banks and their affiliates as well as management are subject to both the control of public supervision, and the risk of being called as defendant in a class action.⁵⁶

With reference to public enforcement, the US regulatory system, as previously noted, provides a wide set of enforcement tools for supervisory authorities. In particular, the latter may adopt suspension, removal and prohibition orders with regards to managers.

Such broad enforcement powers by public authorities over banks' and other financial intermediaries' managers are not present in the Italian regulatory system. Considering that

ensure full disclosure to clients of those situations (art. 13, par. 3, art. 18 and art. 19, par. 1, of the directive). In a recent testimony before the Senate Committee (*Inquiry into matters relating to the implementation of Law 262/2005 "Measures for the protection of savings and the regulation of financial markets"*) the Governor of the Bank of Italy, Mario Draghi, suggested a revision of art. 10 of the law on savings, noting that "*the transposition of the MiFID directive could be an opportunity to re-examine the question of conflicts of interest in the securities industry. The law on savings has introduced solutions intended to prevent conflicts of interest by imposing stringent constraints on intermediaries' organizational and operational freedom. This choice diverges from the line followed by the Community. According to the MiFID directive, intermediaries are required to identify conflicts of interest themselves and adopt organizational arrangements capable of preventing them; the regulatory authorities are controlling the effectiveness of the measures adopted and establishing appropriate transparency obligations*". Along the same line of thought, see L. Enriques, *Dum Romae consulitur. Verso una nuova disciplina comunitaria del conflitto d'interessi nel diritto comunitario*, BANCA IMPRESA SOCIETÀ, 2004, 447.

⁵⁵ As illustrated by F. Annunziata, *supra* note 1, at 179, in Italy – on occasion of the implementation, in 1996, of the directive 93/22/CEE – organizational firewalls imposed by law, and secondary regulation have been almost completely removed.

⁵⁶ On the interaction between public enforcement and private enforcement see G. Ferrarini e P. Giudici, *Financial Scandals and the Role of Private Enforcement: The Parmalat Case*, ECGI Working Paper, 2005, 42; S. Shavell, *Foundations of Economic Analysis of Law*, 2004, 573; L. Zingales, *The Costs and Benefits of Financial Market Regulation*, ECGI Working Paper, 2004. On the problems arising when managers' are shielded from being called in a class action

money penalties do not seem to play a sufficient deterrence role in Italy⁵⁷ and, most importantly, seem unable to stimulate an adequate reputational sanction by the market, the comparison with the US system prompts to question whether it would be more appropriate to provide supervisory authorities in Italy with injunctive enforcement powers over managers⁵⁸. While doing so it would be important not to overlook the procedural protections against possible mistakes or abuses by public authorities in using them⁵⁹.

With reference to private enforcement, it may be observed that for the past few years in the United States a lively debate has been going on with regard to the most appropriate rules to: (a) reduce the number of frivolous suits and; (b) ensure that the lead counsel actually performs his/her task of promoting the class members' interests.

In Italy, the debate on the need for a collective judicial procedure to protect investors has come back to the foreground in the wake of the recent financial scandals.⁶⁰ On this issue the Government has recently presented a bill, which would introduce what is defined as the "collective action protecting consumers".⁶¹

The Government bill envisages a collective protection mechanism which substantially differs from the US class action. It is divided into two phases. The first is assigned to the initiative of (and is lead by) organisations representing collective interests (*i.e.* consumer associations, chambers of commerce and craft unions), the second is activated by the subsequent initiative of each holder of the claim ascertained in the first phase.

In summary, the bill would establish that the aforesaid organisations representing collective interests ("collective organisations") may file a special lawsuit (before the court of the place where the main seat of the defendant is located) to have the defendant declared liable for

⁵⁷ See C. Brescia Morra, U. Morera, A. Nuzzo, *Editoriale*, in *AGE*, I, 2004, 8, emphasizing that current monetary sanctions lack of a deterrence effect and are not accompanied by a market sanction.

⁵⁸ This issue has been emphasized in the IMF report, *Italy - Financial System Stability Assessment 2006*, at par. 71: "one shortcoming is the lack of specific provision for Bank of Italy to require subsequent removal of a director or senior officer who may have become unfit".

⁵⁹ See J.R. Macey, G.P. Miller and R.S. Carnell, *supra* note 11, at 676.

⁶⁰ As noted by G. Costantino, *Note sulle tecniche di tutela collettiva*, *RIVISTA DI DIRITTO PROCESSUALE*, 2004, 1009, note 2 and accompanying text, in fact the debate roots back to the nineteen seventies.

⁶¹ Also various members of the Parliament have proposed different bills aiming at introducing collective actions. All these bills are currently being discussed before the Parliament. In what follows the attention is focused on the Government bill since it seems to gain the largest support in the Parliament, also due to the fact that it replicates a bill which in the previous term had been approved by one the two branches of the Parliament but did not get into legislation due to expiration of the term.

offences committed “*within the context of legal relations concerning contractual and non-contractual relations, illegal commercial practices, or anti-competitive behaviours, provided they prove detrimental to the rights of a plurality of consumers or users*”. In addition, the court decision may consist of a “*generic order requiring the liable person to pay damages, accompanied by the definition of the criteria for determining the damages individual consumers are entitled to, if the elements proved in the case allow for such definition*”. Relying on such judgment holding the defendant liable, each of the damaged parties may take individual legal action to prove the damages individually suffered and to obtain redress.

In addition, the bill enhances the role of settlement. Presumably on the basis of a positive evaluation of the experience of the “*memoranda of understanding*” signed by consumer associations and a number of banks in relation to the Cirio and Parmalat scandals, the bill provides that each harmed individual may obtain compensation by adhering to a settlement agreement which has to be signed by the defendant, by the organisations which have filed the collective action and by the chairman of the settlement chamber established at the court where the lawsuit has been filed. However, the settlement affects also the holders of damage claims who do not wish to adhere to it: the alternative avenue of individual compensation lawsuit is barred for the time needed to pay damages pursuant to the settlement.

From a comparative standpoint, it may be observed that the Italian bill is not following the US class action pattern, in which a central role is played by the interaction between the courts, the lead counsel and the class members. Rather, it draws inspiration from the model of aggregation of claims recently implemented in Germany.⁶² The reasons behind this choice might be due to a negative assessment of the “*entrepreneurial role*” of law firms in the US pattern and to the fact that the management of a complex lawsuit such as that of the US class action would require an organisation of judicial offices’ administration, and a specialist technical training of courts, which at the moment are apparently deemed not available in the Italian system.⁶³

Setting aside the US model, the legislator has opted for a solution along the same line followed by the provisions of the so called “*code of consumers*,”⁶⁴ which already entitle

⁶² See the “*Gesetz zur Einführung von Kapitalanleger-Musterverfahren*”, August 19, 2005.

⁶³ See G. Costantino, *supra* note 60, at note 17 and corresponding text; M. Rescigno, *L’introduzione della class action nell’ordinamento italiano. Profili generali*, in *Giur. comm.*, 2005, I, 407.

⁶⁴ Legislative Decree 206, September 6, 2005.

consumer associations to file in court for cease-and-desist orders with regard to abusive contract clauses, or other illegal actions and behaviours damaging the interests of users and consumers. The bill would therefore bring about an extension of the judicial role of consumer associations and other organisations listed in the bill.

Furthermore, as highlighted above the bill assigns a special legal effect to the settlement between the defendant and the organisations who have filed the collective action. This choice is presumably based on the assumption that the settlement is an instrument which, while respecting the parties' autonomy, (i) allows the defendant to safeguard its image by putting an end to the dispute, (ii) helps to reduce the courts' workload and, (iii) allows for a predetermination of damages.

In theory, the introduction of a collective action could grant private enforcement a greater deterrence effect compared with the current situation in Italy: lowering access costs, for investors, to legal self-protection reduces *ex ante* the economic profitability of illicit behaviours. However, for this deterrence to be efficient and effective, the collective protection system must be regulated such as to reduce the risk of abuses, which could emerge to the detriment of both investors and defendants. With reference to the potential abuses, it may be observed that – despite the differences existing between the class action and the Italian collective action – the US model stands as a useful point of reference for an assessment of the Italian bill.

With regard to procedural rules, drawing from the US experience it seems more efficient to assign the class action to the jurisdiction of the Court of Appeal or of a specialised court, rather than to the courts of first instance (*i.e.* the Tribunals). Indeed, the social and economic relevance of such actions make it particularly important to have judicial decisions that are adequately uniform and predictable.⁶⁵ In addition, following the US debate it seems also worth taking into consideration the introduction in the prospective Italian collective action of a “certification phase”, where the court would assess the validity of the collective action (*i.e.* whether it meets all the formal requirements and is not apparently unfounded) and filter out frivolous actions. After passing through such a “filter”, the court could recognise powers similar to those foreseen by the US provisions on *discovery*. This specific set of rules has not been

⁶⁵ Indeed, this seems to be the rationale of the 2005 Class Action Fairness Act.

mentioned in the bill, although in the United States it has proved essential to the protection of investors and consumers.⁶⁶

In studying the US class action framework, the importance of mechanisms that would induce the alignment of interests of those who lead the class before the court and the members of the class becomes apparent. Several features are worthy of consideration with respect to proposed legislation.

The first, lying outside of the procedural dynamics of the collective actions, has to do with the lack of a governance system and of internal controls in consumer associations and in the other collective organisations that are entitled to file for a collective action. The current Italian regulatory framework seems to neglect that the “rational inertia” and the associated “agency costs” typical of profit-making companies may be even higher in non-profit associations, where associates do not have any monetary incentive to monitor. This seems particularly true with consumer associations, whose members may become associates only to gain special benefits (such as special subscription rate to consumer magazines that are subsidised with public funds), rather than to participate in the association activity. A reform aimed at introducing a set of basic and binding governance guidelines for these organisations seem particularly urgent. Such governance mechanisms should aim at ensuring that the powers granted by the law to these organisations are effectively used to protect the interests of consumers and other represented citizens, rather than to pursue the personal interests of the managers of these organisations.

The second feature concerns the binding effect that, according to the bill, the settlement agreement,⁶⁷ or the judicial decision of the collective action establishing compensation criteria for the following individual actions, would take with reference to all individuals harmed. The doubts on these provisions are based on the drawbacks that have been emphasized with regard to the US class action: the settlement ending the class action could be the product of collusion between the lead counsel and the defendant, to the detriment of the parties directly entitled to

⁶⁶ On the relevance that the *discovery* has in order to make the class action an effective means of protection see G. Ferrarini and P. Giudici, *supra* note 56.

⁶⁷ As previously exposed, the completion of a settlement agreement between the collective organisation which acts as plaintiff and the defendant is followed by a stay of individual lawsuits for the time required to execute the settlement.

compensation.⁶⁸ With reference to this risk, we should consider introducing in the Italian bill adequate solutions, such as:

- (i) a stricter control by the courts on the terms of settlement agreements;
- (ii) time limits for the stay of individual lawsuits which follows the settlement agreement between consumer associations and the defendant;
- (iii) legal instruments allowing individuals to dissent should they believe that collective organisations do not protect their interests appropriately. These instruments could consist of the possibility for any physical person or legal entity to: file a collective action or to join in the collective action already started by an association; oppose the settlement reached between the plaintiff-association and the defendant; ask for his/her position to be separated (the so called *opting out*) with reference to a settlement considered not to be satisfactory.

To conclude, and to sum up, the evolution of the US regulatory framework about conflicts of interest in universal banks provides two useful points worthy of consideration with respect to the Italian ongoing debate mentioned at the beginning of this article. First, with regard to protection of investors through supervision over financial conglomerates, it suggests that in order to have efficient and competitive intermediaries it could be more appropriate to adopt a flexible approach, holding them responsible for the selection and implementation of the governance system that they deem more adequate to their specific structure. Second, with regard to protection of investors through an easy access to judicial redress, the US experience leads us to look beyond the easy slogan of the collective action as a shield for investors. In particular, we should focus our attention on legal and market instruments that would help make the collective action an effective and efficient means of protection rather than an opportunity for the extraction of “private benefits” for collective organisations and law firms who are entrusted to represent them before the courts.

⁶⁸ *Supra*, note 47.