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Corporate bonds: an overview of financial intermediaries' critical duties and responsibilities
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Many legal issues arise from the recent crises involving large Italian corporate entities, and a number of lessons and proposals have emerged, which deserve the attention of financial market lawyers, both at a national and an international level.

Specific national issues aside, following the Enron scandal and other similar cases in the US, the Cirio and Parmalat crises in Italy lead one to conclude that a review of the European legal framework is also needed in order to prevent a breakdown of trust in the instruments issued by European corporate entities, which contribute significantly to market development.

It is not the intention of this paper to clarify and discuss the details of specific cases, nor to comment on the current investigations into allegations of fraud. The issue at stake here is to clarify whether the existing European legal framework is sufficient to minimise the risk of corporate defaults destroying market confidence and exposing the banking system to liability.

In the first place, we would strongly underline that the failure of corporate governance in recent cases suggests that we should consider all measures aimed at strengthening corporate law and securities regulation. Keeping in mind recent US and Italian corporate defaults, lawyers can identify several approaches to the problems faced, including improving and coordinating European rules on the independence and responsibilities of internal and external auditors.

In our view, a review should focus above all on enhancing corporate disclosure requirements, control and monitoring internal procedures and improving related penalties. The proposed response would also affect the regulation of research and recommendations by analysts, as well as the recognition of credit rating agencies, which should result in a wide-ranging assessment process in view of the upcoming Basle capital adequacy regulation. Moreover, a lively debate is currently in progress as to how to achieve a well-balanced system of regulatory, investigative and enforcement powers for financial market supervisory authorities.

We welcome the effort of the European Commission in improving harmonisation in all these fields, being sure that features of the financial market make a proper response at European level necessary.

In this context, we can also focus on the role of market intermediaries, in order to verify where certain major duties and responsibilities of banks and financial entities commonly dealing in corporate bonds issued by large firms should be emphasised.

The insolvency crisis currently being experienced by large corporate issuers highlights certain major risks for financial intermediaries.

First, the prospectus and other disclosure requirements in a public offering or a listing of financial instruments are critical issues, in as far as the finance managers organising and promoting the underwriting syndicate are required to provide certification. Issuers and offerors severally share liability for information provided to investors. Certain national authorities oblige senior managers to certify – jointly with the issuer and the offeror – that, based on their best knowledge, the information contained in the prospectus is true and complete in order to enable potential investors to decide whether to invest or not. Although due diligence standards are internationally observed and it is an international practice to request comfort letters from auditors, the liability that professional intermediaries are required to bear is still determined by national law and procedures.

Examining the prospectus issue in greater depth, national law based on European directives specifies conditions which must be satisfied for exemptions to the requirement for a prospectus to apply. Such laws also define the features of a 'private placement' whereby intermediaries can offer bonds to clients without issuing a prospectus. The European system has not, however, accepted the concept of mandatory holding periods after an exempted issue. This means that subsequent resales are allowed unless they constitute a new public offering. This point seems not to be entirely accepted by several commentators and it appears that the financial community does not consider this assumption to be a foregone conclusion. Certainly, clarification would be appreciated taking into account international market practice. With reference to the exemption issue, a well-considered solution would probably also refer to bids launched on a regulated market or in alternative trading systems, in order to specify appropriate conditions for exemptions to the prospectus requirement to apply in those circumstances.

Nevertheless, in Italy the requirement for a prospectus is not of itself considered to offer retail investors sufficient protection. By way of another approach, the involvement of intermediaries can play a more binding role.

The recent Italian corporate law reform (which entered into force in January 2004) requires professional sellers (banks and other qualified investors subject to prudential supervision) to guarantee offers of corporate bonds where the issuer exceeds the debt/equity ratio limits permitted by law (see Article 2412 of the new Italian Civil Code). This means that if the bond in question is unlisted, the seller will guarantee the issuer's solvency. A draft law currently under discussion in Italy would extend the same guarantee scheme to foreign issuers selling to Italian retail investors.
This measure certainly aims to protect investors and to improve market confidence in sales of corporate bonds made by professional financial intermediaries. On the other hand, the requirement to monitor the balance sheets of corporate issuers whose bonds banks deal in when offering investment services to third parties will impose an ongoing burden on the banks concerned. Moreover, considering the international nature of financial markets, it is probably worth evaluating whether this principle should be extended further. Certainly, a European response would be appropriate in this context.

Examining the standard of information to be provided to investors by financial intermediaries in resales of financial products wherever a prospectus is not mandatory, the Investment Services Directive (ISD) focused attention on the fairness and diligence of intermediaries.

Recent experience of corporate crises leads one to consider what level of information banks should provide when offering both investment services to retail clients and credit facilities to corporate entities issuing the financial instruments in question. Similar concerns exist where banks hold equity in the issuer.

This illustrates two separate problems: i) the conflict of interest to which banks are subject; and ii) the possible conflict between disclosure requirements and confidentiality rules.

Conflicts of interest where banks provide investment services
The ISD currently leaves regulation of this issue to Member States while stipulating a general requirement for appropriate prudential measures to minimise the risk of conflict between the interests of an investment firm and those of its clients.

Member States have developed rules of adequate organisation for investment firms and rules of conduct and disclosure.

The most restrictive approach is based on prohibition. Where the conflict of interest appears to be fundamental to the provision of certain services, banks are forbidden to offer the investment service by a rule that reserves the competence for specialised intermediaries (e.g. an asset management company).

However, as a result of welcome market developments and in view of the fact that banks are no longer forced to specialise, we have to consider that the above approach has also been relaxed in the US as a result of the repeal of the Glass-Steagall Act by the Gramm-Leach-Bliley Modernization Act of 1999. Under the current European law framework, many Member States permit credit institutions to combine banking and investment services within the same corporate structure ('universal banking') or alternatively through a group of controlled companies offering, dealing in and brokering financial instruments, managing savings and collective investment schemes.

Therefore, a compromise approach permits a bank to include such a specialised entity within its group of controlled companies, subject to applying rules reinforcing its independence.

Another solution is to use so-called 'Chinese walls', which forbid any exchanges of information across different divisions of a bank. Schemes of best practice may assist in implementing this by developing 'safe harbour' rules.

However, organisational measures alone seem not enough to fulfil a bank's responsibilities. Rules of conduct for pre-contractual and contractual relationships with clients where a conflict of interest arises impose a 'disclose or abstain' requirement on the banks. They must obtain specific written approval from the client in relation to a conflict of interest inherent in the deal. With reference to corporate bonds, conflict certainly includes contemporaneous dealing in financial instruments, which are either offered or underwritten. Nevertheless, identifying a conflict of interests may sometimes arguably result in certain services unrelated to other relationships with the issuer of the instruments.

Confidentiality and disclosure requirements imposed on the banks
Failure to provide adequate information about traded instruments is one of the major accusations levelled at financial intermediaries.

The nature and extent of the information to be provided should vary, taking into consideration the client's financial awareness and the kind of services offered (offering instruments for sale, execution only, management). In any case it is difficult to accept a surreptitious extension of the requirement to issue a prospectus by transferring the burden of supplying information from issuers to banks.

Other relevant issues are:
- identifying the source of data;
- clear liability for false or misleading information;
- maintaining up to date information;

One point should be clear and unambiguous: only 'market available' information should be considered. Regulators, who often make use of the expression 'available information', should unequivocally prohibit the use of confidential information connected with the bank's other business.

The conflict between the requirements of disclosure and secrecy is apparent wherever a legal obligation to protect confidential data is stated, the infringement of which is subject to sanctions. This is certainly the case for regulation of privileged information on listed companies. It is also the case for centralised risk-sharing data archives, compiled for binding supervisory reasons (e.g. in Italy the information received by Centrale dei rischi of the Bank of Italy). The same privilege would reasonably apply to internal credit assessments (internal ratings) developed in view of the new Basle regulation. Moreover, data on unlisted issuers may be protected differently on the basis of banking secrecy or privacy laws.

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Finally, we would invite the EFMLG to consider whether the Group should continue its analysis in order to put together a proposal of measures for submission to CESR or the European Commission. The package of measures could include:

- harmonising the responsibilities of lead managers and arrangers in submitting prospectuses to the competent authorities;
- clarifying the conditions permitting resale of financial instruments after or during a private placement to institutional investors;
- evaluating mandatory guarantee schemes imposed on financial intermediaries offering corporate bonds to retail investors;
- clarifying conflicts of interest to be disclosed to clients, also by adopting a code of conduct classifying the types of activities ordinarily assumed to result in a conflict and specifying exemptions based on the introduction of specialised divisions or companies separate from other group companies;
- clarifying the nature and extent of information to be provided to clients in the course of broker/dealer activities by referring to the source of data and updating procedures, assuming that any information provided should be based on a ‘market available’ basis.