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Milan Prosecutor Bases Derivatives Suit on U.K. Rules (Update1)

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By Elisa Martinuzzi and Sonia Sirletti

May 6 (Bloomberg) -- Italian prosecutors are seeking to use U.K. securities rules to prove their claim that UBS AG, Deutsche Bank AG, JPMorgan Chase & Co. and Depfa Bank Plc deliberately defrauded Milan when they sold the city derivatives contracts.

Alfredo Robledo, who is leading the probe, said in court documents that the banks violated U.K. rules by failing to tell the city in writing it would be treated as a so-called market counterparty, instead of an intermediate customer, and lose the protection the U.K. Financial Services Authority's rules give to clients signing contracts under English law.

The banks earned about 101 million euros ($134 million) in what prosecutors call illicit profit for arranging the contracts. The City of Milan is suing the four banks after it lost money on derivatives it bought from the lenders in 2005. The city lost 298 million euros on its derivatives as of June. The banks have until tomorrow to appeal the Italian financial police's seizure of 476 million euros of assets last week.

"The use of foreign rules is unprecedented in a case of financial fraud," said Fabio Belloni, a criminal lawyer who represented Parmalat SpA founder

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Calisto Tanzi in a fraud case. “That said, it is common practice in Italy to use foreign rules to prove other crimes. The investigation or proof of the crime in the country in which rules were broken is irrelevant.”

Officials for JPMorgan, Deutsche Bank and UBS declined to comment. A spokesman for Depfa wasn’t immediately available to comment.

Interest-Rate Swaps

The securities swapped a fixed rate of interest on 1.7 billion euros of bonds and derivatives for a variable rate. The banks misled the city on the advantages of the bonds and derivatives by omitting to show the client the costs, prosecutors said in the court documents.

The police seized 92.3 million euros from JPMorgan and Depfa, 84.6 million euros from Deutsche Bank, and 75.8 million from UBS, according to court filings. Robledo’s request to seize the assets was approved by judge Giuseppe Vanore. JPMorgan and UBS have since deposited cash to free up the assets.

“A breach to me doesn’t seem to be noteworthy in what they are seeking to prove,” said Chris Brennan, a regulatory lawyer at London-based Barlow Lyde & Gilbert. Still, “if there is evidence in a foreign court then I suppose it puts the FSA on notice that there may have been a breach of compliance.”

FSA spokesman Joseph Eyre declined to comment on the Milan case. “If a decision has been taken beyond the U.K. by an overseas authority, then that’s what they’ve chosen to do,” he said.

600 Municipalities

The assets seized also include those of a former municipality official and a consultant, both of whom are under investigation for collusion with the banks.

Milan is among about 600 Italian municipalities that took out 1,000 derivatives contracts worth a total of 35.5 billion euros, Italy’s Treasury has said. Local governments should take advantage of lower interest rates to renegotiate derivatives contracts to cut their debt servicing costs, the country’s association of financial analysts, Aiaf, said at a Senate hearing today.

“We should act now in order to spare the local authorities potential losses,” said Alfonso Scarano, an Aiaf member who is heading a study into the derivatives trades. The Senate is leading a review of the use of derivatives among local administrations.

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