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Session 2: Launch “Guide on Fighting Abusive Related Party Transactions in Asia”
Sharing international experience: reforms on related party transactions in Italy

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RPTs regulation is a key item of the policy agenda (not only in Italy)

General reasons

- RPTs are one of the most effective channel to “tunnel” wealth outside the firm, especially in companies with a controlling agent.
- The risk of abusive RPTs is one of the most feared dangers by foreign investors.

RPTS’ role in the corporate scandals

- RPTs played an important role in the financial scandals of the beginning of this decade (In Italy: Parmalat, Cirio)

RPTs and the financial crisis

- In the financial crisis, a specific kind of unfair RPTs with companies’ managers (namely in remuneration area) reinforced the policy relevance of such an issue.
- In the current financial markets situation, RPTs can be a further element of risk for investor protection (M&A and group restructuring linked to the crisis).
The regulatory process in Italy

The policy guidelines for the definition of the draft regulation:

- To establish transparency and *fairness* principles which listed companies have to adopt within their internal rules for conducting and approving related party transactions
- To require *disclosure* to the market of material related party transactions (on an ongoing and periodical basis)

The methodology adopted:

- Identification of a set of policy options submitted to:
  - RIA in order to evaluate their cost-benefit balance
  - A “several-steps” consultation process with the market
Market consultation on RPTs’ regulation: the steps

- **Understand the issue**
  - Preliminary consultation with issuers (January 2008)

- **Discuss the policy proposal**
  - April 2008 – Issue of a Consultation Paper with impact analysis of 3 different options
  - June 2008 – Public Hearing aimed at presenting and discussing the proposed draft regulation

- **Feed back**
  - First months if 2009 – Informal meetings with panels of experts and practitioners
  - July 2009 – The new regulation, partially amended in view of market participants’ feedback, has been published for a fast second-round of consultation.
  - October 2009? – adoption of regulation
The Italian draft regulation is based on the following taxonomy of RTPs

<table>
<thead>
<tr>
<th>TIPOLOGY</th>
<th>CRITERIA</th>
<th>RULES</th>
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<tbody>
<tr>
<td>“Material transaction”</td>
<td>- quantitative (5% of capitalization)</td>
<td>On-going and periodical disclosure</td>
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<td></td>
<td>- qualitative (intangible assets goods)</td>
<td>Determining role of independent directors in the entire process</td>
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<td></td>
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<td>(negotiations and approval) with support of independent experts</td>
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<td>When shareholders’ approval is required, whitewash mechanisms should</td>
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<td></td>
<td></td>
<td>apply</td>
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<tr>
<td>“Other transactions”</td>
<td>residual</td>
<td>mandatory non-binding opinions by independent directors with</td>
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<td></td>
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<td>support of independent experts</td>
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<tr>
<td>“Excluded transactions”</td>
<td>- small transactions</td>
<td>No rules</td>
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<td>(on the basis of explicit</td>
<td>- transactions with subsidiaries</td>
<td>Timely communicated to Consob and periodical disclosure (no</td>
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<td>by-law provisions)</td>
<td>- ordinary course of business</td>
<td>procedural rules)</td>
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<td></td>
<td>- stock options</td>
<td>Specific rules (approval by GM)</td>
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What comes out from our work and experience

Where large conflicts of interests are involved, self-regulation and other market-based control mechanisms are usually ineffective

- In Italy, self-regulation on RPTs (Listed Companies Corporate Governance code) produced more formal than actual compliance

- Actual compliance (low on average) has been affected by:
  - (+) Board composition (independent directors and “minority” directors)
  - (+) institutional investors activism (attendance to AGM)
  - (-) pyramiding structure
  - (+) dual class shares
  - No statistically significant effect of ownership concentration and of the nature of controlling agent (SOEs or family)

- Disclosure-only provisions can be circumvented without robust internal control mechanisms and market reactions can be too late
A key issue for regulation is a clear identification of all the elements of Related Party Transactions definition (risks of applying good rules to an empty set)

- IAS principles provide a good basis for the identification of “transactions” and “related parties” but there are some grey areas:
  - Mergers are not explicitly mentioned
  - Controlling shareholders, namely in cases of joint-control situation (coalitions)

- Need to clarify the implementation of the definitions with reference to national context

- Quantitative criteria (based on thresholds) for identifying “material transactions” can be trivial but are effective
Decisional power allocation is relevant but might be ineffective without a complete information process

- independent directors might be better informed than shareholders provided that they are involved “since the beginning” (conduct of negotiations)

- the degree of “independence” of directors plays a crucial role and has to be granted taking into account the specific control structure of different systems

- more generally, board structure and composition should be coherent with an ambitious monitoring and advisory task (the role of board members appointed by minority shareholders)
Regulation of RPTs has to be tailored taking into account the market failures related to the specific context of ownership and control structure and other systemic features

- in Italy: ownership concentration, pyramidal groups, coalitions of major shareholders, State-ownership, weak private enforcement
- an effective disclosure of ownership and control structure (namely of shareholders’ agreements formal and informal) is crucial
- focus the regulation on the most critical transactions, providing more flexible rules for other transactions (e.g. intra-group, “in case of urgencies” and “in the ordinary course of business”)
- strengthen enforcement powers and instruments
Policy implications

- Substantial failure of “self-regulation only” approach in RPTs area asks for a public regulation aimed at establishing procedural and disclosure rules

- But rules cannot be enough:
  - public enforcement is difficult and leaves room to formalistic or weak compliance
  - Code of best practices will still be relevant provided that effective monitoring and “private” enforcement mechanisms are in place
  - the importance of transparency of actual practices: not only “comply or explain” but rather “in any case explain”

- Good corporate governance internal mechanism and strong shareholders activism can play a relevant role to promote individual company’s actual adoption of best practices (not only in RPTs)
The approach adopted for RPTs can serve as a reference for addressing other conflict of interests such as those occurring in freeze-out transactions (i.e. public offers launched by controlling shareholders aimed at de-listing).

In the current hard times, these transactions are increasing and so the risk of minority shareholders’ expropriation.

The role of independent directors can be enhanced in:

- the issuer “opinion” on the offer
- the bargaining with the bidder (including the research for alternatives)
But this is another story......