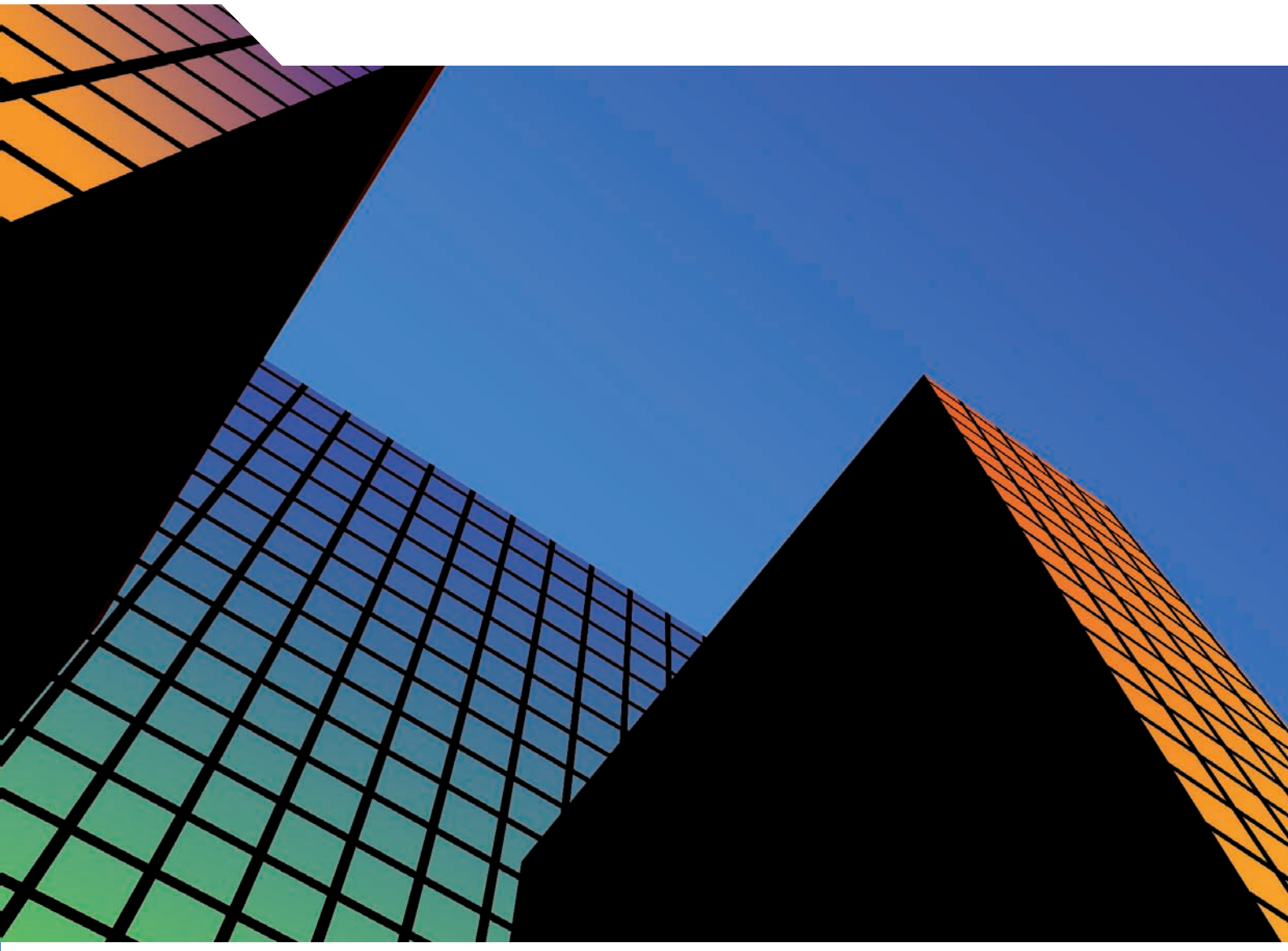
Related Party Transactions and Minority Shareholder Rights



OECD

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Foreword

This report presents the results of the third thematic peer review based on the OECD Principles of Corporate Governance. *The report is focused on the corporate governance framework that manages related party transactions with the aim to protect minority investors. It covers over 30 jurisdictions, including in-depth reviews of Belgium, France, India, Israel,* Italy and India.*

The report is based in part on a questionnaire that was sent to all participating jurisdictions in May 2011. All jurisdictions were invited to respond to a general set of questions so as to provide an overall context within which the review would take place. The five jurisdictions that were subject to the in-depth review were invited to respond to a more extensive set of questions and there was also a visit by the OECD to consult a wider range of market participants.

The report first reviews the experience of the five jurisdictions in managing related party transactions which is set against a general review of legislation in over 30 jurisdictions. The second part comprises the in-depth review of the five jurisdictions. The report was prepared by Grant Kirkpatrick and Daniel Blume with inputs by Akira Nozaki and approved for publication under the authority of the OECD Corporate Governance Committee in December 2011.

The OECD corporate governance peer review process is designed to facilitate effective implementation of the principles and to assist market participants and policy makers to respond to emerging corporate governance risks. The reviews are also forward looking so as to help indentify, at an early stage, key market practices and policy developments that may undermine the quality of corporate governance. The review process is open to OECD and non-OECD jurisdictions alike.

* The statistical data for Israel were supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

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Executive Summary

Around the world, the potential to abuse related party transactions (RPTs) covering both equity and non-equity transactions is viewed as an important policy issue even though they are seldom banned. Rather, jurisdictions have sought to put in place management and approval processes to minimise the negative potential. There is a wide variability across jurisdictions so that this report focuses on the experience of five jurisdictions (Belgium, India, Israel, Italy and France) with supplemental information from 31 others.

While the introduction of IFRS (and therefore IAS 24 for RPTs) around the world has introduced an important standard for transparency, it is not alone sufficient. The reviewed jurisdictions have therefore introduced requirements for ongoing disclosure of material transactions. Defining materiality has been a challenge with indications that quantitative criteria might be more effective. To avoid circumvention, continuous monitoring by the regulator might be necessary.Transactions have also been classed by whether they are on market terms and/or whether they are recurrent. Again, close monitoring appears necessary.

In approving RPTs, great emphasis has been placed on boards' approval, the tendency being for this task to be given to a committee of independent board members. There are often continuing questions about how to ensure effective independence of board members from controlling shareholders. Three approaches have been taken which represent evolving good practice when there are controlling shareholders. First, in a few jurisdictions shareholders have been given a say in approving certain transactions, with interested shareholders excluded. Second, in several jurisdictions minority shareholders are able to vote directly for a board member of their choosing. Third, in some cases a controlling shareholder has a fiduciary duty to other shareholders and the company. An abusive RPT would be against the interests of non-controlling shareholders and thus represent a breach of duty.

Rights need to be enforced and around the world this appears to be deficient. In several of the reviewed jurisdictions steps have now been taken to establish specialised courts and in two, the regulators are now seeking to offset legal fees for derivative shareholder actions. This is an example that could be copied by others.

Around the world, company groups and concentrated ownership are normal, the exceptions being in the United Kingdom, the United States and Australia. Under such conditions, RPTs are mainly with the controlling shareholders and/or with members of a company group. This raises particular problems for managing and classifying RPTs. Some inter-company transactions with 100 per cent owned subsidiaries might present no great threat of abuse but others might be of particular concern. In some jurisdictions law and jurisprudence have come to recognise that the directors of a company owe a duty to the company group. In others, a controlling company must take responsibility for their actions

to the detriment of another group company and in some cases to pay compensation. A wide range of possibilities need to be considered in many jurisdictions with a tradition of focusing only on an individual company.

By and large, the OECD principles deal well with the problems arising with RPTs. However they might need to be adapted in several areas at the time of any revision. First, at present board member duties are restricted to the single enterprise even if the company belongs to a group. Second, the principles do advocate the equitable treatment of shareholders but this might need to be made more specific and cover controlling shareholders.

Assessment and Recommendations

Around the world, the potential to abuse related party transactions (RPTs) covering both equity and non-equity RPTs is viewed as an important policy issue because of some high profile cases that have damaged market integrity through inequitable treatment of shareholders. Jurisdictions have responded in many different ways and efforts to manage such transactions are ongoing. The problems raised center around an acute policy-induced trade-off. On the one hand, the policy process or consensus accepts that related party transactions can be economically beneficial, especially in company groups where there are often developmental arguments that they substitute for under-developed markets and institutions. Therefore, with some exceptions such as loans to directors, RPTs are not banned. Once such an approach is in place it is difficult to change so that there is strong path dependence with reforms often marginal. On the other hand, there is a clear concern that such transactions can be abused by insiders such as executives and controlling shareholders. Indeed, concern to control corporate self-dealing has been a key aspect of the development of corporate law in many countries over the past century. Searching for a balance is ongoing as institutions and economies change. However, as this report demonstrates, the third corporate governance peer review of the OECD Corporate Governance Committee, effective overall solutions have still not been found in many jurisdictions. There is thus a great need to exchange experiences.

Judged by the frequency of reported RPTs, they are quite common around the world, but empirical work also points to shareholder scepticism: just reporting high levels of RPTs can lead to lower valuations. Many jurisdictions have now moved to International Financial Reporting Standards (IFRS, and US Generally Agreed Accounting Principles, GAAP) making definitions of related parties and RPTs standardised. What is less known is how interpretations by the audit and accounting professions vary. Anecdotal evidence indicates that international variation might be quite significant so that efforts to improve the audit and accounting profession need to be continued.

This report focuses on the revenue and balance sheet aspects of RPTs. It does not touch upon to any extent what for several jurisdictions is a pressing political issue: executive remuneration. Remuneration decisions often involve inside controllers (*i.e.* executives) in determining contracts and processes in a non-market setting and is therefore recognised as a RPT by IFRS. It is not handled in any detail in this report for two reasons. First, disclosure standards are now quite specialised and in an increasing number of cases shareholders are directly involved in some form of approval (*e.g.* say on pay) but this is not often true for other RPTs. Second, the issue has been covered by the Committee's first peer review so that another detailed study is not warranted at this stage.

In view of the complex jurisdiction-specific arrangements in place to deal with RPTs, this report is built around the experiences of five jurisdictions (**Belgium**, **India**, **Israel**, **Italy** and **France**) with more general information provided by 31 others. In brief, all five

jurisdictions have made progress in a number of specific areas related to management of RPTs. However, what still appears lacking in many cases is the overall consistency of the framework, with some measures not fully supported by other aspects of the framework. The issues can be dealt with under the general headings of disclosure, board approval processes and controls, shareholder inputs and enforcement with reference to the *OECD Principles of Corporate Governance* in assessing the range of practices.

With respect to disclosure and transparency, the introduction of IFRS has been a major step forward with respect to *ex post* financial reporting and transparency but must be accompanied by other measures such as requirements for ongoing disclosure of material transactions. Such disclosures need not follow IFRS but can be more policy oriented. In the reviewed jurisdictions, a number have sought to make disclosure more informative by separating RPTs according to their materiality and conditions, and by requiring ongoing disclosure. Recurrent transactions on "market terms" are often disclosed only in periodic reports while material transactions are subject to ongoing disclosure requirements. This is the case for example in **Italy** while **Israel**, and **France** which do not have materiality thresholds have had an issue to ensure that disclosure leads to more useful information for the markets.

Materiality thresholds are clearly necessary in establishing an efficient management regime for RPTs. The experience in **Italy** was that qualitative criteria, while superior in principle, did not work well in practice so that they had to replace it with quantitative criteria such as 5 per cent of different balance sheet items. However in the case of pyramids the ratio for materiality is 2.5 per cent reflecting the stronger incentives to abuse RPTs. Further, disclosure is required also for homogeneous transactions entered into with the same related party which, although not individually, reach the materiality threshold when considered cumulatively. However, such essentially arbitrary criteria carries the risk of manipulation by companies so that it needs to be underpinned by actions such as requiring continued reporting of transactions below the limit to the regulator.

All the reviewed jurisdictions have had to deal with transactions within company groups that are RPTs: they are all characterised by extensive and sometimes complex company groups and also by concentrated ownership. They are thus very similar to most of the Committee's participating jurisdictions with the exception of Australia, the United Kingdom and the United States. As a result, most RPTs are either with controlling shareholders or with other companies controlled by such shareholders. Disclosure of transactions with other group companies are exempted from ongoing reporting and are subject to special approval procedures if they are recurrent and on market terms, but other transactions are handled differently. However, market participants are somewhat unsure in some countries such as **France** and **Israel** that important transactions might thereby be concealed. In addition, a number of experts agree that disclosure about the nature, rationale and structure of corporate groups is not reported fully in one place, such as in the corporate governance statement. Other issues regarding company groups are discussed below.

Boards have the primary role in the approval of RPTs (or at least a sub-set of them) both in the reviewed economies and more generally among the Committee's participants, but there are significant differences in board structures and processes. **Belgium**, **India**, **Israel** and **Italy** all place the first responsibility on an audit or specialised committee of the board comprising a majority of independent directors and this appears to be emerging as a good practice more generally. In **Belgium** and **Italy** there is also a statutory right to be able to use

independent experts to help with valuation issues, etc. and this might be good practice especially for material transactions. Some such as **Italy** and **India** also call for public policy statements by the company about processes and policies to be followed in approving RPTs. Disclosure of company policy appears to be evolving as a good practice. Intra-group transactions might not be approved by such a committee but it might nevertheless be called upon to determine net benefits accruing to the company from group membership.

The importance of independent board members around the word in approving RPTs does raise questions about whether they are really independent, and if so, for how long. There is by now a disconcerting body of research to suggest that in companies with concentrated ownership they might evolve to become more in the way of advisors to controlling shareholders (*e.g.* **India**) than company monitors. The question of how to underpin their independence has been explicitly addressed by both **Italy** and **Israel** where minority shareholders have some rights to nominate and elect directly independent directors. For this system to work it is clear that regulators must have the right to determine who is a minority shareholder. Directors' liability and culture are also important but the bottom line appears to be that some shareholder involvement might be emerging as good practice and not only in jurisdictions characterised by concentrated ownership. However, that should not be in conflict with accepted standards with respect to directors' duties and the responsibilities of the board as a whole.

A crucial issue demonstrated by the five reviewed jurisdictions is the definition of the duty of loyalty for directors in the context of company groups. Many if not nearly all company groups are run by a central unit or owner that can also determine the allocation of commercial opportunities between group companies. It is common place for group companies to also assist or "prop" other group companies to the potential detriment in the immediate term of their own shareholders. Normally the duty of loyalty is defined with respect to the company and its shareholders and not to other companies. The issue thrown up by the five reviews is how to combine this duty with the reality that company policy is being determined elsewhere. Moreover, there is the empirical question of whether an independent director is likely to stand against policy determined on a group basis by the very shareholders who have often elected them?

Belgium, **Italy** and **France** have addressed these issues through both law and jurisprudence but **Israel** and **India** have only made some regulatory adjustments to the situation. In the first three jurisdictions, the interest of the group is recognised so that the duties of directors must also take into account the likely benefits from group membership. This could be over a year and then the question of compensation for the company arises. Or it may be over a longer period against which a potential loss must be offset, a critical decision for directors dealing with intra-group RPTs. In the case of France, while the law does not specifically address company groups and the interest of the group, most related party transactions within company groups are subject to France's framework for review and approval of regulated RPTs. Jurisprudence has established that the interests of the group should be taken into account within the penal framework relating to misuse of corporate assets. Whatever approach is taken, it would appear good practice to formalise the *de facto* situation especially if emphasis is given to independent directors to approve RPTs. This might also involve recognition of the liability of the board of a controlling company towards a subsidiary but one with a different set of shareholders.

In view of the need to categorise RPTs for purposes of approval and the reliance on independent directors that may not work every time and under all conditions, it appears to be important to underpin the checks and balances with direct resort to shareholder approval under some conditions. This is indeed universal practice with regard to equity RPTs but less common among Committee participants for other transactions. However, clearly in the context of concentrated ownership voting *per se* is not enough. Thus **Italy** and **Israel** and to some extent, on an *ex post* basis, **France**, call for approval only by disinterested shareholders, otherwise called the majority of the minority. However, the regulator clearly has to be in the position to be able to determine who is a disinterested shareholder. **Israel** has also had to recognise another necessary policy trade-off. Where there is a small free float there is always a possibility of hold-up by some minority shareholders who can abuse their position.

The instance of controlling shareholders and groups has in some jurisdictions led to the concept of duties to other shareholders and in some instances to the company. For instance, **Israel** has an explicit duty of controlling shareholders to other shareholders; **Belgium**, **France**, and **Italy** have provisions concerning the abuse of other shareholders by a majority investor. **India** also recognises oppression by controlling shareholders with 393 cases lodged in 2010 However, all rights need enforcement, either public or private, and this appears weak: very few cases if any are brought each year in the reviewed jurisdictions. In particular, derivative law suits are rare since financial incentives are lacking (*i.e.* litigants might have to cover all the costs of the action but awards are paid to the company). However both **Israel** and **India** have taken or propose to take steps to improve the situation: in **Israel** a specialised court has been established and the regulator can and does support derivative and other actions financially: in **India** the security regulator established a fund to support derivative suits financially. **France** has some limited powers of discovery in which a judge can require the release of documents to litigants. Efficient and effective public enforcement appears important as market mechanisms remain limited in jurisdictions with concentrated ownership.

The corporate governance framework that concerns management and control of RPTs needs to be consistent and coherent: there is not just one silver bullet that will serve to protect minority rights in the presence of powerful insiders and potentially abusive RPTs. Thus independent directors might need to be supported by a shareholder role, but this will not be possible without an effective voting system. Better defined duties of directors and even of controlling boards will not be effective without private and public enforcement.

The review of the five jurisdictions indicates that the current principles cover the issues quite well but that there is also a need to deal with emerging good practices in a future review and with some uncovered issues. In particular, the OECD principles might need to consider more fully the role of company groups in determining the duties of directors. At present the principles argue that the duty is to the firm yet in three of the reviewed jurisdictions, and in some others, there is also a duty of some form to the group as a whole. There is also a need to consider not just the rights of shareholders but in some cases also their duties, such as the potential for a duty of majority shareholders to other shareholders and the company. A need to cover hold-ups by minority shareholders might also be considered. The broad reference by Principle III.A.2 to effective means of redress might also need to be complemented by other principles of enforcement.

In sum, with respect to RPTs the five reviewed jurisdictions have all taken important steps to deal with them in the context of concentrated ownership and company groups. They reflect and contribute to evolving good practices that might have to be considered in the principles. However, more needs to be done to ensure a coherent framework for dealing with RPTs covering not only shareholder rights but also responsibilities and better means of enforcement.

PART I

Overall Situation and Lessons from the Reviewed Economies

PART I

Chapter 1

Managing Related Party Transactions: A Review of Practices

This chapter reviews the experience of five jurisdictions (Belgium, France, India, Israel, and Italy) in managing related party transactions and is set against a general review of legislation in over 30 jurisdictions. The chapter presents a synthesis of the experiences in the reviewed economies and considers the applicability of the OECD Principles of Corporate Governance. *It also notes the measures that appear to have worked and the complementary features of the corporate governance system that may have contributed to this success. Finally, the chapter considers whether the OECD principles adequately deal with the issues surrounding RPTs in these economies.*

Overall setting and objectives of the report

Around the world one of the most commonly heard complaints about corporate behaviour relates to self-dealing transactions by corporate insiders that can either be management, directors and/or controlling entities or shareholders. The *OECD's Asian Roundtable* has identified them as a major issue (OECD, 2009), and so have the *Corporate Governance Roundtables* in Latin America (OECD, 2003), which is currently conducting a review of experience, and MENA (OECD, 2005). The issue is not confined to these regions: the most recent *Green Paper of the European Commission* (2011b) asks whether minority shareholders need more protection against related party transactions (RPTs) and if so, what measures could be taken (see European Commission, 2011c). At least three of the reviewed countries have either introduced new regulations for transparency and approval (**Italy**) or are considering the issues (**France**, **India**). The others have taken measures in the recent past.

The nature of the perceived problem varies across countries and regions. In some economies, self-dealing refers to executive compensation, and indeed these are treated by International Financial Reporting Standards (IFRS) as RPTs, since the executives are often in a position to exercise control.[1] Specialised reporting systems and increasing shareholder input around the world concerning executive remuneration were investigated in the Committee's first peer review (OECD, 2011) and so will only be treated tangentially in this report. In other countries and regions, the issues of concern relate to transactions and the movement of resources between the company and its major shareholders either directly or indirectly. Denial of corporate opportunity by controlling shareholders is also frequently encountered as they shift new opportunities to other business entities they control. Either way, minority shareholders view their rights to equitable treatment as either violated or threatened. It is these issues that the Committee chose for its third peer review: related party transactions in the context of minority protection.

It should be noted that many of the problems in this area arise from the decision by policy makers to permit RPTs. It is true that some are now banned outright, especially loans to executives and directors where abuse in the past has been significant (*e.g.* WorldCom). However, in other cases, legal and regulatory frameworks around the world implicitly or explicitly acknowledge that RPTs could be productive and serve to increase corporate value. They are therefore permitted, although the threat of abuse of minority rights is also acknowledged. A balance has to be struck but this appears difficult in a world increasingly characterised by company groups with, in some cases, fluid boundaries and different shareholders.

This report, the third in the Committee's peer reviews, examines five economies in depth: **Belgium**, **France**, **India**, **Israel**, and **Italy**. The first section of Part I presents a synthesis of the experience in the reviewed economies and considers the applicability of the principles. The section notes the measures that appear to have worked and the complementary features of the corporate governance system that may have contributed to

this success. It will therefore aid policy makers to identify important ideas and practices from other economies and also highlight complementary measures that would need to be considered before seeking to transplant a practice from other economies. Finally, the section considers whether the OECD principles adequately deal with the issues surrounding RPTs in these economies. The second section presents a general overview of practices in the participating economies of the Committee. It is based on Part I of the questionnaire that has been completed by 31 economies. An annex briefly reviews the results of empirical work about whether RPTs are actually to the detriment of minority shareholders in a number of jurisdictions. There is evidence that they are in many cases to their detriment, but there are as always with empirical work in corporate governance a number of caveats. The five peer reviews are presented in Part II of the report.

Lessons from the reviewed economies

The five reviewed economies are all characterised by concentrated ownership and control and by long-standing company groups, although perhaps less so in **France**. They are therefore similar to many participating economies in the Committee, with the exception of **Australia**, the **United Kingdom**, and the **United States**. In such economies the issue of minority protection concerns self-dealing by controlling shareholders, either directly or through company groups. Self-dealing by insiders such as executives is much less important with major shareholders exercising control, although executive remuneration and golden parachutes are an issue of shareholders' concern in **France**.[2] Indeed, the five countries (especially **India** and **Italy**) all indicate a high level of RPTs with either controlling shareholders or affiliated companies. The key transactions vary over time but financing operations, credit guarantees, transfers of property, etc., are particularly important although recurring transactions at "market prices" involving goods and services might be under-reported due to reporting thresholds and exemptions for those on "market terms". The five jurisdictions only ban some RPTs such as loans to directors and the placement of new securities. They therefore implicitly accept that such transactions can be legitimate and raise efficiency, particularly in company groups. That means that suitable policies must be in place to manage and approve RPTs.

All the reviewed economies appear to have moved from controlling transactions to setting the general outlines of the approvals process and its disclosure. As part of this, they have divided RPTs into those that they consider as benign (on market terms, recurrent, etc.) from those that they regard as potentially problematic (large transactions, non-recurrent, potentially not subject to a market test or only with difficulty). On the other hand, enforcement processes and redress for minority shareholders are widely different in part because of the efficiency of the legal systems and also limits on regulatory resources.

The key elements of managing RPTs include definition, regulation and disclosure, detection and monitoring approval processes and sanctions. In dealing with each of these elements, different techniques have been adopted depending on the circumstances, political considerations and in some cases history (*i.e.* path dependence).

Definition, disclosure and transparency

All economies have adopted IAS 24 to define RPTs and related parties for the purposes of financial reporting, with the exception of **India**.[3] However, the latter is in the process of introducing IFRS and the domestic standard is broadly similar. For the sake of transparency, each jurisdiction has had to develop more detailed regulations regarding

which transactions to disclose on a continuous basis, how transactions should be aggregated and whether and how to separate recurrent transactions in the normal course of business (*i.e.* at market prices) from those regarded as special, non-market, etc. This leaves substantial discretion to the company and its auditors. It is here that investors have sometimes argued that there is a significant gap between disclosure and transparency (*e.g.* Hermes, 2009).

For example, **Italy** has introduced a proportionate approach differentiating between material and immaterial transactions. There is a general procedure for RPTs which are below the materiality threshold and a special procedure for material transactions that must be disclosed promptly (within 7 days). Material RPTs are identified using quantitative criteria defined in the regulation. Three class tests are specified in line with the possible characteristics of the transaction: one refers to the ratio between the consideration of the transaction and the market value of the listed company; the other ones regard the ratio between assets and liabilities of the object of the transaction and that of the listed company. A transaction is to be considered material when at least one of the materiality indices exceeds the 5 per cent threshold, or a lower threshold that companies may establish, leaving private ordering as an option. An anti-elusive provision requires disclosure of homogeneous transactions entered into with the same related party which, although not individually, reach the materiality threshold when considered cumulatively. Further, a reduced threshold of 2.5 per cent applies to pyramids in the case of transactions with the parent, reflecting the stronger incentives to abuse RPTs. For some large Italian companies, the value of a transaction that is considered material might be several hundred million euros. As in other reviewed economies, the review and disclosure regime may be waived for intra-company transactions entered into with subsidiaries and associates provided some conditions are fulfilled such as absence of conflicting interests by other related parties.

The other reviewed economies have similar provisions although in **France** there is no materiality threshold. Two general issues arise. First, there is the question of the threshold. While a threshold of 5 per cent might look immaterial for a company, as with executive remuneration, immaterial transactions might appear to the public as exorbitant and constitute nothing but exploitation of the system. Second, the ability of major shareholders and managements to establish what is a normal transaction might open up a large space for abuse of minority rights. The key question then is who is overseeing the process of approval.

The role of independent directors in approving RPTs

All the reviewed economies with the exception of **France** make extensive use of independent board members to approve transactions, sometimes aided by independent experts. They require the use of a committee of independent directors such as an internal control committee or the audit committee to approve transactions, especially those regarded as material and non recurrent, or on non-market terms. This does not relieve the full board from taking responsibility. In **France**, independent directors do not have a *de jure* role and an important role is assigned to the external auditor.

Although both the **United States** and the **United Kingdom** pioneered the use of independent directors to approve self-dealing transactions (and others where there is a conflict of interest), their use in controlled companies is much more problematic since they owe their position to controlling shareholders. This might be even more limiting than dependence on dominant management that relies on diffused shareholders for *de facto*

power. The potential danger is clear in the case of **India** where the chapter indicates that 40 per cent of posts for independent directors are concentrated within a single business group. Moreover, surveys point to the fact that many independent directors regard their primary duty as advising the controlling shareholder, with monitoring being a very low priority that many considered they were not in any case able to perform (Khanna and Mathew, 2010). The review of **Belgium** posed the question whether independent directors of a company would happily denounce constraints emanating from parent companies on which they depend.

Director liability is often put forward as a means of ensuring that directors and especially independents fulfil their duties. However, as pointed out by many legal scholars (*e.g.* Cheffins *et al.*, 2006) the actual legal liability is quite limited and enforcement is weak. The same is true in the reviewed economies. Moreover, as noted below, the need to consider company groups has introduced a wide ranging defence for directors. The case of Satyam in **India** indicates that liability is, nevertheless still important. Independent directors approved significant RPTs seemingly oblivious to commercial logic and not having commissioned their own due diligence. It only took very little time for analysts to lambast the transactions and for the share price to collapse. The scandal, however, has been a shock for independent directors, with over 620 resignations in the following year as they reassessed their liability and damage to reputations. Indeed, liability is sometimes the least important sanction. Thus in **Belgium**, **France** and **Israel**, it is reported that independent directors are very concerned about their reputations, which in a small closely knit community is important.[4]

There are some safeguards for independent directors in the form of numbers. Thus, in **India** 50 per cent will be independent directors if the chairman is an executive director or a representative of the controlling shareholder; otherwise it is a third. There is also at least one independent director from any holding company on the board of a material non-listed subsidiary. **France** and **Israel** have, however, taken the opposite approach. Their voluntary Corporate Governance Codes recommend that at least a half of the board be independent in a company with dispersed shareholding but at least one third in a company with a controlling shareholder. They appear to justify this by the need for a major shareholder to be able to exercise control, and potential negative effects might be offset by improved voting rights for minority shareholders described in the next paragraph.

Another protection of independence is via the nomination and election of board members. Of the reviewed countries, only **Italy** and **Israel** have the potential for independent directors to be elected by minority shareholders to the board, and also to the board of auditors in **Italy**. However, the majority of companies only have one such director. In **Israel**, since 2011 a majority of non-controlling shareholder votes is required to appoint two independent directors (previously a third of the vote) or that the number opposing appointment is less than 2 per cent of total voting rights in the company. Moreover, the controlling shareholder is no longer able to prevent the appointment of an independent director for a further three year term.

The **Israeli** example of an alternative majority system for directors appointed by minority shareholders illustrates a concern for many policy makers: the need to avoid hold-up or greenmail by some minority shareholders. This has been a problem in other economies. For example, **Germany** has had to take steps to deal with the problem of hold-ups by some small investors. The problem might be particularly important in the case of jurisdictions and companies with small free floats.

A back-up or a check and balance for independent directors is to allow disinterested shareholders a direct role in approval of at least some RPTs. This is the case in **Italy**, **Israel** and to some extent, *ex post*, in **France**. **India** is reported to be considering a role for shareholders. In **Italy**, some RPTs are approved by the shareholders. If a committee of independent directors disapproves a material transaction and the board nevertheless wants to proceed, the transaction can then be approved by a meeting of shareholders with the favourable vote of disinterested shareholders (majority of the minority). This approval is an *ex ante* procedure but in **France** it is *ex post* since management has the general authority to enter into related party agreements before authorisation.[5] For the system of disinterested voting to work, the regulator must have the power to determine who is classed as minority shareholder. This is the case in **Italy** and **Israel** but in **France** it is the legal obligation of interested parties to inform the chair and to not participate in the annual approval of regulated RPTs (*i.e.* regulated agreements).

Israel has a role for shareholders with respect to approving extraordinary transactions[6] that must first be approved by the audit committee and the board. To obtain approval from the General Meeting, the transaction must attract the support of a majority of the votes of the shareholders (it used to be one third) who are not classified as a controlling shareholder or an associate thereof. However, the transaction may also be approved even without a majority of the votes of disinterested shareholders if the level of opposing votes among these shareholders does not exceed 2 per cent of total voting rights (previously 1 per cent). The provision appears to be directed against abuse of minority rights.

Dealing with company groups and the implications for directors duties

Company groups are well established in all reviewed economies and, with the exception of **India** in some areas and **Israel**, company law and financial regulations make special provisions for them. However, the provisions come nowhere near the Konzernrecht that is practiced in Germany (and in other European countries) and therefore in some areas might lack coherence (European Commission, 2011a). Company groups are taken into account via accounting and transparency rules and through the definition of directors' duties and thus a basis for enforcement.

The review and disclosure regime may be waived for intra-company transactions in **Italy** and **Belgium**. In **Italy** the waiver can apply to subsidiaries and associates provided there is no significant interest by the controlling or other related party (*i.e.* the cash flow rights are lower in the benefiting company so that there is no rationale for the transaction purely on wealth capture grounds). There is also an opt-out provision from procedures and disclosures regarding transactions in the ordinary course of business and on market terms. When material, they must be notified to the regulator and synthetically described in the half year or annual report so that there is a basis for monitoring policy.

The issue of company groups is more complex when it comes to defining directors duties that may form the basis for public or private enforcement action. In the case of a single standing company, the duties of loyalty and care to the company are more or less clear and in force in nearly all countries.[7] However, a controlling group changes things considerably, especially when a controlling shareholder is acting via a group. Is the duty of loyalty to the individual company or to a wider group? The review of **Belgium** references a case where a company transferred money to a failing subsidiary so that shareholders in the

parent company that incurred a loss and the market regulator sued directors for breach of loyalty. The court ruled that directors have a duty also to the group under certain conditions. Similar cases are reported for **France**.

In both **France** and **Belgium** and to some extent **Italy** a jurisprudence doctrine has been followed that can be loosely termed the *Rozenblum doctrine* or a compensation doctrine. The doctrine admits a group defence for directors regarding loyalty if there is: a group characterised by capital links between the companies; there is a strong, effective business integration among the companies of the group; and financial support for one company to another must have an economic *quid pro quo* and may not break the balance of mutual commitments between the concerned companies; the support from the company must not exceed its possibilities or in other words it should not create a risk of bankruptcy for the company (see Conac *et al*., 2007, p. 519). The question is where does this leave minority rights protection when they are not stockholders in the other company? Where does this leave the duty of loyalty for board members when they must set their duty against a theoretical balance of advantages to the company in the group? For **India** and **Israel** where directors' duties are clearly defined in terms of the interests of their companies, the question is somewhat different. How should directors duties be defined when company groups are in fact widespread with strong centralised control. The conflict of interest of board members is not only with respect to their own financial benefit but with respect to centrally run company groups where allocation or denial of opportunities might occur every day.

While being characterised by widespread company groups, **India** and **Israel** have made only some provisions in their laws and regulations for them. A certain exception is where IFRS has been adopted: IAS 24 and IAS 27 require disclosure about related parties and the group for consolidation purposes. **India** plans to introduce IFRS shortly but domestic standards are already very close to IAS 24. More generally, in the European context one study has noted a lack of transparency: "Although there are numerous and detailed rules on group information, there is no rule requiring an annual report, corporate governance statement or company website to describe the main features of a company's group structure in a clear and investor-friendly manner. Currently, for example, some companies' annual reports contain a chapter on changes in group structure without providing information on the existing group structure. It should also be assessed if a list of subsidiaries should be available for stakeholders" (European Commission, 2011a). Normally, intra-group transactions must be described in the annual report, but it might be quite difficult for shareholders to understand the real meaning of such transactions (and to make any judgment if necessary) without any information of a company's group structure in a clear and investor-friendly manner. **Israel** requires disclosure by non-listed companies that are part of a company group.

Enforcement

In all reviewed countries, formal enforcement appears to be weak. In many ways reliance is on market mechanisms that are based on extensive disclosure obligations about RPTs. This leaves shareholders open to posing embarrassing questions to the board and or selling their shares. In some countries such as **Belgium** and **France**, bad publicity is said to be an enforcement mechanism in itself, but the basis rests on the tight social structure among elites. Reputations might also be important as in **India** where in the wake of the Satyam scandal many independent directors resigned.

Box 1.1. **The issue of company groups in the EU**

The issue of company groups has resurfaced from time to time in the EU, most recently from a reflection group on the future of company law (European Commission, 2011a). As illustrated in the reviews of Italy, France and Belgium, some EU economies already make provisions for company groups and the same applies to the Nordic countries. Similar to the case of an individual company, the Group stated that the parent corporation could be vested with a right and also a duty to manage the group and its constituent companies in accordance with the overall interest of the group. However, some members of the Reflection Group thought that the board of the parent company should have a duty to manage the group only if they choose. The directors and managers of EU subsidiaries would be allowed, subject to certain safeguards, but possibly not forced, to take into account the interest of the group (p. 60). A major advantage of the recognition of the interest of the group is that it provides more clarity to the directors of the subsidiary as to which transaction or operation they can approve.

A few countries have adopted the German model (Portugal, Hungary, the Czech Republic and Slovenia, and outside the EU, Brazil and Croatia) and have established an autonomous body of company group law. There are in fact two types of German groups: factual and contractual. Under factual control, a company owns stocks or voting rights in another company. The negative impact of any influence by the parent must be disclosed, audited and compensated. Any shareholder can request a special investigation by the financial market regulator if the board declares that the negative influence was not properly compensated. The parent and its directors are liable not only to the subsidiary for negative influence but also to the shareholders of the subsidiary if they suffered an additional loss such as through a fall in the share price of the company. The directors and members of the supervisory board of the subsidiary may be liable separately and jointly to the subsidiary if they "covered up" a negative influence of the parent without compensation.

A contractual group is created by a contract of control with the management board of a company binding it to follow directions of the parent and usually also transferring all profits from the subsidiary. Shareholder approval is required for both companies. The parent company must cover the losses of the subsidiary on a yearly basis thereby maintaining capital. Creditors and shareholders are protected; the latter become preference shareholders and receive a fixed dividend. They also have the right to have their shares bought by the parent at a fair price. Compensation might be in the shares of the parent or the grand parent company, or in cash.

However, while group company law might facilitate the operation of company groups there are questions about minority protection. Thus the reflection group noted the work of others (Kraakman *et al.*, 2009, p. 177) when it said "whether the German regime is effective in protecting minority shareholders remains unclear. In the past, parent companies usually ignored the indemnification or compensation requirements – unless the subsidiary was insolvent, in which case not much was left for minority shareholders. Nowadays, improvements in business practices and an increase in litigation risks seem to have resulted in a more adequate treatment of minority shareholders".

Israel has introduced some novel elements so that the securities regulator is able to financially support derivative suits in addition to class actions by individuals for breaches of duty by directors and damages stemming from RPTs. With respect to derivative suits, the support addresses the key issue that there is no financial incentive for shareholders to launch a process, the costs of which they invariably bear alone if the case is lost. More

importantly, the resolution of such suits has been facilitated by the establishment of a special department of one of the courts which will hear, amongst others, such cases. In its first decision in May 2011, they ruled that despite passing the approval process (audit committee, board and shareholder approval) a RPT still needed to pass a fairness test: the minority shareholders were entitled to the best possible price.

In all the reviewed jurisdictions, the securities regulators appear to scrutinise disclosures of material RPTs and to request improvements if necessary. As an example, the **Israeli** regulator reviewed 470 transactions in 2010, 93 per cent of them being approved. In both **Israel** and **Italy** they also scrutinise whether shareholders have been correctly classified as interested or disinterested.

Minority protection: The duties of controlling shareholders

A key feature in all the reviewed economies with the partial exception of **India** is the duty of controlling shareholders to other shareholders not to infringe their minority rights: to not abuse the power of the majority. Such a duty opens another legal way of disciplining RPTs. Such a duty is linked to specific enforceable action such as in **France** where the abuse of corporate property via a RPT (abus de biens sociaux) is commonly used as a basis for enforcement. Indeed, it is a criminal offense with a large number of cases each year though it is not known how many concern RPTs in listed companies.[8]

However, Conac *et al.* (2007) find that in the case of both **France** and **Italy**, the duty of controlling shareholders is more theoretical than real: in practice "the widely held view among Italian legal scholars is that, outside the context of groups, majority shareholders are not liable for damages stemming from the latter's behaviour qua shareholders. Further, if the dominant shareholder's behaviour has harmed the corporation, a court would deny minority shareholders' standing to sue derivatively". Furthermore: "On its face, French law is friendlier to minority shareholders than Italy's. The controlling shareholder can be held liable towards the minority shareholder if she acted with the intention to harm. The standard, however, is very demanding and plaintiff shareholders seldom win in such cases" (p. 510). There is an oppression remedy in **India** with 393 cases lodged in 2009/10. However the process appears to be quite long with 919 cases pending as at 31 March 2010.

In sum, all the reviewed economies have certain good practices but they don't always combine as a seamless system along the lines argued by the *OECD Asian Corporate Governance Roundtable* (Box 1.2). Enforcement is a key issue but so are checks and balances with respect to independent directors.

Evaluation of the principles

The purpose of the peer reviews is not only to examine implementation in jurisdictions participating in the Committee but also to evaluate the principles themselves and whether they remain relevant in evolving circumstances of participating economies. Two areas where the Committee might need to reconsider the principles concern company groups and the duties of one set of shareholders to others.

The key principles are:

- Principle III.A.2 (*minority shareholders should be protected from abusive actions by, or in the interest of, controlling shareholders acting either directly or indirectly, and should have effective means of redress*).

Box 1.2. **The *Asian Roundtable* "*Guide on Fighting Abusive Related Party Transactions*"**

1. The legal definition of "related parties" should refer to control and be broad enough to capture relevant transactions that present a risk of potential abuse. It should be sufficiently harmonised with respect to different bodies of law such as company law, listing rules and accounting standards in each jurisdiction to avoid misunderstanding and an excessive regulatory burden, thereby underpinning better implementation and enforcement.
2. The legal and regulatory framework for "related party transactions" should provide appropriate and effective threshold-based tiers, referring to materiality for disclosure and shareholders' approval and/or board approval of related party transactions according to the risk of potential abuse. It should also take into account regulatory efficiency, weighing the potential costs and benefits.
3. A company should develop and make public a policy to monitor related party transactions that should be subject to an effective system of checks and balances as well as a disclosure process. This can include the possibility for non-controlling shareholders to review the independence of directors in a timely manner.
4. The external auditor should be independent, competent and qualified in order to provide an assurance to the board and shareholders that material information concerning related party transactions is fairly disclosed and alert them to any significant concerns with respect to internal control. The policy framework should support this role effectively.
5. Independent directors should play a central role in monitoring related party transactions, such as designing board approval procedures, conducting investigations and having the possibility for obtaining advice from independent experts. Their role should be supported by the policy framework.
6. Objective judgement in the decision making process of the board should be ensured. This would include giving non-controlling shareholders sufficient influence over the nomination and election of directors, in particular independent directors, and the design of their incentive structures, such as remuneration policy.
7. Where reliance is placed on shareholders' approval, a voting system should be established with a majority of disinterested shareholders for the approval of related party transactions at Shareholder Meetings.
8. The legal and regulatory framework should ensure that legal action, including specialised courts and alternative dispute resolution, does not prohibit minority shareholders from seeking legal redress quickly and cost effectively.
9. A coherent regulatory system dealing with related party transactions, particularly disclosure, board oversight and shareholder approval should be established in each jurisdiction to facilitate implementation and enforcement efforts.

Source: OECD (2009), *Guide on Fighting Abusive Related Party Transactions in Asia*.

- Principle III.C (*members of the board and key executives should be required to disclose to the board whether they, directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the corporation*).
- Principle V.A.5 (*disclosure should include, but not be limited to, material information on … related party transactions*).
- Principle VI.D.6 (*the board should fulfil certain key functions, including … monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions*).

With respect to Principle III.A.2, the most important weakness revealed by the reviews appears to be the lack of effective means of redress. The move to considering corporate group interest might make things even more difficult as board members can justify decisions in many cases by very uncertain claims of a positive balance of group membership. In a legal sense, the protection from abusive actions could be taken to mean a duty of majority shareholders towards minority shareholders or at least not actions to damage their rights. However, the Principles should not be seen as a legal text but more in the way of a normative guide. What is recommended might need to be spelt out more explicitly.

In this context, it might be useful to build out the chapter on the equitable treatment of shareholders to be more explicit about the duties or responsibilities of controlling shareholders to others. It should also be noted that in some jurisdictions the issue has been raised about a small shareholder position being used to the detriment of others. Indeed, the previous peer review on institutional investors did note that in **Germany** there was a general duty of shareholders to the good of the company that would even apply to minority investors.

Principle III.C has proven resilient in the reviews and has been well implemented. However, there is a general question about how it might fully apply in a company group context. It is cast in terms of personal financial advantages for a board member and executives rather than what might be more important: material interest but on behalf of a controlling corporation or shareholder. It might need to extend more clearly to situations where loyalty is affected less by personal enrichment and more by professional considerations such as loyalty to group-initiated policy.

Principle V.A.5 is quite general and is covered by international financial standards that are now widely adopted. The annotations to the disclosure principles more generally notes company groups in several places. Thus for Principle V.A.1 it is stated that "it is therefore important that transactions relating to an entire group of companies be disclosed in line with high quality internationally recognised standards" and Principle V.A.3 covering disclosure of "major share ownership and voting rights" includes in the annotations "the right to such information should also extend to information about the structure of a group of companies and intra-group relations. Such disclosures should make transparent the objectives, nature and structure of the group". It might be worthwhile in the future to consider more general disclosure about company groups perhaps under Principle V.A.8: "Disclosure should include, but not be limited to … governance structures and policies…"

With respect to Principle VI.D.6, all the reviewed economies have established the board as the key institution to control RPTs and manage conflicts of interest. However, the reviews reveal broader questions. The annotations to Principle VI.A (*board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders*) note that the duty of loyalty "… is also a key principle for board members who are working within the structure of a group of companies: even though a company might be controlled by another enterprise, the duty of loyalty for a board member relates to the company and all its shareholders and not to the controlling company of the group". The reviews reveal that this is not the case in some jurisdictions, since the duty of loyalty must also take into account a broader duty to the company group by way in some cases of making judgements about net interests even in the longer term. Further analysis by the Committee might be warranted.

Related party transactions and minority rights around the world

The methodology used by the committee for this and other reviews calls for a general background drawing on the experience of the Committee participants as a whole. The review economies can thus be seen against this broader backdrop. To secure this information, the OECD has relied on answers to Part I of a questionnaire which posed very general questions.

Definition, disclosure and transparency

In all responding economies, corporate law and other related regulatory frameworks covering RPTs vary widely depending, *inter alia,* on the ownership structure and cultural and legal background. However, the majority are characterised by block share ownership with only **Australia**, the **United Kingdom**, and the **United States** having widespread shareholdings (IOSCO, 2007).

With respect to disclosure of RPTs, the majority of committee participants have adopted IFRS and therefore IAS 24, or US GAAP, the two being broadly equivalent. A couple such as **India** are still in the process of adoption but their national standard is similar. Adoption has been put on hold in **Japan**. Hence most would meet the OECD Principle V.A.5 and the Methodology which states that in relation to disclosure: "*The definition of 'related party' is sufficiently broad to capture the kinds of transactions in the jurisdiction that present a real risk of potential abuse, it is not easily avoided and is effectively enforced*."

All **EU** consolidated listed companies have to disclose annually any transactions with directors, senior executives and controlling shareholders in accordance with IAS 24, IFRS being adopted in 2002.[9] Additionally, the Company Law Directives[10] require EU member states to oblige companies (excluding smaller ones) to reveal all material RPTs that have not been concluded under "normal" market conditions. However, with the adoption of IFRS principle-based definitions a premium is placed on domestic auditors and accountants to make the right judgements. There is disquiet in some jurisdictions about whether their interpretations are consistent across countries.

Jurisdictions vary (including reviewed countries) about how and when RPTs should be disclosed, which might vary by the type of transaction such as its size and terms.

Around the world the incidence of RPTs differs widely (Table 1.1) but on the whole they are significant. The table, however, should be read with some caution, especially inter-country comparisons. The table (see CFA Institute, 2009) has been augmented by updates as of May 2010 supplied by the CFA Institute. One possible reason for the wide variation is whether the jurisdiction is characterised by company groups where intra-group transactions fall under IAS 24 and thereby increase reported RPTs. The sample covers major companies in each jurisdiction that may not be representative of smaller ones.

Primary method of the protection of minority shareholders: Board approval

In almost all economies the board is charged with making decisions about RPTs primarily in the interests of all shareholders. Table 1.2 shows the landscape of the primary method of the protection of minority shareholders, denoted by a black circle.[11] Within the decision making process of the board, independent board members, the audit committee, and internal/external auditors (and independent experts if necessary) are required in all jurisdictions to

Table 1.1. **Incidence of reporting of RPTs (excluding remuneration)**

Jurisdiction	What % of companies report significant RPTs (1% of revenue or more) within the last 3 years?	GMI[1] company sample size for each jurisdiction (as of May 2008)	Comments
Australia	20	103	
Austria	22	18[1]	As of May 2010[1]
Canada	7[1]	137 (43 Ontario)	9% for Ontario[1]
France	15	104	
Germany	7	95	
Ireland	47	19[1]	As of May 2010[1]
Italy	8	49	
Japan	3.6	444	
Korea	53	94	
Mexico	46	26	
Netherlands	0	30[1]	As of May 2010[1]
Poland	14	14	
Spain	78	45[1]	As of May 2010[1]
Switzerland	2	49	
Turkey	0	14	
United Kingdom	5.5	382	
United States	7	1 742 (933 Delaware)	
Brazil	16	37[1]	Sample limited to companies where RPT disclosure required[1]
Chile	86	309[1]	Samples are companies adopting the IFRS[1]
China	53	75	
Chinese Taipei	16	79	
Hong Kong (China)	36.5[1]	74[1]	Listed companies sampled by the SFC[1]
India	17[1]	53[1]	[1]
Indonesia	0[1]	15	Indonesian 10% revenue threshold for disclosure of RPTs[1]
Malaysia	7.4	27	
Russian Federation	54	24	
Singapore	26	54[1]	As of May 2010[1]
South Africa	13	46	
Thailand	46	13[1]	As of May 2010[1]

1. GMI (GovernanceMetrics International) generally rates companies only if they are included in a major market index, such as the MSCI Europe/Australasia/Far East Index, Russell 1 000 Index, or S&P 500 Index.

Source: CFA Institute Report, Shareowner rights across markets (2009) and subsequent updates by the CFA Institute. Data for Chile and Hong Kong (China) are supplied by the Committee participants.

perform a significant role in monitoring and approving RPTs to prevent abuse. Many economies have introduced additional requirements or procedures to the board approval process (Table 1.2 third column "Additional requirement/procedure" to "Board approval").

In the board approval procedures, independent board members play an important role around the world (see also IOSCO, 2007) although there are also significant exceptions. Apart from the reviewed economies of **Belgium**, **India**, **Israel** and **Italy**, independent board members play a key role in **Chile**, **Hong Kong (China)**, and **Singapore**. They are required to review the terms and conditions of RPTs often as members of committees. Independence requirements are essential although doubts still remain over the independence from a controlling shareholder in many economies, including those reviewed in this report where the concentrated ownership structure is predominant.

Table 1.2. **Main channels for oversight of non-equity RPTs (excluding remuneration): Selected jurisdictions**

Jurisdiction	Primary method of the protection of minority			
	Board approval		Shareholder approval	
		Additional requirement/procedure		Additional requirement/procedure
Argentina	•	Audit Committee review; board review not required but board review reverses burden of proof. May request report of independent assessment firms (voluntary basis).	–	Only if board does not approve.
Australia			•	The regulator must be given an opportunity to comment on the proposed resolution. Majority of minority approval.
Austria	•	Approved by the supervisory board.	–	–
Belgium	•	Approved by the Independent Committee (3 independent directors and independent experts).	–	–
Brazil	•	Approval of material RPTs based on fiduciary duties.	–	In certain cases (*e.g.* corporate restructuring).
Canada		Management is required to report all RPTs to the auditor. The auditor is required to take several measures to assess the transactions and report back to the board.	•	Obtain a formal valuation from a qualified and independent evaluator. Majority of minority approval.
Chile	•	The Committee of Directors (comprised mainly of independent directors) is required to go through all documents corresponding to RPTs and issue a report in which its findings are properly informed. Board approval required above certain threshold.		Only if board does not approve; ⅔ majority required.
Czech Republic	•	Report of RPTs made by the board.	–	–
Estonia	•	Audit committee can give an advice to the board.	–	–
France	•	Board shall notify auditors of the regulated RPTs that have been approved within one month after the conclusion of the agreement.		Auditors must prepare a special report with the list of RPTs for *ex post* authorisation by shareholders. Majority of minority authorisation.
Germany	–	–	–	–
Greece	•		–	–
Hong Kong (China)			•	Appoint an independent financial advisor to advise the independent board committee, and an independent board committee to advise shareholders. Majority of minority approval.
Hungary	•	Approval by the Supervisory Board/Audit Committee.	–	–
India	•	Audit committee (an independent committee) of the Board is entrusted with the task of reviewing RPTs.	–	–
Indonesia			•	Majority of minority approval.
Israel	•	Approval of the audit committee, the board of directors are also required.	•	Approval of the audit committee, the board of directors are also required. Majority of minority approval.
Italy	•	Opinion by a committee with a majority of independent directors, that may seek the advice of an independent expert of its own choice. Further standards apply when a transaction is material: the committee entirely comprised of independent directors is involved in the negotiation and its opinion is binding.	•	Material transactions rejected by independent directors can be submitted by the board to the (*ex ante*) approval by disinterested shareholders ("Whitewash procedure").
Japan	•		–	–
Korea	•		–	–
Mexico	•	Board review for RPTs above 10% of assets. Close oversight of audit and governance practices' committees.	–	Approval of transactions exceeding 20% of assets, Majority of minority requirement.
Netherlands	–	–	–	–
Norway	•			

Table 1.2. **Main channels for oversight of non-equity RPTs (excluding remuneration): Selected jurisdictions** *(cont.)*

Jurisdiction	Primary method of the protection of minority	
	Board approval	Shareholder approval
	Additional requirement/procedure	Additional requirement/procedure
Poland	• Audit committee.	– –
Singapore	• Oversight by the Audit Committee.	Audit Committee's opinion based on recommendations of the independent financial adviser. Vote on significant transactions.
Slovak Republic	– –	– –
Slovenia	– –	– –
Spain	•	
Switzerland	– –	– –
Turkey	• A report prepared by an appraisal firm for transactions (above the thresholds) should be submitted to the board.	– –
United Kingdom		• Circulate a form prior to entering into material RPTs. Reviewed by independent financial experts. Majority of minority approval.
United States	• Reviewed and evaluated by an appropriate group within the company involved (*e.g.* audit committee).	– –

Source: Responses to OECD questionnaire and Lawrence and Smith (2011).

Besides independent board members, external auditors and advisors/experts have a key role to play in **Canada**, **Chile**, **Hong Kong (China)**, **Singapore** and the reviewed economies, **France** and **Belgium**. These economies focus on professional expertise and stipulate the role of auditors and other financial experts such as qualified and independent valuators in the assessment of the RPTs.

Excluding interested board members is an essential part of the process and is explicitly required in some economies (*e.g.* **Australia** and **Chile**) and in the reviewed economies, **France**, **Israel** and **India**. However, such exclusion also means that a transaction can be authorised by only one director, when all other members are related parties. It might even happen that the transaction cannot be previously authorised by the board when all directors are related parties. As a way to handle these situations, in **France** for example, the auditors will have to mention in their report the cases where most of the directors are related parties, and the general meeting will have to authorise the transactions, albeit as a form of *ex post* approval as the transaction cannot be reversed without a separate court action. In **Italy**, eliminating influence of interested members is normally left to the challenge by internal auditors or other members, while the law requires that the board resolution specifies its ground and the company's interest in carrying out the transaction.

Considering that some RPTs make economic sense, only a few economies (*e.g.* **Brazil**, **Chile**, **France**, **Hong Kong (China)**, **Hungary**, **India**, and the **United States**) have prohibited certain RPTs, especially loans to directors and shareholders while the others leave significant RPTs subject to shareholder approval, although the criteria and framework is far from uniform across countries.

The role of shareholders

Shareholder approval for RPTs (Table 1.2 fourth column: "Shareholder approval") can be regarded as an alternative or complement to the board approval procedure but the practice is not widespread and often only applies to large transactions or those not on market terms. Besides the **United Kingdom** where *ex ante* shareholder approval is mandated for non-routine transactions with directors and large shareholders of listed companies, some economies (*e.g.* **Australia**, **Canada**, **Hong Kong [China]**, and **Italy**) require shareholder approval as an additional control over the potential abuse of RPTs. **Canada**, **France** (on a smaller list of RPTs) and **Italy** go even further and have adopted provisions for approval by non-interested shareholders (sometimes called majority of the minority).

Ensuring shareholders with sufficient information to make a judgement is a key factor of any shareholder approval process. Some economies (especially the reviewed economies) have introduced additional disclosure requirements, such as continuous disclosure of material transactions and/or those not on market terms. Information also includes independent valuations from financial experts or special reports prepared by auditors about the terms and conditions of RPTs (Table 1.2 fifth column: "Additional requirement/ procedure" to "Shareholder approval").

The timing of shareholders approval is not an important consideration in most jurisdictions, although intuitively *ex ante* approval might seem to be more effective in screening RPTs and protecting uninterested shareholders, since the cost of private litigation to compensate the damage caused by the transaction might be prohibitive (Enriques *et al.*, 2009). Regarding liability claims, shareholder approval, whether it is *ex ante* or *ex post*, can shift the burden of proof by the uninterested shareholders in the courts. Regarding individual transactions, on the contrary, it is still unclear how shareholder decisions are enforced in executing transactions, including the possibility whether completed transactions can be unwound with the *ex post* rejection, while shareholders approval needs to have at least the same legal effect as the board decision.

Equity transactions are other potentially damaging RPTs where controlling shareholders could dilute minority shareholders by issuing new equity to themselves at below market prices. Table 1.3 indicates that minority shareholders often have greater rights to deter such self-serving transactions than for other RPTs, possibly because the potential for abuse is much clearer and more directly conflicts with the interest of shareholders.

Table 1.3. **Shareholder approval requirements[2] for different types of RPTs (excluding "say on pay"): Selected jurisdictions**

Jurisdiction	Issue of securities[3]		Asset acquisition or transfer excluding transactions covering all or substantially all of company		Revenue transactions[4]	
		Threshold/comment[1]		Threshold/comment[1]		Threshold/comment[1]
Argentina	Yes[1]	There is a procedure that must be followed.	Yes[1]	There is a procedure that must be followed.	Yes	1% of the corporate capital, as long as said act or agreement exceeds the equivalent of ARS 300 000.
Australia	Yes[1]	No minimum threshold amount (under the listing rules). Subject to exceptions.	Yes[1]	Only applies to substantial (more than 5% of the equity interests of the entity as set out in the latest accounts) acquisitions or disposals by a listed entity or its subsidiary entities. Subject to exceptions.	No	n.a.
Belgium	No	n.a.	No	n.a.	No	n.a.
Brazil	n.a.[1]	Prohibited by the legislation.	No	n.a.	No	n.a.
Canada	No[1]	In excess of 25% of market capitalisation. Subject to exceptions.	No[1]	In excess of 25% of market capitalisation. Subject to exceptions.	No	In excess of 25% of market capitalisation. Subject to exceptions.[1]
Chile	No	n.a.	No[1]	1% of net asset value and 2 000 UF/20 000 UF. If approved by the board of directors. Interested board members are excluded from the decision. If there are not enough members left in the board, shareholders must approve.	No[1]	1% of net asset value and 2 000 UF/20 000 UF. If approved by the board of directors or if the board qualifies as a regular operation related to the business of the company. Interested board members are excluded from the decision. If there are not enough members left in the board, shareholders must approve.
China	Yes	No de minimis waiver.	Yes	5% of the company's latest audited net asset value and CNY 30 million in absolute amount.	Yes	5% of the company's latest audited net asset value and CNY 30 million in absolute amount.
Czech Republic	Yes[1]	The approval is general, regardless of the placement of the issued shares. The pre-emption right of all shareholders applies.	Yes[1]	At least 10% of the company's subscribed registered capital. If the acquisition occurs within three years after incorporation. After this period, only expert appraisal is required.	No	n.a.
Estonia	No	n.a.	No	n.a.	No	n.a.
France	No[1]	n.a. *Ex post* annual vote on auditor RPT report.	No[1]	n.a. *Ex post* annual vote on auditor RPT report.	No[1]	n.a. *Ex post* annual vote on auditor RPT report.
Germany	No	n.a.	No	n.a.	No	n.a.
Greece	No[1]	It is provided in the charter, the board of directors may get shareholder delegation authority to make the decision.	No	n.a.	No	n.a.
Hong Kong (China)	Yes	No de minimis waiver.	Yes	5% of any of the ratio[1]/25% of any of the ratio and consideration of HKD 10 million. Ratio: assets ratio, revenue ratio, consideration ratio or equity capital ratio.	Yes	5% of any of the ratio[1]/25% of any of the ratio and consideration of HKD 10 million. Every three years.
Hungary	No	n.a.	No	n.a.	No	n.a.
India	Yes[1]	Every further issuance of shares other than through rights issue or bonus.	No	n.a.	No	n.a.
Israel	Yes[1]	The approval is general for an extraordinary transaction, regardless of the placement of the issued shares.	Yes[1]	The approval is general for an extraordinary transaction, regardless of the placement of the issued shares.	No	n.a.

Table 1.3. **Shareholder approval requirements[2] for different types of RPTs (excluding "say on pay"): Selected jurisdictions** *(cont.)*

Jurisdiction	Issue of securities[3]		Asset acquisition or transfer excluding transactions covering all or substantially all of company		Revenue transactions[4]	
		Threshold/comment[1]		Threshold/comment[1]		Threshold/comment[1]
Italy	Yes[1]	5% of the lower of market capitalisation or assets. Whitewash (majority of non-interested shareholder approval) applies (in addition to special quorum provided by the Civil Law). If not approved by a committee of independent directors.	No[1]	5% of the lower of market capitalisation or assets. If approved by a committee of independent directors. Otherwise, GM may approve the RPT if the company's internal code and bylaws allow for overcoming the independent directors' veto. Whitewash (majority of non-interested shareholder approval) applies.	No[1]	5% of the lowerof market capitalisation or assets. If approved by a committee of independent directors. Otherwise, GM may approve the RPT if the company's internal code and bylaws allow for overcoming the independent directors' veto. Whitewash (majority of non-interested shareholder approval) applies.
Japan	No	n.a.	No	n.a.	No	n.a.
Korea	No[1]	If allowed in the articles of association which can be changed in shareholder meeting.	No[1]	If approved by the board of directors.	No	If approved by the board of directors.
Mexico	No	n.a.	No	n.a.	No	n.a.
Norway	No	n.a.	No	n.a.	No	n.a.
Poland	No	n.a.	No	n.a.	No	n.a.
Singapore	Yes[1]	No de minimis waiver. This is required in rules on the issue of shares for cash, where placements to certain restricted persons are prohibited without specific shareholders' approval.	Yes[1]	5% of the group's latest audited net tangible assets.	Yes[1]	5% of the group's latest audited net tangible assets. Listed entities may seek a general mandate for recurrent transactions necessary for its day-to-day operations with the annual approval by shareholders.
Slovak Republic	No	n.a.	No	n.a.	No	n.a.
Slovenia	No	n.a.	No	n.a.	No	n.a.
South Korea	No	n.a.	No	n.a.	No	n.a.
Spain	No	n.a.	No	n.a.	No	n.a.
Switzerland	No	n.a.	No	n.a.	No	n.a.
Turkey	Yes[1]	The approval is not required in the registered capital system if the total outstanding share capital after the issuance of securities is below the maximum registered at the Trade Register (the maximum amount is to be approved by shareholders).	Yes[1]	The ISE Index 30 companies are required to ensure shareholders' participation in the discussions that will end up with a change in the capital, management and/or asset structure of the company (*e.g.* divestitures, mergers, share swaps significant asset sales, providing securities, guarantees and liens on behalf of third parties, etc.).	No	n.a.
United Kingdom	Yes	n.a.	Yes	Outside of small transactions or ordinary course of business.	Yes	n.a.
United States – NYSE	Yes[1]	1% of securities outstanding. Reviewed by an appropriate group within the company.	No[1]	Reviewed by an appropriate group within the company.	No	Reviewed by an appropriate group within the company.
United States – NASDAQ	Yes[1]	If security issue is substantial or for asset in which related parties have a substantial interest.	No[1]	Unless in connection with issue of securities.[1]	No	n.a.

1. Where the Yes/No answer is conditional.
2. Limited to the requirement for the individual transaction.The requirement for extraordinary transactions (*i.e.* the transfer of all or substantially all assets, that in effect result in the sale of the company) is excluded.
3. Subscriptions for entitlement under a *pro rata* issue and issues under incentive plans are excluded.
4. Executive pay arrangements and any transaction which would otherwise require shareholder approval regardless of the identity of the counterparty are excluded.

Source: Responses to OECD questionnaire and Lawrence and Smith (2011).

Notes

1. The individual standards are termed international accounting standards (IAS) until revisions are next made when they will become IFRS.
2. For example, the first peer review observed tighter control over remuneration in both Sweden and Brazil in controlled companies. In the latter, companies without controlling shareholders had higher remuneration levels (OECD, 2011).
3. In addition to IAS 24, the adoption of IFRS also involves a number of other highly relevant standards. In particular, IAS 27, IAS 28 and IAS 31 require both a list and a description of the significant investments in subsidiaries, associates and entities under joint control. However, it is important to note that the consolidation perimeter for financial reporting purposes is not entirely coincident with the perimeter of a group (*i.e.* not all companies belonging to a group are included in the consolidated accounts).
4. City-based companies in Italy such as Parmalat should have had the same type of incentives. However, the board was ranked very low in terms of independence.
5. In France the review process relies on the external auditor to prepare a special report setting out relevant information about the non-recurring transactions to be considered for an annual shareholder approval. These can be grouped together for a single vote or separated.
6. An extraordinary transaction is one not in the ordinary course of business, not undertaken under market conditions, or a transaction that is likely to materially influence the profitability of a company, its property or liabilities.
7. The key difference between jurisdictions is more in the nature of whether there is a fiduciary duty which is to act in the best interests of the shareholders and the company. The duty of loyalty is more restricted.
8. In Germany an abusive RPT represents an illegal distribution of capital that can be and is enforced.
9. Regulation on the Application of International Accounting Standards (2002), O.J.L. 243/1.
10. Article 43 in the Fourth Council Directive 78/660/EEC and Article 34 in the Seventh Council Directive 83/349/EEC.
11. Bar (–) denotes that there is no special rule regarding RPTs in general. Approvals might be required for specific transactions, such as shareholder approval requirement for issue of securities, asset acquisition/transfer, revenue transactions (see Table 1.3).

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ANNEX 1.A1

What Is Known about Related Party Transactions? Empirical Studies

Invariably policy makers are challenged to show empirical work to underpin the importance of good corporate governance. Evidence comes from various sources including a series of incidents or even major scandals and can become part of a Regulatory Impact Assessment (OECD, 2009). Indeed, an assessment was carried out by Consob, the **Italian** regulator, as part of its new regulatory changes (see the country review). However, all too often critics and supporters of any changes are thinking of econometric analysis when they call for evidence and not just anecdotal cases. There is some such evidence from the reviewed economies which is suggestive as well as wider evidence from other economies which is very briefly reviewed in this annex.

With formal econometric work the hypotheses must be clear. The material reviewed in this report makes it evident that policy has been driven by the view that RPTs may or may not be to the detriment of minority shareholders. Whether they do will depend on the type of transaction as well on the processes followed for approval. Should the processes of approval fail, the loss to minorities will also depend on the possibilities for enforcement. The type of regression would thus look like:

Minority loss = function (type of RPT, type of approval, minority rights for redress,…) (1)

However, it is clear from Equation 1 that the type of RPT is also endogenous and not something exogenous to the firm. Put another way, the probability of a RPT that is hypothesised to be damaging (one off, material transaction, no market prices or not at market price) is a product of the same type of considerations:

Probability or volume of abusive RPT = function (type of approval, minority rights, regulatory action, cash flow and voting rights of a controlling shareholder,…) (2)

Actions by policy makers suggest that the existence of company groups is regarded as also a factor in Equation 2. In particular, theory and experience with groups (anecdotal evidence) suggests that the probability of a RPT by a controlling shareholder at the expense of minority shareholders is conditioned by the difference between their voting rights and their cash flow rights (*i.e.* wedge): controlling shareholders are hypothesised to shift resources from enterprises in which they have a lower relative cash flow right to enterprises where their claims are greater. Clearly, this incentive will be conditioned by minority rights, probability of facing legal action, etc.

Almost all other corporate governance mechanisms might also be at play, such as transparency and disclosure, board structure, etc. Leaving out any other factor may result in "omitted variable bias": what might be attributed to one variable such as minority protection might be simply because a variable that is highly related to the one included has been left out.

Finding accurate measures of all these variables is not for the weak-hearted. Many times the variable cannot be measured so that a proxy is used instead. This introduces what is termed "errors in variables" and might actually account for the negative results about good corporate governance found in many studies. An even greater problem is measuring the loss to minorities, a problem that courts have to grapple with. To our knowledge it has not been measured but is replaced by a measure of share price performance, *i.e.* Tobin's Q.[1] There are many problems with Tobin's Q, one being that the valuation of a company is related to many factors such as industry cyclicality, and stock market booms and bubbles. The missing equation is therefore:

Minority loss = function (Tobin's Q, industry and cyclical factors) (3)

What is normally estimated is, however, Equation 4 which has serious statistical problems. RPTs have been eliminated by substituting Equation 2 so that the equation is now called a reduced form. Two effects are thus compounded: the probability and/or type of RPTs and the effects on valuation. Clearly a great deal of information is thereby lost. Against this background, the section will briefly review empirical studies of the reviewed economies followed by a more general but brief review of a vast and contradictory literature.

Tobin's Q = function (minority rights or more generally a measure of governance, shareholding and cash flow rights of controller, control variables for industry/company/country,…) (4)

The cash flow/voting rights wedge

There are a number of empirical studies focusing on the relation between the corporation valuation and cash-flow ownership or control-ownership wedge such as via estimation of Equation 4 above. The research question is particularly important in company groups with pyramids where a controlling shareholder often has control of a listed company but with very few claims on its cash flows. This creates an incentive to use RPTs to transfer cash to companies in which their rights are greater. The empirical studies conclude that in general cash-flow ownership and control-ownership wedge is associated with lower firm value respectively, although through which channels this occurs is left open (Table 1.A1.1). There might well be non-abusive RPTs but on balance they are outweighed by those that negatively affect valuations. Another study that shows the cost of debt financing is significantly higher for companies with a wider divergence between the largest ultimate owner's control rights and cash-flow rights (Lin *et al.*, 2011).

Table 1.A1.1. **Empirical studies on the relation between corporate valuation and cash-flow right or control-ownership wedge**

Data sampling	Measurement of corporate valuation and analytical method (left: dependent variables, right: explanatory variables)		Key findings
La Porta *et al.* (2002)			
539 large firms from 27 wealthy economies (the firms have a shareholder who controls over 10%).	Random-effects regressions. Tobin's Q.	Cash-flow right [+]. Common law [+].	Poor shareholder protection is penalised with lower valuations, and *higher cash-flow ownership by the controlling shareholder improves valuation*, especially in countries with poor investor protection.
Claessens *et al.* (2002)			
1 301 publicly traded corporations in 8 East Again economies (Hong Kong [China], Indonesia, South Korea, Malaysia, the Philippines, Singapore, Taiwan, Thailand).	Random-effects regressions. Tobin's Q.	Cash-flow rights [+]. **Wedge [–].**	Stronger entrepreneurial control adversely affects valuation, while cash-flow ownership affects it positively.
Lemmon and Lins (2003)			
800 firms in eight East Asian countries during the region's financial crisis (July 1997-August 1998).	Comparison of cumulative stock returns (CSR) by ownership category. CSR1 – CSR2 = **–12%**. CSR3 – CSR4 = **–20%**. CSR1: Firms in which managers separate their control and cash-flow rights through pyramid ownership structure. CSR2: The others. CSR3: Firms in which the management group has a high level of control. CSR4: The others.		Although indirect, the evidence is consistent with the view that corporate ownership structure plays an important role in determining the incentives of insiders to expropriate minority shareholders during times of declining investment opportunities.
Laeven and Levine (2007)			
1 657 firms across 13 countries in Western Europe (Austria, Belgium, Finland, France, Germany, Ireland, Italy, Norway, Portugal, Spain, Sweden, Switzerland, and the United Kingdom).	OLS regressions. Tobin's Q.	CF1 [+]. **Wedge [–].** CF1 – CF2 [–]. CF1: Cash-flow rights of largest shareholder. CF2: Cash-flow rights of the second largest.	There is a strong negative relationship between cash-flow rights dispersion and future valuations. The negative association between valuations and the dispersion of cash-flow rights become more pronounced when the holders of the largest cash-flow rights are of different types.
Gompers *et al.* (2010)			
Comprehensive sample of dual-class companies in the United States during the 1995 to 2002 period.	Median regression. Tobin's Q.	Cash-flow rights [+]. Voting rights [–]. **Wedge [–].**	Firm value is positively associated with insiders' cash-flow rights and negatively associated with insiders' voting rights, and negatively associated with the wedge between the two.
Xiao and Zhao (2011)			
156 publicly listed Chinese firms with individual persons as ultimate owers (pyramid structure) between 2002-07 (936 firm-years).	OLS regressions Tobin's Q.	**Wedge [–].** Cash-flow rights [–]? Log(asset) [+]. Leverage [–].	Ultimate owners' agency cost (control-ownership wedge) negatively and significantly affect firm value. This effect is particularly significant for some types of RPTs, notably loan guarantees and direct fund transfers.

The reviewed economies

In **Belgium**, the use of pyramids and company groups gives controlling shareholders, *ceteris paribus*, an incentive to engage in advantageous RPTs and tunnelling. Whether they do so or not will depend upon a range of other factors, including governance processes. Empirical evidence about the extent of RPT is lacking and there are only two studies looking at indicators of tunnelling and RPTs. One, Buysschaert (2008), finds conflicting evidence about behaviour. On the one hand, they estimate that financially weak companies in a company group appear to be supported by those doing better, a finding that corresponds with studies in other economies. If the shareholder base were different, such transfers would be to the disadvantage of the shareholders of the stronger enterprises, even though it might be in the interest of the group as a whole. On the other hand, they cite another study (Buysschaert, 2004) that used event methodology (the change in share prices relative to an assumed base at the time of announcements to calculate excess profits) to show that intra-group equity sales create value for minority shareholders, unlike results found in a number of other jurisdictions such as **Italy**. One potential reason they acknowledge for this result is that company groups during the period covered by the sample were in the process of being rationalised with greater transparency of benefit to minority shareholders, something that also happened with some companies in **Italy** (see the Italy chapter).

Event methodology has also been used by Chakrabati *et al.* (2010) to determine whether large scale resignations by independent directors in **India** after the Satyam scandal in January 2009 says something about how they are perceived by shareholders. The large scale resignations were related to changed perceptions of director liability and so represented an exogenous shock. Taking a four day cumulative abnormal return they found that the returns were negative (*i.e.* they were perceived as contributing to company value) especially if the exiting independent director sat on the boards' audit committee and possessed accounting experience. The effect was much less in closely held family companies.

In **India**, some studies suggest that RPTs have been to the detriment of minority shareholders and to valuations. One study of 600 of the 1 000 largest (by revenues) listed companies in 2004 and controlling for other governance characteristics, found that their performance is negatively associated with the extent of RPTs for group firms (as quoted in Chakrabarti *et al.*, 2008) but for stand-alone firms where RPTs would be with insiders, the relationship was positive. It is thus suggestive of both a positive or negative effect of RPTs depending on circumstances.

An important question for empirical work but highly speculative is the extent to which RPTs might be abusive and therefore possibly disguised. Studies focus on identifying resource flows and the nature of incentives to identify possibly concealed RPTs called tunnelling. One such study is by Kali and Sarkar (2011), which examines the nature of group diversification and the structure of the control/cash flow wedge of the major or controlling company. The findings are only indicative, but they do suggest that firms in which controlling shareholders' cash flow rights are highest (*i.e.* the firm is located to the top of the pyramid) benefit most from a positive shock to firms elsewhere in the group.[2] However, there is also evidence of a negative shock to a group firm being associated with resource transfers to that company which would be to the benefit of its minority shareholders (propping). Accounting research has also pointed to earnings management

and discretionary accruals. CEO duality, where the top executive also chairs the board and the presence of controlling shareholders as inside directors are related to greater management of earnings by management (see Chakrabarti *et al.* for a review of research).

For **Italy**, the chapter notes a study that looked at compliance with a corporate governance code. This is important since many studies use declarations of compliance at face value. Bianchi *et al.* (2010) measured the actual level of compliance with the code to contrast with statements of formal compliance that was around 86 per cent for the 2007 compliance reports. By contrast, they found that only around one third of companies implemented the Code's recommendations in a sufficiently satisfactory way. The gap between formal and actual compliance was higher for non-financial firms and smaller companies.

The investigation also found that factors such as "board composition and institutional investors' active ownership, may play a major role in explaining the quality of RPTs internal procedures. In particular actual compliance is higher in companies where board structure is more aligned with best practices and where foreign institutional investors not only have a stake but also participate in general meetings. Surprisingly, with reference to the use of control enhancing mechanisms, non-voting shares and voting caps have a positive effect on compliance, while separation between ownership and control obtained by means of pyramids drives poor compliance" (Bianchi *et al.*, 2010, p. 4).

One study of **France** recognises that RPTs are determined at the same time as company valuations and by many of the same variables (Nekhili and Cherif, 2011). It also includes a number of approval process variables such as whether there are two large external audit companies. Due to the lack of value data, RPTs are measured by number. Nevertheless, the study finds a negative effect of RPTs on valuations but that some RPTs have a greater impact on value than others, particularly those directly with controlling shareholders. Disturbingly, they find that the presence of independent directors and audit committees did not have the effect of reducing RPTs.

Empirical studies covering other economies

A large number of studies point to a negative relationship between cash flow rights and control rights (measured as either a ratio or difference) on the one hand and corporate valuations as measured by Tobin's Q. However as noted above, there is every reason to suppose that cash flow and ownership rights is not an exogenous variable but could be determined by both valuation and other variables. Even more importantly, the process that leads to lower valuations (and presumably losses for minority shareholders) is not described.

Recent studies analyze the relationship between the RPTs announcement and shareholder value directly (event analysis, see OECD, 2009 for an explanation). A study analysing Chinese firms with a pyramid structure shows that the stock returns decrease around the RPTs announcement but that the negative effect depends on the type of RPT: loan guarantees and direct fund transfers (Xiao and Zhao, 2010) have a greater negative impact on valuations than other RPTs. Another study for the United States indicates that disclosing RPTs resulted in significantly lower valuations and marginally lower subsequent returns than those that did not make disclosures because they presumably had none (Kohlbeck and Mayhew, 2010).

The findings of a number of papers suggest that covert expropriation of minority shareholders through tunnelling is prevalent in business group both in emerging and developed countries (Bertrand *et al.*, 2002; Friedman *et al.*, 2003; Cheung *et al.*, 2006; Baek

and Lee, 2006; Atanasov *et al.*, 2008). For example, a study of Korean business groups finds that large chaebols under-perform unaffiliated firms, and this is attributable to expropriation of firm resources (tunnelling) by controlling shareholders (Joh, 2003). In a cross-country study of seven emerging markets, it is found that diversified firms trade at a considerable discount compared to single-segment firms and the discount is most severe when management control rights exceed cash-flow rights, also suggesting expropriation in diversified firms (Lins and Servaes, 2002). However, the group discount might also be due to inefficient reinvestment of funds (Holmen and Högfeldt, 2005).

Similarly, a study of the determinants of the diversification of firms affiliated to business groups in East Asia finds that one of the key determinants of value-destroying diversification by firms affiliated to business groups is expropriation incentives of controlling shareholders (Claessens *et al.*, 2000).

In many countries, the evidence suggests the existence of "propping" – controlling shareholders use private funds (or funds from other companies) to provide temporary support to a firm that is in trouble, *i.e.* negative tunneling. An empirical study shows that it is optimal for entrepreneurs to prop when there is a moderate adverse shock, so that the firm stays in business (Friedman *et al.*, 2003). Another study with connected transaction data from China shows that controlling shareholders of the companies in financial distress are likely to conduct RPTs to prop up their companies and the market reacts favourably to the announcement of these transactions (Peng *et al.*, 2010).

Others studies that have examined the relationship between RPTs and corporate governance mechanisms (such as board characteristics, CEO pay-performance sensitivity, and outside monitors) shows that weaker corporate governance mechanisms are in general associated with more and higher value RPTs (Gordon *et al.*, 2004; Wahab *et al.*, 2011). Putting it another way, the firms with relatively robust corporate governance (with a board that has a higher percentage of independent directors or a lower percentage of parent directors, or have different people occupying the chair and CEO positions, or have financial experts on their audit committees) are less likely to engage in transfer pricing manipulations in RPTs (Lo *et al.*, 2010).

As a final word of caution, a recent study (Black and Gledson de Carvalho, 2011) covering **Brazil**, the **Russian Federation**, **India** and **Korea**, shows that the impact of different corporate governance variables differs widely across the examined economies and across size classes of companies. That should not be too surprising but it does caution against adding economies to regression work to obtain a larger sample without at the same time adding many necessary controls and caveats. Probably the most important lesson is that constructing similar indices across many jurisdictions might introduce significant errors.

Notes

1. Tobin's Q is the ratio of the market capitalisation of a company, corrected by the level of net debt, to its net assets (a proxy for their replacement value). In effect this measures the sustainability of a company.
2. The converse where controlling shareholders also act to prop-up a failing group firm has also been observed. See Balasubramanian 2009 for a critique of the shock analysis.

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PART II

Country Reviews of Provisions and Practices Covering Related Party Transactions and Protection of Minority Shareholder Rights

The following part provides detailed analysis of each of the five focus countries: ***Belgium***, ***France***, ***India***, ***Italy*** *and* ***Israel****. The reviews are based on information provided by the national authorities via an OECD questionnaire, together with independent research by the OECD including missions to each country to gain the views of market participants. Each country chapter first identifies the major issues with the type of prevalent RPTs before considering the approach to minority protection. It identifies processes that have been put in place to approve such transactions and then assesses their effectiveness in preventing abusive RPTs. Finally, the chapters examine enforcement frameworks and the role of minority shareholders in directly approving RPTs and voting for independent directors to underpin the approvals process.*

PART II

Chapter 2

Belgium: Review of Related Party Transactions and Minority Shareholder Rights

This chapter on Belgium describes the structure of listed companies and especially the concentration of ownership and the use of company groups all of which are related to the type and intensity of related party transactions. The corporate governance framework that has been established to manage such transactions and to protect minority shareholders is analysed and the potential for improvements discussed.

Ownership of Belgian companies, whether listed or not, is for the most part concentrated in the hands of families, holding companies or groups that not infrequently resort to control enhancing mechanisms such as pyramids and shareholder agreements.[1] As in the rest of the world, Belgium has sought to address the conflicts of interest that are associated with such an ownership structure, of which RPTs are a part. The specific treatment of some RPTs, in particular regarding the misappropriation or diversion of assets and the allocation of corporate opportunities, were a key feature of revisions to the company law in 2002. However, one close observer (Goldschmidt, 2009) concluded that there was still a need for a systematic comprehensive review to examine whether inconsistencies and any lacunae remain.

The first section of this review describes the structure of ownership and control of Belgian listed companies followed by a general review of the approach to minority protection. The law and regulations pertinent to RPTs, especially between group companies are then reviewed together with enforcement issues. The final section presents an assessment and conclusions.

The ownership and control of Belgium listed companies

As of June 2010, 128 Belgian companies were traded on Euronext Brussels with a further 42 on other exchanges.[2] Ownership of the listed company sector has evolved somewhat in recent years with large shareholders reducing their majority voting block until around 2007 when a new takeover code established a threshold of 30 per cent to launch a mandatory takeover offer.[3] As of 2008, some 60 per cent of companies included shareholders that alone, or with allies held a voting block exceeding 30 per cent which gives them *de facto* control of the company (Van Der Elst, 2008, p. 26). The market capitalisation of listed Belgian companies also includes a number of holding companies.[4]

Another key feature of corporate governance in Belgium is the widespread practice of controlling shareholders appointing either themselves or their own representatives to the board (Van der Elst, 2008). Indeed, the most recent study of listed companies by Heidrick and Struggles (2011) indicates that in Belgium the category of directors associated with controlling shareholders (termed "reference shareholders") was still the predominant group accounting for 35 per cent of directors, with independent directors comprising 32 per cent (Heidrick and Struggles, *op. cit.*, p. 42). However, 34 per cent of directors are from other countries, one of the highest proportions in Europe (*op. cit.*, p. 37).

The use of pyramids and company groups gives controlling shareholders, *ceteris paribus*, an incentive to engage in advantageous RPTs and tunnelling. Whether they do so or not will depend upon a range of other factors, including culture and governance processes. Empirical evidence about the extent of RPTs is lacking and there are only two studies looking at indicators of tunnelling and RPTs. One, Buysschaert 2008, finds conflicting evidence about behaviour. On the one hand, they estimate that financially weak companies in a company group appear to be supported by those doing better. If the

shareholder base were different, such transfers would be to the disadvantage of the shareholders of the stronger enterprises, even though it might be in the interest of the group as a whole. On the other hand, they cite another study (Buysschaert, 2004) showing that intra-group equity sales create value for minority shareholders, unlike results found in a number of other jurisdictions such as Italy. One potential reason they acknowledge for this result is that company groups during the period covered by the sample were in the process of being simplified, in particular the number of layers in company pyramids were being reduced. Greater transparency could have benefited minority shareholders, something that also happened in some Italian companies.

The best known abusive related party transaction (actually more in the form of resource transfer to the detriment of minority shareholders) is now quite old (Wymeersch, 1993) and concerned a major shareholder stripping a Belgian company of assets and the diversion of corporate opportunities (the case of Flambo and Barro, see Johnson *et al.*, 2000). At that time, Belgium had no statutory rules relating to intra-group transactions so that the court relied on a business judgement rule to hold that the conduct of the shareholder was consistent with the interest of the group as a whole. Johnson (2000) concluded that the court took a broad view of the interests of the group rather than the subsidiary company and therefore (up to a limit) saw no problem with the tunnelling of resources out of the subsidiary to the controlling shareholder (the *Rozenblum doctrine*, Box 2.1).

Box 2.1. **Group defence for directors: the *Rozenblum doctrine***

The *Rozenblum doctrine* admits a group defense if there is: a group characterised by capital links between the companies; there is a strong, effective business integration among the companies of the group; and financial support for one company to another must have an economic *quid pro quo* and may not break the balance of mutual commitments between the concerned companies; the support from the company must not exceed its possibilities or in other words it should not create a risk of bankruptcy for the company (see Conac *et al.*, 2007, p. 519).

An important case from the perspective of jurisprudence concerns an insurance company that distributed cash to a subsidiary to prevent it failing (the Assubel case in 2000). The shareholders and the public prosecutor sued the company and the directors for violating their interests but lost since the court ruled that the transaction was in the interests of the group as a whole.

The approach to protection of minority shareholders

Defining minority rights

Belgium was once considered weak in the area of minority protection (la Porta *et al.*, 1996) but more recent work shows that the questions were system biased and did not take account of other means of protection (Cools, 2005) such as mandatory bids. Thus, recoding the La Porta anti-director rights index for Belgium results in a score of four out of six rather than the original value of zero. Over the past ten years, reforms have sought to improve the rights of shareholders to attend meetings and to exercise their voting rights: one study indicates that Belgium had the second lowest turnout (44.4 per cent) out of 31 countries with an average of 63.4 per cent (Hewitt, 2011; but see Van der Elst, 2011 for more recent data).[5]

The incentives will improve from the beginning of 2012 with the introduction of a record date to replace the system of share blocking and the phasing out of bearer shares by 2016.[6]

The equal treatment of shareholders is a general principle of law. As in France and other European countries, Belgium therefore seeks to protect the rights of minority shareholders from infringement. Belgian jurisprudence has developed the doctrine of abuse of majority powers to be understood as abuse by shareholders of their power ensuing from a majority stake. The claim can be instituted by any person who has a personal and legitimate interest. Abuse of majority power is mostly defined as the situation where the board uses its competences or the majority employs its power in the shareholders meeting for private purposes outside the corporation rather than in the interests of the corporation. The damage to shareholders should be disproportionate to any benefits (*i.e.* general theory of abus de droit). Minority shareholders also have a special right to exercise a put option by selling their stakes to controlling shareholders but this has been rarely used since abuse is difficult to prove. The court is responsible for evaluation.

Minority rights are also protected by takeover law. A mandatory takeover bid must be launched by a person (and/or persons acting together) who acquires more than 30 per cent of the voting securities in a Belgian company whose securities are admitted to trading on a regulated market, Alternext or the Euronext Brussels free market (subject to certain exemptions). There also exists a sell-out right that can be exercised by the minority shareholder if the bidder ends up with at least 95 per cent of the target's voting rights, at the price paid for the acquisition.

Where necessary, the general meeting may decide to initiate litigation on behalf of the company against directors. As an additional protective mechanism for minority shareholders, the Company Code allows one or more shareholders representing at least 1 per cent of the voting rights, or representing at least EUR 1.25 million of the share capital to initiate a minority action against a director on the company's behalf. Any damages are payable to the company, not the shareholder who must advance expenses that cannot be recuperated if their claim is dismissed. As in other countries, the actual resort to derivative actions appear to have been rare.

The general assembly must be called when shareholders representing 20 per cent of the share capital make a request. One or more shareholders having together at least 3 per cent of the share capital may request to add points to the agenda or submit propositions concerning subjects mentioned in the agenda. A shareholder may vote in person or by proxy that is based on the concept of power of attorney. The system is used with proxies being given to the chairman unless otherwise stated. Shareholders in Belgian public companies cannot give blank proxies: they must instruct the proxy on how to vote. Since April 2011 shareholders can participate in the AGM via electronic means.

Apart from cases where capital transactions, major corporate restructurings or share-related remuneration features are concerned, shareholders have few *ex ante* opportunities for expressing views or approving RPTs and few *ex post* rights. Other governance and legal protection for shareholders are discussed in the following sections. Thus although shareholders might be protected from abusive action and have a number of avenues open to them, they may not have effective means of redress as required by Principle II.A.2.

Conflicts of interest

In Belgium, conflicts of interest between board members and the company have been regulated for quite some time, but conflicts of interest between major shareholders and the

company were only addressed for the first time in 1995 (Van Der Elst, p. 9) and then again in the update to the Company Law in 2002 when an approval procedure by independent directors for RPTs was introduced.

The law recognises the duties of loyalty and care on the part of board members to the company and these are underpinned by the new Corporate Governance Code (CGC). However, they are defined in terms of "the company". How they fit in practice with the reality of company groups and centrally driven strategies is complex and subject to interpretation. In particular, the *Rozenblum doctrine* (Box 2.1) that arises from jurisprudence allows directors to consider, under some circumstances, the interest of the company group as a whole rather than just the company and the shareholders of the company in which they are a member. In the absence of offsetting measures reviewed below, this could weaken minority protection.

In addition, the 2009 Belgian Corporate Governance Code[7] (CGC) says a lot about managing conflicts of interest including with major shareholders. The code although formally a comply or explain code in fact has a quasi legal status. It has acquired a degree of enforceability that it did not enjoy up to now and can be referred to by courts seeking criteria for good practice. A number of clauses are also covered by the company law with the code fleshing out implementation details. However, there is no permanent monitoring commission and the FSMA (the securities regulator) does not check company corporate governance compliance statements.

Particularly important is the recommendation that the board should establish a policy for "transactions or other contractual relationships between the company, including its related companies, and its directors and members of management" that are not covered by the legal provisions on conflicts of interest. The policy statement should be published. Other key provisions include:

- For companies with one or more controlling shareholder(s), the board should endeavour to have the controlling shareholders make a considered use of their position and respect the rights and interests of minority shareholders.
- At least half of the directors should be non-executive among who at least three should be independent.
- To be considered independent, a director should be free from any business, close family or other relationship with the company, its controlling shareholders, or the management of either, that creates a conflict of interest such as to affect that director's independent judgment. Independence criteria are specified in the CGC but most of them have been taken over and enhanced by the law of 20 December 2008, and inserted in the Company Code as Article 526 ter.
- Management is responsible for informing the audit committee about methods relating to significant and unusual transactions where different approaches can be used, with special reference to offshore centres and special purpose vehicles.
- Each director should arrange his or her *personal and business affairs* so as to avoid direct and indirect conflicts of interest with the company. All directors should inform the board of conflicts of interest as they arise and abstain from voting on the matter involved in accordance with the relevant provisions of the Company Code. Any abstention from voting, motivated by a conflict of interest, should be disclosed in accordance with the relevant provisions of the Company Law.

- The board should establish a policy for transactions or other contractual relationships between the company, including its related companies, and its directors and members of management, which are not covered by the legal provisions on conflicts of interest. This policy should be disclosed in the Corporate Governance Chapter. Comments on the application of this policy should be disclosed in the Corporate Governance Chapter of the annual report. Transactions between the company and its board members should take place at arms' length.

Principle III.C covering disclosure of material interests by board members and Principle VI.D.6 covering monitoring by the board of RPTs appear to be broadly implemented although subject to how group conflicts are handled.

Disclosure and transparency of RPTs

The Belgian approach to RPTs and minority protection relies to a great extent on transparency. The definition of RPTs and Related Parties (RPs) follows the International Accounting Standards (IAS), including IAS 24. It is only applicable to consolidated accounts together with other IAS standards (*e.g.* IAS 27 and IAS 31). There is no similar requirement under the Belgian accounting standards but Article 524 of the Company Law forces disclosure about some aspects of intra-company transactions. There is also a requirement to disclose the company's policy towards dealing with related companies and its directors and members of management. Disclosure thus corresponds to Principle V.5 which is broadly implemented.

There are extensive requirements to disclose details about RPTs and especially those categorised as material and not on market terms. In practice, it has been difficult to define "market" transactions and therefore the abnormality of a given transaction. The Accounting Standards Commission issued an opinion in January 2010 to help clarify the situation but perhaps unavoidably it remains general. The issue has also been addressed by advice of the Belgian Institute of Auditors in March 2011. At the end of the day it is for the independent directors (and their advisors) to decide and for the external auditor to check.

External auditors have a mandate to certify that accounts and statements in the annual report (including references to RPTs and their value) conform to law and regulation. That mandate extends to special reports that are legally prescribed in connection with RPTs (Articles 523 and 524 of the Company Law, public tender offers, etc.). Apart from their scrutiny of the accounts and their supporting documents, in line with International Standards of Audit external auditors will also examine board and executive committee minutes where they may find indications of unreported RPTs.

Since December 2008, an audit committee is required for listed companies that can only comprise non-executive directors, of which at least one must be independent and competent in accounting. Independence criteria are more stringent than those of Article 524 of the Company Law so that they have been superseded since that time.

The imposition of tight disclosure requirements about RPs and RPTs has been complemented by legal requirements covering board approval and monitoring procedures by independent directors, presumably disinterested parties of the board, and special requirements covering RPTs with group companies. There are also additional reporting obligations.

The approach to Related Party Transactions

Company groups and RPTs

The Belgian authorities have responded to the ownership and group structure of the country that may result in significant RPTs with key changes to the Company Law in 2002. Since then, all intra-group dealings with the exception of those on market terms and dealings of minor importance (less than one per cent of consolidated net assets) must be assessed by a committee of three independent directors assisted by independent financial experts designated by them. A separate auditors' report must also be submitted before the board of directors can take a decision. The committee is required to evaluate the transaction and assess the gain or loss for the company and the risk of manifestly abusive damages in the light of the company's policies. Denial of corporate opportunities must also be disclosed in the annual report. Of the key legal changes, six articles are of particular interest (see Goldschmidt, 2009 for more details).

Article 523 (and its mirror Article 524 ter) prescribes that directors (and executive committee members)[8] shall disclose their own conflicts of interest of a financial nature (including RPTs) to the board, to the auditors and to shareholders (with a waiver for recurrent transactions on normal market terms). They may not take part in the deliberations or vote on conflicted transactions and the board's decisions in this respect must be minuted, reported to the external auditor and disclosed in the annual report. This also applies to executives who are members of the executive committee.

Article 524 mandates an approval procedure involving the board, independent directors and auditors as well as disclosure to shareholders of decisions and transactions of their company granting advantages to other companies of the same group, with the exception of the company's direct subsidiaries and the direct subsidiaries of the latter. Neither the subsidiary nor its subsidiaries need to be wholly owned so that shareholders other than those of the mother company might be involved. Non-listed Belgian subsidiaries need approval by the listed mother company to transact with an affiliate of that company.

Article 526 bis requires audit committees for listed companies, including at least one independent director (now superseded by the audit committee law).

Article 526 ter lists independence criteria for directors.

Articles 527 *and* **528** articulates directors' and executive committee members' liability in general.

Article 529 defines directors' and executive committee members' specific liability with respect to:

i) Violations of Articles 523 and 524 ter, but they only apply if the transactions concerned generated an abusive financial benefit for them personally.

ii) Violations of Article 524, but they too only apply if the transactions concerned generated an abusive financial benefit for another company of the group to the detriment of the company. It is enforced via derivative actions with all the problems that these involve.

Other new facets of this reform were:

- Advantages conceded to the beneficiary are no longer those granted to natural shareholders, but to related companies within the group (upstream, downstream and laterally, but with the exception of direct subsidiaries and their direct subsidiaries).

- Advantages conceded are no longer restricted to financial matters but also to other immaterial gains.
- If the company suffers a "simple" prejudice, compensatory amounts if any should be declared.
- Not only decisions but also actual transactions concerning advantages conferred on the company by a member of a group (*i.e. Rozenblum doctrine*) must be reported by the independent directors committee.
- Independence of directors is no longer defined "*vis-à-vis* the decision", but by four groups of criteria (three objective ones and one catch-all),[9] to be justified on their election by the AGM.
- Conflicted transactions and their value are reported in the annual accounts.

It should be noted that this legislation applies only to Belgian companies listed on a regulated market either in Belgium or abroad, and not to non-listed companies: the rationale is firmly the protection of minority shareholders of a listed company. For private companies, minority shareholders are assumed to be able to negotiate the protection they see fit at the time the company is formed (or when an investment is made).

The new Article 524 reflects a subtle shift from minority protection *per se* to also considering the issue of company groups, something required by the development of the *Rozenblum doctrine* (see Box 2.1) in cases such as Wiskeman (Hopt, 2011) and Assubel noted above. The legislation now focuses on quite a broad range of intra-group transactions or decisions thus regulating RPTs as well as promoting transparency and equal treatment of shareholders. But the omission of physical shareholders (natural persons) and the rather convoluted language used to capture some but not all companies of the group, on the basis of various considerations (*e.g.* whether account consolidation is necessary), is judged by some observers, have led to incoherent or unintended consequences. That is particularly so when considering the exclusion of direct subsidiaries that are not 100 per cent owned by the company concerned and that therefore have their own minority shareholders to protect and that might also have the controlling entity as a shareholder.

Also to be noted are the questions of constraints imposed by the group regarding allocation and, especially, denial of corporate opportunities. These cover elements such as the transfer of R&D benefits, geographical/product segmentation of activities, the setting of staff or accounting policies, etc. and are captured by Article 524, Section 7. Since it is obviously impossible to legislate in detail over such a wide variety of cases, the solution imposed here is one of transparency in the annual report, limited to disclosing constraints of material impact. While there are no specific sanctions regarding failure to make such disclosure, there would be a general liability for false disclosures and in the case of non-disclosure, a liability for misleading disclosure under the Company Code. Cases appear to be rare. However, one may wonder whether this is dissuasive enough to prevent abusive group constraints or whether independent directors of a company would happily denounce constraints emanating from parent companies on which they depend. However, it is said that cultural expectations of directors are high in what is after all a very small business community where the maintenance of reputation is critical.

It can be seen from the above that although a serious attempt has been made to cover a fair number of RPTs, loopholes exist: transactions between a company and its subsidiaries to the second degree (where outside shareholders may exist) are exempted which ties in with accounting law in Europe that restricts compulsory disclosure to consolidated accounts that also eliminate transactions between parent companies and direct subsidiaries.

Whistle blowing by the staff is one of the origins of information of the organs charged with detecting and monitoring RPTs that complements other sources should these fail. The CGC aims at enabling improprieties to be raised by company staff without fear of reprisal and at ensuring that deserving cases are properly followed up.

Shareholders, analysts, market players and the media may become aware of events or circumstances that point to the existence of as yet undisclosed RPTs. Such occurrences should normally be rare. In those cases, engagement with the board and management either behind the scenes, at analyst gatherings or at general meetings of shareholders, or publication in the media would bring those RPTs to light.

Enforcement

Although there is an important body of jurisprudence in Belgium, especially the *Rozenblum doctrine*, derivate actions and other enforcement cases appear not to be common. Indeed, Article 529 of the company law that covers intragroup RPTs (Article 524) only applies if directors and management grant an abusive financial benefit to another group company. They would of course remain liable under more general duties of loyalty but this may also involve a group defence.

Liability with respect to RPTs finds its source in general legal principles such as those of Articles 527 and 528 of the Company Law and notions such as the abuse of majority rights (see above) that may not always be explicitly embedded in actual texts. More specific are the provisions of Company Law Article 529 that refer to violations of Articles 523 and 524 discussed above. There are also specific criminal sanctions for certain behaviour in contravention of the Company Law such as with respect to annual accounts.

Except where they have to give prior approval to regulatory documents referring to RPTs (*e.g.* a prospectus), regulators generally see disclosure documents after they have been published by the company. Unless they discover discrepancies within those documents in the course of their ordinary examinations, regulators have limited possibilities of unearthing undisclosed RPTs. The FSMA and the Belgian Institute of Auditors prescribes a series of routine checks for auditors which includes RPTs and requires that they submit periodic reports on subjects that it specifies. Further, as the main regulatory authority, the FSMA receives complaints from shareholders who have not obtained satisfactory answers from the company to questions they may have, and this also constitutes a source of relevant information.

The Belgian stock exchange (a branch of NYSE-Euronext) has undergone a major change of nature (from a semi-public institution to a de-mutualised commercial company). In parallel, its regulatory powers have largely been transferred to the FSMA, those retained being more directly relevant to the actual technical regulation of the market. The stock exchange is therefore not as concerned as the FSMA in the monitoring process of RPTs, except perhaps at the time of initial listing but even there it will essentially be the FSMA that takes the lead.

Regulators can (and on occasion do) impose sanctions, from private rebuke and warnings, through public exposure and the obligation of publicising corrected or completed statements where they failed to conform to standards or reality, and the imposition of administrative fines. In a small society such as in Belgium, it is said by market observers that directors do fear critical public announcements and act prudently.[10] Where warranted the regulator and prejudiced parties can also turn over the file to the courts and that can lead to civil sanctions in the form of annulments of irregular transactions, the attribution of

compensatory damages to the prejudiced company or other victims of wrongdoing, and/or the penal sentencing of wrongdoers in the form of fines or prison. However, most cases relate not to RPTs but to insider trading and market manipulation.

Assessment and conclusions

The protection of minority shareholders rights in Belgium is more developed than some old empirical work (*e.g.* La Porta *et al.*) would suggest. There is a law and jurisprudence covering the abuse of controlling powers by the board or controlling shareholders even though it appears to have been used only rarely. This does not amount to a fiduciary duty towards minority shareholders but does serve to deter them from abusing their rights. On the other hand, the *Rozenblum doctrine* allows a group defence so that the duty of loyalty of directors has been widened to cover the interests of the group as a whole. This opens the way for potentially damaging groups RPTs and effectively weakens minority protection.

Shareholders have very few powers with respect to RPTs, either *ex ante* or *ex post*, reliance being placed on independent directors for approval of RPTs. Since 2002, independent directors have the duty to approve company group RPTs, as well as RPTs to directors and management. In carrying out their duties they must use independent financial experts designated by them. In particular they have a duty to ensure against "manifestly abusive damages" to the listed company as well as determine which transactions require compensatory benefits. There is a high level of transparency to the process. Thus Belgium has moved to offset the weakening of minority rights through the *Rozenblum doctrine*.

On the other hand, there are still some areas that might require tightening. Thus the exclusion of subsidiaries and sub-subsidiaries from the oversight of the listed company's independent directors committee might represent a loophole if controlling shareholders are part of its share structure. If anything the role of the independent directors is more important but the question that always comes to the fore is whether they would really contradict the orders of a controlling company or shareholder on which they depend. It is clear that their concerns about reputations are particularly important in a small country and might have served Belgium and minority shareholders well in the past. But questions still remain about whether this factor is important to all companies and all directors at all times.

Under such conditions the limited rights of shareholders, either *ex ante* or *ex post* with respect to RPTs might be limiting especially when derivative suits face a number of uncertainties including a group defence. A more direct role for shareholders in approving key transactions might be considered as well as greater formalisation of the law surrounding company groups.

The key OECD principles concerned by the above considerations are:

- Principle III.A.2 (*minority shareholders should be protected from abusive actions by, or in the interest of, controlling shareholders acting either directly or indirectly, and should have effective means of redress*). There is a significant body of law covering both group transactions as well as the concept of abuse of shareholder power. However it is not clear that there is an effective means of redress available to minority shareholders.
- Principle III.C (*members of the board and key executives should be required to disclose to the board whether they, directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the corporation*). This principle appears to be broadly implemented although may be too individual oriented and might be difficult where directors are representing major shareholders.

- Principle V.A.5 (*disclosure should include, but not be limited to, material information on … related party transactions*). Disclosure rules are broad and cover many aspects of RPTs.
- Principle VI.D.6 (*the board should fulfil certain key functions, including … monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions*). This is implemented in the law and the role of the independent directors is well defined. Questions remain about directors' duty of loyalty in a group context.

Notes

1. In addition, Belgium has traditionally been characterised by bearer shares and by blocking periods to determine voting rights both of which are changing.
2. 12 companies were traded on NYSE Alternext Brussels and a further 30 were on the Free Market Brussels.
3. Some owners increased their holdings above 30 per cent in anticipation of the takeover legislation.
4. At the end of 2001 they comprised around 20 per cent of market capitalisation.
5. In 2008, the deal by Fortis Bank to acquire ABM Amro was approved by 95 per cent of shareholders but only some 35 per cent were present.
6. From 2008, the issuance of bearer shares has been prohibited. Companies need to replace this share class by 2016.
7. The CGC will not be compulsory for Belgian companies at large although it aspires to serve as model that can be emulated by at least the largest non-listed ones. In addition, another code exists (the first of its kind anywhere) specifically designed to inspire all non-listed companies (the "Buysse code") but in view of its essentially aspirational nature it is not commented on here.
8. The single tier board can delegate some of its authority to an executive committee that can include both executives and board members. The system can therefore be seen as an augmented single tier system. The board cannot delegate the strategic management of the company, control of the management committee and the powers that are legally reserved to the board of directors such as its own functioning.
9. The four groups of criteria are, in summary:
   i) Functional: not to be a member of the company's board or management for a specified number of years.
   ii) Family: not to be a relative to the 2nd degree of anyone mentioned in *i)*.
   iii) Financial: not, individually or through controlled companies, to own 10 per cent or more of the company's capital, net worth or any class of shares.
   iv) Catch-all: not to have any relationship with the company that might interfere with independence.

   Those criteria have in December 2008 been amplified and/or given greater precision by new legislation as Article 526 ter, the main additions being:
   - Tenure: a maximum twelve years limit for service as independent director.
   - Representation: not to represent a shareholder in a situation incompatible with independence, as defined for directors.
   - Auditor incompatibility: not for the last three years to have been partner of or employed by the auditor of any company of the group.
10. For example, at Picanol the extreme level of the CEO's remuneration caused a public scandal and obliged him to step down and reimburse the excessive remuneration.

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PART II

Chapter 3

France: Review of Related Party Transactions and Minority Shareholder Rights

This chapter on France describes the structure of listed companies and especially the concentration of ownership and the use of company groups all of which are related to the type and intensity of related party transactions. The corporate governance framework that has been established to manage such transactions and to protect minority shareholders is analysed and the potential for improvements discussed.

A corrigendum has been issued for this page. See: http://www.oecd.org/dataoecd/12/58/50125065.pdf

The issue of how to regulate and prevent abuse of related party transactions has attracted close scrutiny in France, particularly in view of the strong role played by company groups, family control or at least large block shareholders in most French listed companies. While commercial code requirements for board and shareholder approval of such transactions are well-elaborated, excluding all interested parties from voting on them, there is an active current debate on whether or how review and reporting processes could be improved. Two working groups, the financial markets regulator (*Autorité du Marché Financier*) and institute of directors, are debating these issues, considering on the one hand demands from companies to streamline review and disclosure processes, and on the other, demands from investors to improve information available to the market. In addition, France's professional auditor's association is working to update its 1990 study of related party transactions focusing on company groups, in co-ordination with the financial market authority and the High Council to the Auditor's Office (*Haut Conseil des Commissaires aux Comptes*).

This chapter first provides general information on the French securities market and patterns of ownership and control, followed by a description of the legal and regulatory framework for how related party transactions are defined, disclosed, reviewed and enforced in the context of minority shareholder protection, with reference to relevant cases. It concludes with some suggested improvements for consideration within the current French debate on these issues.

Corporate governance landscape and framework for dealing with RPTs

France has an active capital market with 941 domestically-based listed companies on the Paris Euronext exchange, with market capitalisation constituting 744 per cent of its GDP by the end of 2009, according to the World Bank indicators. Most companies, including some foreign-based companies, are listed on the main market (Eurolist) along with bonds. A separate segment called "Alternext" is targeted towards small and medium-sized companies, providing simplified access to the market. Companies most actively tracked by investors include those in the CAC40 and SBF120. There is also an SBF250 which incorporates all companies in the SBF120 along with other smaller companies.

Academic literature places France among those countries with relatively concentrated ownership often dominated by families, and suggests that company groups play an important role. For example, Faccio and Lang (2002) found that only 14 per cent of French listed firms were widely held (having no owner with greater than 20 per cent of shares), compared to 37 per cent for European firms as a whole. This study found that 64.8 per cent of French firms were controlled by a single family, *versus* 44.3 per cent for Europe as a whole.

A separate study of Euronext intraday trading data and annual reports for all listed French companies (918) from 1998-2002 found that on average, the largest shareholder directly held 46.4 per cent of the capital and 52 per cent of the voting rights. However, these

percentages are smaller for CAC40 firms, for which the largest shareholder held an average of 21.2 per cent of the capital and 24.4 per cent of the voting rights, which still suggests levels often sufficient to maintain *de facto* control of such companies (Ginglinger and Hamon, 2007).

Under French law, block shareholders are also able to enhance control of the company by including in the company charter double voting rights for registered shares that have been held by the same shareholder for at least two years. Ginglinger and Hamon found that double voting rights were used by 68.3 per cent of listed firms, and for 52.2 per cent of these firms it was the only control-enhancing device used. Pyramids were used by 18.5 per cent of the firms, voting caps by 2.3 per cent, and dual-class shares by 1.2 per cent. They found that the identity of controlling shareholders also seemed to affect how firms separate ownership and control, with families typically using double voting rights, while the other controlling shareholders (financial institutions, the State and other widely held firms) prefer pyramids.

The number of companies belonging to groups also appears to be increasing. Data from the Banque de France indicate that the share of French companies with turnover above EUR 750 million that are associated with company groups increased from 80 per cent to 90 per cent between 1999 and 2004 (Nahmias, 2007). Firms affiliated to small business groups have doubled in ten years and now represent one-third of small French firms (Hamelin, 2009).

In light of the predominance of company groups, family control and at least large block shareholders in most listed companies, how to regulate and prevent abuse of related party transactions is an issue that is well-elaborated in France, and that has recently been attracting growing attention. Reasons for this attention range from complaints among investors that insufficient information is being reported to the market, to concerns among issuers that the current reporting and approval system should be streamlined.

Definition of RPTs subject to review and approval

The French legal system makes a distinction between "related party transactions" which are accounted for and reported according to IAS 24 standards within the context of consolidated company group accounts, and a specific approval process for what are called "*conventions réglementées*" (literally this can be translated as "regulated agreements" but for the purposes of this paper, they will be referred to as "regulated related party transactions", or regulated RPTs). More specifically, listed companies must follow special procedures for approval of regulated RPTs based on the French commercial code. These apply to "direct or indirect agreements" involving non-recurring operations and/or those reached under abnormal conditions between a company and its CEO, a designee of the CEO, board members or a shareholder with more than 10 per cent of voting rights in the company, or with the company controlling that shareholder. Agreements falling under this definition include a wide range of transactions involving parties with a direct or indirect interest, including contracts between companies, remuneration of board members and management, retirement and severance packages such as golden parachutes, loans, rental agreements, etc.

For transactions falling within this definition, the interested party is legally required to inform the board of directors about the considered transaction and to abstain from voting both within the board and at the shareholders meeting. Board members have a duty to act in the interests of the company, and can be sued individually or collectively for "abuse of corporate assets" ("*abus de biens sociaux*") stemming from decisions considered to have

caused damage to the company. Although the commercial code requires that regulated RPTs are subject to both board authorisation and *ex post* shareholder approval involving all disinterested parties, it is important to note that company executives do have legal authority to enter into RPTs before the board authorises them, and if the board or shareholders vote against such transactions, a court action is still required to nullify the agreement. The provision requiring a court judgement is considered to be necessary to protect the interests of the company, because invalidating a contract that is already in force may also be damaging to the company's interests. It was also suggested that in practice, executives do in most cases wait to obtain the board's *ex ante* authorisation before executing related party agreements, in order to avoid vulnerability to legal processes that challenge the executive's decision.

Under French law, audit committees have no statutory responsibilities to review regulated RPTs, although they are responsible to review company accounts including their compliance with IAS 24 standards on related party transactions. There is also no special statutory role for independent directors on French boards, and no requirement under the French system to have independent directors (except for the audit committee to have at least one independent member). However, the French "Corporate Governance Code of Listed Corporations", a comply or explain corporate governance code, does contain a recommendation that boards include at least half of their members as independent in widely-held companies, and at least a third of the board be independent in controlled companies. GMI's 2008 sample of 104 listed French companies reported that an average of 52 per cent of board members were considered independent (CFA, 2009). On the other hand, some scepticism was expressed in interviews with a range of market participants about the true independence of many such board members, appointed by the votes of controlling shareholders in many cases. In addition, it was noted that board members often serve on the boards of multiple companies and have the right to serve on up to five French company boards simultaneously. Some investors suggested that there is a trend in annual meetings of increased opposition by shareholders to such multiple board service, so that companies are increasingly hesitant to nominate board members with such extended responsibilities.

With audit committees not playing a statutory role in reviewing or making recommendations on related party transactions that are subject to board review, the French review process relies upon the external auditor to prepare a special report setting out relevant information about these agreements to be considered for annual shareholder approval.[1] However, the auditor is not required to offer an opinion or recommendation regarding whether the transaction is in the company's interest. It is the legal responsibility of the individuals involved to inform the Chair when they are an interested party in a transaction, and for the Chair to issue the list of regulated RPTs to be considered by the board and transmitted in the auditor's special report to shareholders.

Once the board chairman informs the external auditor of the board's decisions on the list of regulated RPTs, the auditor is then required to prepare a special report setting out all such RPTs for a vote by disinterested shareholders at the AGM. These can be grouped together for a single vote, or as is done in many cases, subject to separate votes depending on the nature of the agreement. If a transaction fails to obtain a majority of disinterested shareholder votes (abstentions count as no votes), it is not automatically nullified based on the logic that *ex post* nullification of a contract or agreement potentially could do more damage to the company than the transaction itself. Rather, the board is given the opportunity to revisit the decision, recognising its increased vulnerability to a civil or criminal action for failure to correctly exercise its duties to the company and third parties,

both individually and collectively, in relation to violations of the law or errors committed by their management. Self-dealing transactions are voidable only if they were not subject to a vote by the board of directors and they have a detrimental effect on the company, or if the interested shareholder or director voted at the board of directors' meeting authorising them, regardless of whether the contract would have been authorised even without his or her vote (Conac, Enriques *et al*., 2007a).

These rules do not apply to "recurrent transactions entered into under normal conditions", which until recently had to be disclosed by the interested party to the chairman of the board, who was required to provide a list of such transactions to the board and to the statutory auditors to be included as an annex to the annual report (but not for approval). However, a new law adopted 17 May 2011 has eliminated this disclosure requirement.

Despite this exclusion, the current legal framework results in a substantial reporting and approval process for non-recurring transactions. A review by the French market regulator (*Autorité des Marchés Financiers – AMF*) of 80 large French listed companies including the CAC40 found that 600 such transactions were submitted for AGM approval, an average of 13.3 per company, with the number of transactions ranging from three to 30 per company.

It is worth noting that many of these transactions are quite small, because there is no threshold under French law related to the size of the transaction. GMI's (2008) data sample of 104 French companies (CFA Institute, 2009) found that only 15 per cent of these companies reported "significant" related party transactions of 1 per cent of company revenue or more (but no such threshold for materiality is in place under the French system).

In addition, French law prohibits certain transactions, notably loans to managers or directors, or guarantees for their benefit. However, loans to shareholders are not prohibited, regardless of whether they are individuals or legal entities (but remain subject to the usual RPT board authorisation and shareholder approval processes).

Enforcement

If shareholders' opposition to a related party transaction does not succeed in getting the transaction overturned or at least reviewed by the board, the main enforcement tool available to them is a criminal law provision against abuse of corporate assets (*abus de biens sociaux*). This provision prohibits, among others, board chairmen, directors or managing directors of a public limited company or limited liability company from "using the company's property or credit, in bad faith, in a way which they know is contrary to the interests of the company, for personal purposes or to favour another company or undertaking in which they have a direct or indirect interest".

While class action suits are not permitted for abuse of corporate assets, a minority shareholder may act derivatively in the name of the company to initiate a criminal prosecution by filing a criminal complaint against the board or individual board members. The plaintiff must demonstrate that the director acted in bad faith in directing the use of a company's assets or credit contrary to the interests of the company, for his personal benefit or in favour of another company in which he has a direct or indirect interest. The director may also be held liable even if he did not vote, if he was aware of the transaction and failed to inform the chairman of his interest in the case. For the complaint to be admissible, the circumstances which gave rise to the complaint must be sufficient to enable the examining magistrate to consider "possible" the existence of the damage to the company and the link

with the alleged abuse of corporate assets. According to Conac, Enriques *et al.* (2007b), case law has made clear that the examining magistrate has a duty to investigate if he or she considers this standard to have been met, and may access documents at little or no cost to the plaintiff.

In addition, the commercial code establishes that shareholders may act, individually or collectively under certain conditions applying to related party transactions as well as other cases, to file a "social action" against board members to repair prejudice suffered by the company, including award of damages and interest.

During a criminal process, shareholders may also seek civil damages on behalf of the company. However, the burden of proof remains with the party filing the action to demonstrate that the director(s) subject to the action were at fault, except in the case where a criminal penalty has already been decided, in which case the burden of proof in the civil case is simplified.

The plaintiff in a case does not have discovery powers but can seek an order from the judge to furnish documents relevant to the case, as long as he or she determines that there is no "legitimate obstacle" against it. Although it is not a common practice for civil cases, the judge can also convene the relevant parties for a meeting to interrogate them on the facts of the case.

According to a range of investors and other market participants interviewed for this report, in practice, cases of shareholders contesting decisions on related party transactions in court are quite rare, because of both the time and costs involved and the uncertainty of receiving compensation, which is awarded to the company which shareholders benefit from only indirectly, and not to individual shareholders. The most common court cases generally have involved actions by companies or shareholders to invalidate transactions and seek damages against a former executive who has since lost favour with the company, particularly in the case of severance packages. For shareholders, however, it is much simpler and less expensive to sell shares in a company they are dissatisfied with, and to invest those resources in other companies that will yield more predictable returns.

While market participants suggested that specific prosecution of related party transaction cases are relatively rare, Conac, Enriques *et al.* (2007a) found that on a more general level, criminal prosecutions for abuse of corporate property are relatively common in France. According to their review of Ministry of Justice data, there were between 416 and 480 convictions annually in France between 2000 and 2006, which can result in a prison term of up to five years and a fine of up to EUR 375 000. It should be noted, however, that cases of abuse of corporate property do not necessary involve related party transactions, and that very few of these cases applied to listed companies.

Conac *et al.*'s follow-up review (2007b) of 40 relevant French court decisions between 2004 and 2006 involving 36 cases of self-dealing, found that three-fourths of these cases were brought by minority shareholders. The few remaining cases were split among companies, the state attorney (public prosecutor) or the bankruptcy liquidator. Only four of the 36 cases dealt with listed companies: two initiated by active investors having acquired a blockholding; another initiated by the French Association for the Defence of Minority Shareholders (*Association pour la Défense des Actionnaires Minoritaires – ADAM*) dealing with a squeeze-out situation by a parent company; and a fourth by an individual minority shareholder. Decisions were about evenly split between the plaintiffs (usually minority shareholders) and the defendants. Among the preliminary findings of this work, which is still under development, is

that plaintiffs were most successful in winning cases in which the majority shareholder had not requested the authorisation of the board before entering into a self-dealing transaction. For civil actions alleging an abuse of the majority, plaintiffs won only six out of 18 cases. They were more successful in criminal allegations of abuse of corporate assets, winning four of six cases. The authors concluded more generally that French courts do not want to disrupt the business of companies or second-guess business decisions, even when self-dealing is apparent. They also tend not to second-guess the conclusions of experts involved in merger procedures and are also extremely reluctant to appoint their own experts, declining to do so in four of the five cases where an expert appointment was requested.

While shareholders potentially have an important role to play in ensuring enforcement against abuse of related party transactions, the focus of the French market regulator (*Autorité des Marchés Financiers – AMF*) is mainly on ensuring compliance with disclosure requirements. Authorities interviewed for this review stated that the AMF reviews all consolidated accounts and proceedings included in the company Annual Report and documentation for AGMs (including the auditor's special report) to ensure that proper procedures are followed, that required information is provided and that accounts are in compliance with regulatory requirements. If a problem is found, the first step is to ask the company to "regularise the situation". It was suggested that this is usually sufficient to result in a change in behaviour. While they have the power to issue an injunction in case of abuse, they have not done this. They also do not get involved in directly helping shareholders, for example, by requesting that a company obtain the review of a transaction by an independent expert.

On the other hand, the AMF has taken an active role through working groups to reflect on ways to improve the framework for minority shareholder protection. An AMF working group report issued in January 2011, on compensation for damages suffered by account holders and investors (AMF, 2011) concluded that the mechanisms for providing compensation for damages were insufficient. It cited as signs of this weakness, the low number of requests addressed to judges and consequently few decisions rendered, lack of clear parameters for assessing damages and interest to be provided, and the under-utilisation of mediation to resolve disputes at lower costs. The report strongly encouraged both greater publicity for and greater use of AMF's own mediation mechanism to resolve disputes. However, on the question of facilitating collective action through the courts, the AMF report noted strong opposition of financial institutions and listed companies, as well as the reservations of the government. The report therefore only presented "lines for reflection" on the way that collective actions could be implemented in the event that there is an initiative to consider more significant legal reforms.

While the above group did not deal specifically with the issue of RPTs, the AMF more recently established a working group to consider recommendations to improve the functioning of shareholders' annual general meetings that includes a sub-group dealing with related party transactions. The working group issued its report for public consultation in February 2012, with recommendations aimed at improving the transparency of RPT reporting.

The issue of how to deal with related party transactions has also been the subject of working groups organised by the French Institute of Directors (*Institut Français des Administrateurs – IFA*). In addition, France's national association of auditors, the *Compagnie*

Nationale des Commissaires aux Comptes, has issued a detailed, 163-page information note setting out explicit guidance to auditors for the preparation of the special reports that auditors are obliged to prepare on related party transactions for the annual general meeting.

Transactions within groups

A few special rules also apply to transactions within company groups. Loans, while prohibited to directors as individuals, are permitted to related legal entities and in this case indirectly to directors who are legal entity representatives. A special provision allows cash pooling within groups, which otherwise would be prohibited by the banking law to businesses other than banks. French jurisprudence has also established a special doctrine on abuse of corporate assets within groups, known as the *Rozenblum doctrine*, stemming from a 1985 French Supreme Court ("*Cour de cassation*") decision allowing for a "group defence" under certain conditions. First, the group in which the transaction takes place must be characterised by capital links between the companies, and strong effective business integration among the companies within the group. Second, the financial support from one company to another company must have an economic *quid pro quo* and may not break the balance of mutual commitments between the concerned companies. Third, the support from the company must not exceed its possibilities, *i.e.* not create a risk of bankruptcy. (Conac, Enriques *et al.*, 2007a).

Thus, in the case of such well-integrated groups, the standard for a criminal case of abuse of corporate property is not whether the transaction was damaging to the company, as in other cases, but the more difficult to prove case of whether it "broke the balance of mutual commitments" across a wider spectrum of the companies' interactions within the group or created a risk of bankruptcy for the company concerned.

Both the French association of auditors (*Compagnie Nationale des Commissaires aux Comptes – CNCC*) and jurisprudence have attempted to shed further light on how this "balance of mutual commitments" should be considered in practice within company groups. While companies within groups remain subject to regulated RPT approval processes for non-recurrent operations, their interpretation of what constitutes an exempt transaction involving "recurrent operations under normal conditions" provide groups with greater flexibility to undertake such transactions without subjecting them to RPT approval processes. This greater flexibility is indicative of a "privileged relationship" among companies within groups that should be taken into account, according to the French authorities. The key focus is on interpreting what are considered "habitual" or "recurrent operations" under "normal conditions". CNCC guidance in this regard continues to leave room for differing interpretations, suggesting that "habitual operations" within a group must be compensated at a price covering the cost to the company providing it, along with a "reasonable" margin to cover indirect costs. These operations may include, for example, rental of property, provision of personnel and billing for shared services, loans, advances, and guarantees. Commitments of guarantees provided to an affiliate at no charge are not subject to regulated RPT approval processes (although they are subject to other board approvals). On the other hand, interest-free loans between entities in the same group are considered to be subject to the regulated RPT approval process.

While the CNCC guidance and jurisprudence offer some guidance to directors as to how their duty to the interests of the company should be interpreted, there remains the potential for confusion among company directors as to their duty to the company *versus* the group as a whole. Conac, Enriques *et al.* (2007b) in a review of 40 French court decisions

between 2004 and 2006 found only one of the 40 discussing the *Rozenblum doctrine* for company groups, which rejected its application. The authors suggested that either the group defence is rarely applied or that, because French judges follow such doctrine, prosecutions are not brought to the courts for intra-group transactions.

Shareholder actions in France – some recent cases

Several recent cases illustrate minority shareholder concerns surrounding related party transactions in France. Although this review does not aim to cover RPTs involving remuneration because a recent OECD review has already addressed remuneration issues in depth, two of the cases cited below nevertheless highlight transactions involving severance packages, because these were clearly one of the main preoccupations among investors and media in France within the scope of France's framework for reviewing regulated RPTs. One investor suggested that shareholder opposition focuses most frequently on RPTs involving remuneration and severance packages because they are relatively easy to assess and make a judgement on. In addition, these types of transactions are subject to the same reporting and approval processes as other RPTs.

A few recent cases in France that have drawn strong reactions from minority shareholders include the following:

- The severance package offered to Alcatel-Lucent's former CEO first in 2006 and under a modified agreement proposed in 2007 attracted strong criticism and opposition from some shareholders, as well as media coverage. Certain investors objected both to the level of compensation as well as performance targets that were insufficiently demanding to fulfil as a condition of maintaining the offer (achieving at least 90 per cent of the target group revenues or 75 per cent of operating profit), particularly considering that Alcatel-Lucent suffered from growing losses in 2007 while share prices dropped from EUR 11.04 to EUR 4.98. Nevertheless, the severance package was approved at the 2008 AGM with 80.5 per cent of the votes (the 19.5 per cent opposition, including 3.9 per cent abstentions which are counted as negative votes, represented a doubling of the opposition in comparison to the 2007 vote). Although the measure passed, it is worth noting that Alcatel-Lucent subsequently announced that its future CEO would not be entitled to a similar severance package.
- In 2010, shareholders were asked to approve a related party transaction involving Spanish-owned Gecina's wholly-owned subsidiary, *Société des Immeubles de France* and its purchase of a 49 per cent stake in Bami Newco. The board authorised the transaction in February 2009. Subsequently the Association for the Defense of Minority Shareholders (ADAM) wrote to the AMF asking for an inquiry on the financial information disclosed by Gecina, and suggesting that certain transactions would not comply with Gecina's corporate interests, constituting misuse of corporate assets under French law. In the end, based on a vote of disinterested shareholders, the proposed RPT was rejected by 83.7 to 16.3 per cent. This case was significant in that it was one of the rare cases cited in which shareholders defeated a related party transaction.
- Another case in which shareholders rejected a deal, involving a CEO severance package considered at the Valeo AGM of 2009, was also mentioned, but in this case the board had issued an opinion prior to the AGM that it no longer supported the transaction in light of new information that had emerged (including the fact that the board meeting at which the deal was originally approved had been recorded without board members' knowledge).

Other types of transactions involving interested parties or affiliated companies are more complicated for shareholders to assess. A number of cases were cited involving deals that were questionably in the interests of the company. For example, one SBF120 company funded the MBA education abroad for a board member who is a relative of the controlling shareholder; in another case the controlling owner has established a foundation which lends or leases art work to the company he controls. Additional cases cited involved consulting contracts paid to company managers; contracts for holding companies to provide "management services" remunerated as a percentage of revenues earned by the companies that it controls; and family-owned companies that lease property they own individually to the company that they control. All of the examples cited were approved by shareholders and, according to those interviewed, may or may not have been abusive to the company's and minority shareholders' interests. The difficulty, they said, is having sufficient information, as well as access to independent fairness opinions if necessary, to make a determination as to whether the deal represents fair market value.

Current market perspectives on related party transactions: Are RPTs a problem?

Despite the strong focus by a number of different working groups on the issue and publicity surrounding some of the cases mentioned above, there is no consensus within the market or among policy-makers on whether the current handling of related party transactions constitutes a problem for the market.

Business associations in France argue against stronger protection and in favour of less burdensome reporting requirements. They suggest that the requirement that regardless of their size, all related party transactions (except for recurrent transactions executed under normal market conditions) are subject to inclusion in the auditor's special report and to approval by the board and shareholders, already imposes a heavy regulatory burden and makes it one of the more transparent and comprehensive regimes for treatment of these transactions. In addition, French companies must follow IAS 24 for disclosure of RPTs as part of their financial reporting requirements.

However, among investors' association representatives, the most common concern expressed was that the information made available to shareholders to consider related party transactions is not always sufficient to make an informed judgement on whether the deal is in the company's interests or not. Some investors complained that reporting has been uneven and not followed the commercial code requirements, especially for smaller companies and certain other cases. Nevertheless, the requirements for information that should be included in the auditor special report are explicitly specified.[2] In addition to explanations of the nature and objective of the transaction, the related parties involved and its essential elements, the code requires that the auditor should give "any other indications that permit shareholders to appreciate the interest attached to the conclusion of the agreements and commitments analysed". Some investors have suggested that this provision should be interpreted broadly by auditors to provide their own assessment of the deal, while the French auditors' professional association maintains that it should only provide the factual information necessary for shareholders to reach their own opinion. Shareholders only have the right to request an expert opinion if they have at least 5 per cent of shares, and this occurs quite rarely. If a director requests an expert opinion for the board's consideration of a deal, the special auditor is not obliged to include it in the special report for the AGM.

Market participants also highlighted concerns about lack of disclosure of board voting on approval of related party agreements; a tendency to group related party transactions together for a single vote, considered problematic in particular when these transactions are of differing nature; and a recent and growing tendency not to submit the auditor's special report to the AGM when it concerns only recurring RPTs deemed to have occurred under normal conditions. These recurring transactions are not required to be brought to shareholders for a decision but must be disclosed as an annex to the annual report, which is published on the AMF website as well as typically on each company's website.

The French Asset Management Association's (*Association Française de la Gestion Financière – AFG*) annual corporate governance recommendations requested in 2011 that "Whenever related-party transactions are poorly detailed in the auditor's special report, AFG recommends that additional information should be provided in the report of the board" to the general meeting. The AFG also requested that the most important related party transactions should be presented in separate shareholder resolutions, particularly for transactions involving executive directors and family holding companies.

Investors interviewed suggested that their greatest influence in their review of related party transactions is not to defeat them by shareholder votes, which occurs quite rarely, but rather through raising questions and in high-profile cases, through press coverage and negative publicity when minority shareholders raise concerns. Concerns about reputation are said to influence director and executive behaviour and to deter abusive practices even if such practices are not commonly challenged through the courts. As mentioned previously, it is considered too costly to challenge decisions through derivative suits on behalf of the company, without sufficient prospect of reward for the individual shareholder or group of shareholders involved. The most immediate sanction that these shareholders are able to apply is to sell their shares, which can have an influence on share prices.

The AFG suggested this "soft approach" is making a positive difference, leading to improvements in reporting and transparency, especially since the 2003 French law requiring institutional investors either to vote or to explain why they did not vote. Before this, AGMs tended to pass most or all resolutions with at least 95 per cent of the vote, whereas now, shareholder disagreement is much more common and majorities often may fall to 80 per cent or less, particularly on highly publicised issues such as executive pay, golden parachute packages, or election of board members who hold seats on too many boards. The fact of receiving significant opposition and negative coverage in the press often leads to reluctance to raise such issues for approval in the future, even if they are still likely to pass. Board members who receive less than 80 per cent of the vote have difficulty getting appointed to other positions in the future. Investor complaints or concerns about RPTs, including decisions to sell their shares, may also be influencing firm valuations. One new study (Nekhili and Cherif, 2011) of 85 companies listed on the Paris stock exchange from 2002-05 supports this view. The study found that RPTs made by those companies with main shareholders and with companies affiliated with those companies had a negative influence on firm value.[3]

Some market participants suggested that the French shareholder meeting culture is based on dialogue rather than confrontation, and noted that France has a reputation for relatively passive shareholders in comparison to markets with more dispersed shareholding structures. Some business association representatives challenged this viewpoint, noting that there have been a number of high-profile challenges by shareholders to French companies

led by the Association for the Defense of Minority Shareholders (*Association pour la Défense des Actionnaires Minoritaires – ADAM*) and others. However, a representative of ADAM suggested that the 20 or so cases that it has initiated over the past decade on behalf of minority shareholders have tended to focus on issues related to application of takeover laws and buy-out of shares, which are more easily enforceable than provisions concerning related party transactions.

Assessment and conclusions

Among the positive elements of the French framework for addressing related party transactions is a systematic review of regulated RPTs at multiple levels, including at the level of the auditor, the board, and *ex post* by shareholders during the annual general meeting. French law sets out a broad definition of the interested parties who are excluded from voting on decisions both at the level of the board and in the annual general meeting. Commercial code requirements and clarifying information from the national association of auditors set out clearly what information must be provided by auditors in the auditor's special report in order for shareholders to be able to vote on all regulated RPTs. Although the timing of review after RPTs have already taken effect makes it difficult to reverse such decisions, shareholder review and press coverage of more controversial RPTs nevertheless creates some incentives for board members to review their decisions carefully.

On the other hand, some weaknesses were identified in terms of insufficient information provided by some companies on such transactions, the difficulty of nullifying RPTs that have already been initiated prior to disinterested shareholders' or even in some cases board member votes, and weak enforcement against abusive transactions, reflected in an absence of injunctions or sanctions imposed either at a regulatory level or, except in rare cases, through the courts. Proving that a case is against the interests of a company is even more difficult in the case of company groups that meet the conditions necessary to apply the *Rozenblum doctrine*, *i.e.* that the transaction upsets the "balance of mutual commitments" among companies within the group or creates a risk of bankruptcy.

A number of steps could be considered to address such weaknesses, including measures such as:

- The AMF could intervene more aggressively to seek improved information through sanctions or by requiring the public issuance of independent expert opinions on material related party transactions in which minority shareholders raise questions about the true market value of a deal; or issue injunctions in cases where they consider such transactions to have been against the interests of the company.
- The 5 per cent threshold for minority shareholders to have the right to request an independent valuation or fairness opinion could be lowered, and fairness opinions provided for board deliberations could also be subject to disclosure to shareholders.
- French working groups established to consider recommendations (AMF, French Institute of Directors, auditors' professional association) should consider issuing templates that set out best practice examples of the type of information necessary to come to a well-informed judgement on whether a related party transaction is in the interests of the company.
- More significant changes could involve actions to facilitate shareholders' ability to obtain compensation in cases of abuse, and the institution of requirements that a related party transaction cannot take effect without approval of at least the board. However, the French authorities have expressed reservations concerning this recommendation, suggesting that

board pre-approval could be disruptive to normal business practices and that improved information to shareholders combined with existing protections could provide sufficient shareholder protection.

Overall, the French approach to treatment of related party transactions provides for broad implementation of the relevant principles, but some gaps remain, mainly due to the difficulties associated with reversing decisions or obtaining damages in cases that the board or shareholders oppose such transactions. The key principles are:

- Principle III.A.2 (*minority shareholders should be protected from abusive actions by, or in the interest of, controlling shareholders, acting either directly or indirectly, and should have effective means of redress*). Some protection is in place, but obtaining redress in cases of abuse remains a challenge.
- Principle III.C (*members of the board and key executives should be required to disclose to the board whether they, directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the corporation*). This requirement is in place in France for related party transactions.
- Principle V.A.5 (*disclosure should include, but not be limited to, material information on …related party transactions*). The legal requirements for disclosure of non-recurrent related party transactions through special auditors' reports are clearly elaborated, providing for broad implementation of this principle, but their implementation could be improved to enable shareholders to better understand the interests and nature of such transactions.
- Principle VI.D.6 (*the board should fulfil certain key functions, including … monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions*). This principle is broadly implemented, although in the case of companies within groups, how they treat the interests of the company *versus* those of the group is less clear.

Notes

1. Under the French system, companies are required to hire two external auditors who jointly sign off on reports, an approach that is said to have been adopted with the objective of reducing the risk of an auditor becoming "captured" by the company. Audit contracts must be considered for renewal or change at least every six years, and while the same auditing company may be retained for a new mandate, the principal audit partner must be rotated.
2. Article R225-31 of the commercial code sets out the elements that must be included in the auditor's report:

   "1. *Explanation of the agreements and commitments submitted for the approval of the general meeting of shareholders.*
   2. *The names of interested board members.*
   3. *The name of the interested Director-General or those designated to act on the Director-General's behalf.*
   4. *The designation of the interested shareholders with more than 10 per cent voting rights and, if the transaction involves a shareholding company, designation of the controlling shareholding company in the sense of the Article L. 233–3.*
   5. *The nature and objective of the agreements and commitments.*
   6. *The essential modalities of the agreements and commitments, notably an indication of the price or fee established, the receipts or commissions agreed, the timing of payments agreed, interest stipulated, security or safety provided, the nature, amount and modalities granting each of the advantages or disadvantages mentioned in Articles L. 225–22–1 and L. 225–42–1 and, if need be, any other indications that permit shareholders to appreciate the interest attached to the conclusion of the agreements and commitments analysed (bold added for emphasis).*

7. *The importance of goods delivered or services furnished along with the amounts and sums disbursed or received in the course of exercising and executing the agreements and commitments mentioned in the second line of Article R. 225–30.*"

3. Using Tobin's Q as a proxy for performance (calculated on the basis of total stock market capitalisation of the company at the end of the fiscal year and the book value of its liabilities as a ratio of total assets), Nekhili and Cherif found a significant negative impact (both economically and statistically) of related party transactions on firm valuations.

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PART II

Chapter 4

India: Review of Related Party Transactions and Minority Shareholder Rights

This chapter on India describes the structure of listed companies and especially the concentration of ownership and the use of company groups all of which are related to the type and intensity of related party transactions. The corporate governance framework that has been established to manage such transactions and to protect minority shareholders is analysed and the potential for improvements discussed. Reference is made to the scheduled review of company law by the parliament.

India has a major listed company sector and has been pursuing improved corporate governance standards since 1998 when the country produced one of the first substantial codes of best practice in corporate governance in Asia. Further improvements followed during the first decade of the century including the introduction by the Securities and Exchange Board of India (SEBI) of Clause 49 in the Listing Agreement covering corporate governance. This clause was further developed in 2004 in relation to the role of independent directors and audit committees. However, the Satyam fraud of late 2008 (see Box 4.1) which also involved a controversial related party transaction that was approved by independent directors, indicated a need for further measures.

Both SEBI and the Ministry of Corporate Affairs (MCA) have reacted with, *inter alia*, new rules by SEBI in February 2009 requiring greater disclosure by controlling shareholders (*i.e.* termed promoters in India) of their shareholdings and any pledging of shares to third parties. However, some investors (*e.g.* ACGA, 2010) believe that more needs to be done about the heart of the problem in India: the accountability of controlling shareholders (*i.e.* promoters) to other shareholders. This is compounded by over-burdened courts, and limited enforcement resources for the two main institutions, the Company Law Board (CLB) of the Ministry (MCA) and SEBI. The MCA has drafted a new company law that was being considered by Parliament at the time of writing. The proposed Bill contains some far reaching measures to improve the rights of shareholders and to facilitate implementation. It is thus a good time to review the situation.

The chapter first outlines the structure of ownership and control in India and the major role of company groups and controlling shareholders. It then examines evidence of RPTs and the incentives that could lead to abuse. It next reviews the current regulatory framework and the enforcement record of the two principal agencies. Finally, an assessment of the implementation status of the relevant OECD principles is presented and suggestions made for possible future actions, some of which might be included in the new company law.

The ownership and control of Indian listed companies

India is characterised by concentrated ownership and by the widespread use of company groups, often in the form of pyramids with a wide basis (in many different activities and companies) and with a number of levels. There are some 6 000 listed companies in India on two primary stock exchanges but many have a very small free float and some 2 500 are suspended from trading. One study of the 1 470 companies listed on the National Stock Exchange indicated that as of March 2010 controlling shareholders (*i.e.* promoters) held 57 per cent of all shares and institutional shareholders about 20 per cent (Bhardwaj, 2011). One study (Balasubramanian *et al.*, 2009) of 300 companies indicated that 142 included a shareholder with an ownership stake higher than 50 per cent. A further 100 included a shareholder holding 30-50 per cent of the equity. Studies summarised by Chakrabarti *et al.* (2008) found that promoters held 48 per cent of shares in a sample of

Box 4.1. **The case of Satyam**

Satyam Computer Services Limited proposed to acquire stakes in Maytas Infrastructure Limited and Maytas Properties Limited both of which were controlled by the controlling shareholder (*i.e.* promoter) of Satyam: Ramalinga Raju. Satyam Computers informed the Exchanges on December 16, 2008 that their Board of Directors at its meeting that day had approved proposals to acquire a 100 per cent stake in Maytas Properties Limited and a 51 per cent stake in Maytas Infrastructure Limited. In the announcement it was mentioned that the total outflow of the acquisition was expected to be USD 1.3 billion for Maytas Properties and USD 0.3 billion for 51 per cent stake in Maytas Infrastructure Limited. The Ramalinga Raju group held around 8.60 per cent of equity in Satyam Computers and 36.64 per cent of the equity capital of Maytas Infrastructure Limited, whereas Maytas Properties limited was an unlisted company belonging to the Ramalinga Raju group.

Several media reports questioned the action of the Board of Satyam Computers regarding the rationale for diversification of an information technology company into the real estate sector and the rationale for paying a huge consideration for acquiring stakes in the entities owned by the group of the controlling shareholder. Further, the media reports questioned the role and the duties of the independent directors since the deal was approved unanimously by the Board of Satyam Computers. Due to adverse investor sentiment, the price of the ADRs of Satyam Computers listed in NYSE fell 55 per cent from its close the previous day.

Subsequently, Satyam Computers made an announcement on 17 December 2008, stating that it was not going ahead with its proposed acquisition of Maytas Properties and Maytas Infrastructure, in light of the feedback received from the investor community. An independent director resigned on 25 December 2008, stating that she had voiced reservations about the transaction during the board meeting, but had failed to cast a dissenting vote to ensure that her views were put on the record. It transpired that the compensation package of one of the independent directors was more than seven times that of the other independent directors and well above the market rate. It turned out that he was undertaking consulting work for the company, something that should have barred him from being an independent director.

Following the Satyam scandal and the Nimesh Kampani case,* independent directors around India recognised their potential liability. As a result it is reported that at least 620 resigned in the year following the scandal (Khanna and Mathew, 2010).

Another aspect of the case is that it showed that the independent directors remained focused only on fair valuation and on obeying SEBI and Company Law regulations. The business case does not appear to have been considered. Moreover, the independent directors did not actually commission the valuation. The Chair claimed that this had been undertaken by a reputable audit company, a claim strenuously denied by the big audit partnerships.

* Nimesh Kapani was one of India's leading investment bankers and served as an independent director on the board of Nagarjuna Finance from 1998 to 1999. The promoters and executives of the company were later charged under state law with failing to repay depositors. The state government also charged Kampani who had left the board prior to any of the allegations surfacing. Kampani avoided arrest and jail by staying in Dubai for 9 months until the state court stayed the proceedings against him in October 2009. The event showed the remote possibility of arrest and jail, but panicked many independent directors in India. See Khanna and Mathew (2010).

2 500 listed manufacturing companies; around 51 per cent in group companies and 46 per cent in standalone companies. The study also suggested that actual holdings are likely to exceed 50 per cent since holdings are often hidden in the form of other corporate bodies in a pyramid structure or individual shareholders.[1]

Table 4.1. **Ownership of Indian listed companies**

Largest shareholder ownership stake	Number of firms	Per cent
75% and more	19	7
50.01%-74.9%	123	43
40.01%-50%	61	21
30.01%-40%	42	15
20.01%-30%	26	9
Up to 20%	18	6

Source: Balasubramanian *et al.* (2009), p. 19, Table 12.

Of the firms sampled by Balasubramanian *et al.* (2009), 165 of them (a little over a half) are part of an Indian business group which includes one or more other public firms. This is broadly supported by another study of 500 large Indian companies of which in 2003, 378 were affiliated with a group (Sarkar, 2010). The study also cites a data base (Prowess) that in 2006 identified 2 922 firms affiliated with 560 Indian owned groups, a predominant majority of these identified with specific families (Sarkar, 2010, p. 299). The number of such groups is compounded by their size: for all firms, the share of total assets of affiliated firms was around 70 per cent in 2006 and amongst the top 500 firms, it was around 80 per cent (Sarkar, p. 301).

Concentrated ownership and group company structures are associated with a particular structure of boards. One study found that 40 per cent of Indian companies had a promoter on the board and in over 30 per cent of cases they also served as an executive director (Chakrabarti *et al.*, 2008, p. 17). Executives of one group company often serve on the boards of other group companies as outside directors. Potentially concerning, Sarkar reports that independent directors are also related to company groups, with about 67 per cent of their directorships in group affiliates, and notably 43 per cent of directorships concentrated within a single group.[2]

The fact that independent directors are appointed by controlling shareholders (*i.e.* promoters) might have a significant impact on their perception of their duties. One study noted that all the independent directors in the study (admittedly a small and not fully disclosed sample) viewed their role principally as that of strategic advisors to the promoters and most did not perceive their role as monitoring management and controlling shareholders (Khanna and Mathew, 2010). This is probably just as well for them: another study noted that "if controlling shareholders cease to be pleased with the efforts of an independent director, such a director can be certain that his or her term will not be renewed" (Varottil, 2010).[3]

Nevertheless, a recent study (Chakrabarti *et al.*, 2010) suggests a more nuanced position. From event analysis occasioned by the resignations of many independent directors in the wake of the Satyam scandal, it appears that resignations particularly by those independent directors with business/accounting knowledge and on audit

committees led to lower (excess) returns (*i.e.* they are valued by shareholders). However, for tightly held family companies there was little impact, suggesting that independent directors are not regarded as effective in such companies.

Within groups, a common structure involves pyramids and cross holdings of shares. As a result, there is a significant difference between cash and control rights in group firms (so called wedge).[4] This can present opportunities for moving resources from one company in which the controller has low cash flow rights to another where the rights are higher. One method for shifting is via related party transactions.

Evidence indicates that groups are controlled by a single management entity that sets the strategic vision, the philosophy and management practices of a group, often through the inclusion of family members on the boards of affiliates (see Sarkar, p. 307 and references therein). This can lead to the issuance of debt by a group company in favour of others that could go against the interest of minority shareholders in group affiliates (Kakani and Joshi, 2006).

In sum, the structure of Indian listed companies creates incentives that, unless balanced by corporate governance arrangements, company law and financial regulation, is conducive to related party transactions that might violate minority shareholder rights.

Defining and disclosing RPTs: The Indian accounting and listing standards

The Indian accounting standards relevant to RPTs is AS 18 which is close to IAS 24 (Table 4.2). The statutory body responsible for preparation of accounting standards has announced a convergence with IFRS and has already prepared the standards. However, implementation has been delayed from the target date of 2011. AS 18 clearly recognises the

Table 4.2. **Key differences between AS 18 and IAS 24**

AS 18	IAS 24
Excludes non-executive directors from the definition of key management personnel by virtue of merely his being a director unless he has the authority and responsibility for planning, directing and controlling the activities of the reporting enterprise.	Key management personnel under IAS 24 include non-executive directors.
Does not provide any exemption in case of disclosure requirements. Accordingly, the financial statements of holding and subsidiary would be self-contained.	No disclosure of transactions is required in parent financial statements when they are made available or published with the consolidated financial statements; and in financial statements of a wholly owned subsidiary if its parent is incorporated in the same country and provides consolidated financial statements in that country.
Does not require disclosure in circumstances where making disclosures as per the requirements of the standard would conflict with the duties of confidentiality of the reporting enterprise as specifically required in terms of a statute or by any regulator or similar competent authority.	IAS 24 is silent in this regard.
The definition of the term related party provides that parties are considered to be related if at any time during the reporting period one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions.	The definition of related party as per IAS 24 does not include the expression "at any time during the reporting period".
AS 18 clearly lists the relatives of an individual, viz spouse, son, daughter, father, mother, brother and sister.	IAS 24 does not state clearly who the "close members of the family" are.
Recognises one more situation in the definition of control, *i.e.* control of the composition of the board of directors in the case of a company or of the corresponding governing body in case of any other enterprise such as a foundation.	Defines control as ownership, directly, or indirectly through subsidiaries, of more than one half of the voting power of an enterprise, or a substantial interest in voting power and the power to direct, by statute or agreement, the financial and operating policies of the management of the enterprise.

Source: http://rbidocs.rbi.org.in/rdocs/PublicationReport/docs/18353.doc.

case of a company being controlled by another making transactions between them a RPT. Noteworthy is the requirement for separate disclosure by both the subsidiary and the holding company. A materially significant transactions report must be provided to the holding company by a subsidiary and published. Thus India is similar to Italy, Israel and Belgium for reporting intra-group transactions separately.

Some investors such as ACGA (2010) have noted significant weaknesses in the structure and operation of the Indian auditing profession which could mean weak implementation of the standard. Among other things, they propose consolidation of the profession to improve the resources of partnerships, lifting of artificial caps on the number of audit trainees and audit partners; establishing an independent regulatory body for the audit profession; and the adoption of recommendations establishing mandatory rotation of audit partners and the clarification of the audit committee's responsibility regarding auditor independence.

Experience of RPTs

Related party transactions are widespread and are significant in value. An analysis of company reports by the stock exchanges of 50 companies indicates that loans, advances, and guarantees account for a high percentage of net worth of the reporting companies, with subsidiaries and associated companies accounting for the bulk (see Annex 4.A1).[5] Key management personnel, individuals and relatives accounted for an insignificant share. Payment for research accounted for 8.8 per cent of net worth and involved subsidiaries. Although based on a small sample, other studies broadly support the results. One study of over 5 000 firms for the period 2003-05 reported that most RPTs occurred between the firm and "parties with control" as opposed to management personnel as in the United States (as quoted in Chakrabarti *et al*., 2008).[6] Group companies consistently report higher levels of RPTs than stand alone companies.

Other information also indicates that RPTs are quite common with one study (Balasubramanian *et al*., 2009) of 301 companies noting that 275 replied that they had reported RPTs to shareholders. Clause 49 requires firms to disclose materially significant RPTs to shareholders. Nearly 80 per cent said that they have policies requiring RPTs to be on arms length terms. RPTs appear to be important in terms of size with some 20 per cent of firms reporting RPTs greater than 5 per cent of revenues (Table 4.3). The analysis undertaken in support of Annex 4.A1 also indicates RPTs as a high share of revenues.

Table 4.3. **Related party transactions**

Characteristic	Required	Firms with characteristic	Mean (median)
RPT disclosed to shareholders	(2004)	275 (94%)	
Firm requires RPTs to be on arms length terms		230 (78%)	
Company has outstanding loans to insiders	(1956)	20 (7%)	
Company rents real property to or from insider		50 (20%)	
RPTs are > 1% of revenues		142 (67%)	
RPTs are > 5% of revenues		42 (20%)	16 (10)
Board reviewed at least 1 RPT in last year		107 (60%)	14 (6)
Board reviewed at least 5 RPTs in last year		63 (36%)	

Source: Balasubramanian *et al*. (2009), Table 14.

Some studies suggest that RPTs have been to the detriment of minority shareholders and to valuations. Using a sample of 600 of the 1 000 largest (by revenues) listed companies in 2004 and after controlling for other corporate governance characteristics, one study found that firm performance is negatively associated with the extent of RPTs for group firms (as quoted in Chakrabarti *et al*., 2008). For standalone firms where RPTs would be with insiders, the relationship was positive.

An important question is the extent to which abusive RPTs are possibly disguised. Some scandals such as that at Satyam (Box 4.1) indicate the abusive character of some RPTs. Some studies focus on identifying resource flows and the nature of incentives to identify possibly concealed RPT called tunnelling. One such study is by Kali and Sarkar (2011), who examine the nature of group diversification and the structure of the control/cash flow wedge to the major or controlling company. The findings are only indicative, but they do suggest that firms in which controlling shareholders cash flow rights are highest (*i.e.* the firm is located to the top of the pyramid) benefit most from a positive shock to firms elsewhere in the group.[7] One method of transferring resources that has also been indentified is where group companies take on high leverage for the benefit of other group firms, but ones it should be stressed with different shareholders. Accounting research has also pointed to earnings management and discretionary accruals. CEO duality, where the top executive also chairs the board, and the presence of controlling shareholders as inside directors are related to greater earnings management (see Chakrabarti *et al*., 2008, for a review of research).

The approach to protection of minority shareholders

This section first reviews the RPT relevant sections of the company law and outlines minority shareholder rights. It then reviews the very important listing requirements that concern corporate governance: Clause 49.

Company law and the listing requirements

In India, all public firms must have audit committees and a one share, one vote capital structure. There is a single tier board. Directors' duties are not fully specified but there is a highly developed jurisprudence that establishes the fiduciary duties of directors. However, as noted by the 2004 ROSC (World Bank, 2004), enforcement and implementation of laws and regulations remain important challenges even though progress has been significant.

General features of the Company Law

The Companies Act that is currently in the process of revision includes six main sections relevant to related party transactions and the protection of minority rights and, taken together, suggest that India has the law in place and thus has partially implemented Principle III.C (*members of the board and key executives should be required to disclose to the board whether they, directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the corporation*). The main elements are:

- **Section 295** states that companies shall not make any loan, or give any guarantee or provide any security in connection with a loan to their directors (or directors of their holding company) or any partners or relatives of any of their directors, or any firms in which any of their directors (or relatives of a director) is a partner, without first obtaining the approval of the central government. This does not appear to cover group firms taking on leverage for financing other group firms.[8]

- **Section 297** requires directors to seek board consent for contracts with the company in which they or a relative are interested. For bigger companies (having paid up share capital of Rs 1 crore or more), the approval of the Central Government is required in addition to the board's consent.
- **Section 299** states that directors must disclose at a meeting of the board any direct or indirect interests in existing or proposed contracts or arrangements entered into by the company.
- **Section 300** bars directors from voting on, or participating in any board discussions regarding any contract or arrangement in which they are directly or indirectly interested. Exemptions are provided for private companies that are not subsidiaries or holding companies of public companies. The Central Government can override this clause in favour of individual companies if it feels that it would "not be in the public interest to apply any of the prohibitions in this section". This has never happened with the exception of some state owned companies.
- **Section 314** requires that director remuneration be approved by the Central Government if it exceeds INR 250,000 a month.
- **Section 173** states that where any business that is to be transacted at a meeting of the company relates to, or affects any other company, the extent of shareholding interest in that other company of every director and the manager, if any, of the first mentioned company shall also be set out in the explanatory statement if the extent of such shareholding interest is not less than twenty per cent of the paid up share capital of that other company. This clause mainly refers to RPTs covering equity transactions and shareholders approval of amalgamations or sale of substantial parts of the undertaking.

It should be noted that the penalties for non-compliance with the company law have been, with the exception of loans to directors and associates that are a criminal offense, minimal (see section on the enforcement record) although it is expected that they will be increased with the next revision of the law: the penalty for contravening the law is a mere INR 5 000 (approximately USD 100). In addition, there are also separate fines for violating the listing Clause 49 which are now more significant being recently revised to INR 2.5 million. There are other provisions in the company law prescribing consequences, including penalties, for violation of RPT-related legal and regulatory provisions. Some of the relevant provisions are as follows although it is expected that the new Company Law will increase the level of punishment:

- Failure to make disclosures of interest or variation from prescribed procedure of disclosure of interest by an interested director constitutes an offense and the director may be punished with a fine which may extend to INR 50 000.
- An interested director who votes in a matter in which he is interested is punishable with a fine which may extend to INR 50 000.
- Such a director would be liable to cease office and failure to do so may subject him to prosecution.
- They would also have to refund remuneration received after cessation of his directorship.
- Non-compliance of provisions for maintenance of a RPT register may lead to monetary sanctions, which may be levied on the company and on every officer in default, and the fine may extend to INR 5 000 for each default.

Rights of minority shareholders in the Companies Act

Other sections of the Companies Act specify a number of rights for minority shareholders although enforcement is weak. The rights include:

- In the case of different classes of shares, the rights attached to them can only be changed with the consent of 75 per cent of holders of that class and holders of at least 10 per cent can apply to the courts for cancellation of the changes.
- 100 or more members or a tenth of the total number of shares whichever is less can apply to the Company Law Board (CLB) for protection against oppression and mismanagement. The Ministry of Corporate Affairs can also approve an application even if the minimum requisite number of members is not fulfilled. In case of oppression or mismanagement by a major shareholder, the minority shareholder can apply for investigation or apply to the tribunal.
- An extraordinary general meeting can be called by shareholders with 10 per cent of the total number of shares.
- 200 members or more, or members holding 10 per cent of the total voting power may request an investigation into the affairs of the company,
- Members holding at least 10 per cent of voting power can demand polls in a general meeting.
- Transparency issues are handled mainly through listing requirements and accounting standards.

The rights of shareholder meetings are strictly limited. Certain proposals such as disposing of substantially all of the company's assets, the issuance of further shares and inter-corporate loans and guarantees exceeding 60 per cent of its paid-up share capital and free reserves, or 100 per cent of its free reserves require shareholder approval, some by way of special resolution. RPTs do not require shareholder approval. An earlier version of the new Companies Law that is believed to have been retained in the new version requires shareholder approval of RPTs exceeding some prescribed limit that would be established by regulation later. The vote would be through a special resolution: the votes cast in favour of the resolution in person, or by proxy, should be not less than three times the number of votes, if any are cast against the resolution, *i.e.* 75 per cent majority. The SEBI Board has further recommended to the Ministry of Corporate Affairs a crucial addition that the new law include a provision for listed companies, that shareholders may not be permitted to vote on such proposals in which they have an interest. Once there is a general clause in the Companies Act, SEBI could always impose the requirement through changing the listing agreement (Clause 49).

Up till the present such a proposal may not have made much sense because of deficiencies in the way shareholder meetings have been conducted. One study noted that "shareholder meetings and proxy voting practices in India – like many parts of Asia – lack efficiency and accountability". Voting processes need to be modernised to reflect best market practices and the growing global interest in active share ownership (ACGA, 2010, p. 6). Among their key recommendations, they call for conducting voting on all resolutions at AGMs and EGMs by poll rather than by a show of hands that often occurs at present, and allowing proxies to speak at meetings, irrespective of whether the company law is amended on this point.

The ACGA study notes correctly that in theory it should not be too difficult for a proxy or group of proxies to call for a poll. Section 179 of the Companies Act states that "any member or members present in person or by proxy" may call for a poll if they hold shares in the company giving them not less than 10 per cent of total voting power or on which the aggregate sum of not less than INR 50 000 (USD 1 054) has been paid up. However, they do point out that in practice it is often far from straight forward since in part, some custodian banks will not do so, *i.e.* request a poll on the basis of proxies received (ACGA, 2010, p. 17). On the other hand, it should be noted that "important matters" are according to the Company Law voted by postal ballots, allowing investors to have their shares counted on issues of "significance".

However, with the Government's Green Initiative in the Corporate Governance of April 2011, the situation could improve significantly in some areas. Notification of AGMs, a source of complaint, can be through the Internet and meetings can be via video conference. Platforms for electronic voting will be permitted by approved agencies. Whether it will address some of the problems raised above remains to be seen.

Directors duties

The companies' law imposes liabilities on directors for violation of various clauses of the law, but as in many other jurisdictions it does not set out their duties in great detail. Rather, these have evolved over time through jurisprudence and these might be codified in the current revision of the law. For example, a director should take reasonable care in performance of his duties. As in Australia and the United Kingdom, courts have stressed that the duty of directors does not stop at a "to act bona fide" requirement. They have evolved a doctrine called the "proper purpose doctrine". Even if directors honestly believe that their actions are in the best interests of the company, actions done with improper motive are liable to be set aside. Directors are in a position of trust so that their probity and conduct should be above suspicion. Directors must not exercise their powers for personal aggrandisement. However, if their action is in the wider interest of the company, the decision cannot be struck down on the grounds that it has incidentally benefitted directors in their capacity as shareholders.

The current company law does not make explicit reference to the problems that arise for directors in a company group in following central directions. Nor does it explicitly refer to related party transactions apart from if it involves self-dealing. More generally, there is a clear notion of the duty of loyalty to act in the interest of the company, two court cases from 2004 affirming the duty. The issue of following group company strategy even at the cost of the company does not appear to have been dealt with. As noted above, the listing requirements contain a number of directions with respect to RPTs for independent directors some of which it is believed will be taken into the new company law.

Clause 49 of listing requirements; the Indian "Corporate Governance Code"

An important aspect of the Corporate Governance framework in India concerning related party transactions is Clause 49 issued by SEBI as a key section of the listing agreement. It is sometimes called a code even though most of its provisions are now mandatory. The most recent version dates from 2004 and includes a minimum number of

independent directors on boards with the definition widely defined, and an audit committee which includes independent directors (Box 4.2). With respect to RPTs:

- Audit committees shall review annual financial statements (before submission to the board for approval) with particular reference to several factors, one of which is disclosure of related party transactions.
- Audit committees shall also review, on a more general basis, any statements of "significant related party transactions (as defined by the audit committee) submitted by management".
- Listed companies must periodically give their audit committees a summary statement of "transactions with related parties in the ordinary course of business" as well as details of "material individual (related) transactions that are 'not in the normal course of business' or not done on an arm's length basis ('together with management's justification for the same')".
- For subsidiaries, a significant transactions report must be given to the holding company's board along with the board minutes of the subsidiary.

Box 4.2. **The main corporate governance elements of the listing standards: Clause 49**

Characteristic	Clause 49
Director independence	• Requirement 50% independent directors if chairman is executive director or is related to any promoter (*i.e.* controlling shareholder) or a person occupying a management position or one level below the board, or 33% if the chairman is a non-executive. • Definition: no pecuniary relationship with the company, not related to board or one level below board and no prior relationship with the company for the last three years. • Nominee directors of nationalised financial institutions considered independent.
Board requirements and limitations	• Meet four times a year, with a maximum of 3 months between meetings. • Limits on number of Committees a director can be on (10) but only 5 for which director can be chair of Committee. • An Ethical Code of conduct is required.
Audit committee composition	• At least 3 directors, with at least two thirds independent. • All financially literate. • At least one having accounting or financial management experience.
Audit committee role and powers	• Minimum 4 meetings a year with gap between them not to exceed 4 months. • Broad role – review statutory and internal auditors as well as internal audit function, obtain outside legal or other professional advice, and review whistleblower programme if one exists.
Disclosures	• Material related party transactions. • Accounting assumptions and deviations from standards. • Risk management. • Annual report including discussion of the adequacy of internal controls, significant trends, risks and opportunities. • Proceeds from offerings. • Compensation for directors including non-executives and obtain shareholders approval. • Details of compliance history for last three years. • Corporate governance reports (and disclosure adoption, if any, of mandatory and non-mandatory requirements).
Certifications	• CEO/CFO – financial statements , effectiveness of internal controls, inform audit committee of any significant changes. • Auditor or company Secretary – compliance with corporate governance standards.
Subsidiary companies	• At least one independent director of holding company should sit as a director on board of material non-listed Indian subsidiary. • Significant transactions report to holding company board, along with subsidiary board's minutes. This will be published in the annual report of the parent company.

Clause 49 also requires listed companies to submit a quarterly compliance report on corporate governance to stock exchanges. One element of this disclosure is the basis of related party transactions. Companies must also include a section on corporate governance in their annual reports and it is suggested that they include "disclosures on materially significant related party transactions that may have potential conflicts with the interests of the company at large".

For more general aspects of Clause 49 which are mandatory and relevant for minority protection see Box 4.2. Of particular note is the reliance on independent directors for minority protection in general and RPTs in particular. A key requirement is that if the chair is also an executive or a major shareholder, there is a requirement for 50 per cent of independent directors, the definition of which is fairly wide (*e.g.* a material pecuniary relationship with the holding company is prohibited). The provision is intended to counter-balance the powers of a controlling shareholder on the board but as noted above might be less effective in practice.

The enforcement record

Compliance with Clause 49 has been enforced by both the Bombay (BSE) and National (NSE) Stock Exchanges. The chosen method appears to be through suspensions either of a short term nature or in some cases for a considerable period. De-listing is rarely used. As of March 2011 the (BSE) had suspended 1 405 companies out of 5 067 listed companies on account of non-compliance with the listing agreement.[9] The NSE had also suspended 97 companies out of 1 559 listed companies. The bulk of the problem appears to be with the important state-owned enterprises (Public Sector Undertaking: PSU) and smaller companies, with the top companies mostly compliant. The issue for the SOEs (PSU) concerns independent director requirements since SEBI has ruled that government nominees on PSU boards are not independent per Clause 49's requirements.

SEBI is also involved in enforcing Clause 49 which contains certain penalty provisions, the strongest and least used being de-listing. Financial penalties for directors of non-compliant firms were introduced in 2004, effective from 2006. The regulator brought its first enforcement proceedings in September 2007: 15 were private companies and five were PSUs (Afsharipour, p. 390). It has been more effective in blocking IPOs if companies fail to meet the standards. Due to the overburdened Indian courts there is little enforcement through private litigation, increasing the responsibility of SEBI and its need for enforcement resources.

In cases of violation of the Listing Agreement, SEBI has the power to appoint adjudication officers to levy penalties. In the past three years, adjudicating officers have levied penalties on six companies for violations of the provisions pertaining to Corporate Governance (Clause 49). There is in principle no limit to fines and promoters (controlling shareholders) can even be banned.

While the scope of Indian securities laws are judged to be quite pervasive (Bose, 2005; Batra, 2008), there appear to be significant problems in enforcement, an issue previously noted by the World Bank ROSC in 2004. However, progress is being made. International benchmarks and comparisons are exceedingly difficult, but Bose documents that over the period 1999-2004, SEBI took action in 481 cases (on average a little under 100 per year) as opposed to 2 789 cases for the US's SEC, although the latter regulates a significantly more mature and extensive financial market. Over the last three years about 80 cases have been taken up each year for investigation. As a ratio of companies that are not suspended to the number of companies

under their respective jurisdictions, SEBIs figure recently is approximately 0.45 (0.09 inlcuding all firms), while that of the US SEC is 0.52. Bose also points out that in appeals to higher authorities, the decision went against SEBI in 30-50 per cent of cases, but the most recent data indicates that SEBI is now quite successful (out of 182 appeals only 17 were allowed)

Only certain provisions of the Companies Act, especially those pertaining to issuance and transfer of securities are delegated to SEBI. Provisions including the duties of directors and the remedy of oppression/mismanagement by the majority fall under the administrative domain of the Ministry of Corporate Affairs/Company Law Board. However, SEBI is empowered to prescribe listing conditions.

There have been a number of cases covering oppression and mismanagement with the latter being easier to prove. In one case in 2006 (Central Government *vs*. Pentamedia Graphics, Ltd.), gross violation of statutory provisions and irregularities in relation to sale of assets was judged to be mismanagement. The CLB has wide powers to grant relief such as the removal of some or all directors. In the financial year 2009/10, 393 applications relating to oppression and mismanagement were received and 219 cases were settled. However, the number of cases pending also increased from 745 to 919 (*http://clb.nic.in/2k9-2k10.htm*).

In the year 2009/10, the MCA/CLB started 9 000 prosecutions but had 60 000 pending at the start of the year. With some 7 000 disposed of during the year, 61 700 remained pending at the end of the year. The percentage of convictions to total cases decided was only around 50 per cent but above the longer term average of about one third (MCA, p. 50). The bulk of the new filings related to administrative issues such as three copies of the balance sheet to be filed with the registrar (4 000) and the filing of annual returns (3 800). Other cases of more relevance for the issue of this report include: loans to directors, 4 cases; board's sanction for certain contracts in which particular directors are interested, 5 cases; and interested director not to participate in Board's proceedings; 3 cases (MCA, pp. 48-49).

The problem of enforcement is a more general one in India. In his analysis of RPTs in India, Batra (2008) notes that case arrears and decade long legal battles are commonplace in India. In spite of having around 10 000 courts (not counting tribunals and special courts) India has a serious shortfall of judges. While the United States has 107 judges per million citizens, Canada over 75, Britain over 50 and Australia over 41, for India the figure is slightly over 10. He quotes one study that there are 20 million cases pending in lower courts and 3.2 million in High Courts. A dispute contested until all appeals are exhausted can take up to 20 years for disposal, while petitions in High Courts can take between 8 and 20 years. Chakrabarti *et al*. note that in 2004, 63 per cent of pending civil cases were more than a year old, and 31 per cent were over three years old. Automatic appeals, extensive litigation by government, underdeveloped alternative mechanisms of dispute resolution like arbitration, and the shortfall of judges all contribute to the state of affairs in Indian courts. Most important, since the same courts try both civil and criminal matters, and the latter gets priority, economic disputes suffer even greater delays.

In order to improve efficiency of enforcement actions, the MCA proposed to change the CLB to a Tribunal staffed by commercial professionals such as lawyers and accountants. However, due to certain provisions with regard to eligibility conditions and qualification requirements for Chairpersons/member of the Tribunal, the proposal was successfully challenged before the Supreme Court in 2010. The directions given by the Supreme have been taken into account in the proposed new Company Law. If it is passed as planned a Tribunal will be established.

Assessment and conclusions

India has done a great deal to develop a sound corporate governance framework in recent years to cover the 6 000 listed companies. Clause 49 of the listing requirements establishes a significant framework for RPTs and minority protection. Observers also judge the securities laws to be quite pervasive and to offer important investor protection. The Indian parliament will be considering a new company law and this opportunity should be used to deal with a number of outstanding issues including removing the role of the government in approving some corporate actions that is historical. They need to be returned either to company boards or to the meeting of shareholders.

The situation in India with respect to minority protection and RPTs needs to be assessed in the light of widespread company groups with strong controlling shareholders, and an overburdened judicial system. The resort to control of RPTs via independent directors on the audit committee might not work effectively since in practice independent directors appear to believe that they are advisors to the controlling shareholders. The role of the board and its independent directors needs to be underpinned by the right of shareholders to have a say on certain material transactions. Moreover, given the structure of ownership in India, it is essential that interested shareholders are not permitted to participate in the shareholder vote. The new Company Law and implementing regulation is well advised to introduce these features. Introducing such a right might need to be accompanied by safeguards to avoid potential hold-ups by a small number of investors.

In addition, if as recommended shareholders are given additional rights to approve some RPTs both *ex ante* and *ex post*, it will be essential to improve the efficacy of AGMs by, *inter alia*, ensuring the effective possibility to call for a poll vote rather than a show of hands. The recent decision to publish full results of the voting, including abstentions, is a commendable initiative.

A major issue that needs to be addressed concerns company groups since they are likely to be the source of major RPTs that can be abusive. While intra-group transactions are reported and are regarded as RPTs by the accounting rules and Clause 49, the approach to control of RPTs is heavily oriented to self-serving behaviour by directors and management. Directors' duties are specified in terms of loyalty to the company. Yet the reality is that company groups are widespread with a number of functions conducted at group level. Independent directors often serve on other boards in the group and indeed Clause 49 calls for the independent director of the parent to sit on the board of a non-listed subsidiary. Additional measures need to be considered to recognise the reality of corporate groups, perhaps along the lines taken in other countries reviewed in this report.

Steps need to be taken to strengthen law enforcement by both the MCA/CLB and SEBI and especially to remove civil cases from the overwhelmed court system. While on paper India has strong investor protection, in reality a slow judicial system, marked by overburdened courts makes application and enforcement of those laws far from a simple matter (Batra, 2008). The proposal in the draft Company Law to have a corporate law tribunal comprising judges assisted by professionals needs to be implemented as a priority.

Weak enforcement possibilities are the primary reasons why some principles are not fully implemented. The key principles are:

- Principle III.A.2 (*minority shareholders should be protected from abusive actions by, or in the interest of, controlling shareholders acting either directly or indirectly, and should have effective means of redress*). While laws and regulations are in place, effective means of redress is lacking.

- Principle III.C (*members of the board and key executives should be required to disclose to the board whether they, directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the corporation*). This is implemented by laws and regulations even though enforcement might remain problematic.
- Principle V.A.5 (*disclosure should include, but not be limited to, material information on related party transactions*). Broadly implemented through the listing agreement and accounting standards although disclosure about the company group might need to be better developed.
- Principle VI.D.6 (*the board should fulfil certain key functions, including .. monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions*) is broadly implemented by Sections 299 and 300 of the company law although they might need to be tightened to cover conflicts of interest with controlling shareholders and company groups.

Notes

1. The study also noted a case where the address provided by a company for a non-promoter shareholder actually turned out to be that of the company's chairman. See also Afsharipour, 2009.
2. The listing requirements call for at least one independent director of a holding company should sit as a director on the board of material non-listed Indian subsidiaries. This is not the reason why the study reports a group concentration of independent directors since the author only covered listed companies.
3. Another study (Aggarwal, 2010) is based on interviews with 16 legal experts working with 50 companies so is not as broad as Khanna and Mathew. It concluded that "there has been no case where an ID has opposed the action of management and the remaining directors have voted in his favour for a valid and just purpose" (p. 130).
4. For a description of calculating control rights and cash flow rights see *OECD Methodology*, Annex A.
5. One reason why loans might be important is the practice of making advances to wholly owned subsidiaries for the purchase of land that will be used by other group companies.
6. The quoted unpublished PhD study is by Jayashree Saha, "A Study of Related Party Transactions in Indian Corporate Sector" (2006), from IGIDR.
7. The converse where controlling shareholders also act to prop-up a failing group firm has also been observed. See Balassubramanian *et al.* (2009) for a critique of the shock analysis.
8. According to Section 295(2), the regulation shall not apply to any loan made, guarantee given or security provided by a private company unless it is a subsidiary of a public company.
9. For suspended companies, see *www.bseindia.com/about/datal/suspend.asp*.

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ANNEX 4.A1

Aggregate Related Party Transactions of 50 Companies as a Percentage of Net Worth, 2008-09

Category	Period	Related party transactions as a % of net worth								Grand total as a % of net worth
		Associates	Subsidiary	Key management personnel	Relatives of key management personnel	Joint venture	Individuals	Others	Holding company	
Accounts payable	2008-09	0.02	0.79	0.05	0.00	0.00	0.00	0.88	0.00	1.74
Advance given	2008-09	0.01	0.94	0.00	0.00	0.32	0.00	0.18	0.00	1.45
Advance received	2008-09	3.19	0.32	0.00	0.00	0.28	0.00	0.25	0.00	4.05
Advance refunded	2008-09	0.00	1.37	0.00	0.00	0.00	0.00	0.00	0.00	1.37
Bad Debts written off	2008-09	0.00	1.04	0.00	0.00	0.39	0.00	0.00	0.00	1.43
Corporate guarantee	2008-09	1.36	18.81	0.00	0.00	0.37	0.00	0.24	0.00	20.78
Deposits given	2008-09	0.80	6.08	0.01	0.00	0.72	0.00	0.26	0.00	7.88
Deposits recovered	2008-09	0.76	3.83	0.00	0.00	0.00	0.00	0.00	0.00	4.59
Deposits repaid	2008-09	0.04	3.60	0.00	0.00	1.60	0.00	0.00	0.00	5.24
Dividend paid	2008-09	0.45	0.66	0.02	0.00	0.27	0.00	0.25	2.00	3.65
Interest/dividend received	2008-09	0.30	0.92	0.00	0.00	0.10	0.00	0.00	0.00	1.32
Investment made	2008-09	2.02	5.71	0.00	0.00	0.14	0.00	1.22	0.01	9.12
Investment sold	2008-09	0.30	1.05	0.00	0.00	0.00	0.00	0.41	0.00	1.76
Loan and advances recovered	2008-09	0.00	40.94	0.00	0.00	0.00	0.00	0.02	0.00	40.96
Loan and advances repaid	2008-09	1.89	1.68	0.00	0.00	0.00	0.00	0.00	0.00	3.57
Loans and advances given	2008-09	0.50	25.11	0.00	0.00	0.54	0.00	1.11	0.00	27.26
Loans and advances received	2008-09	0.01	1.20	0.00	0.00	0.00	0.00	0.00	0.00	1.21
Other income	2008-09	1.05	0.16	0.00	0.00	0.01	0.00	0.33	0.00	1.55
Other liabilities	2008-09	0.00	2.21	0.00	0.00	0.00	0.00	0.00	0.00	2.21
Payment for expenditure	2008-09	0.02	1.22	0.01	0.00	0.05	0.00	0.17	0.01	1.48
Payment for research	2008-09	0.00	8.83	0.00	0.00	0.00	0.00	0.00	0.00	8.83
Payment for service provided	2008-09	0.08	1.46	0.10	0.00	0.11	0.00	0.14	0.10	1.99
Purchase of fixed assets	2008-09	0.06	0.33	0.00	0.00	0.08	0.00	0.39	0.13	1.00
Purchase of goods and services	2008-09	2.44	3.36	0.00	0.00	1.81	0.00	4.77	1.92	14.30
Receipt for service provided	2008-09	0.18	1.39	0.00	0.00	0.10	0.00	0.06	0.28	2.02
Sale and services	2008-09	0.37	11.09	0.00	0.00	0.28	0.00	5.00	0.21	16.95
Share application money	2008-09	0.00	3.86	0.00	0.00	0.00	0.00	0.00	0.00	3.86

Source: Data sources of both the Bombay and National Stock Exchanges. The fifty companies are part of the leading index "S&P CNX Nifty"and the thirty companies of the BSE SENSEX. Fully owned subsidiaries are included. Not all companies had related party transactions to report.

PART II

Chapter 5

Israel: Review of Related Party Transactions and Minority Shareholder Rights

This chapter on Israel of the OECD report on the corporate governance framework for managing related party transactions describes the structure of listed companies and especially the concentration of ownership and the use of company groups, all of which are related to the type and intensity of related party transactions. The corporate governance framework that has been established to manage such transactions and to protect minority shareholders is analysed, and the potential for improvements discussed.

The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

The OECD's Review of Israel, carried out during 2008-09, identified highly concentrated ownership and the prevalence of pyramidal company groups within the Israeli market as a key risk to the enforcement of shareholder rights and equitable treatment, and noted the Israeli authorities' active efforts to address this issue. In the time since the review was completed, Israel has taken steps to further strengthen its framework for upholding minority shareholder rights. New company law amendments that took effect in May 2011 enhance the enforcement tools available to the securities authority and give disinterested shareholders strengthened powers in the election of independent directors and the review of related party transactions. In addition, a specialised economic court was established early in 2011 in Tel Aviv, allowing for more rapid resolution of cases involving shareholder abuse. Nevertheless, the dominance of company groups in the Israeli economy and the risks associated with them remain a subject of active consideration and debate, both in the press and through deliberations of an intergovernmental working group established to look at issues related to their role in the economy.

This report briefly describes Israel's principal market characteristics before setting out the requirements for approval and disclosure of related party transactions. It then describes the wider set of measures in place that are intended to protect minority shareholder rights and more specifically to prevent the abuse of related party transactions, before concluding with an overall assessment of the situation.

The ownership and control of listed companies

Recent research has estimated that three-quarters of Israeli listed companies (613 as of the end of 2010) are controlled by family or individual interests. Twenty business groups, nearly all of them family-owned, controlled 160 publicly-traded companies with a 40 per cent segment of the market. The market segment of the 10 largest groups was estimated at 30 per cent, quite high relative to other OECD countries (Bank of Israel, Kosenko, 2008).

Israeli corporate pyramids tend to be quite complex and diversified, spanning a wide range of industries, with several of the large groups including financial concerns such as banks and insurance companies at their lower levels. Reforms have curtailed banks' ability to play an active role in the pyramids, principally due to the fact that they have been limited in their investments in industrial companies and through company law restrictions on related party transactions (OECD, 2011).

Nevertheless, many of the groups continue to maintain ties to institutional investors that create a potential conflict of interest between their role of representing their beneficiaries and the interests of other companies within the group. While most shares in the Israeli market are owned by individuals including blockholders, institutional investors owned 18 per cent, foreign investors 17 per cent, and government 1 per cent, according to 2007 data from the Tel Aviv Stock Exchange (TASE) provided for the OECD review of Israel (OECD, 2011).[1]

The free float in most Israeli companies is low, averaging less than 25 per cent for more than 250 companies, and 31 per cent overall excluding Israel's largest company, TEVA, a pharmaceutical group which has a 91 per cent free float, according to the TASE 2007 data. While the OECD review of Israel covered the structure and characteristics of the Israeli market in greater detail than is required here, one of its key conclusions was that, with no trends apparent toward significant changes to the current market structure, "The Israeli approach so far has been to accept the concentrated ownership and take steps, mainly through *ex ante* regulatory means, to avoid abuse" (OECD, 2011).

Approval processes for related party transactions

A special approval process is required under the Companies Law for the following related party transactions:

- Audit Committee, Board and General Meeting approval is required for all extraordinary transactions[2] of a public company with a controlling shareholder or with another person in which the controlling shareholder has a personal interest, including a private placement; a contract with the controlling shareholder or relative for the provision of services to the company; if he is an officer in the company, regarding the terms of his service and his employment; and if he is a company employee but not an officer, regarding his employment by the company.
- To obtain General Meeting approval, the transaction must attract the support of a majority of the votes of the shareholders who do not have a personal interest in the transaction and who are present and voting. The company itself has the responsibility for the classification of shareholders for such votes, but the Israel Securities Authorities (ISA) also checks *ex post* on whether shareholders have been correctly classified, particularly in cases where they judge that incorrect classification would have the potential to change the outcome of the vote. This "majority of the minority" provision was recently strengthened through Companies Law Amendment 16 to be increased from one-third of disinterested shareholders to a majority requirement. To reduce the risk of abuse by a small minority in cases where few disinterested shareholders are present and voting, the law also allows a measure to be approved even without a majority of the votes of disinterested shareholders if the level of opposing votes among these shareholders does not exceed 2 per cent of total voting rights (increased from 1 per cent under the same amendment).
- Other transactions relating to employment contracts and remuneration, including employment of company officers, controlling shareholders or their relatives, are also subject to RPT approval processes but are not the focus of this particular review.

Disclosure of related party transactions

Israeli Securities and company laws provide a quite detailed and specific list of interested parties and types of transactions subject to disclosure through either immediate or periodic reports. Securities law stipulates that immediate reports, known as transaction reports, must be filed following any company transaction with the controlling shareholder or with an individual or corporation in which the controlling shareholder has an interest, including details of who approved the transaction and the reasoning behind its approval. Company law further specifies that immediate reports must be filed in the case of an "extraordinary transactions" (see previous footnote for definition) between a public company and one of its controlling shareholders or another interested party.

The company must give notice of these transactions and their terms along with the convening of a general meeting for the purpose of approving the transaction within 14 days of its approval by the Board of Directors. The transaction report: "must include every detail concerning the transaction that may be important to a reasonable investor … for the purpose of voting at the general meeting, including, *inter alia*: a description of the main points of the transaction; the name of the controlling shareholder who has a personal interest in the transaction; details of the rights that give him control in the company, including his proportional stake in voting rights; the nature of the personal interest; and approvals required or terms that were determined for carrying out the transaction. The report must also include the reasons of the audit committee and the board of directors for approving the transaction, the value of the consideration and the manner in which it was determined, and the reasons of the directors opposing it, if there were any, and the names of the directors who participated in the board and audit committee meetings with regard to the approval of the transaction, indicating who of these is an external director; the manner in which the consideration was determined and the name of each director who has a personal interest in the transaction and the nature of this interest."[3]

Separate but similar requirements are established for extraordinary transactions involving a company officer or between the company and another person that the officer of the company has a personal interest in; for contracts between the company and its CEO regarding the terms of his employment; contracts between the company and one of its directors regarding terms of service, including the granting of loans in the context of employment terms; or a contract between the company and one of its directors regarding terms of employment in other positions. If a transaction involving an officer or director was not approved due to conflict of interest or lack of good faith, it must still be reported.

Finally, Securities Law specifies a set of related party transactions, essentially recurrent transactions, subject to less detailed, "periodic reports". Company annual reports must specify the identities of the parties to the transaction; its details; the date and authorising body; and the controlling shareholder's personal interest in the transaction.

In addition, Israeli public companies are required to follow International Financial Reporting Standard (IFRS) requirements, including IAS 24. Because IAS 24 defines related parties as including parent companies and subsidiaries, and companies of the same group (among other related parties), intra-group disclosures are treated under IAS 24 as part of the disclosure of consolidated financial accounts.

Provisions concerning board duties and the role of independent directors

On a broad level, Israel's legal framework provides a wide range of protection and support for minority shareholder rights. In the case of boards, this protection is established both through the definition of directors' duties as well as through provisions that give minority shareholders special powers in the appointment of a special type of independent director known as an "outside director". These provisions may be seen as reinforcing the requirement for independent judgement of both the Audit Committee and the board, which both play a role in reviewing related party transactions.

The Companies Law stipulates that directors owe a duty of care and fiduciary duty to the company (*i.e.* a duty of loyalty) rather than specifically to shareholders. However, they also have an obligation to maximise profits, although within this scope they may take into account the interests of the company's creditors, employees and the public. The

Companies Law also requires that directors use independent judgement and may not be a party to voting agreements or instructions. Directors must also refrain from any act that involves a conflict of interest, competing with the company, and exploiting corporate opportunities for their own benefit. Shareholders can seek redress for violation of directors' fiduciary duties mainly through derivative suits on behalf of the company, although it is possible to file individual or class action suits against directors if the breach of duty relates to disclosure or an attempt to defraud, covered under Securities Law. The issue of shareholder suits is covered in greater detail under the section on enforcement.

In addition, the Companies Law provides specifically for the appointment to the board of at least two independent directors, including at least one "outside director" who must be both independent and have special qualifications, *i.e.* accounting or finance expertise. If one outside director with such expertise is already in place, other professional qualifications are also acceptable to be designated as an "outside director". To be classified either as independent or outside directors, they must also not possess any connection to the company or hold any position that gives rise to a conflict of interest, including economic or family relations to corporate management or major shareholders (OECD, 2011). Outside directors play a crucial role in chairing the Audit Committee, and along with at least one additional independent director (but not necessarily "outside director"), comprise a majority of the Audit Committee. This committee has the first responsibility to review related party transactions before board or shareholder approval. The Audit Committee also has been given a new role under Israel's recent Company Law amendments obliging it to set up arrangements to protect whistleblowers and to treat reports dealing with deficiencies in management.

The 2011 Company Law amendments also increased the percentage of non-controlling shareholder votes required to appoint outside directors from one-third to at least half (or that the total number of votes opposing the appointment from among the non-controlling shareholders is less than 2 per cent of the total voting rights in the company). While these "majority of the minority" provisions apply to appointment of outside directors, independent directors do not require such minority shareholder approval, but they must meet the above described criteria for independence. Outside director elections are further facilitated by the fact that directors are elected individually, rather than as part of a slate. The controlling shareholder is also no longer able to prevent the appointment of an outside director for a further 3-year term, if a majority of minority shareholders approve the appointment. There must also be at least one independent director on all board sub-committees other than audit.

For the more specific case of reviewing related party transactions, Companies Law requires that a Director not be present for the discussion and abstain from voting on any transaction for which he or she has a personal interest in its approval. Likewise, company officers with a personal interest in a transaction may not be present unless the Chairman of the Audit Committee or the Chairman of the Board requires their presence in order to present the issue before the board or the committee. An exception can be made to allow a board member with an interest in the transaction to participate in the discussion and to vote if a majority of the Directors of the company have such a personal interest in the transaction, but in such a case, the transaction also requires approval of the General Meeting.

Beyond these legal provisions, the Companies Law recently adopted a Corporate Governance Code setting out voluntary recommendations that a majority of directors within a company with dispersed shareholding should be independent, and at least

one-third of the directors in a company with a controlling shareholder. At the time of writing, the ISA was still working to implement reporting requirements associated with the Code, whose reporting corporations will have to disclose non-compliance with recommended provisions ("comply or disclose"). The reporting requirements related to the new Code were expected to be issued later in 2012.

The role of shareholders in reviewing related party transactions

A central provision of the Companies Law establishes that all shareholders are required to "act in good faith and in a customary manner" towards the company and towards other shareholders, including a duty to avoid discriminating against other shareholders. More specifically, shareholders shall refrain from abusing their power in the company when voting, *inter alia*, on alteration of the articles of association, increases in the registered share capital, mergers, approval of acts and transactions requiring the approval of the general meeting. A controlling shareholder or shareholder who knows that he or she has a decisive vote on a resolution has an additional duty to "act fairly" towards the company. These duties have been interpreted by the courts to generally require that in transactions with interested parties, these categories of shareholders are under an obligation to disclose their personal interest. Failure to comply with these approval and disclosure requirements is subject to either administrative or criminal liability and sanctions (OECD, 2011).

For the system of disinterested shareholder approval to function effectively to protect minority shareholders, it is crucial for minority shareholders to play an active role in reviewing and opposing transactions that may be found to be contrary to the company's and their interests. In this regard, the Israeli framework has focused particularly on the role of institutional investors (mainly pension funds and mutual funds), who represent 18 per cent of the market's shareholdings, by requiring them to vote. First, these institutional investors have a general "duty of care" to vote on issues that could affect their own investors; and second an explicit duty to vote on self-dealing transactions involving controlling shareholders, directors, and senior officers. They are also required to disclose their votes (Hamdani and Yafeh, 2011).

This public disclosure of voting decisions enabled Hamdani and Yafeh to carry out a review of 26 000 votes by pension and mutual funds occurring during 2006 (including 10 000 decisions not to vote). Their review raised a number of concerns about institutional investor voting patterns and their implications for the protection of minority shareholder rights. They found that institutional investors tended to be active primarily when legally required to do so, but often failed to use their voting powers on other significant votes, most notably in the case of independent director elections. They noted that proposals related to compensation triggered the highest percentages of their negative votes, even when it was clear that their votes could not influence the overall outcomes. On the other hand, cases for which minority shareholders had a greater legal power to influence the outcome did not have a significant impact on their voting decisions, such as for votes on extraordinary RPTs requiring approval of at least one-third of disinterested shareholders (modified in 2011 to require more than 50 per cent approval of disinterested shareholders).

Hamdani and Yafeh also examined concerns expressed by some in the market that institutional investors' inclination to play an effective monitoring role as a minority shareholder is inhibited by potential conflicts of interest involving owners of some of these funds, since a number of them are part of larger company groups. While they stated that data on business ties between an institutional investor and any given firm were not publicly

available, they divided institutional investors into two categories: one group, involving funds expected to have fewer commercial ties due to government or employee ownership; and a second group of commercially-owned mutual funds with higher potential for conflicts of interest. They found that the support rate for AGM proposals favouring corporate insider positions was 10 percentage points lower among the "non-commercial" pension funds than among "commercial" institutions that they considered to have a higher potential for conflicts of interest. They concluded that: "One policy implication of these findings could be that measures to empower minority shareholders may not bring about considerable improvement without parallel measures to remove potential conflicts of interest that impede institutional investor involvement in corporate governance."

While the requirement for mutual and pension funds to vote does not extend to cases in which they have a conflict of interest, the multiple group structure to which many of these funds belong may undermine their willingness to act in shareholder abuse cases, particularly in cases where groups have cross-shareholdings with each other. However, some provisions related to mutual fund disclosure of voting decisions and cases of conflicts of interest are in place or under consideration. The fund manager's director or board members may not vote on transactions for securities issued by a corporation in which the fund is the principal shareholder. In other cases where a transaction may involve a conflict of interest for the mutual fund, mutual fund managers are required to submit decisions on shareholder votes to their board of directors. Proposed new regulations of the Joint Investment Trust Law, which are not yet enacted, would also require the fund manager to explain the reasoning behind its vote on each specific resolution on which it is required to vote. The regulator is also currently considering a proposal that investors should undertake and report on their market analysis related to their votes, which may either be conducted in-house or by paying an external market analyst. These provisions, however, do not apply to pension funds, provident funds and insurance companies, which are not regulated by ISA.

Enforcement

Shareholder suits

Apart from shareholder voting, the main enforcement tool available through the Companies Law is individual enforcement by shareholders of their rights. These may take the form of both individual and class action civil suits to recover damages stemming from related party transactions they regard as abusive, or against directors for breaches of duty. They may also initiate a derivative suit on behalf of the company when the company fails to take action, following a petition in writing by the shareholder.

An important new development is the Amendment 16 to the Companies Law allowing ISA to financially support derivative suits filed by plaintiffs. This is a significant change, since the costs of bringing such suits are considered to be one of the barriers to such suits. This new capacity to support the filing of derivative suits adds to a similar provision of financial support available for class action suits. Equally important, the new amendment 16 facilitates access to information needed to support the plaintiff's case, by allowing the plaintiff to receive information from the company that would assist him in the preparation of the claim.

The ISA received and granted six requests for financial support for class actions that were filed during 2011, five of which are still pending. Eight requests for ISA support of class action suits were filed in 2010, all of which are still pending (not necessarily dealing specifically with related party transactions). While ISA does not disclose the individual amounts provided to support these suits, it reported that overall it provided more than USD 100 000 in financial assistance for class action suits from 2009-11.

Perhaps most significantly, the resolution of such suits has been facilitated by the establishment in December 2010 of the new Tel Aviv District Court's Specialised Department for Securities and Companies Law litigation. The specialised department may consider claims arising in the fields of Companies Law, Securities Law, Joint Investment Trust Law, Regulation of Investment Advice, Investment Marketing and Portfolio Management Law and regulations under these laws. Its judges hear all criminal and civil cases deriving from these laws, class actions and derivative claims, as well as petitions with regard to administrative decisions made by ISA, TASE and the Companies Registrar.

Its first decision, issued on 15 May 2011, a class action suit brought against Makhteshim Agan and Koor Industries, supported the action by stating that despite the fact that all correct procedures were followed (audit committee, board and shareholder approval), the related party transaction in this case needed to also pass a fairness test. The implication of this fairness test is that the shareholders were entitled to the best possible price, and that the controlling shareholder was not entitled to extra consideration at their expense. The Court also held that if the Company wished to avoid the application of the fairness test, it should consider setting up a sub-committee of the board with independent directors and excluding representatives of the controlling shareholder empowered to negotiate the transaction (or decide against the execution of the transaction). This finding marks a change in that, while controlling shareholders or other related parties are not allowed to participate in decisions of the Board or shareholder meetings, they are not excluded from participating in the negotiations over the transaction itself.

The judge approved a settlement in the case so it will not be appealed. Market observers interviewed for this report suggested that this would have an important impact on the market, as controlling shareholders will understand that even if they follow all procedures, if a related party transaction is not fair to minority shareholders, they face a risk of having to pay damages. Their view was that big cases such as this, even if they do not occur every year, are enough to put the market on notice that abuse of minority rights on related party transactions will be punished and that controlling shareholders must be careful in this regard. Some investors suggested that more such suits are needed to ensure strong protection of minority shareholder rights. Nevertheless, the establishment of the economic court and its quick action in support of minority shareholder rights appears to be a major development, providing both more consistent judicial expertise, and a speedier process (90 days) to resolve shareholder disputes.

Regulatory review of RPTs

The Israel Securities Authority (ISA) actively reviews all material related party transactions except those involving liability insurance for directors, both through formal and informal processes. While no specific guidance or thresholds are in place regarding what constitutes a material transaction, the ISA reviews every transaction which it considers to materially affect the reporting of a corporation's business, including in some cases relatively small transactions. For example, they review all transactions regarding

compensation to related parties, sale of affiliated companies, and provision of services by a controlling shareholder. They check whether procedures were followed, whether shareholders are correctly classified as interested or disinterested in voting procedures, and whether disclosure requirements have been followed, with particular attention to the question of whether sufficient information has been disclosed that would be important and necessary for a reasonable investor to cast an informed vote. If they feel information is insufficient, they may send a letter to directors asking them to explain the reasons why they approved a deal, while providing ISA's legal opinion. Board members' answers are made public to all investors, potentially exposing them to liability if their reasons are not justifiable. In some cases, they have required a company to obtain an external opinion concerning the fair market value of a related party transaction, and cited one example in which the board of one of the concerned companies voted against the transaction following the issuance of the external opinion.

Overall, they reviewed 400 related party transactions in 2009 and 470 in 2010, 93 per cent of which were approved under company RPT approval processes. ISA was not able to provide more specific breakdowns on the number of companies that reported such transactions, or the average number of transactions reported per company (excluding those who reported none), or to classify what types of transactions are most commonly submitted for review. ISA noted that there are many other cases on which informal feedback is sought but which leads to the proposed transaction being dropped or altered. With recent reforms and court decisions that have supported minority shareholder protection, they would expect these numbers to come down in the future.

An important new development is a Securities Law amendment that allows ISA to impose administrative sanctions (such as fines, suspension of licenses, requirement to repair the violation and not repeat it, etc.) or negotiate a settlement. Prior to this amendment, they only were allowed to pursue criminal cases, which are more time-consuming and complex, involving a higher burden of proof. It was suggested that the securities law amendment would enhance ISA's accountability by formalising the processes available to them to challenge violations that are not at a level of criminal intent. It also greatly increases their flexibility and ability to more efficiently address less serious cases and cases where criminal intent is not provable.

In addition, the State of Israel also initiates criminal prosecutions in some cases based on joint work carried out by ISA's investigations department and the District Attorney's office, filed by a jointly staffed Securities Division. Powers of discovery and in some cases strong co-operation with foreign regulatory authorities for cases involving transactions occurring outside of Israel have helped lead to successful prosecutions for most cases, according to ISA. While precise statistics on the number of cases brought to court were not available, ISA stated that the State has won a majority of the cases and lost no more than five such cases over the past five years. Not all of these cases have dealt with related party transactions; some for example have dealt with disclosure and insider trading.

An important recent criminal related party transaction case, the *State of Israel v. Aviv Algor and Ian Nigel Davis*, resulted in the January, 2009 conviction of Mr. Algor and Mr. Davis, the controlling shareholders for Middle East Tubes, Ltd., for obtaining the approval of one-third of disinterested shareholders by fraudulently presenting an associated shareholder as independent, when in fact this "straw man" had been given a loan by the controlling shareholders to buy shares. The main transaction concerned the payment of

management fees, while a second decision concerned an extraordinary transaction between the controlling shareholders and the Company for the Company's undertaking liability insurance for its directors and officers. Mr. Algor was sentenced to 24 months in prison plus a fine of 2 million Israeli shekels (approximately EUR 400 000), substitutable for 18 months in prison, while Mr. Davis received a similar sentence but with six months less of prison. The case was appealed and subsequently upheld by the Supreme Court in June 2009, but with a modification of the sentence for each of the defendants to two years in prison, of which one year suspended sentence, provided that they not commit any further violation of which they were convicted for a period of two years. The fines and possibilities to substitute the fines with 18-month sentences were also upheld.

Some market participants have expressed a concern that too many powers are concentrated in ISA, and that the administrative court, to be staffed by ISA employees, will further concentrate power in ISA's hands. However, ISA's Chair has responded to these concerns by announcing an appointment process under which two-thirds of the court's appointees will be appointed by Ministry of Justice and one-third by the ISA Chair. The new Chair also announced that his appointees would be ex-judges, and that the Ministry of Justice appointees should have either capital markets expertise or expertise in companies and securities law. The independence of ISA's budget also provides some degree of protection against political intervention in such cases.

Transactions involving company groups

While numerous recent steps have been taken to strengthen the tools available to shareholders and enforcement authorities to ensure that related party transactions are not abusive, the prevalence of pyramidal company groups in Israel continues to be recognised as enhancing the risk of such transactions. This may be the case particularly where such groups include private companies that are subject to lower levels of disclosure than those required of publicly listed companies. However, the Israeli legal framework does seek to address such situations by requiring that any matter relating to a private company that is considered to be of material importance to a public company (where both companies belong to the same group) has to be reported to ISA and to the public. This is further reinforced by IAS 24 disclosure requirements applying to related parties within company groups. Contractual agreements between a public company or its subsidiaries and affiliated companies in the group must be disclosed in detail, if they are substantial for the public company. Existing case law provides some evidence of the application of this legislation (OECD, 2011). In addition, director's duties are clearly defined to be in the interests of the company, stipulating that in upholding fiduciary duties, the director is not permitted to consider the interests of other companies in the group.

Nevertheless, the large holding company group structure that dominates Israel's listed market is an issue of continuing debate, and a special inter-governmental committee called the "Market Concentration Committee" has been reviewing this issue since its establishment in October 2010. The Committee, led by the offices of the Prime Minister and Ministry of Finance, issued interim recommendations to the Prime Minister in September 2011.

The recommendations focus on two major areas:

- The first set of recommendations aims to separate financial holdings (banks, insurance companies and investment firms) from "real" business enterprises, if the dual holding exceeds a certain threshold. Owners of dual holdings would be required to divest either

their financial or non-financial holding within a period of four years. In addition, the Committee recommended that directors be prohibited from serving on the boards of both a financial and non-financial firm within the same group.

- The second issue the Committee seeks to address is corporate pyramid structures. The Committee outlined a number of recommendations aimed at strengthening the rights of minority shareholders within such structures. For example: 1) a company owned through a pyramid structure would be required to appoint at least one-third of the board members as outside directors; 2) outside directors could only be appointed by a majority of the minority shareholders; and 3) remuneration of corporate officers would require approval by the majority of the minority shareholders.

Two recommendations of the Market Concentration Committee specifically address related party transactions: 1) the committee proposed that the company "comply or disclose" if it has put in place a competitive process before approving the sale of an asset or receiving a service or loan from an interested party; and 2) the Audit Committee would be required to review and approve all transactions with an interested party even if it is not an extraordinary transaction, unless it is deemed as being only a negligible transaction.

The Committee issued its final report in March 2012 with proposals along similar lines but with some adjustements of the details; the proposals were under review by the government at the time of writing. If enacted, they clearly would involde significant steps to enhance minority shareholder protection and to reduce potential conflicts of interest within company groups and for directors serving on boards of companies within such groups.

Assessment and conclusions

Since the time of its OECD corporate governance review (OECD, 2011), Israel has taken numerous additional steps to strengthen an already robust framework to prevent the abuse of minority shareholder rights, including for related party transactions in particular. Among the key, positive recent steps highlighted in this report are:

- Provisions that require at least 50 per cent of the votes of disinterested shareholders to approve "extraordinary" related party transactions, up from one-third previously.
- Increased power of these shareholders to also appoint independent "outside directors", requiring a similar majority of disinterested shareholders. Outside directors cannot have any economic or family ties to the company or its controlling shareholders. Controlling shareholders also are no longer able to block reappointment of these directors after three-year terms if a majority of disinterested shareholders approve the appointment.
- A stronger role for "outside" and "independent" directors in the Audit Committee. The Chair of the Audit Committee must be an outside director, and at least one outside director must be present for any decision by the Audit Committee. The Audit Committee must also be comprised of a majority of independent directors, and a majority of independent directors must be present for any Audit Committee decision. Lastly, the Audit Committee plays a specific role in approving related party transactions and establishing safeguards for whistle-blowers to report concerns.
- ISA has gained new authority to impose administrative sanctions including monetary sanctions in relation to certain Companies Law requirements such as failure to appoint outside directors or failure to appoint an audit committee. It also has new discretion to settle cases.

- ISA also gained new authority to financially support derivative suits filed by plaintiffs, which are further supported by the plaintiff's right to petition the court to instruct the company to reveal information relating to the derivate suit. The court may approve the request for information if it is convinced that the plaintiff has sufficient preliminary evidence for the fulfillment of the conditions for the filling of a derivative action.
- Finally, the establishment of the Tel Aviv District Court's Specialised Department to consider class action and derivative suits as well as criminal cases filed by the State is seen as having a significant impact in speeding up the resolution of court cases and enhancing the expertise brought to bear by these courts. Its first decision was seen as sending a strong signal to the market that minority shareholder rights will be supported.

Yet, Israeli authorities do not claim to have "solved" the problem of preventing related party transactions that could be abusive. Even with extensive protection in place, a question remains as to whether institutional investors or other minority shareholders are fully willing to play the role assigned to them to monitor transactions that could be to their detriment, given the costs and time involved in analysing and voting on such transactions, and in enforcing against abuses through shareholder suits. Questions have also been raised as to whether the ownership structure of some institutional investors, involving cross-shareholdings and in some cases pyramidal ownership, establishes inherent conflicts of interest that undermine any realistic possibility that they will effectively monitor minority shareholder rights. For these reasons, the interim recommendations emerging from Israel's Market Concentration Committee represent significant new measures to minimise potential conflicts of interest and mitigate the risk of abusive related party transactions within such groups.

Israel has broadly implemented the OECD Principles relevant to the prevention of abuse of related party transactions, with one of the most elaborated systems of disclosure and review among OECD countries reviewed. By providing for the appointment of two independent directors including at least one "outside director" who must obtain a majority of non-controlling shareholder votes, and giving them majority status on the audit committee, Israel has established significant safeguards to promote scrutiny of related party transactions at the board level. Audit Committee and Board review and approval is complemented by an active role of the regulator to ensure that adequate information is provided to the market and that additional safeguards enabling disinterested shareholders to also review and decide on these transactions are implemented correctly. While some questions remain about the incentives and capacity of minority shareholders to safeguard their interests to prevent abuse, particularly in light of the predominance of company groups with potential conflicts of interest, Israel has taken a number of steps to try to mitigate these concerns and is currently considering additional actions. The key principles are:

- Principle III.A.2 (*minority shareholders should be protected from abusive actions by, or in the interest of, controlling shareholders, acting either directly or indirectly, and should have effective means of redress*). While some doubts remain about minority shareholder incentives or capacities to enforce their rights against abusive actions, Israel has a wide range of measures in place that support this principle's implementation.
- Principle III.C (*members of the board and key executives should be required to disclose to the board whether they, directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the corporation*). Israel has such requirements in place.

- Principle V.A.5 (*disclosure should include, but not be limited to, material information on … related party transactions*). Legal requirements are in place for disclosure of related party transactions both through adherence to IAS 24 for consolidated accounts and through requirements for immediate and periodic reports.
- Principle VI.D.6 (*the board should fulfil certain key functions, including … monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions*). The legal requirements are in place, while insufficient information on actual board practices is available to make a clear judgement on its full implementation.

Notes

1. The statistical data for Israel were supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.
2. Companies Law defines an extraordinary transaction as a transaction not in a company's ordinary course of business, not undertaken under market conditions, or a transaction that is likely to materially influence the profitability of a company, its property or liabilities.
3. Securities Regulations (2001), Section 3, *Transactions between a Company and a Controlling Shareholder*. The reference to "external director", also known in Israel as an "outside director", refers to independent directors who must be elected by a majority of disinterested shareholders, *i.e.* not including the votes of the controlling shareholder or others associated with the controlling shareholder.

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PART II

Chapter 6

Italy: Review of Related Party Transactions and Minority Shareholder Rights

This chapter on Italy describes the structure of listed companies and especially the concentration of ownership and the use of company groups all of which are related to the type and intensity of related party transactions. The corporate governance framework that has been established to manage such transactions, and especially the new regulations introduced by CONSOB to protect minority shareholders is analysed and the potential for improvements discussed.

With the introduction of new regulations covering related party transactions at the beginning of 2011, Italy has taken the next step in improving minority protection, a process that got underway with the Draghi reforms of 1998 and that accelerated in the wake of the Cirio and Parmalat scandals around 2003. Italy has now come a long way from its earlier characterisation as complex company groups that were easily exploited by dominant owners to capture the private benefits of control with little legal redress for minority shareholders. It is thus an opportune time to review the new corporate governance landscape.

This country review first highlights the evolution of the Italian corporate landscape over the last decade which although significant still offers opportunities for those in control of companies. The following section outlines the approach to shareholder protection in Italy after which the most recent reform measures to manage related party transactions are discussed. Conclusions are presented in a final section.

The ownership and control of Italian listed companies

The Italian listed corporate sector has traditionally been defined by concentrated control through opaque corporate structures such as pyramids and by dominance of a small number of interlinked but competitive entrepreneurs that could appropriate private benefits of control.[1] Cross shareholdings were also widespread. In these circumstances, protection of minority investors was weak which was believed to have led to the underdeveloped capital market. The reality now is somewhat more subtle but still represents challenges for minority shareholders.

The evolution of the corporate control landscape between 1990 and 2005 has been documented by Bianchi and Bianco (2006). Despite a new banking law, an increased role for institutional investors, a securities law, a corporate governance code and a new company law in 2003, followed by the so called Parmalat laws ("law on savings"), the evolution of ownership and control has not changed much although the instruments to maintain control have evolved. The largest shareholder in 1990 owned an average of 55 per cent of total capital (Table 6.1), although weighting shares by the size of the company, the value was lower at 48 per cent (*i.e.* in larger companies ownership concentration was lower). This had fallen to 45 and 29 per cent respectively by 2005. Dispersed ownership (defined as the sum of all shareholders with less than 2 per cent of the company, the reporting threshold in Italy), on the other hand, increased from 28 to 38 per and the capitalisation weighted share from 41 per cent to 55 per cent in 2005. Driving this shift were a number of privatisations in the period 1992-2005, especially in the banking sector. Noticeable is the increase in "other relevant shareholders" in the banking sector.

The pattern that has evolved is towards tight control of companies through shareholder coalitions and a significant simplication of pyramids/company groups. Table 6.2 shows that groups have been simplified thereby reducing the wedge between voting and cash flow rights. Technological change and industrial sector shifts have played a role in this simplification, but so have market forces. Complex company groups have been under

Table 6.1. **Ownership concentration of listed companies in Italy**

	1990	1998	2001	2003	2005
All listed companies					
Largest shareholder	54.7	47.1	45.4	44.7	44.6
Other relevant shareholders	16.9	14.0	16.8	17.3	17.5
Dispersed Ownership	28.4	38.9	37.8	38.0	37.9
Listed banks					
Largest shareholder	64.7	34.3	34.4	33.7	31.9
Other relevant shareholders	11.4	11.7	14.3	15.8	18.5
Dispersed ownership	23.9	54.0	51.3	50.5	49.6
Private non-financial listed companies					
Largest shareholder	52.0	48.4	46.8	45.6	46.0
Other relevant shareholders	18.6	15.7	18.1	18.4	18.4
Dispersed ownership	29.4	35.9	35.0	36.0	35.6

Source: Bianchi and Bianco (2006), "Italian Corporate Governance in the Last 15 Years: From Pyramids to Coalitions", *ECGI Finance Working Paper*, No. 144/2006, Table 8, p. 26, simple average.

Table 6.2. **Group width (number of listed companies) and group depth (distance of listed companies from the top) in the ten largest private non-financial listed groups**

	1990	2001	2005
Average number of listed companies per group	6.8	3.4	2.4
Weighted (market cap) average of number of listed companies per group	13.9	5.7	2.3
Average distance from the head of the group	2.6	2.1	1.6
Weighted average distance from the head of the group	3.0	4.1	1.6

Source: Bianchi and Bianco, *op. cit.*, Table 14, p. 30.

pressure for some time through a pronounced "Italian discount". This ultimately led, for example, one major company interviewed for the report to simplify its structure from 30 listed companies to two at present. On the other hand, control has been maintained by a significant increase in companies controlled by coalitions, both those governed by shareholder agreements, that need to be registered to be enforceable, and through informal coalitions. In 2005, fully a third of listed companies were controlled through coalitions accounting for nearly 50 per cent of market capitalisation (Table 6.3). Of particular note from the perspective of this review is the role of informal coalitions.[2]

It is therefore hardly surprising that Italian company law and financial regulation has been focused on the issue of company groups and shareholder protection for quite some time, driven by several high profile scandals over the years. The most recent two at Cirio

Table 6.3. **Listed companies controlled by coalitions (%)**

	Number of companies					Capitalisation				
	1990	1998	2001	2003	2005	1990	1998	2001	2003	2005
Shareholders agreement	5.0	11.0	10.9	12.3	10.9	18.1	7.4	11.5	15.1	16.9
Informal coalition	5.9	16.1	18.4	20.0	23.5	1.0	38.8	16.1	19.4	29.9
All companies controlled by coalitions	10.9	27.1	29.3	32.3	34.5	19.1	46.2	27.6	34.5	46.8

Source: Bianchi and Bianco, *op. cit.*, Table 15, p. 31.

Box 6.1. **The cases of Parmalat and Cirio**

Parmalat has been described by the US SEC as "one of the largest and most brazen corporate financial frauds in history". While the case is one of pure corporate fraud it involved elements that together required a policy response. The fraud at Parmalat involved the use of a highly complex corporate Group with key assets located overseas and therefore not covered by the new main auditor (an audit rotation was in force) who had to rely on another auditor for confirmation of cash balances that later proved false. The board of statutory auditors failed to detect the fraud while the board and its audit committee lacked independence: in 2001, Parmalat declared that four of its thirteen directors were independent but did not name them. It gave names in 2002 when it became clear that they all had had close relations with Mr. Tanzi.

One of the earliest known abuses of corporate property occurred in 1989 when Parmalat was used to cover the debts of Mr. Tanzi in other business areas such as a television station. Thereafter the company's funds were used to support, *inter alia*, an ailing tourism company owned by the family. In addition, discounts from a packaging company amounting to some USD 15 million per year were diverted from the company to the family's accounts.

The failure of the gate keepers, the board, the auditors and the audit board were all background for wide ranging legal changes (the Savings Laws).

Cirio, which occurred before Parmalat, involved a major conflict of interest on the part of banks and therefore a failure of board and internal oversight. Cirrio was failing and had large debts to a number of banks. They arranged for the company to issue new bonds that were bought by their wealth management subsidiaries and soon transferred to retail investors. The proceeds from the bond were then used to repay the banks, leaving the investors to take the loss. Later, retail investors were in some cases compensated by the relevant financial intermediary, pursuant to Court sentences finding a breach of duties when providing investment services to the public.

Source: Ferrarini and Giudici (2005).

and at Parmalat showed that the institution that was expected to protect minority shareholders, namely the board of statutory auditors (collegio sindicale), failed to detect the damaging fraud and associated abusive related party transactions.

Recent experience of RPTs

As with other countries of the EU since 2005, Italian companies are subject to IAS 24 (and other standards) covering reporting in the financial statements of transactions and related parties. However, Italian law goes much further and also deals with *ad hoc* disclosure of major RPTs.

The *ad hoc* disclosure of major RPTs has been mandated since 2003 by Consob (the Italian Securities Regulator) and recently revised in 2010. In the period 2003-07, few transactions were reported (17 per year) (Consob Consultation Paper on the regulation of related party transactions, April 2008). Disclosure has markedly increased since 2008, reaching 37 cases per year in the period 2008-10. Such an increase, that coincided with discussions regarding new regulations, was mainly due to a change in Consob supervisory policy which started to require companies to disclose material RPTs on a case by case basis.

In the period 2003-07, the majority of RPTs reported under the *ad hoc* disclosure regime issued by Consob were related to the transfer of assets between the listed company and subsidiaries or insiders. With a lower frequency, RPTs were related to financing but the relative value was greater than for transfer of assets. There was no clear relation between the magnitude of the RPTs and the nature of the related party, but the high value transactions were with controlling shareholders or with entities controlled by them. In the period 2008-10, disclosed RPTs were largely disposal of assets and to a lesser extent financing transactions. The majority of them (two thirds) were with insiders: controlling shareholders, a director or other major shareholders. Another study for a sample of 60 non-financial companies for the period 2005-07 (Moscariello, 2011) indicated that the bulk of RPTs reported in the annual financial reports were intra-group in nature with only a small role for insiders: 85 per cent of RPTs were with subsidiaries and only ½ per cent with executive directors. However, 15 per cent of RPTs were with entities outside the consolidation area. Some 48 per cent of RPTs were classified as sales/purchases of goods and services, 40 per cent as borrowings/loans and 7 per cent as off-balance sheet transactions. Some 6 per cent were classified as sales/purchases of fixed assets.

An analysis of 2003-07 *ad hoc* disclosures showed that the magnitude of RPTs differed consistently across companies, leading Consob to amend the qualitative definition of RPTs to be disclosed by introducing quantitative criteria: material transactions are now identified as a result of a significance test. The new regulations came into force at the end of 2010.

The approach to protection of minority shareholders

Before looking at the special discipline applying to related party transactions entered into by listed companies, a description of the Italian regulatory framework relating to conflicts of interest, group of companies and mechanisms for the appointment of directors is provided.

Conflicts of interest

For quite some time, Italy has had a reputation for poor minority protection in part due to weak enforcement of existing laws and regulations, although the situation has improved in recent years.

Since 2004, directors have to disclose to other board members and to the members of the board of statutory auditors any direct or indirect interest they have in any transaction. When an interested party is an executive director, they must also abstain from executing the transaction, entrusting it to the board of directors. Whenever the board decides on a transaction for which an interest has been disclosed, it has to adequately explain the reasons for entering into the transaction and why the transaction is advantageous to the corporation.

Standards are in place that restricts directors' ability to manage the company in the interest of dominant shareholders to the detriment of other shareholders. Specifically, the duty of loyalty requires them to disregard or even oppose dominant shareholders' attempts to self-deal. Moreover, as in France and Belgium, a doctrine has been developed covering "abuse of majority powers" ("abuso della maggioranza") that – even if generally considered in relation to resolutions of the GM of not listed companies (typically, resolutions on capital increase or on the winding-up of the company) – restricts the majority shareholders' freedom to vote as they wish at general meetings: they may not exercise their voting rights in such a way as to pursue their own self-interest (and not the company's) to the detriment of fellow shareholders.

On the other hand, remedies are very difficult and rare. Challenges to the validity of shareholders resolutions are available to shareholders representing at least 5 per cent of the shares, in not-listed companies, or 0.1 per cent in listed companies. Minority shareholders may not challenge the validity of board resolutions relating to self-interested transactions: only dissenting directors and the board of auditors have the right to challenge (Conac *et al.*, 2007, p. 20). Directors are liable to the company for damages deriving from a breach of obligations laid down by law or company by laws: the legal action is decided by the GM but a derivative action can be pursued by shareholders representing 20 per cent of capital of a non listed company or the 2.5 per cent of capital or the lesser percentage set by company's bylaws of a listed company.

Criminal sanctions are available against abusive self-dealing. Moreover, a recent provision punishes directors who fail to disclose their interest in a transaction. Thus Principle III.C is for practical purposes fully implemented; the only question remaining being active enforcement.

In view of the dominance of company groups in related party transactions, Italy has developed special rules and jurisprudence. There are as noted above special disclosure rules covering intra-group transactions. Under the Civil Code, executives must periodically report to the board about the company and its subsidiaries. Listed companies have to give subsidiaries instructions about prompt reporting to them. The board of the subsidiary must describe in the annual report the relationships with the parent company and the other companies of the group and illustrate the effects of the group on the company's management and results.

Company groups and the duty of directors

Transactions within a company group are treated differently than normal transactions on the basis that the harm caused by one single intra-group transaction might find compensation in other transactions or group relationships, whether past or future: the theory of compensatory group advantages which has been upheld by courts in the last two decades. The 2003 corporate law reform provided for specific rules on integrated groups and intra-group transactions. It introduced procedural rules and a standard for the *ex post* review of the group's management fairness to subsidiaries' minority shareholders and creditors. Subsidiaries have to provide an "analytical justification" of transactions that are entered into under the influence of the parent company, by specifying the reasons and the interests that have been considered in entering into it, and an account of such transactions must be given in the annual report. Minority shareholders can sue the parent company and its directors for damages if they "in carrying out their activity of management and co-ordination of the group, act in their own or others business interests in violation of the principles of correct company and business management of those companies" (Conac *et al.*, 2007). However, relying on the principle of compensatory advantages, the parent "shall not be liable when the damage is lacking in light of the overall results of the management and co-ordination activity or when it has been entirely eliminated, even through transactions specifically aimed at such purpose" (Conac *et al.*, 2007, p. 24).

No legal proceedings have been launched based on the new law, but starting in 1998 the highest civil court began to affirm the concept of the interest of the group and to discuss the compensation requirements, notwithstanding the absence of specific legislative provisions. However, the new discipline has been taken into account in confirming previous jurisprudence. The basic concept affirmed by the courts is that the

directors of the subsidiary are not relieved of the fundamental duty to act in the best interest of the company they manage, but the assessment of the interest of the company can include the overall interest of the group, provided that the interests of the subsidiary are not jeopardised arbitrarily and without compensation. Therefore what directors should take into account is not only the negative result deriving to the company in the short term from a certain transaction but also the benefits, even if they are medium to long term, that may accrue to it by virtue of the advantages which the transaction has brought to the group. The benefits expected are not required to be strictly proportional but actual and not hypothetical, and consistent with the economic/financial strategy of the group.

On the criminal law level, a specific exception has been introduced in the provision regarding disloyalty (infedeltà patrimoniale) to take into account compensatory advantages: while the crime requires intent of directors to gain or let others gain an "unjust profit", in the context of a group the profit derived to the parent company from the subsidiary's directors behaviour is not unjust, whenever the company's damage is offset by advantages deriving from the company being part of the group.

Election of directors

In view of the importance of independent directors for the analysis and approval of RPTs, it is important how they are nominated and elected. Since 2007 a slate vote mechanism is mandated for the appointment of directors for all listed companies.[3] Directors are appointed on the basis of slates (*i.e.* lists of candidates) presented by shareholders owning a minimum threshold of the share capital. The threshold is determined annually by Consob taking into account the company's capitalisation, free float and ownership structure.[4] Each list of candidates must indicate which director meets independence standards set by the law and/or the Code of Corporate Governance.

At least one board member must be elected from the minority slate that received the largest number of votes and who is not linked in any way, even indirectly to the shareholders who presented or voted the list that came first by number of votes. Some companies such as privatised ones have reserved a higher number of board places for the minority slate (*i.e.* must be a fifth of the board). Company bylaws establish the mechanisms according to which board seats are distributed among the slates presented. The questionnaire reports that more often than not, companies grant a majority premium to the slate receiving the highest number of votes, which takes all board seats but the quota reserved for minorities (one seat). However, a few companies adopt a proportional multi-winner system where any slate takes a number of board seats proportional to the votes it received. Box 6.2 outlines how votes are allocated within a slate.

An assessment of implementation, carried out by Assonime (2011), shows that companies where more than one slate of directors was presented in the period 2007-10 account for nearly 40 per cent of the market. Moreover, minority slates are more frequently presented in blue chips (companies belonging to the FTSE MIB index) and in financial companies (generally characterised by higher ownership dispersion). Finally, minority slates are presented by shareholders classified as institutional investors, either Italian or foreign, in nearly 20 per cent of cases (*i.e.* in 8 per cent of the market). It is important to note that Consob has ruled out situations where a slate is possibly connected with the "majority slate" for the purpose of appointing statutory auditors (*i.e.* the board of audit).

Box 6.2. **Attributing votes with a slate of candidates**

Attributing the votes a slate receives to individual candidates is commonly undertaken using the quotient method: the votes received by each candidate are the result of the ratio between the total number of votes received by the relevant slate and the ordinal number associated to the candidate (the first candidate receives the total number of the slate's votes; the second candidate receives one half of total slate's votes; the third candidate receives one third of total slate's votes, etc.). The quotients resulting from these calculations are progressively attributed to the candidates and those with the highest quotients are appointed, with the possible exception in order to meet legal or regulatory requirements for board composition.

Source: Italian response to the OECD questionnaire.

Moreover, Consob monitors that such connections do not affect in practice the appointment of directors and of statutory auditors. In this it is aided by the requirement in Italy to register shareholder agreements.

Related party transactions

The Code of Corporate Governance

Reflecting the ongoing issue of minority protection and related party transactions, the Italian Code of Corporate Governance, first adopted in 1999 and later amended in 2002 and in 2006, contains provisions regarding directors' interests and transactions with related parties (which represented the primary source of standards on this matter until Consob issued its regulation in 2010). The revised Code of 2006 went further in defining best practice so as to clarify procedures for handling the transactions. Article 9 of the comply or explain Code contain the principle: "the Board of Directors shall adopt measures aimed at ensuring that the transactions in which a director is bearer of an interest, on his/her behalf or on behalf of third parties, and transactions carried out with related parties, are performed in a transparent manner and meet criteria of substantial and procedural fairness". The associated criteria state: "the board of directors shall, after consulting with the internal control committee, establish approval and implementation procedures for the transactions carried out by the issuer, or its subsidiaries, with related parties. It shall define, in particular, the specific transactions (or shall determine the criteria for identifying those transactions) which must be approved after consulting with the internal control committee and/or with the assistance of independent experts". The internal control committee can also be the audit committee. Furthermore, "the board of directors shall adopt operating solutions suitable to facilitate the identification and an adequate handling of those situations in which a director is bearer of an interest on his/her behalf or on behalf of third parties" (Corporate Governance Committee, 2006).

The Comment to the principle notes that it sets out best practices to clarify the law (Civil Code) and to ensure the substantial procedural fairness of RPTs. In this regard the Code mentions examples: reserving to the competence of the board the approval of the most important transactions; the provision of a prior opinion of the internal control committee; entrusting negotiations to one or more independent directors (or the directors having no ties with the related party); and recourse to independent experts, possibly

selected by independent directors. The Comment goes on to note the importance of related party transactions such as between subsidiaries where efficiency considerations might call for a conflicted director to take part in voting and in the approval process.

In view of the potential benefits that can accrue from related party transactions, the use of a Code to specify best practices in order to complement the law does raise questions about compliance and what companies understand by the Code. Bianchi *et al*. (2010) measured the actual level of compliance with the code to contrast with statements of formal compliance that were around 86 per cent for the 2007 compliance reports. By contrast, they found that only around one third of companies implemented the Code's recommendations in a sufficiently satisfactory way. The gap between formal and actual compliance was higher for non-financial firms and smaller companies.

The investigation also found that factors such as "board composition and institutional investors' active ownership, may play a major role in explaining the quality of RPTs internal procedures. In particular actual compliance is higher in companies where board structure is more aligned with best practices and where foreign institutional investors not only have a stake but also participate in GMs. Surprisingly, with reference to the use of control enhancing mechanisms, non-voting share and voting caps have a positive effect on compliance, while separation between ownership and control obtained by means of pyramids drives poor compliance" (Bianchi *et al*., 2010, p. 4).

The new regulatory approach

Consob introduced a new regulatory regime at the start of 2010 covering both *ad hoc* and periodic disclosure of RPTs and general principles for procedural steps issuers must comply with in order to ensure the entire fairness of an RPT.

The general principle is that RPTs need to be reviewed by a committee of independent directors. A proportionate approach is followed differentiating between material RPTs, which observe a special procedure involving review and *ad hoc* disclosure (within 7 days) and transactions of minor importance (*i.e.* below the materiality threshold) for which a general procedure applies. According to the latter, a non-binding opinion must be given by a committee with a majority of independent directors (*e.g.* audit committee). If transactions are approved by the board despite a negative opinion of the committee, they must be disclosed periodically to the market.

Material RPTs are identified using quantitative criteria defined in the regulation. Three class tests are specified in line with the possible characteristics of the transaction: one refers to the ratio between the consideration of the transaction and the market value of the listed company, the other ones regard the ratio between assets and liabilities of the object of the transaction and that of the listed company. A transaction is to be considered material when at least one of the materiality indices exceeds the 5 per cent threshold, or a lower threshold that companies may establish, leaving private ordering as an option. However, an anti-elusive provision requires disclosure of homogeneous transactions entered into with the same related party which, although not individually, reach the materiality threshold when considered cumulatively. Further, a reduced threshold of 2.5 per cent applies to pyramids in the case of transactions with the parent, reflecting the stronger incentives to abuse RPTs. For some large Italian companies, the value of a transaction that is considered material might be several hundred million euros.

For material RPTs, a committee of independent directors must be involved in the negotiations about the transaction and must receive adequate information from executives for its members to express their views. The approval by the board of directors follows since the favourable opinion of the committee of independent directors is binding: they have veto power over material RPTs. Outside experts can be used in both procedures.

The review and disclosure regime may be waived for intra-company transactions entered into with subsidiaries and associates provided there is no significant interest by any other related party. The rationale is that, unless a related party has an interest in the transaction, any transfer of wealth from the listed company to companies where the ultimate controlling agent owns a lower economic interest (such as subsidiaries or associates) would be detrimental to the controlling shareholder: the decision makers of the listed company will thus have no interest to carry it out.

There is also an opt-out provision from procedures and disclosure regarding transactions in the ordinary course of business and made on terms equivalent to those that prevail in arm's length transactions. However, they must be notified to Consob within 7 days when material and also described generally in the half year or annual report.

In line with these principles, companies must establish their own internal codes which must be published on the company website. The board of statutory auditors is in charge of monitoring that the internal code reflects Consob's principles and that the board implements them.

The direct involvement of shareholders is limited and residual. Provided that bylaws allow for it (and many companies have passed such bylaws), a material related party transaction which has been rejected by the committee of independent directors can be submitted to the approval of non-interested shareholders. To be sure, the interested party may vote, but for the GM resolution to be effective, it must be approved by the majority of the non-interested shareholders. This process is rather unfortunately termed a Whitewash. Internal codes and bylaws may require that a de minimum percentage of non-interested shareholders must be present for the Whitewash to be effective. There are some other cases where approval of a transaction is foreseen as a GM power (*i.e.* transactions falling within the scope of its authority).

Enforcement

The *ex ante* enforcement of the new RPTs framework relies on market mechanisms and shareholder activism, both of which are underpinned through transparency requirements. Consob does have some *ex post* enforcement powers: it can request information on compliance with the RPT regulation and order them to disclose relevant information to the public.

Given the importance of the majority of the minority for approval, and for determination of voting rights on a minority slate of candidates, it is important to note that Consob has the power to make a determination and monitor that the relevant disciplines are not eluded. In this respect it is important that Consob registers shareholders agreements.

A major weakness in Italy is judicial enforcement to underpin public and private *ex post* enforcement. One study notes that corporate law adjudication by Italian judges is so much tainted by formalism and the absence of a specialised judiciary that it normally results in deference to the controllers' decision making, even in the presence of conflicts of interest (Enriques, 2003). This is not always true of other civil law jurisdictions.

Assessment and conclusions

Italy has made considerable progress in recent years to promote and defend shareholder rights and to improve transparency. In particular, minority shareholders now have a direct role in selecting at least one member of the board and of the board of auditors.

Given the complex corporate structure in Italy, policy has had to balance the potential efficiency raising effects of RPTs with the strong possibility that they can also be used to the detriment of minority shareholders (and creditors). The development by jurisprudence and the law have moved to recognise company groups and have thereby expanded the concept of director loyalty to include transactions justified by group interest. While this is important from the perspective of efficiency, it can also be to the detriment of minority shareholders (and creditors). To be sure, the doctrine of abuse of majority rights helps redress the balance but this is offset by the difficulty of private enforcement via the courts. The need to take into account the balance of interests between a company and a group should be monitored carefully since it can be abused and makes legal challenges difficult and risky.

The new regulations covering RPTs have helped to redress this situation by increasing transparency and by establishing an important *ex ante* role for independent directors and shareholders. In particular, approval by non-interested shareholders (the majority of the minority) of material transactions that have been rejected by the independent directors is a major step forward. However, the threshold of 5 per cent of net worth seems very high and would allow for major transactions even though they may not be material to the company. Transactions in the normal course of business will need to be closely monitored to ensure that the concept is not violated in practice. The high threshold risks creating a situation similar to remuneration where public support is low. A great deal of responsibility is placed on independent directors so that the role of the nomination committee will remain crucial. Most companies only permit one director to be elected by the minority shareholders and also to the board of auditors. Experience by the large privatised companies suggests that this could be increased in the future.

The key principles appear to be broadly implemented. The principles are:

- Principle III.A.2 (*minority shareholders should be protected from abusive actions by, or in the interest of, controlling shareholders acting either directly or indirectly, and should have effective means of redress*). This is only partly implemented. The doctrine of abuse of controlling shareholder power is important. However, in view of judicial weaknesses, the means of redress including cases against directors is not effective in practice.
- Principle III.C (*members of the board and key executives should be required to disclose to the board whether they, directly, indirectly or on behalf of third parties, have a material interest in any transaction or matter directly affecting the corporation*). This principle appears to be fully implemented. Failure to disclose is a criminal offense.
- Principle V.A.5 (*disclosure should include, but not be limited to, material information on … related party transactions*). Disclosure rules are broad and in principle cover all major areas although what is considered to be a transaction at arm's length might need to be better defined. There is also significant disclosure about company groups.
- Principle VI.D.6 (*The board should fulfil certain key functions, including … monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions*). The principle is implemented in the law but questions remain about expanded directors duties in a group context that could still be to the detriment of minority shareholders.

Notes

1. For the case of Telecom Italia which occurred before tighter takeover regulation, see Meoli *et al.* (2006).
2. Bianchi and Bianco define a company as controlled by an informal coalition when they could not identify one controlling shareholder and the three largest shareholders together owned more than 20 per cent. Dispersed ownership is classed as holdings under 2 per cent of equity.
3. Privatised companies have longer been subject to similar provision, introduced by the 1994 Law on Privatisation. Further, for the appointment of statutory auditors in all listed companies slate voting has been mandated since 1998.
4. Consob has defined different classes of capitalisation and a corresponding threshold so that the higher the capitalisation, the lower the threshold to present a slate. For smaller companies that threshold is determined also taking into account the free float and the ownership structure.

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Related Party Transactions and Minority Shareholder Rights

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