

Strategic plan
2010-2012



CONSOB

COMMISSIONE NAZIONALE
PER LE SOCIETÀ E LA BORSA

Strategic plan 2010–2012

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Introduction

Supervisory experience acquired in recent years, and in particular during the recent crisis, has revealed the need to respond to changes in the external scenario through a structured process of strategic planning.

The ultimate purpose of strategic planning is to allocate human and financial resources to the "most efficient uses". Said uses must be identified on the basis of their suitability to contend with risks that can be classified into two macro-categories: those associated to changes in the economic and financial system (market risk) and those associated to the legislative framework (regulatory risk). A risk can be defined, in very general terms, as an unwanted scenario that is very likely to arise and an unfavourable consequence in terms of the negative impact on the mission pursued by an organisation; on the contrary, a risk can be defined in positive terms, namely as an opportunity. Risk assessment is therefore linked to forecasts on the evolution of a scenario and of the relevant legislative framework and requires an analysis of the reactions of supervised entities and of investors to said

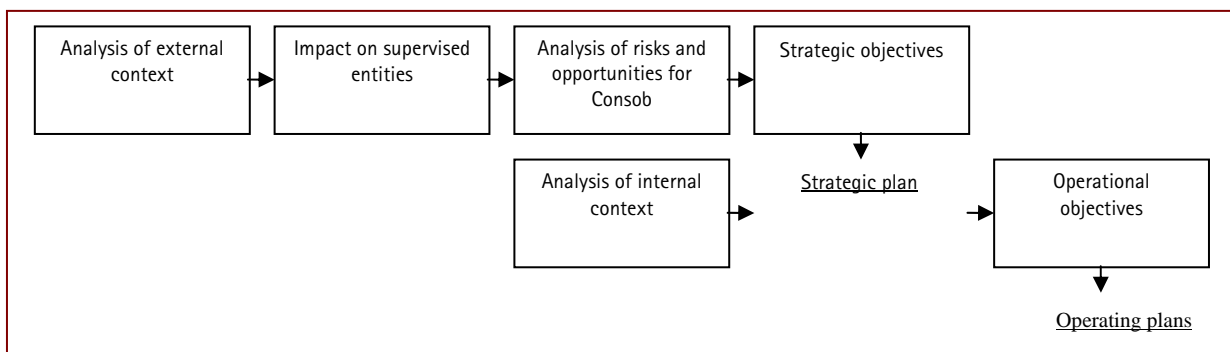
changes as well as the impact that said reactions have on the likelihood of the Authority achieving its institutional objectives.

The planning process concludes with the definition of strategic objectives taking into consideration the constraints and strengths of the internal organisation (so-called internal context; Fig. 1) and with the subsequent breakdown into operational objectives that specify timing, roles, responsibilities, main activities and resources employed in a plan of action.

The 2010-2012 Strategic Plan is set in the economic scenario resulting from the crisis that has upset the financial markets in recent years and to which governments, international organisations and national supervisory authorities have reacted by launching numerous initiatives.

The global proportions of the crisis, rekindled by tension in the currency and government bond markets, resulting from serious budget imbalances of several euro area countries, triggered an overall review of the "scope of regulation" in

Fig. 1 The logical planning model



Box 1

The ultimate objectives of Consob

Consob's supervisory objectives derive from the combined provisions of several articles of the Consolidated Law on Finance which, although set out as part of the regulations regarding the supervision of specific categories of parties, concern the Authority's activities as a whole. In particular, with regard to the regulation of intermediaries, the Consolidated Law on Finance states that the objectives of supervision are to safeguard confidence in the financial system; to protect investors; the stability and smooth functioning of the financial system; the competitiveness of the financial system and compliance with regulations on financial topics. To pursue said objectives, Consob is responsible for the transparency and correctness of conduct, while the Bank of Italy is responsible for the limitation of risk in its various forms, the capital adequacy and the sound and prudent management of intermediaries (art. 5). With regard to the supervision of issuers, Consob exercises the powers envisaged by the law regarding the protection of investors as well as the efficiency and transparency of the corporate control market and the capital market (art. 99). As regards market regulation, the objectives of supervision are stated as the transparency, ordered performance of transactions and the protection of investments (art. 74).

order to include phenomena that were at the time not supervised and not fully recognisable in the supervisory and regulatory framework. The European Commission recently published a communication on the regulation of financial services for sustainable growth and indicated the interventions retained as priority for the coming months¹. Alongside the completion of the proposed reform of the European supervision structure (see below), we also find, inter alia, the final approval of the directive on Alternative investment fund managers (including therein hedge funds), due to be completed by level 2 measures; the regulation of short sales and of credit default swaps (CDS) and the regulation of over-the-counter (OTC) markets and of post-trading infrastructures. The Commission has already started a consultation process on the latter topics. Further initiatives regard the review of Market Abuse Directives (MAD) and of the Markets in Financial Instruments Directive (MiFID) and the forthcoming publication of a consultation paper on so-called packaged retail investment products (PRIIPs) and a communication on the use of ratings for regulatory purposes.

Consob actively contributes to evolutions of the international legislative framework, which pose complex challenges, also due to the need to guarantee that said regulatory changes reflect the specific nature of the domestic financial system as well.

In addition to analysing the external scenario, the strategic planning process requires the ultimate objectives of institutional activities (the so-called mission) to be clearly stated, with respect to which the strategic objectives have an attendant or instrumental value.

Consob's fundamental mission is to protect investors and is pursued by means of "tools" to supervise transparency and rules of conduct. Indeed, the objectives set out by the Consolidated Law on Finance as regards specific supervised entities (issuers, intermediaries and markets) can substantially be considered as intermediate (or coincident) objectives with respect to the ultimate objective of protecting investors (Box 1).

¹ See *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the European Central Bank. Regulating Financial Services for Sustainable Growth*; Brussels, 2.6.2010; COM (2010) 301.

Alongside actions for ultimate enforcement, Consob believes it is necessary to intensify the use of the tool of dialogue and of moral suasion, which should become increasingly important in discussions with the market and enhance the structural and behavioural prerequisites needed to improve the efficiency and effectiveness of supervisory action.

Pursuing the objective of investor protection does not imply that the work of the Authority must be focused on predicting or even less so anticipating the downfall of operators that issue and/or distribute financial products and instruments to the public. In fact, the law does not assign Consob responsibilities as regards the supervision of stability; instead one of its tasks is the prompt reporting of irregularities in market information and the assessment of the adequacy of procedural and organisational structures to guarantee complete and timely information.

Being responsible for supervising transparency and rules of conduct must therefore seek to ensure that issuers and intermediaries disclose, in a timely and appropriate manner, all of the information needed for investors and analysts to make a comprehensive assessment of the risk of default. As better illustrated below, said risk is amplified by the economic scenario that is expected to characterise financial and credit market trends in the coming years.

When the state of crisis of a supervised entity is self-evident and acknowledged, the way in which supervisory powers are exercised must find an adequate balance between the public's information needs and the need for confidentiality of the issuer involved in restructuring or rescue operations, the success of which also depends on a temporary lack of information.

Supervising transparency does not only regard the information "produced" by issuers, but also so-called derived information, namely that "produced" by analysts and rating agencies.

Community regulations on rating agencies give Consob the opportunity to actively control said parties (as part of the coordination made at present by the CESR and in the future by the new European supervisory authority, the European Securities and Markets Authority (ESMA) to which a regulatory proposal recently submitted by the European Commission envisages transferring direct responsibilities of authorisation and supervision; see below).

The information disclosed to the public must be timely (even with the previously cited caveats) as well as clear and easy to understand; compliance with the rules of conduct that issuers are obliged to observe when providing investment services is equally important. Supervisory experience has also highlighted the need to improve the information provided to investors at the time of subscription and placement of financial products and instruments, and equally the need to apply standard rules of transparency and conduct to products with similar financial profiles, even if they have different legal forms. As regards transparency in the event of a public offering, although equivalent in financial terms, structured and illiquid products, such as bonds and insurance policies with financial content, are subject to different regulatory standards due to diversities in the reference Community legislative framework. With regard, instead, to rules of conduct, the Italian lawmaker and Consob have extended the investment services regulation to the distribution of financial products issued by banks and by insurance companies, overcoming the prior segmentation; however, it is the only intervention of this kind in the European scenario.

Box 2

The Lehman Brothers default

The bankruptcy of the American investment bank Lehman Brothers, made public on 15 September 2008, involved all of the European entities of the US group, and, in particular, the holding company established in the United Kingdom, which operated extensively throughout Europe through a branch network. The Lehman Brothers group operated in Italy through parties authorised to provide investment management services or operate collective investment schemes (Lehman Brothers A.M. Italy Sgr, an authorised but at the time non-operational management company, and Lehman Brothers International, a branch of a Community investment company that provided investment advice and trading services, particularly in derivatives, also with local bodies and social security funds, with around 150 employees). Lehman Brothers International also traded directly in the markets managed by Borsa Italiana through "remote access" (direct online connection) and was categorised as a main operator in the markets managed by MTS Spa (Electronic Market for Government Bonds and other fixed-income securities).

Of over 1,000 securities made up of shares and bonds of Lehman Brothers group companies in circulation in Italy, only one bond issue refers to an offering and listing prospectus approved by Consob (in November 2005). From the end of 2005, with the entry into force of the Prospectus Directive 2003/71/EC, to the end of 2007, the placement of Lehman bonds on the Italian market benefitted from a European passport, under which the relative prospectuses were approved by the competent foreign Authorities (mainly those of Ireland and Luxembourg), excluding Consob's control and supervisory powers. In particular, in the period between January and June 2008, the Irish Authority approved 725 prospectuses, while in the same period, the Luxembourg Authority approved 863.

The impact of the default of the Lehman Brothers group on Italian customers was mainly observed in index-linked insurance policies (with € 1.6 billion of products linked to Lehman bonds placed with Italian investors) and assets under administration (according to sample surveys involving the main banking groups, the presence of securities of Lehman Brothers group companies in customer portfolios totalled around € 1.1 billion); instead, the default had a lesser impact on individual investment management (€ 409 million in Lehman securities, corresponding to 0.1 percent of assets managed) and on collective investment schemes (€ 138 million in Lehman securities, corresponding to 0.05 percent of assets managed). On the other hand, with regard to positions in OTC derivatives with Italian customers, contracts have been written with the Republic of Italy and with three Regional Authorities, while no positions have been recorded in derivatives with Municipal or Provincial Authorities.

These circumstances take on particularly complex characteristics in the Italian scenario, due to the structural prevalence of assets under administration over investment management, to the high proportion of structured and/or illiquid products and instruments in household portfolios, to the scarce use of high-added-value investment advice services and to the low level of financial education.

Further difficulties are generated by the widespread presence in the portfolios of Italian investors of products issued abroad and placed in Italy on the basis of a prospectus approved by the Authorities of countries that apply supervisory standards different to those of Consob. The Lehman Brothers' default provides a significant ex-

ample in this regard, also drawing attention to how extensive and far-reaching the effects of the insolvency of a foreign intermediary can be on Italian investors. (Box 2).

Given the central role of the supervisory Authority of the country of origin in the case of cross-border offerings, the measures taken by Consob to date have met numerous obstacles. The recent common position of the Council and Parliament to change the proposed directive has, however, confirmed the principle of control over prospectuses exclusively by the authority of the country of origin and does not envisage any role in the control of information or in the definition of its content by the authority of the host country.

By virtue of the high proportion of non-equity products (bonds, funds and insurance policies) in the financial wealth of households, Consob's supervisory activities have for some time focused on encouraging a higher level of transparency of these products, especially the more complex ones and those that incorporate derivative (including embedded) components related to market and/or credit risk, based on what is known as the "three pillar" approach. This approach is based on three synthetic quantitative indicators that grasp the essential characteristics of non-equity financial products – the level of risk, potential returns and optimum investment time horizons with respect to the preference for liquidity. This information structure could be taken into account in the supervision of distributor intermediaries, as we will see in more detail below (see Objective 4), which for some time has focused on the conduct of intermediaries as regards the distribution of products – including their own – examining the illiquidity or not easy liquidity of the same, amongst other things (also with relation to their

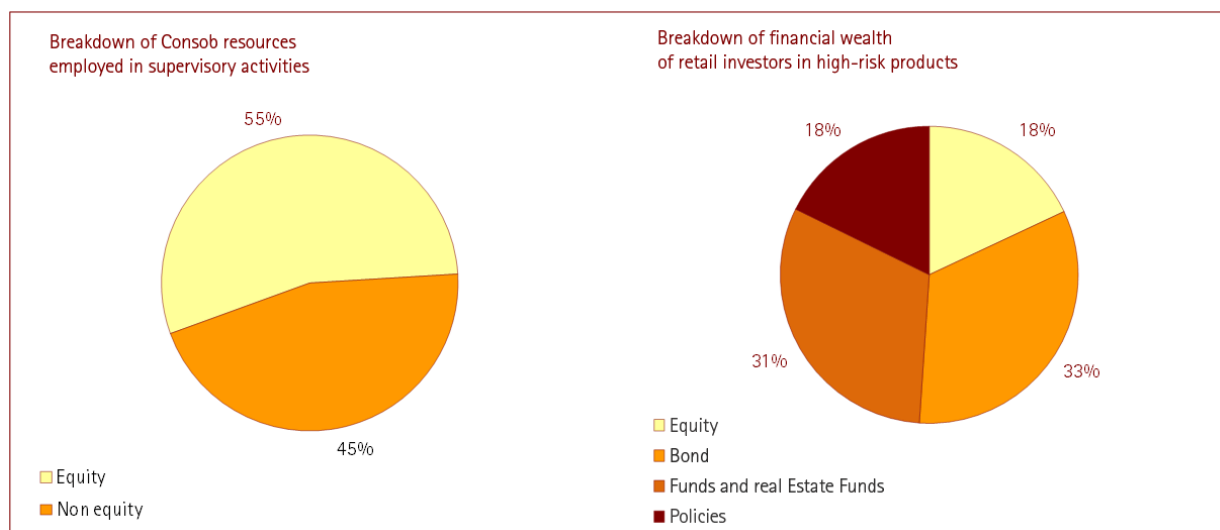
optimum investment time horizon) and to what extent the risk level of the products and the customers attitude towards risk match.

This approach is an effective and incisive method to guarantee adequate levels of transparency also in a context characterised by a high rate of financial innovation and of change in the characteristics and structure of the products offered to retail investors.

An important challenge awaits therefore, that of finding a solution that makes this approach compatible with Community regulations, regulations that incidentally are undergoing significant changes, the expected outcomes of which are illustrated in §4 of Chapter I below.

The current allocation of the Authority's resources to front office activities is, however, mostly focused on the equity area, even though shares represent a small proportion of the portfolios of Italian households (Fig. 2).

Fig. 2 Breakdown of Consob resources directed towards supervision and break down of the financial wealth of retail investors invested in high-risk products



Note – Consob resources dedicated to supervision are split into supervision of issuers and share markets (mainly as regards equity instruments) and supervision of non-equity products and instruments and placement intermediaries. The equity part includes 70% of the resources of the Markets Division and the resources of the Issuers Division, excluding the ENQ Office, while the non-equity part includes the Intermediaries Division, the ENQ Office and the Audit Division for the estimated share of resources dedicated to audits of intermediaries (the remainder refers to the equity sector). Figures on investor wealth have been taken from estimates on Gfk Eurisko data

The structural characteristics and the specific nature of the Italian financial system require a clear line of action to be taken on the supervision and control of issuers with listed shares and of stock markets (namely the equity area) that guarantees the confidence of stock market investors and preserves our competitive position in the international panorama, although said action could appear disproportional to the weight of shares in household portfolios and may not be fully accepted in the conduct of the equivalent supervisory authorities of countries with more developed capital markets.

The reason for said allocation is twofold. Firstly, supervision of the equity area requires a considerable commitment in terms of resources, insofar as it encompasses checks on issues as regards corporate dynamics (accounting aspects, governance and ownership structures, market disclosures etc.) and on the secondary market (Stock market and other platforms) as regards the regularity and transparency of trading. Secondly, the supervision of share-related products is strategically important in terms of maintaining the confidence of investors in the market and the development of the stock market, which has always poorly represented the real situation of Italy's production system. Safeguarding confidence in the financial system and its competitiveness represents, in fact, an important mission for Consob, given that, as we have already seen in Box 1, the Consolidated Law on Finance includes it in the objectives of supervision, placing it on the same level as the protection of investors.

The events linked to the corporate crises witnessed in recent years have, in reality, demonstrated that – although the involvement of retail investors was minimal – episodes relating to a few issuers transversally impact the stock market, the corporate bonds and the bank credit markets, with negative repercussions also on the relationships between investors and financial intermediaries. Furthermore, some corporate transactions, although relating to a modest percentage of investors, give rise to potential expropriation phenomena (transactions with related parties, delisting in extremely critical market conditions, IPO at prices that are very distant from those that are

then observed in the secondary market), which have far-reaching implications on the public's confidence in the functioning of the stock market and undermine its potential development.

Supervision of the equity area is therefore crucial to ensure that Consob achieves its institutional objectives; the central role of the supervision of share instrument issuers in pursuing the afore-mentioned goals is also magnified, in Italy, by the lesser structural effectiveness of in-company control mechanisms to guarantee effective investor protection mechanisms and by the poor activism and participation of shareholders in corporate affairs.

Divergences in the manner in which Community legislation is incorporated and interpreted and differences in supervisory practices and in sanctioning systems represent the weaknesses of the model based on what is known as the Lamfalussy approach. This awareness has triggered intense debate on the reform of supervisory structures in Community circles. The de Larosière group² made several recommendations, which

2 *Report of the High-Level Group on Financial Supervision in the EU*, Chaired by Jacques de Larosière, Brussels, 25 February 2009. The proposals of the de Larosière group, published on 25 February 2009, outline a solution based on the evolution of institutional structures, entailing the transformation of the current Level 3 Committees into 3 European authorities. In particular, the reform process would take place in three stages. The first, preparatory stage envisages that Member States reinforce National supervisory authorities, working, amongst other things, to align responsibilities and powers with the European framework and to harmonise rules, powers and sanctions within the EU ambit. The second stage entails the creation of three European authorities, European Banking Authority, the European Insurance and Occupational Pension Authority and the European Securities Authority.

were followed by a draft reform by the European Commission, contained in regulatory proposals dated 23 September 2009³. The approach proposed by the European Commission is confirmed both in the document agreed by the ECOFIN Council and in discussions underway in the European Parliament, which should soon state its position. It is founded on two pillars: the first regards the establishment of the European Systemic Risk Council (ESRC); the second regards the establishment of the European System of Financial Advisors (ESFS), including a Joint Committee, three new European Supervisory Authorities (ESA), with legal status, and National Supervisory Authorities⁴. The Joint Committee will have the task of encouraging cooperation and the consistency of the supervisory approaches adopted by the three European Authorities, with particular regard to financial conglomerates and institutions that operate on a cross-border basis. The sector-specific European Authorities would replicate the current division of responsibility between the Level 3 Committees (Cesr, Cebis and Ceiop) supervising banks, insurance companies and securities markets respectively. The National authorities will continue to exercise supervision over single national par-

ties, with the exception of rating agencies, which will be subject to centralised supervision at European level, according to the procedures indicated in the recent regulatory proposal presented by the European Commission.

The European Parliament, the Commission and the Economic and Financial Affairs Council (ECOFIN) must reach a political agreement on this overall architecture, particularly as regards the powers of the ESAs on means of intervention in the event of the infringement of Community legislation and in emergency situations and the settlement of disputes between National authorities as regards cross-border supervision⁵ (Box 3).

The new architecture of the Supervisory authorities does not question the Lamfalussy model or the manner in which Community legislation is produced, which will continue to be based on first and second level directives and on directly applicable regulations. Nevertheless, the new European authorities will play a very important role in the implementation of Community regulations, as they may issue technical standards that are legally binding for National authorities as regards the interpretation and application of regulations (so-called level 3), as well as recommendations and (non-binding) guidelines regarding supervisory practices and approaches.

The new institutional architecture, which, as soon as the European Parliament and Council reach an agreement in September, could be effective as of 2011, determines the need for Consob to conduct an in-depth review of the approach to regulation and controls in order to ensure that the Authority is fully integrated with the new European supervisory system. In particular, the domes-

The final goal (third stage) envisages the application of a model in which supervisory responsibilities are divided on the basis of control objectives, with the creation of an authority responsible for micro-stability profiles and prudential supervision (applicable to the banking and insurance sector) and of an authority in charge of transparency, rules of conduct and the securities markets. As regards the supervision of macro-stability and its systemic risks, the de Larosière group proposes to create a Committee chaired by the governor of the European Central Bank, comprised of the chairmen of the authorities and the governors of national central banks.

3 These proposals are based on Commission Communications (4 March and 29 May 2009 respectively) that set out a plan of action for the reform of financial supervisory regulations in Europe and launched a consultation of the parties involved. The European Council approved said documents on 19 June 2009.

4 *Proposal for a Regulation of the European Parliament and of the Council on Community macro prudential oversight of the financial system and establishing a European Systemic Risk Board*, Brussels, 23.9.2009, COM(2009) 499 final; *Proposal for a Regulation of the European Parliament and of the Council establishing a European Banking Authority*, Brussels, 23.9.2009, COM(2009) 501 final; *Proposal for a Regulation of the European Parliament and of the Council establishing a European Securities and Markets Authority*, Brussels, 23.9.2009, COM(2009) 503 final.

5 Council of the European Union, *Financial Stability Arrangements and Crisis Management, Draft Council Conclusions*, n. 16434/2009, Brussels, 20 November, 2009; Council of the European Union, *Proposal for a regulation of the European Parliament and the Council establishing a European Securities and Markets Authority (ESMA) - Presidency compromise*, n. 16751/1/09, Brussels, 7 December 2009.

Box 3

The new European supervisory authorities

The three new European supervisory authorities (the *European Banking Authority* – EBA, the *European Insurance and Occupational Pension Authority* – EIOPA, and the *European Securities and Markets Authority* – ESMA) will have two fundamental powers.

The first entails the definition of technical standards, guidelines and recommendations regarding regulation and supervision for national authorities in order to ensure the uniform and consistent application of European legislation. The standards will be binding, although they must obtain the approval of the European Commission according to a "formal endorsement" procedure. With regard, on the other hand to recommendations and guidelines, national authorities may comply on a voluntary basis according to the "comply or explain" principle; The ESA may then decide on a case-by-case basis whether to make any non-fulfilment public.

The second task of the ESA regards the power to make recommendations to National authorities as to the measures needed to counter any infringements of Community legislation, setting binding deadlines for the adoption of said measures; if the National authorities do not take any action, the European Commission could formally request the adoption of the measures needed to return to the correct application of Community regulations; lastly the ESA can directly apply the measures recommended to supervised entities, in the event that the non-fulfilment of the National authorities continues and immediate intervention is retained necessary to re-establish the proper functioning of the financial system. In emergency situations, the ESA should act to facilitate and coordinate the measures adopted by National authorities, requesting the intervention of the Council, although they may directly take binding decisions in exceptional circumstances.

Further tasks regard, amongst others, the settlement of disputes between national authorities and the authorisation of specific pan-European bodies (including rating agencies, with regard to which the ESMA exercises powers relating to the authorisation and supervision of the same on an on-going basis).

tic legislative framework will need to be more strictly aligned with the approach and the decisions established by the ESMA, which in specific areas, will becoming binding for all Member States. It will also be necessary to harmonise supervisory practices with standards that will be set at Community level, actively participating in the peer review process with the other National authorities.

It is therefore fundamental to contribute actively and incisively to the European legislative and regulatory process, to minimise the risk that the increasingly centralised production of legislation and maximum harmonisation does not

take the structural peculiarities of our financial market into account.

Increased centralisation at European level of the generation of legislation and regulations will therefore considerably reduce the degree of autonomy and the role of individual National authorities.

These developments do not necessarily imply that Consob will no longer have regulatory responsibility; however, the professionalism and know-how it has acquired in this sector must be increasingly projected into an international context, requiring the adequate participation of Au-

The new architecture of financial market supervision will imply increased centralisation of legislative activity at European level. Consob therefore believes it must increase its participation in the new European authority for the financial markets sector through personnel with adequate professional experience, in order to ensure that the production of Community regulations takes the specific nature of the Italian financial system into due consideration and preserves the competitiveness of the same.

thority staff in the future sector-related European authority (ESMA) and the development and enhancement of specific professional figures able to gather consensus and ensure that positions that sufficiently reflect the risks and the specific nature of the domestic financial system are adequately represented.

Important repercussions on human resource management do not only stem from the cited developments that characterise the institutional context at European level, but also from the need to develop skills in analysing market dynamics and the conduct of companies and in-

termediaries, in order to calibrate supervisory approaches to financial innovation and the complexities of the strategies of market operators. This entails investing in personnel training and in IT infrastructure.

The impact of strategic planning on the investment in human and technological resources must be assessed in the light of the constraints dictated by the financial balances that Consob's budget has to observe and by the need to maintain the contributions of supervised entities within thresholds that are sustainable for the financial system as a whole.

If Consob is to really achieve its strategic objectives, the possibility of funding the necessary investments in human capital and technological infrastructure becomes crucial, while at the same time preserving the financial equilibrium of the Authority's budget and its sustainability for those contributing to the same.

Trends in financial markets and regulation and key risks

1 Economic outlook and financial markets

1.1 The real economy and public finances

After the Lehman Brothers default in September 2008, the real effects of a crisis, which had initially appeared to be limited to the financial system, emerged.

In 2009, global GDP fell by around 1%; in Italy, said fall was close to 5%, marking one of the most serious post-war recessions. Simulation exercises conducted by the major international organisations indicate that we will see a slight recovery in 2010, although differing by geographical area, while in 2011 growth could be more sustained in emerging countries.

One of the most important risk factors for the evolution of the economic scenario is represented by the increase of the public deficit in all of the main advanced economies, due in part to the spread of the procyclical effects of automatic stabilisation mechanisms and in part to the measures taken to tackle the financial crisis and to sustain aggregate demand. The corrective measures made on public budgets could have a significant impact on consumption and employment. Further risks stem from the negative impact – on consumption and the cost of labour – of the adjustment process of variables such as employment rates and real wages, from inflationary pressure (resulting from the rise in the price of commodities) and from continuing significant imbalances in the balance of payments

at global level.

Short-term interest rates in the USA and in the euro area should continue to remain at very low levels, and then rise moderately in the second half of 2010 and in 2011, as the Central Banks increasingly seek to take control of liquidity. On the other hand, there is pressure on raising long-term interest rates, linked to the need to fund the growing deficits of public budgets and the increase of sovereign risk in the euro area. Therefore the positive slope of the interest rate curve should increase.

1.2 The financial markets

The financial markets will probably continue to suffer for some time from the high uncertainty of the economic scenario and the tensions triggered by the sharp rise in the pricing of sovereign default risk. After an initial period of high severity, the lending standards of the banking system are gradually being relaxed, although a downturn in bank loans has been recorded in all of the major advanced economies.

On the stock markets, volatility and aversion to risk continue to converge towards the figures recorded in the period leading up to the Lehman Brothers default, although prospects on the evolution of share prices are highly uncertain. In the first few months of 2010, the deterioration of the public accounts of numerous euro area

countries led to a significant rise in the risk premiums on public securities and of quotes of credit default swaps (CDS), triggering new turbulence in the financial markets. An increase in CDS trading was recorded, as is shown by the rise in their gross notional value. However, the entity of the risk actually transferred through the CDS market has been fairly contained. In actual fact, the net notional value, calculated by taking into account any offsets of opposite-sign positions, is around 10 times lower than the gross notional value and represents a small percentage of overall public debt stock (around 5 percent in Portugal, 2 percent in Greece and 1 percent in Italy). The rise in CDS quotes was more marked for the debts of Greece, Ireland and Portugal, countries which suffered a significant and sharp deterioration of public accounts in 2009.

The new turbulence did not have a negative effect on either corporate bond spreads or on the value of multipliers; nevertheless analysts revised their growth rate forecasts for company profits, predicting lower figures.

The 2009 financial statements of the major listed companies show clear signs of fragility: the corporate sector recorded a 10% fall in revenues and a significant increase in the debt to profit ratio, while in the banking sector, the deterioration of credit quality could continue to have negative repercussions on profits.

1.3 The banks ...

With regard to the banking industry, the 2009 financial statements of the major Italian groups show that gross income was substantially unchanged due to a fall in the net interest income and in commissions, balanced by an increase in profits from financial transactions. The fall in operating costs has led to a rise in operating results; however, net profit fell due to the increase of adjustments on loans.

Analysts are expecting a further fall in profits in 2010, while an improvement could be seen in 2011. The factors that could have the most negative effect on profit are associated to the fall in the growth rate of loans and the deterioration of credit quality; lower net interest income, due to the decline of interest rates and to the reduction in commissions on investment and asset management services.

In terms of costs, following the merger and acquisition processes of recent years, the margins to achieve synergies and increases in efficiency appear to be exhausted, while, on the basis of prior experience, the upward trend of non-performing loans is expected to continue for at least one or two years after the inversion of the cycle.

Instead, direct exposure to the global liquidity crisis appears to have had a limited impact, given that the business model of Italian banks is focused on the national market and, in particular, on traditional commercial banking activities. However, this does not exclude potential difficulties for banks that are more active in Eastern Europe.

With regard to capital adequacy, a first cycle of stress tests conducted by the Bank of Italy for the major banking groups showed adequate levels of capitalisation⁶. These results were confirmed by the outcome of a new cycle of stress tests completed in July 2010, conducted by several European institutions (including the Central Bank) in collaboration with national supervisory authorities⁷.

6 However, according to some studies, Italian banks are less capitalised (in terms of Tier 1) than Spanish, German, French and English banks (see Bank of England, Financial Stability Report, n. 27 June 2010).

7 See the Report published by the CEBS, Aggregate outcome of the 2010 EU wide stress test exercise coordinated by CEBS in cooperation with the ECB, 23 July 2010.

... funding

The funding of Italian banks, in particular as far as bond issuance is concerned, grew at very high rates even during the most intense periods of the financial crisis. It is reasonable to predict that this trend will continue over the next few years due to the structural characteristics of the supply and demand of financial assets of households. The latter will probably be driven by a moderate reduction in aversion to risk, by the cited possible positive slope of the interest rate curve and by several structural factors (illustrated in more detail below). Italian banks continue to be among the most exposed to bond refunding risk (in the three-year period 2010-2012, around 30% of the outstanding bond liabilities, as observed at the end of 2009, will mature), also in light of the fact that bonds represent a higher proportion of funding liabilities than in the banks of the major European countries.

Although decreasing, the growth rate of structured bond net issues by banks could return to an upward trend in the next few years. Incentives to the offer of bonds and other structured products, including those of other issuers issued by third parties, partially depend on the distribution and commercial policies of the major banking groups, which guarantee very high upfront commissions on these types of products to the distribution networks. These incentives, which are likely to increase given the fall in profits, could discourage the placement of investment management products, which, on the other hand, generate annual commissions for the network, initially lower, but continuous⁸.

8 This remuneration policy for sales networks provides a strong incentive to distribute structured products as branches and finan-

... securitisations

The demand for structured securities by institutional investors remains very weak, making the use of securitisation in the management of bank assets difficult. In the immediate future, overall market conditions are likely to improve only marginally, but an impulse to recovery could come from product innovations that several foreign banks are experimenting in order to save regulatory capital.

The poor liquidity of the secondary market and the continuing high number of downgradings – both due to the deterioration of the underlying assets and following (more restrictive) changes to the method used to assess credit-worthiness used by rating agencies⁹ – will no doubt continue to result in high market weakness. Further risks are associated to the deterioration of types of assets other than mortgages, such as consumer credit and exposures of companies resulting from leasing and factoring transactions.

... loans and the credit crunch

From the beginning of 2009, the banking industries in Europe and USA have been showing strong signs of a tightening of lending standards. The risk of a credit crunch is linked both to the so-called strong rationing, entailing the actual refusal to grant new loans, and to the

cial advisors can easily achieve their short-term budget objectives (and obtain the related bonuses) The placement of structured bonds and index-linked insurance policies therefore allows the sales network to immediately collect commissions that otherwise would be spread over the whole life of the product.

9 In particular, in the US, this phenomenon is mainly linked to the deterioration in the quality of home mortgage loans, while in Europe, the phenomenon is more pronounced as regards CDOs and securities relating to commercial loans.

so-called weak rationing entailing the granting of loans at conditions so onerous that debtors would reject the offer of credit. The modest growth rate of bank loans, currently close to zero in Italy and in the major industrialised countries, also reflects a weaker demand for lending by companies, due to uncertainties stemming from the evolution of the economic scenario that influence investment decisions. As regards both supply and demand trends, the growth of bank loans is likely to remain very weak in coming years; the fall in profits and the increase of non-performing loans, with the resulting impact on levels of capitalisation, lead us to retain that the risk of a credit crunch, particularly with regard to SMEs, remains high.

1.4 Corporate sector ...

Operating profits in the corporate sector continue to be positive for large listed companies, although there is a noticeable fall in revenues. Medium sized companies continue to be the most exposed to changes in the cycle and to situations of economic-financial tension.

... sources of funding

Due to difficulties in accessing bank credit, the need to seek funding on the capital market increases. Recourse to the capital market is penalised, however, by a low price/book value ratio (especially for Italian companies, for whom said ratio is lower than or close to one unit for a very large share of listed companies). This scenario is likely to remain as it is even in the future, given the uncertain trend of share prices and the fall in profits and revenues.

Access to the bond market, although rela-

tively easy for companies with high credit standings, is much less so for speculative grade companies or those without ratings, whose spreads, although lower than during the most intense periods of the crisis, remain high. Forecasts of the growth default rates for speculative grade issuers lead us to retain that this phenomenon is set to last until the end of 2010.

... default risk

The likelihood of default of the Italian companies most exposed to the crisis remains high and the downgrading process in the corporate sector continues. Furthermore, the risk of a credit crunch increases the likelihood of "unexpected" default resulting from sudden liquidity problems due to credit rationing or to requests to repay already agreed loans.

Market crises increase the likelihood that issuers, in particular SMEs and those most exposed to the negative economic scenario, experience economic-financial difficulties, even without warning. For these companies, there is a risk that disclosures to the public are incomplete or are not fully suitable to provide an accurate picture of the financial situation, especially when the internal control systems are unable to identify and report any deterioration in profits and the capital situation in time, or when the governance systems are not able to manage or uncover conflicts of interest that distort the decision-making process and market information.

The risk that the information disclosed does not allow investors to make an informed assessment of the assets, liabilities and financial situation of the issuer is more relevant as regards those financial statement items for which international accounting standards IAS/IFRS al-

External factors

- Real economy
 - High uncertainty of the economic scenario
 - Public deficit on the rise
 - Inflation modest but on the rise
 - Low short-term interest rates, but a strong positive slope of the curve
- High uncertainty as to the evolution of the stock markets; difficult access to the risk capital market

Impact on issuers

- Corporate sector
 - Revenues down for large companies
 - High sensitivity to cycle changes for SMEs
 - Difficult recourse to the capital market for SMEs
 - Rationing of bank credit
 - Increased likelihood of sudden/unexpected economic-financial tensions
- Banks
 - Reduction in loans with potential credit crunch effects
 - Profits down
 - Increase of non-performing loans
 - Risk of re-funding bond issues
 - Difficulty in recourse to securitisation

low significant margins of discretion in measurement (measurement of goodwill and of intangible assets, application of impairment testing, mark-to-model of illiquid financial instruments, exercise of exceptions to IAS 39 for the cost accounting of financial instruments, definition of the scope of consolidation as regards conduit and Special purpose vehicles – SPV).

Given the funding difficulties being encountered in capital markets and the tightening of conditions on bank lending, it is possible that (otherwise resolvable) economic-financial tensions may lead to a state of insolvency. However, this regards events that, per se, do not represent

a risk to our institutional objectives. As mentioned in the Introduction, the law does not allocate Consob responsibilities as regards the supervision of stability or the task of predicting, or even less so of anticipating, company bankruptcies. Defaults, when not the result of fraud or similar, are a natural element that characterises the functioning of the financial markets. The risks to institutional activities emerge when the brusque deterioration of the financial situation creates incentives to expropriate minority shareholders (moving, for example, the "best" assets out of the company) to manipulate financial information (to conceal the state of health of a company and/or the effect of transactions to transfer wealth to majority shareholders).

Risks and opportunities for Consob

Financial crises or defaults increase the risk of the expropriation of minority shareholders and the manipulation of financial disclosures.

With regard to companies that start to show signs of difficulty or that are in a clear state of crisis, there is a need for confidentiality (to ensure, for example, the successful outcome of restructuring operations) which may conflict with the need to guarantee the market complete and correct information.

When companies demonstrate the need to suspend disclosure obligations that arise from specific requirements for the publication of figures and news, Consob handles the delicate trade-off between transparency and legitimate need for confidentiality.

Risks and opportunities for Consob

Faced with the emergence of clear economic-financial difficulties, managing the trade-off between the need for confidentiality and that of market transparency entails Consob carrying out delicate discretionary assessments, the outcome of which could either entail the application of disclosure obligations that penalise the company (which in some cases, could, subsequently, turn out to be of limited use to the market), or the safeguarding of the confidentiality of the issuer at the cost of an excessive reduction in the information available to the public.

2 Ownership structures and corporate governance

2.1 The governance of listed companies

The governance structures of listed Italian companies reflect several structural aspects, which have always characterised the capitalistic model which has established itself in Italy, featuring a high concentration of ownership structures and the presence of majority shareholders – essentially households and the State – able to significantly influence the strategic decisions and the management of the company¹⁰.

Said circumstance has always led to debate on conflicts of interest between majority shareholders and minority shareholders (as well as with respect to the other stakeholders, such as creditors and workers) and on the adequacy of governance mechanisms to manage, mitigate or in any event render said conflicts transparent.

Majority shareholders have the power and the motivation to make a company perform transactions that entail the transfer of profits or resources in their favour, damaging minority shareholders and other stakeholders. The instrument most traditionally used in this regard is represented by transactions conducted not at market conditions with said majority shareholders or with other companies in which the same have an interest (so-called related party transactions). However, there are other mechanisms, also very widespread in Italy, that may considerably penalise minority shareholders, such as delisting in very critical market conditions, share capital increases with option rights at prices much lower than those of the market, IPO at prices that do not re-

flect the quotations of the secondary market, remuneration policies for board directors that do not take the long-term performance of the company into account, etc.

The frequency of these types of transaction in our market – for which estimating the potential harm to minority shareholders requires merit assessments often beyond Consob's powers of intervention and supervision – is an index of the weakness of the governance structures of listed Italian companies and of the poor effectiveness of in-company control mechanisms (particularly those entailing the scrutiny of independent board directors or of minority shareholders with the larger shareholdings, such as for example institutional investors). The very presence of majority shareholders actually discourages the activism of minority shareholders, participation in corporate affairs (as demonstrated by the lack of attendance at general meetings) and the request for more transparency which could increase the awareness of the market and the financial community of transactions which do not obviously appear to be in the company's interest.

In our legal system, like in others, it is retained that corporate governance problems can be effectively managed through self-regulation and market regulation imposed by transparency, or requiring the adoption of the relevant Codes of self-regulation, namely the (compulsory) disclosure of the reasons for failure to fully comply with the same (according to the "comply or explain" principle). Companies that report non-compliance with the best practices dictated by the Codes to the market would be penalised in terms of higher capital costs.

A recent survey conducted by Consob, however, demonstrated how, precisely with regard to the internal procedures that regulate transactions with related parties, it should not be taken for granted that this market mechanism is immedi-

¹⁰ The reasons for this structure are numerous and complex. According to one now consolidated approach in literature, one is these the civil law origins of our legal system, which has less incisive mechanisms to protect shareholders with respect to common law systems. This is supposed to have hindered the diffusion of share ownership and the success of the public company model, which is very common in Anglo-Saxon nations.

ately effective. Indeed, the substantial adoption of the Code of self-regulation by companies established by Borsa Italiana appears far inferior to that which emerges from the statements of companies based on merely formal assessments.

In short, listed Italian companies still have some unresolved issues as regards governance structures, which represent a point of structural weakness in our financial system and have negative repercussions both on the ability of the Authorities to guarantee full protection of investors and on the potential growth and development of the private capital market.

At least two important changes to the legislative framework are envisaged – the incorporation of the directive on shareholders' rights and the issue of the regulation implementing a code-based system for transactions with related parties – which could encourage the participation of minority shareholders in corporate affairs and which offer Consob the opportunity to take action which, in the long-run, could have a significant impact on the weakness of the governance structures of the listed companies illustrated above.

2.2 The shareholders' rights directive

Directive 2007/36/EC (so-called Shareholders' rights directive) envisages a series of minimum guarantees as regards the rights of shareholders in listed companies, with the objective of encouraging their participation in corporate affairs, removing impediments to participation in general meetings and exercising voting rights. This topic is particularly important for cross-border shareholders, who at present are penalised by the need to use, in order to exercise voting rights, the services of a chain of intermediaries that spans from the co-called global custodian to the local agent (namely the domestic intermediary that directly holds the securities account at the centralised financial instrument management company).

Community regulations regard, in particular,

the process of convening general meetings as regards establishing the requirements for participation and voting, participation by electronic means, the opportunity to table draft resolutions and to put items on the agenda, proxy voting and remote voting.

In their implementation of the Directive, Member States guarantee that the rights of shareholders to participate and vote in general meetings are determined on the basis of the shares held by the same on a specific date prior to the general meeting (so-called record date). Said date must be established as between 30 days prior to the convocation of the general meeting and 8 days from the latest permissible date for the publication of said convocation, so that the shareholding is represented as accurately as possible. Furthermore, there will no longer be an obligation to deposit shares prior to the general meeting and the prohibition to sell shares during the period between the record date and that of the general meeting has been removed. In any event, Member States are not bound to apply these provisions to companies able to identify their shareholders from a shareholder register updated as at the date of the general meeting.

The Directive also requires that the limitations and constraints to proxy voting rights be eliminated. To avoid any abuse of proxy voting, however, Member States may establish that the representative is bound to act on any instructions received from the shareholder and may introduce appropriate measures to avoid conflicts of interest between the representative and delegating shareholder.

In implementing the Directive (Italian legislative decree n. 27 dated 27 January 2010), the national legislator has established the record date, reconciling the need to ensure that the shareholding legitimised for participation corresponds as far as possible to the actual one on the date of the general meeting with that of not discouraging the participation of foreign parties, which need an

adequate period of time between the date on which they are able to confirm the number of votes they are entitled to (namely the record date) and the forwarding of any voting instructions to their proxy holders at the general meeting.

The legislator has also established that the right to participate in a general meeting must be based on a certificate issued by a depository intermediary following the request of the shareholder.

In order to encourage participation in general meetings, it appears to be very important, above all for non-resident shareholders, to avoid overlapping dates of general meetings or concentrating said dates in very restricted time windows. To this end, the legislator has reviewed regulations on the terms for the approval of financial statements, allowing companies more flexibility in establishing the date of the general meeting (compared to the current limitation of four months from the end of the financial year, which instead will refer to the availability of general meeting documentation).

Lastly, the legislator has established simpler and more efficient procedures for the exercise of proxy voting, in order to encourage the participation of small shareholders in corporate affairs, and has removed the impediments related to this type of operation (such as quantitative restrictions on gathering proxies, the obligation to use an authorised intermediary, the prior authorisation of Consob for the publication of prospectuses for proxy solicitation activities), envisaging at the same time new forms of protection of small shareholders (transparency obligations of proxy holders in the presence of deposits exceeding certain quantities and for all proxy collection operations that exceed specific quantitative thresholds and which entail proxy solicitation as disciplined by the new art. 136 of the Consolidated Law on Finance).

2.3 Regulations on related party transactions

Consob has issued a regulation implementing art. 2391-bis of the Italian civil code, establishing the general principles regarding transactions with related parties, both in terms of transparency and of substantial and procedural correctness, which companies with listed shares or those with a large proportion of their shares circulated publically will be bound to comply with.

The new regulation for said transactions envisages both immediate and periodic disclosure obligations and principles as regards the procedures that companies must adopt in order to guarantee the necessary conditions of correctness regarding the performance of related party transactions as a whole¹¹.

With regard to the first aspect, the regulation adopted established a dual regime of transparency for related party transactions: on one hand, immediate disclosure to the market is required for "significant"¹² transactions, through a specific disclosure document; on the other hand, forms of periodic transparency are envisaged by means of reports (interim and annual) on management both as regards transactions identified as significant and for any other related party transactions performed in the period in question that have, in any event, had a significant impact on the company's assets and liabilities or financial results.

With regard to procedural aspects, the new regulation is based on making independent board directors more aware of and more involved in evaluating related party transactions. In particu-

11 At the same time, in order not to hinder ordinary and frequent intergroup transactions, companies may exclude transactions with or between subsidiaries and transactions with associated companies from the application of all of the procedures and the disclosure rules introduced by the regulation, on condition that there are no interests of other related parties in said subsidiary or associated companies.

12 Namely transactions of particular importance, based on a series of mainly quantitative parameters.

External factors

- Concentrated ownership structures of listed companies and conflicts of interest between majority and minority shareholders
- Regulations for related party transactions
- Implementation of the shareholders' rights directive

Impact on issuers

- Improvement of corporate governance

Impact on investors

- Lower risk of expropriation of minority shareholders
 - Less impediments to participation in corporate affairs
-

lar, the regulation is focused on establishing a general procedure for related party transactions and a special procedure for significant transactions only¹³.

The general procedure envisages, amongst other things, that a committee of independent directors issues a non-binding opinion on the basis of an ex ante and timely provision of adequate information to the decision-making body and to the same independent directors, and that the public must receive information - on at least a quarterly basis - on all those transactions approved despite the disagreement of the independent directors.

The special procedure for significant transactions, instead, establishes in brief that the approval of said transactions, reserved to the board of directors, is issued following the approval of a committee comprised of non-related independent directors, who will be allowed to make observa-

tions and to take part in discussions as to the performance of said transactions. If the independent directors do not approve the transaction, the procedure envisages that, where permitted by the articles of association, the transaction must be authorised by the general meeting, which must resolve using mechanisms aimed to avoid that the outcome of voting is determined by shareholders that are related parties in the transaction (so-called whitewash).

The governance of listed Italian companies, as mentioned above, has always been characterised by the high concentration of ownership structures and by the significant risk that conflicts of interest between majority and minority shareholders could lead to transfers of wealth to the benefit of the former. It is a well known fact that related party transactions represent one of the main instruments to perform transactions that may potentially harm minority shareholders, when the same take place at prices different to those of the market.

The regulation implementing art. 2391-*bis* of the Italian civil code regarding related party transactions is therefore a fundamental tool to reinforce the external control of the market and the internal control of companies.

¹³ The principles of substantial and procedural correctness, and the relative involvement of independent directors in negotiations and in the investigative and decision-making stages, have been graded according to the size of the company: small-scale issuers, newly-listed companies with widespread share circulation, usually characterised by less complex corporate structures, are allowed to use the simplified general procedure also for significant transactions.

Risks and opportunities for Consob

Regulations on related party transactions offers Consob the opportunity to ask issuers to disclose to the public any shortcomings encountered in the procedures and governance structures that regulate the performance of related party (or atypical or unusual) transactions, increasing the impact of market regulations on corporate governance mechanisms.

The incorporation of Community legislation on shareholders' rights represents an opportunity to encourage minority shareholders to participate in corporate affairs both through the usual consultations and technical support vis-à-vis the

legislator and the exercise of the margins of discretion assigned to Consob under secondary legislation, and by encouraging the private sector to adopt the appropriate initiatives.

Risks and opportunities for Consob

Consob believes that the incorporation of the shareholders' rights directive represents an opportunity to remove the impediments to participation in corporate affairs and to reduce the costs of exercising voting rights for shareholders.

3 Intermediaries and households

3.1 The portfolio of retail investors and securities intermediation

The financial crisis and negative economic conditions have driven Italian households to replace higher-risk financial products (shares, bonds, investment management and financial insurance policies) with safer, more liquid instruments. The proportion of a household's financial wealth represented by deposits and Government securities was estimated to be around 60% at the end of 2009, against around 50% at the end of 2007¹⁴. Furthermore, the number of households that hold financial assets exclusively in the form of deposits and currency has risen. These figures confirm the procyclical nature of the investment decisions of retail investors, which may prove to be wrong with respect to the situation of the markets, amplifying the negative effects.

However, it is likely that, after the initial reactions induced by the financial crisis, the low level of returns on government securities and the strong positive slope of the interest rate curve may lead to a search for alternative investments to bank deposits and that the high volatility of the stock markets may steer demand towards bank bonds (including structured bonds and/or foreign issuers) and insurance policies, perceived by investors as low financial risk products. For the above reasons, the distribution and commercial policies of the major banking groups will continue to encourage the placement of bonds and other structured products.

The direct investment of wealth in products with a high liquidity risk (such as bank bonds and insurance policies with financial content) is a structural characteristic of the choices of Italian investors, who often hold poorly diversified

portfolios and portfolios in the form of assets under administration. The survey results indicate that bank bonds (including those of foreign issuers) and financial insurance policies are the most popular instrument after deposits and Italian government securities.

The poor portfolio diversification also appears to be correlated to the limited availability of high added value investment advice services: figures relating to a representative sample of Italian households provide evidence of this and show that the most diversified portfolios with a lower concentration of deposits and government securities belong to households assisted by financial advisors¹⁵. This phenomenon derives from the characteristics of the Italian securities intermediation industry, on one hand structurally organised to distribute and provide investment services with a low added value for the customer (such as placement, trading and order collection), on the other hand centred around offer policies characterised by a very limited range of investment products and services, which usually coincide with those issued or "packaged" within the group to which the placement agent/distributor belongs. This business model, mostly inspired by group logic, has strengthened the role of the distribution network, also as regards "constructing" products that guarantee sufficiently interesting returns for placement agents.

15 Even though almost 2/3 of households say they have a financial advisor, it is estimated that only around 10% of households receive investment advice services, while a further 10% receive "generic" investment advice services (namely that do not regard recommendations on specific financial products or instruments). A large share of households, therefore, even if they have a financial advisor of reference, do not have a substantial relationship with the same (a situation which is defined as "passive advice"). Furthermore, over 60% of households that have financial market exposure – in the sense that they possess high-risk financial products or instruments such as shares, bonds, investment management products, insurance policies with financial content and pension funds – do not receive advice.

14 Calculations on Gfk Eurisko data.

3.2 The investment management crisis

The Italian investment management industry has been experiencing considerable difficulties for some time. In the 4 years from 2006 to 2009, transferable securities investment funds (UCITS) promoted by Italian intermediaries have recorded an outflow of resources corresponding to over € 200 billion. On the other hand, the offer of real estate funds has grown, whose assets at the end of 2009 represented around 13% of the assets managed by UCITS (compared to around 1% in 2003).

The crisis of the funds promoted by Italian intermediaries has revealed the weaknesses of the industry's current structure, such as the lack of independence in strategic decisions due to the ownership structures of Investment management companies, the vertical integration between production and distribution and the poor ability to innovate. This has also conditioned the pricing of mutual funds: the fee due to the distributors has ended up representing the largest element of the product-fund cost¹⁶.

The substitution effect between structured products, such as bank bonds and insurance policies with financial content, and the traditional investment management products continues to benefit from the above-mentioned commercial policies, also made possible by the high implicit costs of structured products, while from a legislative and disclosure perspective, room for regulatory arbitrage has been removed by legal provisions (which have subjected bank bonds and the financial products issued by insurance companies to prospectus obligations) and by the application of the MiFID (with the extension of the rules of conduct envisaged by the directive to the distri-

bution and placement of bank and insurance financial products, such as mutual funds and class III and V insurance policies and bank bonds when the latter are placed by banks or investment companies).

One area worth a particular mention, due to its potential repercussions on investors that intend to liquidate their investments, is represented by the performance of so-called retail real estate funds, listed on a regulated market, which for some time have been recording very low trading volumes at a significantly discounted price compared to the value calculated on the base of shareholders' equity (so-called market discount).

This situation is accompanied by the increasing difficulties that Investment management companies are encountering in achieving plans to free-up portfolios of funds as the deadlines envisaged by operating regulations draw near. This will be very significant in the future as the majority of these products will mature in 2012-2018¹⁷.

3.3 The MiFID and investment advice services

The Markets in Financial Instruments Directive (known as MiFID, Directive 2004/39/EC) should encourage intermediaries to shift from a "product selling" approach to one of "providing services". This shift sets the foundations for steering changes in the strategic and organisational decisions of operators, who should focus their efforts on the principle of best serving the interests of the customer.

One specific area envisaged by the service model adopted for customer relations regards the provision of investment advice to investors. It is a well-known fact that the MiFID includes the

¹⁶ Financial statement figures show that around 78% of the commission expenses of Investment management companies for the distribution of open-end funds issued and managed by the same, is paid to companies belonging to the same Group.

¹⁷ Around 52% of said products, with balance sheet assets at the end of December 2008 totalling around € 22 billion, will mature in the period in question.

External factors

- Business models of intermediaries highly oriented towards distribution
- Important role of retail in the direct funding of the banking system
- Scarce availability and low added value of investment advice services
- Investment management crisis
- Weakness of the real estate market and the approaching maturities of real estate funds

Impact on retail investors

- Poor portfolio diversification
 - High proportion of financial wealth represented by complex and illiquid products
 - Difficulties freeing up investments in real estate funds
-

provision of investment advice to investors in the list of regulated activities, i.e. those which require prior authorization by the competent authorities in order to be carried on, and introduces a reinforced regime of protection for non-professional investors. The rationale of the rule lies in the fact that said service can significantly influence a household's portfolio decisions and marks a crucial step in customer-intermediary relations, which may trigger other investment services (as an almost natural sub-product) of an executive nature (trading and placement).

MiFID does not set minimum qualitative standards for the provision of the service, other than those ingrained in the very definition of advice, entailing the need to personalise recommendations on the basis of the customer's profile. Personalisation implies the obligation to present the recommendation as "suitable" for the customer or based on the characteristics of the same¹⁸.

The approach of the MiFID, in particular, does not necessarily embrace a portfolio logic, as suitability for the customer's profile can also be assessed in terms of individual proposal or recommendation regarding specific financial

instruments. In other words, a specific transaction regarding a specific financial instrument recommended by the intermediary to the customer, could be considered as suitable if taken alone. However, a series of transactions recommended by the same intermediary to the same customer (even at different timings and in different circumstances) could give rise to an overall portfolio of financial assets which cannot be considered suitable because of its poor diversification in terms of market risk and issuer.

Substantially, according to the MiFID, intermediaries must assess the adequacy of a financial product or instrument they are recommending with respect to a series of parameters that contribute to distinguishing the customer's profile – such as aversion to risk, the time horizon of the investment, financial wealth and level of financial knowledge¹⁹ – but not necessarily based on the structure and make-up of the customer's portfolio at the time the advice is given. In other words, the regulation on investment advice does not necessarily envisage the need to assess "the marginal

18 Art. 52, Directive 2006/73/EC.

19 Financial wealth is a parameter that allows the intermediary to assess the ability to withstand financial risk that the customer is willing to undertake – in line with his aversion to risk and investment time horizon – while the level of financial knowledge enables the intermediary to assure itself that the customer is able to adequately understand the risks he is undertaking.

impact” of including a specific financial product or instrument on the overall risk-return profile of the customer’s portfolio.

As mentioned earlier, the securities intermediation industry is distinguished by a structure highly oriented towards distribution, rather than a “customer service” approach. This business model and the characteristics of bank deposits have profoundly influenced the way in which the MiFID has been applied by the industry.

Based on results gathered by Consob in the first cycle of inspections following the entry into force of the MiFID at the major banking groups, it appears, in fact, that the way in which the new regulations are being applied, is characterised, in some cases, by a formalistic approach, which ignores the substance and spirit of the Directive. In a number of cases, for instance, products that are not suitable for a customer were distributed anyway as part of the provision of execution services or order receipt and transmission services which only require the appropriateness test; other times, instead, the provision of investment advice is used to steer the customer towards “in house products” only.

The substantial application and compliance with the spirit of the MiFID require, instead, a change to a “customer service” model, which entails a radical change of the overall strategies that characterise the offer of investment services. This change should influence the definition of procedures and organisational structures, of the decision-making processes relating to business plans, of the way in which the range of products and services offered is selected, and of policies to incentivise and compensate distribution networks.

While on one hand, operators are required to adopt the customer service model in order to align their interests with those of investors in a long term relationship, on the other hand, it enables easier supervision – off-site and on-site – of the level and quality of the service offered in terms of disclosures, analysis of needs, extent of the product range, reporting-monitoring of investments made.

The poor diffusion and the low qualitative level of the investment advice services offered by intermediaries are key risk factors, which have negative repercussions in terms of the incisiveness and the costs of supervisory measures, because – although supervision continues to be focused on the organisational and procedural structures that regulate the provision of the services as a whole – there are circumstances in which there is a risk of concentrating controls on individual transactions rather than focusing on the general terms and conditions of service that regulate the intermediary-customer relationship.

Intermediaries therefore need to share the idea that the correct application of the MiFID represents an opportunity to enhance their trust relationship with the customer, giving them a stability that could prove to be beneficial especially in times of economic downturn. Improving the quality of investment advice services, induced by competition and by the moral suasion that Consob intends to exercise, could contribute to favourably shifting the distribution logic permeating the financial intermediation sector to a customer service approach.

Risks and opportunities for Consob

The structure and the business models of the securities intermediation industry, highly oriented towards "selling a product" rather than "providing a service", make the substantial application of the principle of serving the best interests of customers more complex and amplify potential conflicts of interest of bank operators and often even issuers. This industry structure is the reason for the scarce availability and low level of quality of the investment advice services provided to retail investors, which in turn create an environment characterised by a greater risk of conducts that does not comply with the MiFID or entails merely a formalistic application of the same.

Continuing supervision of the way in which the MiFID is applied by the industry offers Consob the opportunity to redirecting the choices of operators towards an approach based on serving the customer's best interests.

4 Non-equity financial products and instruments

External factors

- High uncertainty as to the evolution of the stock markets
- Modest short-term interest rates, but strong positive slope of the interest rate curve
- Investment management crisis
- Non-equity products very popular with retail investors
- Lack of harmonised transparency rules for similar non-equity products
- Inadequate disclosure standards for risk-return profiles
- Different supervisory practices across Europe for the approval of prospectuses

Impact on retail investors

- Difficulty in assessing the risk-return profile of non-equity products
 - Difficulty in comparing similar products
-

Community legislation on non-equity products, namely mutual investment funds, insurance policies with financial content and bonds, is extensive and detailed. In fact it includes provisions on disclosure obligations, rules of conduct, incentives and conflicts of interest contained in the relevant directives, regarding the securities, insurance and funds sectors respectively, as well as horizontal legislative provisions on sales channels and specific commercial practices²⁰.

The European legislative framework is inconsistent, insofar as it envisages disclosure obligations and rules of conduct that differ between products, even if they are similar from a

financial perspective, only because they are sold with different "legal forms" and through different distribution channels. Moreover, the same legislative framework dictates disclosure standards based on a "narrative" illustration of the risk-return profile. Said standard often proves inadequate to enable retail investors to assess to what extent a specific product meets their investment objectives and to reach an informed assessment on the convenience of the investment compared to transactions in similar products²¹.

In addition to the complexity of the structural elements, said products also have poor liquidity, in some cases ingrained in the product's structure (for instance, insurance policies that envisage high penalties in the case of early ter-

²⁰ With reference to legislation in force as at June 2010, note Directive 2004/39/EC on markets in financial instruments (MiFID), Directive 2003/71/EC regarding the prospectus to publish for a public offering or admission to trading of financial instruments, Directive 2002/83/EC on life insurance and Directive 2002/92/EC on insurance brokerage, Directive 1985/611/EC regarding the coordination of legislative, regulatory and administrative provisions as regards some OICVM and lastly Directive 2009/65/EC which, jointly with the level 2 measures adopted by the European Commission – Reg. 583/2010, Reg. 584/2010, Directive 2010/42 EC and Directive 2010/43/EC – has redefined the regulation of harmonised mutual funds and Directive 2002/65/EC on the distance marketing of financial services.

²¹ For example, some class III insurance products (unit-linked insurance policies) have the same financial profile as that of standard investment management products (mutual funds and SICAV), while others (index-linked insurance policies) have similar features to structured bank bonds; class V insurance products (capitalisation policies) are similar to ordinary bonds; covered warrants and certificates have structural elements similar to insurance policies, structured bonds and some types of investment management products.

mination) and in others related to the way in which the secondary markets work (as happens, for example, with bonds).

Further problems stem from the central role that Community rules allocate to the home country Authority in cross-border solicitation transactions (in particular for investment management products and for bonds). However, European supervisory authorities do not always adopt harmonised standards for the approval of prospectuses. Furthermore, when foreign issuers use the so-called base prospectus, in the case of sales in Italy, Consob receives a document from the competent foreign Authority that does not contain product details or specify the characteristics of the products that will be placed (as this information is included in the final terms, which are published at the time of each issue and do not have to be transmitted to Consob). These circumstances make it difficult to identify the types of so-called "passported" financial instruments distributed on the national market.

This lack of harmonisation in legislative regimes and in the way in which Community legislation is applied, create opportunities for regulatory arbitrage which undermines the protection of retail investors and the balanced development of the capital market.

With regard to "packaged retail investment products" (PRIPs), the European Commission has recommended due consideration of the matter²². In particular, the Commission has set in place a project to harmonise regulations on summary disclosure and the marketing rules applicable to traditional investment management products (UCITS) and insurance products (index and unit linked)

and to similar structured products²³. A recent European Commission Communication dated 2 June 2010 on the regulation of financial services for sustainable growth indicates, among the possible projects, the presentation of a proposal on PRIPs in the spring of 2011.

These topics have been a focus of attention for the national legislator and Consob for some time, who have undertaken initiatives aimed at extending the rules of conduct relating to subscription and placement envisaged by the MiFID for financial instruments to the financial products issued by banks and insurance companies, as well standardising rules on transparency at the solicitation stage for some types of non-equity products. In particular, Consob has intervened with regard to the public offering of Italian mutual funds and financial insurance policies, to standardise the information contained in the summary documents that must be delivered at the solicitation stage and to introduce synthetic quantitative indicators on the level of risk that are clear and easy to understand. However, this lack of harmonised disclosure continues to remain for the other product categories, in particular for bonds and for all foreign products marketed in Italy on the basis of prospectuses approved by foreign Authorities.

The critical aspects of the regulatory structure illustrated above are an important risk factor, because, for the reasons previously discussed extensively, it is likely that non-equity products (including the "passported" products of foreign issuers) are destined to remain one of the most common forms of asset investment for retail investors (after government securities).

Within the Community, the regulation of

22 Communication on packaged retail investment products dated 30 April 2009. The Communication refers however to a subset of non-equity products, namely mutual investment funds, insurance policies with financial content (unit- and index-linked), structured securities and structured term deposits. With regard to the set of non-equity products, substantially plain vanilla bonds would be excluded.

23 In the reconstruction of CESR, PRIPs could substantially be considered as products with an exposure to other financial assets, which could be direct (such as in the case of investment management products) or indirect (for example, through index-linking mechanisms, such as in the case of structured products). See CESR's Report on Packaged Retail Investment Products, November 2009 (CESR/09-814).

non-equity products is in any event undergoing a period of profound evolution and will be subject to important changes, although we will probably have to wait several years before they become fully effective.

With regard, for example, to the disclosure profiles of traditional investment management products (harmonised mutual funds), the adoption of some important changes is already underway following the application of the so-called UCITS IV directive²⁴ and that of level 2 measures issued by the European Commission on the basis of the technical opinion published by CESR (Regulation 583/2010 applicable as of 1 July 2011). The revision of the UCITS directive reflects the acknowledgment of the fact that the "simplified prospectus" has proven to be inadequate to guarantee concise, exhaustive and comprehensible information on the characteristics of funds, and will therefore be replaced by a document containing "key investor information (KII)". Said document should be drawn up in a clear and comprehensible way and should provide investors with the key information needed to make informed investment decisions²⁵.

The KII will be contained in a document of no more than 2 pages of A4 format (the front and back of a single page with a font of an appropriate size), drawn up clearly, in plain language and avoiding the use of jargon. As regards information on the risk-return profile, a synthetic qualitative indicator will be adopted (although based on quantitative methods), accompanied by a narrative explanation of the main limitations of the indicator in question and a

presentation of the important risks that are not covered by the methodology underlying the calculation of said indicator²⁶. Discussions with consumers, promoted by the European Commission and CESR on a number of occasions, have in reality led to the conclusion that in comparison to a lengthy narrative description of the expected risks and returns, consumers prefer the use of synthetic indicators that are immediate and easy to understand for investors with a limited level of financial education.

Action to review the standards of summary information on mutual funds will be accompanied by similar measures relating to the financial instruments covered by the Prospectus directive²⁷ (particularly complex structured bonds). The common position of the European Council and Parliament on the draft directive that would change the Prospectus directive envisages that the prospectus, for all of the various financial instruments covered by the directive's scope of application (including equity instruments) includes a summary note – the so-called summary prospectus. This document should be brief and simple to understand for retail investors and should contain key information to help the same make informed investment decisions²⁸ as well as summary information on the risk-return profile of the products and on its costs.

The revised Prospectus directive should be followed by level 2 measures that detail the information content of the summary prospectus, changing the second level rules currently in force²⁹,

24 Directive 65/2009/EC, which should be applied by 1 July 2011.

25 This document must be drawn up in the same format in each country, in a concise way, using non-technical language, in order to facilitate the understanding of investors, and should contain key information regarding: the identification of the fund, the objectives and the investment strategy, historic performance (or for structured funds, performance scenarios), the costs and commissions and the risk-return profile. Each piece of information must be able to be easily understood by the investor without the need to refer to other documents.

26 The synthetic indicator will be formed by a numeric scale of whole numbers in increasing order, from left to right, that represent the level of risk and return from the lowest to the highest. The method used to construct the indicator is based on historic volatility (even though this does not reflect credit, liquidity, counterparty and operating risks) and, for structured funds, on volatility calculated by means of a reconstruction of the VaR (although this does not reflect for example the risks of "tail" events).

27 Directive 2003/71/EC.

28 In fact, the summary is not supposed to replace the full prospectus.

29 Regulation 809/2004.

following the same path taken for mutual funds. Furthermore, the proposal to change the Prospectus directive envisages a link with the cited project to harmonise the rules on packaged products (PRIPs), as regards the summary information provided to investors. The common position of the European Council and Parliament on the proposal to amend the directive envisages that as regards the securities covered by the Prospectus directive that can be considered PRIPs (substantially bonds and other structured securities), there must not be a duplication of the summary information provided to investors, insofar as the summary document that will be adopted as part of the PRIPs project could be considered a summary prospectus. On the other hand, the European Commission has underlined the possibility that the KII adopted for mutual funds can be considered a benchmark for efforts to harmonise the summary information on PRIPs³⁰.

In brief, it is likely that over the next few years, a series of regulatory initiatives will be undertaken, which will lead to an extensive harmonisation of the summary information provided to retail investors on the non-equity products covered by the PRIPs project – substantially excluding therefore, non-structured ordinary bonds (so-called plain vanilla) – adopting the KII model established for mutual funds as a standard.

On the other hand, the road to harmonising the rules for selling and distributing non-equity products appears to be more complex – general principles to act in the best interests of customers, pre-contractual disclosures made by the placement intermediaries, rules on incentives and the management of conflicts of interest, the provision of investment advice, etc. One possibility, as indicated in the preliminary documents of the European Commission, is to extend the rules of the MiFID to insurance and investment management products (as partially performed on the domestic market)³¹.

The evolution of the European legislative framework will therefore lead to a better harmonisation of the rules for the disclosure and placement of non-equity structured products that should create an effective level playing field. However, several years are needed before this process actually reaches its conclusion; in the medium-term, therefore, the protection of investors continues to be exposed to the significant risks mentioned above, stemming from difficulties in accessing harmonised, easy to understand summary information on the characteristics and the risk-return profile of products able to facilitate the comparison between similar products sold in different legal forms.

30 CESR, in the cited technical opinion dated October 2009 to the European Commission, also suggested that the KII as defined as part of level 2 measures of UCITS IV should be adopted as a basis for the standardisation and harmonisation of the summary information for PRIPs (namely for insurance products, bonds and structured securities).

31 However, CESR comments how some provisions contained in the Investment Mediation Directive (IMD) – in particular, in terms of pre-contractual disclosures and the regulation of advisory services – could represent a more appropriate point of reference, profitably integrating the MiFID rules (see CESR's Report on Packaged Retail Investment Products, cit.). This aspect has also been reported in the preliminary document of the European Commission (Update on Commission Work on Packaged Retail Investment Products, 16 December 2009).

Risks and opportunities for Consob

Disparities in the disclosure rules applicable on the basis of current Community regulations, differences in the supervisory practices adopted to approve prospectuses and the absence of harmonised summary information on characteristics and the risk-return profile create room for regulatory arbitrage and may prevent retail investors from making an informed assessment as to the convenience of an investment in non-equity products. Other elements that contribute to creating room for regulatory arbitrage are represented by differences in the rules of conduct applicable to placements (MiFID for funds and financial instruments, other directives for insurance policies).

5 Rating agencies

External factors

- Community regulations of rating agencies
- Structural reform of the European system of financial supervision

Impact on market participants

- The potential improvement in rating quality could increase the confidence of market participants, extend the set of financial instruments considered for investments and improve portfolio diversification
- Market participants could perceive the ratings issued by supervised entities as supported by a quality guarantee and rely excessively on the same

The subprime crisis has again shifted the attention of the regulators to the inadequacy of ratings issued by rating agencies, a topic that arose at the time of several large-scale bankruptcies (including Parmalat and Enron). From an information perspective, ratings have proven to be a crucial element in structured finance transactions, due to the complexity of the products being evaluated, the opacity of issuers (SIVs, *conduits* and vehicles that issue CDOs), and the assistance provided by agencies to set up the transaction, with the aim of achieving the rating objective required by the originator.

Discussion of possible strategies of intervention, also triggered by the Report of the Financial Stability Forum in April 2008, has led to the adop-

tion in Europe of a Regulation on rating agencies, promulgated by the European Parliament and Council on 16 September 2009 (Box 4). However, this Regulation is set to undergo significant amendments, following the presentation of the Regulation proposal dated 2 June 2010. Said proposal envisages that exclusive supervisory powers over rating agencies are attributed to the new the European Securities and Markets Authority (ESMA). In particular, it has been proposed that said Authority should hold the rating agency register, the power to request information, the power to conduct assessments, also through inspections at the agencies, as well as the power to impose sanctions (financial penalties would be proposed and subsequently imposed by the European Commission). The current version of the Community

Box 4

Community regulations on rating agencies

Community regulations on rating agencies apply to the ratings issued by agencies registered in the Community and disclosed to the public (they do not apply, on the other hand, to private ratings produced on demand and not to be disclosed to the public). The new discipline intends to improve transparency at the time of issue of said ratings, boosting the competitiveness of the agency market and encouraging innovation and the reliability of assessment processes; to ensure that the evaluation process is characterised by adequate quality standards; to safeguard the integrity and independence of agencies.

Supervision at time of registration

The regulations currently establish that the use of ratings for regulatory purposes is only possible for ratings issued by agencies established and registered in the Community. Registration applications must be addressed to CESR, which organises their notification to the competent authorities of all Member States and provides assistance to the authority of the agency's home country in order to check the completeness of the application. CESR also keeps a central register to hold and publish information regarding, inter alia, ratings issued in the past by registered agencies and, acts as mediator in the event of a disagreement between the competent authorities that are part of a supervisory board. Registration is mandatory in the entire Community following a decision adopted by the competent authority of the home country Member State jointly with the other authorities that are members of the supervisory board.

After receiving the registration application, (within 10 days) the home country authority invites the competent authorities of all Member States to attend an agency supervisory board meeting. The authorities which, in addition to that of the home country, may be members of the board are those in which there is a subsidiary or branch of the agency and the use of the ratings issued by the agency for regulatory purposes is widespread or it is in any event likely that it will have a significant impact (the authorities to which these conditions do not apply may in any event attend meetings of the board and participate in several activities of the same). The competent authorities establish all supervisory powers over disclosure and inspections needed for the exercise of their functions. Furthermore, the appointment of a facilitator is envisaged to encourage cooperation between board authorities, coordinate their activities and facilitate the exchange of information.

For registration purposes, the authority of the country of origin and those that make up the board examine the application submitted by the agency and seek to reach agreement on the approval or rejection of said application. In the event of disagreement, CESR is involved to resolve the dispute; if a common decision cannot be reached, the home country authority must reject the application, justifying said decision.

On-going supervision

Home country authorities may revoke registration, issue a temporary prohibition to issue ratings, suspend the use of the same for regulatory purposes, adopt injunctive provisions, inform the public of infringements made by agencies and inform the judicial authorities of assumed penal unlawful acts. Said decisions have effect throughout the Community and are either taken independently, or after having consulted the board, even if agreement is not reached by members of the same. In this regard, a mediation procedure is envisaged which involves CESR. If a request to revoke registration is submitted to the board by a host country authority, the home country authority may decide not to approve the request, justifying its rejection.

The competent host country authorities, members of the board, also have powers of intervention. Effective only to its own jurisdiction, the same may adopt injunctive provisions (aimed to guarantee compliance with legal obligations) and suspend the use of a rating for regulatory purposes by parties with registered office in their jurisdiction. The adoption of said provisions is in any event conditional to consultation with the board, even though, if agreement between board members is not reached, the competent host country authorities may implement the proposed provisions.

The host country authorities may submit to the examination of the board the possible adoption of provisions effective throughout the Community concerning the temporary prohibition to issue ratings, the suspension of the use of ratings and injunctive provisions.

regulation envisages, instead, that the registration of agencies and on-going supervision is assigned to the National authorities, also by means of participation in a board comprised of the competent Authorities of the other Member States³². As at the moment, the outcome of the debate on the cited proposal to attribute supervisory powers to the ESMA is difficult to foresee, the comments below are based on the assumption that National authorities will, in any event, be required to cooperate with the cited European authority even in the performance of technical duties. Furthermore, the regulation in force requires the competent authorities to fulfil obligations of registering rating agencies according to the afore-described system. To this end, for 2009, Consob has been indicated by Community law as the competent authority for Italy responsible for compliance with the Regulation in force.

Lastly, the European Commission announced the presentation of a Communication in autumn 2010 on the overreliance on ratings, which could preclude further changes to the relevant legislative structure.

Consob could have the opportunity to play an active role in the supervision of agencies both as home country authority for agencies based in Italy and as host country authority for agencies with registered offices in other countries, but whose ratings are widely used and have a significant impact in Italy. However, from preliminary contact with the main international rating agencies, it has emerged that the latter intend to maintain an operational registered office in Italy as well, therefore Consob would also be the home country authority for the same. The Authority could therefore participate in the agency registration process as well as on-going supervi-

sion, and exercise the more incisive powers of intervention held by home country authorities (as well as being part of the European board). In particular, if irregularities emerge, Consob could independently exercise (although following consultation of the board) various prohibitory powers, even as far as suspending the use of the ratings issued by the agency for regulatory purposes.

Community regulations on rating agencies could therefore allow the Authority to verify, even in compliance with the constraints imposed by participation in supervisory boards specifically established at European level, that the organisation of agencies and the procedures for issuing the relative ratings meet the requirements of integrity, independence and transparency. Supervisory activities, however, cannot guarantee the "informative efficiency" of the rating, namely the ability of the same to correctly reflect actual probability of default on the basis of all of the information available on the issuer; nor may the authorities make merit assessments regarding the models and the data used by agencies (although, however, they may verify the adequacy and the completeness of the information used to issue the rating and the correctness of presentation of the same as well as the models used). The Authority's exercise of powers may however be less incisive as regards operators whose registered office is abroad, insofar as any provisions would only be effective in Italy and in any event conditional on the evaluation of the board of European supervisors (with the exception of that stated regarding large international rating agencies that intend to maintain a registered operating office in Italy)³³.

32 Or, as will be illustrated in Box 4, also independently by individuals of national authorities, who may, at the conclusion of a specific procedure, adopt prohibitory or precautionary provisions, whose effectiveness is restricted to their own legal system.

33 An area of potential difficulty regards the funding of the costs of supervising rating agencies. Current provisions establish that the same may be funded through the application of supervisory fees only to parties resident in Italy. In fact, Community regulations award only one home authority the right to request a fee of agencies. However, this difficulty may be overcome if, as mentioned earlier, agencies adopt a group structure with branches registered in the State where their registered office is located.

Risks and opportunities for Consob

Considering that nowadays ratings represent an essential part of market information, the supervision of rating agencies would be an opportunity to strengthen and extend the scope of control over derived information (studies and surveys published by analysts, opinions published by auditing companies), integrating these controls with standard activities to supervise the market disclosures of issuers.

As regards risks, the European regulations could create a situation in which the supervision of agencies leads to excessive reliance of market participants on ratings, if supervision is perceived as a guarantee of the quality and informative efficiency of said ratings.

The supervision of rating agencies, especially if conducted within a structured and continuative control system, would represent a new area of activity for Consob and would entail a high workload, given the widespread use of ratings also as part of the information prospectuses of financial instruments. However the level of effectiveness of the mixed "home/host country" supervisory model outlined in the European regulations will need to be verified to guarantee Consob adequate supervisory and enforcement powers with regard to rating agencies registered in other countries.

6 Fragmentation and transparency in secondary markets

The abolition of the concentration rule for trading on regulated markets introduced by Directive 2004/39/EC (MiFID) together with the technological developments and structural changes underway in capital markets has set the foundations for an intensification of competition between trading platforms (regulated markets and multilateral trading facilities) and for an increase in the level of trading fragmentation.

In this context, the consolidation of pre- and post-trading information and trading transparency become particularly important to protecting investors and to guaranteeing the clear performance of trading transactions, considering the risk that the growing trend towards trading fragmentation could lead to a deterioration in the quality of the information available to the public.

With regard to consolidation, the MiFID simply recommends Member States to eliminate the obstacles that could hinder consolidation at European level; CESR then issued level 3 provisions that Consob has transposed into the domestic legal system. However, the measures it was hoped would be implemented by the industry to ensure an adequate consolidation of information have not yet materialised.

As regards the transparency of information, the Community legislator of the MiFID has dictated a detailed pre- and post-trading transparency regime as regards shares, envisaging, however, that the competent authorities may exempt operators from pre-trading transparency rules on the request of the same, in specific circumstances; it has also once again granted Member States the power to introduce transparency obligations on transactions relating to non-equity instruments.

However, Member States have not demonstrated any convergence in the regulation and interpretation of the Community provisions, with

consequent repercussions on the quality of the price formation process and on the level playing field in the offer of trading services.

There are clear examples of disparity in the interpretation and application of Community provisions as regards authorisation for exemption to pre-trade transparency on regulated markets and multilateral trading facilities (MTF) and as regards the organisation of initiatives by operators to avoid the application of transparency obligations.

The application of pre- and post-trade transparency requirements to financial instruments other than shares admitted to trading on regulated markets is an equally critical area. Italy has introduced obligations in this regard and has actively participated in initiatives of CESR which, after having published a report on the matter, then sent, jointly with other countries including Italy, a letter to the European Commission indicating, inter alia, the need for more post-trade transparency for non-equity instruments and soliciting intervention in this regard through an amendment to the MiFID.

The MiFID has, in any event, profoundly innovated the competitive scenario, which is increasingly characterised by more competition between trading platforms (regulated markets and multilateral trading facilities). The regulated markets, facing the risk of erosion of their position, have set in place strategies to acquire new platforms and to form business combinations with other regulated markets³⁴ which allow them to exploit economies of scale and to diversify the services offered. Furthermore, requests for ex-

34 Such as operations that led to the creation of Euronext (integration of the markets of Paris, Brussels, Amsterdam and Lisbon) and OMX (alliance between the Nordic markets of Stockholm, Helsinki, Copenhagen, Reykjavik, Vilnius, Tallin and Riga) and three important mergers conducted in 2007, that of the NYSE and Euronext, Borsa Italiana and LSE, NASDAQ and OMX respectively.

emption from the pre-trade transparency regime outlined by the MiFID have increased, given the interest shown by regulated markets and MTF to launch so-called dark pools (NYSE Euronext and Nasdaq OMX), which meet, above all, the needs of institutional investors³⁵.

Furthermore, competition between markets and intermediaries is on the rise, both due to the strong incentive for the latter to direct trading flows towards participated platforms, which in turn attract liquidity also thanks to aggressive pricing policies³⁶, and due to the inclination to carry out activities very close to that of systematic internalisation (without being classified as such), namely to set up crossing networks for orders. The latter initiatives, however, do not appear to be included in the trading venues established by the MiFID (MTF and systematic internalisers), thus avoiding application of the regulations associated to the same³⁷.

These phenomena, which are more evident at European level and with regard to which CESR has launched several inquiries, have not yet reached important proportions in the Italian scenario. This is most likely due both to the effect of inertia linked to the application of the concentration obligation in regulated market trading,

and to the fact that European multilateral trading facilities have only recently started to trade Italian securities. Liquidity on Italian securities is therefore still "concentrated" in domestic regulated markets and, in the case of shares, in the markets managed by Borsa Italiana³⁸; nevertheless, initiatives aimed to channel order flows to other regulated markets and foreign MTF are on the rise.

The supervisory experience acquired by Conso indicates that the growing tendency towards trading fragmentation triggered by the MiFID implies the risk of a deterioration in the quality of the information available to the public. This problem arises particularly as regards trading conducted outside of regulated markets, given the tendency of intermediaries to publish information through numerous channels (often only on their websites) and in a format that hinders any consolidation with figures coming from other sources; the diversity of the channels and the formats in which the information is published also makes supervising the correctness of the figures published very complex and onerous³⁹.

The lack of harmonisation of the transparency regime on transactions regarding non-equity instruments compromises supervision of the regularity of secondary market trading of bonds and

35 The term dark pool indicates systems in which the orders input (usually from institutional investors and regarding so-called "blocks", namely transactions with a very high countervalue) and whilst awaiting execution are not visible to the public and therefore the relative trading actually takes place outside of regulated markets. From an initial analysis of the phenomenon, it has emerged that the spread of dark pools has not entailed a real deviation of trading on regulated markets, insofar as even before the introduction of the MiFID, blocks were exempted from the concentration obligation and were performed OTC.

36 One example in this regard is represented by Chi-X, which applied different commissions to traders depending on the type of order input (namely order with price limits, so-called limit orders, or orders known as "market orders").

37 The objective stated by the intermediaries that have set up crossing networks and that do not define themselves as systematic internalisers appears to be that of performing OTC transactions to avoid the trading fees applied by trading venues, whilst complying with legislative obligations of best execution and post-trade transparency.

38 With regard to FTSE MIB securities, in March 2010, Borsa Italiana was the main trading venue, with around 70% of the total countervalue traded; the MTF active on Italian securities had a share of just under 10%, while OTC transactions had around a 20% share (taken from transaction reporting data). The MTF active on Italian securities are Chi-X and Turquoise, which initially operated on Anglo Saxon securities. Chi-X lists the 40 securities of the FTSE MIB, while Turquoise permits the trading of around 200 Italian shares. Although not yet significant, the operations of Chi-X and Turquoise on Italian securities appear to be steadily rising, also thanks to aggressive rate policies and the use of an advanced technological infrastructure.

39 When relating to transactions on regulated markets or MTF, the data circulated appears to be generally reliable, as the main European data vendors (such as Reuters and Bloomberg) gather information directly from the trading venues, then consolidate and circulate it in an aggregated format, generally by trading venue.

External factors

- Development of new trading venues and increase in trading fragmentation
- Increase in number of requests for exemption from transparency rules for share transactions
- Transparency of trading in non-equity instruments is not harmonised at European level

Impact on the market and on the Italian stock exchange

- Fall in the quality of trading information
 - Regulatory arbitrage leads to lower supervisory standards
-

other non-equity financial instruments, as well as naturally leaving room for regulatory arbitrage between different legal systems. Disparities in the interpretation and application of Community provisions by the Member States is equally problematic: we have already referred, for instance, to the regime of authorisation for exemption from pre-trade transparency rules for regulated markets and MTF and to the organisation of initiatives by

operators to avoid the application of transparency obligations (such as crossing networks). Irregularities in supervisory approaches as regards the authorisation for exemption from transparency rules may contribute to increasing "opacity" in the case of a high volume of transactions, with consequent repercussions on the quality of the price formation process and on the level playing field in the offering of trading services.

Risks and opportunities for Consob

Increased trading fragmentation leads to a fall in the quality of information on transactions available to the public. This, in turn, hinders any initiatives to consolidate information and makes supervision on compliance with the transparency obligations envisaged by the MiFID more complex and onerous.

Irregularities in the post-trade transparency regime for non-equity instruments and in the application of Community provisions on pre-trade transparency for equity instruments, resulting from the margins of discretion conceded by the MiFID as well as disparate supervisory approaches, imply the risk of regulatory arbitrage and may cause a generalised fall in the level of transparency (so-called race to the bottom).

The MiFID review process, which will be launched in 2010, therefore represents an opportunity to promote more harmonisation in the application of the current rules and to extend the scope of application.

7 Market abuse

External factors

- Listed issuers have weak procedures to manage inside information
- Low level of quality in reporting suspect transactions

Impact on market participants and on the Italian stock exchange

- Increase in information asymmetries and of opportunities for market abuse
-

The market abuse directive (Directive 2003/6/EC) has strengthened the tools for the prevention and ascertainment of unlawful conduct by dictating provisions regarding, respectively, the handling of inside information by issuers and the reporting of suspicious transactions by intermediaries.

As regards the first aspect, it should be noted that alongside the obligation to disclose inside information to the public, the Consolidated Law on Finance envisages the option for listed companies to delay disclosure, on condition that this does not "mislead the public as regards key facts or circumstances" and that the same companies are able to guarantee the confidentiality of said information. The Issuers' regulation illustrates the type of organisational measures that must be set in place to avoid the improper (internal and external) circulation of inside information; when the confidentiality constraint is broken, issuers must promptly proceed with disclosure.

Regulations on internal dealing add to provisions aimed at avoiding unlawful conduct by identifying the parties that must notify Consob and the public of transactions regarding the shares or financial instruments of a listed company. The latter is in turn directly involved in fulfilling disclosure obligations, as it must set in place a specific procedure to this end.

The obligation to keep a register of the persons that have access to inside information (so-called insiders' register) completes the relevant rules. The purpose of said obligation is to encourage the establishment of adequate internal procedures on the circulation and monitoring of inside information, even in order to control the market rumours' phenomenon. The criteria on the basis of which said obligation is fulfilled should reflect the choices made by issuers regarding the circulation and monitoring of inside information: in other words, they may be established according to the needs of the organisational structure of each issuer.

As regards provisions regarding ascertainment, in order to facilitate the identification of conduct that may damage market integrity, the Directive envisages the obligation for intermediaries to report cases to the competent authority where they reasonably suspect that the transactions constitute an abuse of inside information or market manipulation (so-called suspect transactions). On the basis of said provision, implemented through article 187-*nonies* of the Consolidated Law on Finance, Consob has indicated the categories of parties bound to comply with said obligation, the elements and the circumstances to take into consideration to assess conduct that can be considered suspect transactions and the procedures and terms for reporting the same.

Risks and opportunities for Consob

The importance of the rumours' phenomenon, which indicates weaknesses in the handling of inside information by listed companies, increases the likelihood of unlawful conduct and makes ensuring orderly trading more complex.

In a later Communication, the Authority implemented the level 3 rules of CESR regarding conduct that could represent market manipulation or suspect transactions and has identified several potential parameters or elements that may lead the intermediary to reasonably suspect the existence of possible unlawful conduct. The objective is naturally to receive from authorised intermediaries (Asset management companies, banks and Italian investment companies) and from market management companies reports that have effective "added value" and that may enhance Consob's ability to identify market abuse, shedding light on cases that otherwise would have been difficult to uncover as part of ordinary control activities on cash or derivative markets.

Experience in applying regulations on the management of inside information and the reporting of suspect transactions shows that fulfilment of said obligations by supervised entities could be significantly improved.

With regard to handling inside information, the spread and the frequency of rumours recorded close to company events that will have a significant impact on price dynamics indicates, in fact, a persistent inadequacy in the measures adopted by companies to ensure confidentiality on developing events. It is likely that the most significant weaknesses are due to a high number of insiders, the lack of any formal control on the dispersion of information, to the limited training of non-professional staff and to excessive trust in the confidentiality of the third parties involved.

The spread of rumours between employees

and their consequent possible publication by both traditional and new generation (websites and blogs) information bodies create information asymmetries and increase the volatility of quotations.

As regards the reporting of suspect transactions made by intermediaries, experience acquired to date shows that, although extremely important in terms of uncovering potential market abuse, reports often contain partial information insofar as they do not expressly state the abusive circumstance, or do not pass the so-called "test of reasonable suspicion" as the grounds are not sufficiently detailed⁴⁰; an analysis of said reports for the purpose of identifying any unlawful conduct therefore is lengthy and diverts already scarce resources from other equally important activities. Furthermore, reports mainly refer to transactions set in place by natural persons and for small sums, originating, in the majority of cases from intermediaries that act as order collectors and that serve retail customers above all. The above observations are consistent with the outcomes of inspections conducted on several intermediaries specialising in trading-on-line services, from which it can be seen that the procedures adopted to identify suspect transactions are lacking in terms of content and/or in their application. In particular, sometimes the procedures were unsatisfactory, while in other circumstances, even with sophisticated procedures, intermediaries tend to deactivate the

⁴⁰ In the case of reporting suspected insider trading, for example, the connection between the transaction reported and the effective spread of price sensitive information on the market is often lacking. In other cases, instead, the report lacks an evaluation of the real ability of the information disclosed to influence prices.

anomaly warnings that generate the reports, based on the assumption that the customers' transactions to which the irregularities refer are

actually "normal", despite the peculiarities and atypical nature that often distinguish trading-on-line transactions.

Risks and opportunities for Consob

The shortcomings encountered in the application of regulations on the reporting of suspect transactions have negative repercussions on the use of Consob's resources and run the risk that the enforcement of market abuse rules is fairly ineffective.

8 Assessing risks and setting priorities

The paragraphs above have outlined the main risk factors deriving from the evolution of the legislative framework and of market structures.

Risks can be qualified and measured in terms of the significance of their potential impact on the Authority's mission, taking three parameters into consideration: the probability that the event that leads to the risk will occur (P), the extent to which the risk-related event can be detected, namely the possibility of understanding and detecting the occurrence of the event in time (D) and the impact or gravity of the event with respect to the Authority's mission (G). The quantification of these parameters is based on a score that goes from 1 to 10 and that measures probability and impact on an increasing scale (1 for low impact or low probability and 10 for high impact or high probability) and detectability on a decreasing scale (1 for a high possibility of detecting the risk factor and 10 for the impossibility of detecting the risk factor).

Figure 3 shows the matrix of the risks discussed earlier, based on a quantification of the cited parameters that reflects evaluations based on the changing scenarios of the reference framework. The top right-hand portion of the graph identifies the risk areas with the highest level of priority in terms of corrective measures (in particular where the impact, represented by the size of the sphere, is more significant).

Risks with a higher probability of occurrence are related to events that, to a certain extent, represent the structural characteristics of our financial system (weak governance structures and poor participation of minority shareholders in corporate affairs; low quality of investment advice services and poor service orientation of intermediaries) or that clearly emerge from information acquired as part of supervisory activities (tendency to a for-

malistic application of the MiFID requirements, which emerges above all with regard to placements by banks of its own products, inadequate disclosure of the risk-return profiles of non-equity products and poor understanding of their characteristics by retail investors).

The fall in the quality of post-trade information can become an important risk factor as it further increases the tendency towards trading fragmentation. The latter has a medium-high probability associated to it.

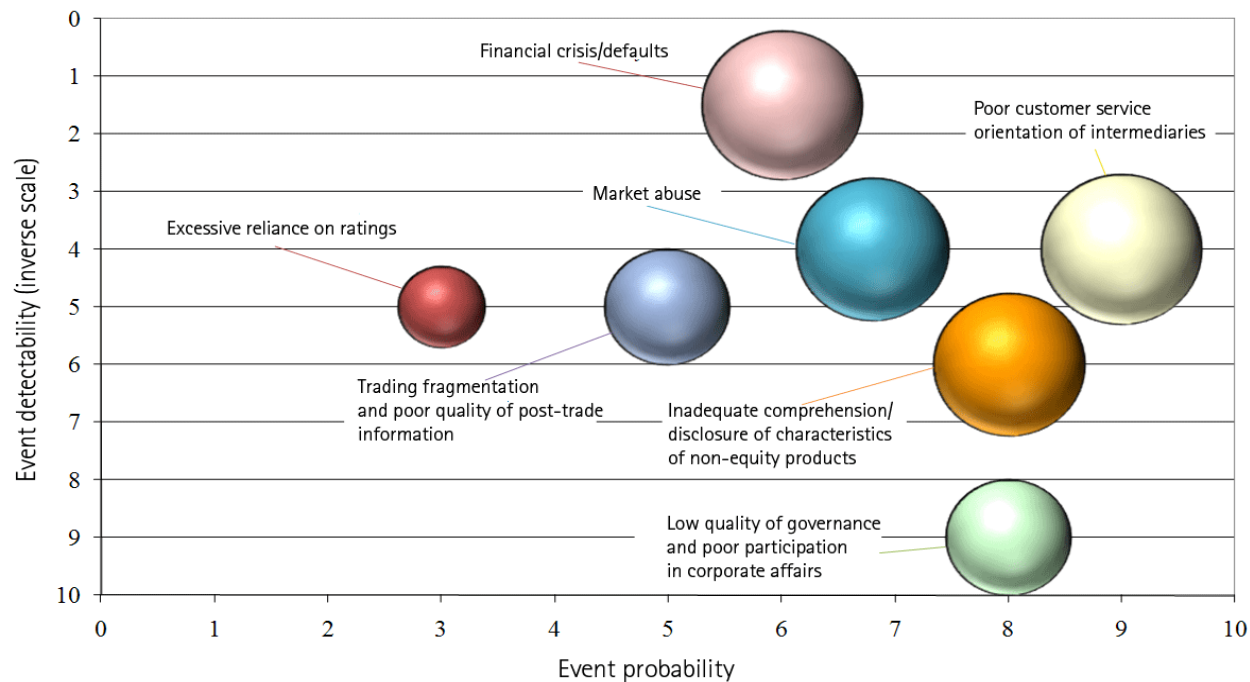
The emergence of financial difficulties and defaults, sometimes not fully expected by the market, represents a risk factor which, for the above-cited reasons, may have a strong impact on Consob's ability to pursue its own institutional objectives, as it encourages the manipulation of financial information and behaviour that may lead to the expropriation of minority shareholders. The probability of this risk factor largely depends on the expected evolution of the economic situation, of the capital market situation and on the behaviour of bank intermediaries in terms of lending policies.

The risk that public regulation may lead to excessive reliance on ratings is estimated to have a medium-low probability, also by virtue of recent experience that characterised the Lehman default and the ratings of structured securities.

In the light of the expected evolution of the economic scenario, it is likely that the spread of rumours in times of financial difficulties, not yet known to the market will increase, intensifying information asymmetries and the risk of market abuse. This risk has been assigned a medium-high probability of occurrence, also considering the low qualitative level of both issuers' procedures to handle inside information and of the reporting of suspect transactions by intermediaries.

Fig. 3 – Matrix of risks resulting from the evolution of the reference framework

(the size of the sphere indicates the gravity of the impact of the event)



1 Strengthening financial information supervision while balancing the needs of market and supervised firms

Consob will strengthen supervision of the transparency and correctness of financial information by recruiting skilled staff, within the unit responsible for secondary market supervision, in order to ensure that issuers' published information fully responds to investors' needs and allows a regular price discovery process.

The overall negative forecasts on the economic situation and on the conditions of the capital market illustrated in the previous chapter, imply the risk that the situation of apparently "healthy" issuers may suddenly plunge towards financial crises or even bankruptcy that may "surprise" operators, with negative repercussions on the ordered performance of trading and on the protection of the interests of retail investors.

However, the more or less sudden deterioration of the financial situation of companies represents a particularly clear example of a more general problem – which therefore also regards companies with stable assets, liabilities and economic situations or with positive outlooks – which is that of guaranteeing efficient dialogue with issuers so that on-going disclosures on developing events always fully respond to the information needs of the financial community (and in particular of the analysts that produce periodic reports and studies on companies, which often have a high impact on the process of share price formation).

Only close interaction with issuers during the "production" of the on-going disclosures on

developing company events will enable Consob to effectively raise the added value and the quality of information provided to the market, in order to guarantee a constant and correct share price formation process.

Consob therefore intends to create specialised units (also based on industrial sectors) – within the structures responsible for secondary market supervision – able to interact with issuers and with financial analysts and to verify that market information reflects, in terms of analytic content and timeliness, all of the elements needed to guarantee an efficient share price formation process.

These types of checks obviously represent the first phase of a more structured and integrated process of supervision of company information, which sees the involvement of other structures responsible for analysing the integrity of accounting data and the quality of the issuer's management control and internal control systems. Nevertheless, enhancing controls on on-going disclosures enables any sign of irregularity to be promptly intercepted. This may indicate

both the excessive reaction of the market to positive news – triggering speculative bubbles or high volatility – and, on the contrary, the undervaluation of critical elements that may prelude the sudden deterioration of the assets, liabilities and financial position without the market being fully aware of said developments. In these cases, the opportunity to intercept signs of potential irregularities will enable more targeted and penetrating measures to be set in place – which require more time – such as an analysis of the regularity of accounting information, a request for data or news or a meeting with the issuer's supervisory body.

In order to seize all potential signs of irregularities in on-going disclosures, it would be useful to also establish several "warning signs" based not only on variations in accounting or financial statement figures (insofar as they represent "historic" data, which are inevitably of limited use for this purpose) but above all on trends of market indicators such as, for example, credit default swap quotes or bond spreads, or of indicators based on credit risk assessment models similar to those used by the bank intermediaries themselves.

There could be further "warning signs" as regards the "quality" of a company's management control and internal control systems. Delays in the market's awareness of the real situation of the issuer may indeed stem from inadequate or inefficient management control systems, which do not identify and signal a deterioration in the financial position in time, or internal control systems that are not able to manage or uncover conflicts of interest that distort deci-

sion-making processes and market information. In order to understand any failings in management control or internal control mechanisms, greater use will be made of the information acquired from independent auditors or from internal control bodies (even by remodelling the content of the control sheets of independent and statutory auditors).

As regards the issuers selected on the basis of the afore-mentioned warnings, additional targeted disclosure obligations may be established according to a specific procedure that will permit controls to be scaled as a function of the level of risk.

In addition to the afore-cited indicators, reinforcing the supervision of financial information will also be based on signals that may be inferred from prospective indications contained in the so-called "derived" information. It is therefore crucial to reinforce supervision even of this type of information, in order to improve the use of the same to signal the evolution of an issuer's assets, liabilities and financial position.

The increase in the sources of market-relevant information, with the development of forms of derived information which provides another level of detail on the "primary" form supplied by issuers, is linked not only to the increasingly crucial role of analysts that produce studies or ratings, but also to the growing impact of blogs and forums on the internet where (retail) investors share opinions and judgments on issuers and on share price trends. Derived information is also characterised by a widening gap between the sources and the users of information,

Consob will strengthen the supervision on the information disclosed on listed issuers in order to help understanding of the various and often contradictory signals due to the increased amount of information available to the market. In particular, Consob may intend to enhance supervision on rating agencies, while launching investor education programmes aimed at preventing excessive reliance on ratings.

which traditionally converge both in terms of geographic location (due to the prevalently domestic nature of issuers and investors), and trading platforms (due to listing on a single market where the majority of investors operate).

The quali-quantitative evolution of company information, both in terms of market conduct and rules, attributes more responsibility to all parties involved in the processes of formation, diffusion and analysis of information and, to Consob in particular, which must supervise the integrity of market information and the regularity of the price formation process.

The Authority will adapt its supervisory activities in order to guarantee the coordination of information and to improve the ability to understand and interpret the various, often contradictory, signs that materialise as a consequence of the increased amount of information available to the market. In particular, the "signalling" value of studies by analysts (for example, target prices and expected growth rate of profits) and of assessments published by rating agencies will become a fundamental tool to improve the supervision of financial information of listed companies.

As already illustrated in § 5 of Chapter I, the European Community regulations on rating agencies provide the opportunity to supervise agencies registered in the European Community. In fact, each competent authority will be able to exercise supervisory powers over parties with registered offices in their national territory (acting as home country Authority), or that operate there through subsidiaries and whose ratings are widely used for regulatory purposes and that have a significant impact (acting as host country Authority). Although it is not yet known what the actual role of the ESMA will be, Consob will supervise agencies on the basis of the wider objective of reinforcing the quality of derived information, in accordance with the procedures envisaged at the end of the review process of

Community Regulations consequent to the reform the European supervisory system.

Although, as clarified previously, supervision cannot guarantee the informative efficiency of ratings – namely the ability of a rating to correctly reflect the effective likelihood of insolvency in the light of all publically available information on the issuer – the way in which controls are organised should also be based, amongst other things, on a verification of the rating's consistency with respect to the other information available to the market (whether direct or derived) as regards potential signs of irregularity relating to areas in which the European Community regulations assign direct powers of intervention to the Authorities – the integrity of organisational and decision-making processes, mitigation of conflicts of interest, transparency of the methods and data used⁴¹.

When it has been established which of the powers currently attributed to national Authorities by Community regulations will be assigned to the ESMA, Consob will develop a supervisory model for the early identification of irregularities; in any event, it should be a part of the wider model to assess the risk of distortion of financial information and the risk of financial difficulties emerging or of unexpected or sudden defaults.

Supervisory activities will also be supported by investor education programmes aimed, on one hand, to make the public fully aware of the nature and the limits of the Authority's supervisory competence as regards ratings and on the other hand, to mitigate the tendency of investors to rely excessively on said ratings.

41 In general, misalignments between ratings and indications stemming from sources other than agencies may reflect different information content and subjective assessments; however, they become important from a supervisory perspective if they can be interpreted as a warning sign of organisational or procedural shortcomings.

As for issuers showing the first signs of financial difficulties, financial information supervision will be directed at balancing the needs of market and supervised firms, through the implementation of a procedure disciplining the scope and the criteria for the exercise of the Authority's discretionary powers.

With regard to the first aspect, market operators and investors must be made aware that Consob cannot (and must not) evaluate the merit of the methods used to formulate ratings, an area expressly sanctioned by the Community regulations⁴².

With regard to the second aspect, on the other hand, in investment decisions, the use of indicators and parameters that are not exclusively based on ratings must be encouraged mitigating the expectation gap regarding the "quality" of the information content of agency ratings.

As illustrated in the previous chapter on risk factor analysis, there appears to be an increased likelihood that issuers, especially small-medium scale ones, will experience financial and economic difficulties, sometimes even serious. When a listed company shows the first signs that may prelude crisis situations or financial difficulties, the supervision of corporate disclosures poses specific problems resulting from conflicting interests between issuers (current shareholders) and the market (potential shareholders). In these cases, the need to guarantee complete and correct information must be balanced with the need for confidentiality of the company and of its shareholders (for the purpose, for example, of increasing the likelihood that operations to overcome the situation of crisis have a successful outcome). Forcing a company in crisis to disclose a very wide set of information, on one hand may have limited added value for analysts and the market, when there is already sufficient information available on the company's prospects and on

the other hand, could compromise financial operations underway or planned, which aim to restore economic-financial balance (disposal of assets, restructuring or rescue plans), or create disadvantageous situations with respect to competitors.

The Consolidated Law on Finance envisages that Consob may request the disclosure of information that, although not yet qualified as insider, may in any event vest importance for the market⁴³. This is a power that the Authority has exercised mainly as regards companies that start to show clear signs of deterioration of their assets, liabilities and economic situations, by retaining it necessary to integrate market disclosures with additional informative elements (for example, the level of liquidity of available funds, the period of time for which available funds will be sufficient in the event that the capital market or bank credit cannot be accessed, any repayment requests from banks and other creditors, difficulty in disposing of assets, etc.).

This accounting and financial information is part of a extensive area of "significant" information (information potentially useful to the market but that the issuer is not bound to make public under market abuse regulations), the scope of which is not always easy to identify with respect to the area of inside or price sensitive information⁴⁴ (information that the issuer must independently make public without any solicitation from Consob).

42 Art. 20 of the Regulation, approved by the European Parliament and Council on 23 April 2009.

43 Art. 114, paragraph 5, Consolidated Law on Finance.

44 Established by art. 181, Consolidated Law on Finance.

Qualifying the cited information as "significant" to the market often requires delicate discretionary assessments; assessments on the damage that the disclosure of information could have on the company is equally discretionary. Issuers that request a suspension of disclosure obligations, following a solicitation from Consob, sustain, in fact, that said disclosure could cause them serious damage as the disclosure of the accounting and financial information described above could trigger reactions from competitors, suppliers or lending banks that amplify the company's difficult situation or hinder the success of restructuring plans⁴⁵. In these cases, as Consob has to acknowledge the actual existence of the "serious damage", it is forced to conduct particu-

larly complex and delicate assessments as to the impact of the disclosure on the company's prospects.

The above considerations lead to the need, therefore, to seek an adequate balance between the issuer's legitimate needs for confidentiality and the objective of guaranteeing information to the public, just as the need to establish the criteria on the basis of which the discretionary powers that the legal system has assigned to Consob are exercised. To this end, a specific procedure will be set in place detailing the type of information that companies who show signs of financial difficulties, in the presence of given circumstances, may be asked to disclose.

45 Art. 114, para. 6, Consolidated Law on Finance.

2 Monitoring related-parties transactions and corporate governance mechanisms

Consob will draw up a model to assess the corporate governance mechanism of listed companies, also in order to ensure compliance with the procedures regulating related-parties transactions.

The structural problem that characterises the governance of Italian listed companies, as illustrated in § 2 of Chapter I, stems from conflicts of interest between majority and minority shareholders, as the latter are exposed to the risk that majority shareholders decide to carry out transactions entailing the transfer of wealth in their favour.

Related party transactions represent one of the main tools to perform operations that are potentially harmful to minority shareholders, when the same take place at prices other than market ones. Consob, also given the problems that have emerged in recent years, believes that it is strategically important to set up initiatives to promote the improvement of corporate governance mechanisms in order to hinder opportunistic behaviour by majority shareholders.

From a regulatory perspective, the regulation implementing art. 2391-*bis* of the Italian civil code regarding related party transactions is a tool to reinforce the external control of the

market and a company's internal control mechanisms. In fact, it gives the Authority the opportunity to request issuers to inform the public of any shortcomings uncovered in governance procedures and structures that discipline the performance of related party (or atypical or unusual) transactions, thus encouraging the market to improve corporate governance mechanisms.

On a more general note, in addition to the specific supervision of related party transactions, Consob intends to systematically monitor the quality of corporate governance systems by developing a model to formulate governance ratings based both on information publically available and on data and information that will be systematically requested of companies. Said synthetic indicator on the quality of corporate governance will enable a benchmarking mechanism to be set up aimed at identifying the more deficient companies who should be subject to moral suasion, in order to encourage the adoption of better standards and to reinforce market disclosures.

3 Supervising the implementation of the MiFID regulations in the provision of investment services and promoting quality improvements and competition in the provision of the advisory service

Consob will continue to supervise and interact with the intermediaries in order to verify that the strategic choices, the product design and the distribution network incentives underpinning their business models are consistent with the objective of serving the client's best interest.

The securities intermediation industry in Italy, as already mentioned in § 3 of Chapter I, is distinguished by a structure that is highly oriented towards distribution, focused on the provision of investment services usually with a low added value for the customer, and characterized by offer policies based on group logic.

To properly enter into the spirit of the MiFID, intermediaries need to reconsider said business model and radically change their underlying strategies, rather than limiting themselves to investing in procedures and changing the organisational structure. Indeed, it is essential that they shift from an approach based on assistance for individual transactions or financial products to a customer relationship model aimed to forge a long-term relationship and solid bonds of trust, within which investment advice services will play a key role in ensuring the coherence of individual transactions in products or financial instruments recommended or executed over time.

The results gathered by Consob in the first cycle of inspections of the major banking groups following the entry into force of the MiFID, however, show that in numerous cases, the application of the new regulation is characterised by a more formalistic approach, namely by an approach that continues to be "segmented by product" which ignores the substance and spirit of the Directive.

Consob's supervisory action does not intend to censure or enter into the merit of an intermediary's strategic choices (such as, for example, the construction of budgets, staff incentive plans, the selection of products offered, customer segmentation methods, and service pricing). Supervisory attention to the above is however justified in the event that the strategic plans indicate potential irregularities resulting in organisational procedures and solutions that are inconsistent with the logic and the nature of the services provided and that represent the driving engine of conflicts of interest and of conduct that does not comply with the rules set in place to protect the interests of the investor. The shift from a purely "distribution model" to a "customer service" model continues to be fundamental to ensure the substantial consistency between all operating decisions – procedures, organisation, information, contracts, etc. – and the underlying structure of the MiFID, in order to effectively raise the level of investor protection.

Front office conduct are in any event conditioned by the procedural and organisational solutions adopted by top management, which may significantly influence independence and the ability to act in the customer's best interests in investment services. From this perspective, constructing budgets or establishing employee incentive plans based on product "campaigns" or

on the volume of products placed, or suitability tests based on IT procedures that do not sufficiently take the profile of the individual customer and the characteristics of the financial products in question into account, cannot, for example, be considered consistent with a "customer service" approach.

Adopting a top-down approach, analysing strategic and organisational choices will enable the parties and areas with the highest risk of non compliance to be identified and to intervene as proactively as possible; adopting a bottom-up approach, analysing the complaints provided by customers and other specific reports of individual episodes will represent an indicator of widespread dysfunctions, therefore critical in organisational terms.

This desired repositioning of the strategies of operators will enable the direction and the structure of supervision – both off-site and on-site – to be re-established placing more focus on enforcement and intervening on overall and concrete "behaviour" towards customers in the provision of investment services.

As highlighted in the previous chapter, the low level of quality of investment advice services offered by intermediaries and the scarce availability of high added value investment advice services are very significant risk factors as regards our institutional objectives.

Research conducted by Consob has highlighted the scarce availability of investment advice services as regards retail customers and also how those that receive or request investment advice services are often not satisfied with the quality of the services received. This

depends, to a large extent on the aforementioned distribution approach that characterises the strategies of intermediaries and on the fact that advice is often provided within "vertically-integrated" parties (at individual company or group level), consequently only embracing the usually very limited spectrum of products issued or "packaged" within the group or company (so-called restricted advice). For these reasons, often households do not perceive advice as a truly independent service, provided in the full and exclusive interests of the customer.

Raising the quality of the investment advice services provided to retail investors is strategically important to Consob as it has an immediate and significant impact on the protection of investors; it could considerably reduce the cost of supervision for society and encourage the shift from a distribution approach to a customer service one.

Consob therefore believes that the provision of investment advice to customers should become more widespread while at the same time improving the quality of the same, both in terms of independence and as regards the professional preparation of advisors. Advice must be characterised by a content that – even if the level of detail and depth differ between intermediaries due to different policies and commission levels – must in any event have a basic added value for the customer. Investment advice services should also act as an "umbrella" for a customer's transactions as a whole, covering all of the different types of execution services that may be provided to the investor; limiting advice to a subset of the intermediary's product range or providing execution only ser-

Consob will foster the improvement of the investment advice services provided to non-professional investors and will promote the appropriate initiatives to increase competition and to remove the barriers to entry of independent financial advisors.

vices that are clearly not suitable is inconsistent with the customer service approach.

The provision of high added value investment advice services, charged separately – with the associated reduction in the proportion of retrocession fees perceived by the intermediary – would have the effect of better aligning the interests of the intermediary with those of the customer, with respect to the current commissions system based on the product distributed, and would provide tangible evidence of the correct implementation of the service model.

Consob therefore encourages independent initiatives taken by supervised entities aimed to clearly specify the pricing and the level of quality of investment advice services in the contractual terms subscribed by their customers. Developments of this kind could encourage the establishment and spread of operators that specialise in the provision of investment advice that do not belong to a banking group (whether they are investment companies or natural persons), triggering a virtuous circle in terms of competition and service quality.

Another intervention that vests strategic importance with a view to enhancing the quality of investment advice services, is linked to the opportunity of introducing more competition in the distribution channels of mutual funds by switching to the dematerialised and centralised management of units of said funds, similar to that in force for all the other financial instruments.

Although said developments must to a large extent originate from the private sector, Consob (together with the Bank of Italy) has been soliciting the industry and operators to launch initiatives to achieve such objectives. The Authority will therefore continue in its efforts to stimulate and set the right incentives to the private sector so that said projects may be concluded within a specific timeframe and ac-

ording to an agreed plan.

Centralised management is instrumental to creating a system infrastructure that can link the information flows of intermediaries-distributors, product-houses (investment managers) and depositary banks, so as to completely automate subscription and redemption transactions (and the relative records). The system infrastructure would therefore interact between "producer" intermediaries and "distributor" intermediaries as single entry points in order to facilitate and standardise relations between parties and render them more efficient.

Overcoming the fragmentation of languages and operating systems and reducing operating risks would facilitate the establishment of a more competitive market, extending the choice of distribution channels for "producer" intermediaries. The higher degree of opening of the system could facilitate commercial decisions to extend product ranges for "distributor" intermediaries, in order to reach a wider spectrum of investors characterised by different levels of sophistication.

The presence of a system infrastructure would enable the added value for the investor resulting from the provision of investment advice to be maximised, as the distributor-intermediary, by virtue of the more extensive product range offered, could be better able to recommend those most suitable for the risk profile and the investment objectives of the customer. The higher degree of opening of the system also sets the foundation to facilitate the portability of investments by investors, by giving the latter the opportunity to choose the distributor or the advisor they retain better able to serve their best interests.

Overall, as well as contributing significantly to raising the quality of investment advice services, the desired developments would stimulate competition in the collective invest-

Consob will enhance supervision aimed to verify that intermediaries are fulfilling the suitability duty, especially as regards the placement of more complex financial products, at the same time launching in-depth checks on the efficacy of the methods used to elicit customer's preferences and risk attitude.

ment management sector and in the distribution of said products, with a positive impact on efficiency, the level of costs for investors and product innovation.

The inclusion of investment advice services within the investment services regulated by the MiFID is a very important step to reinforce the protection of non-professional investors, in particular where the service must be personalised to the customer's profile. However, as illustrated in § 3 of Chapter I, the application of the Directive does not necessarily guarantee that the intermediaries providing investment advice services will seek to build portfolios that are suitably diversified in terms of market risk and issuer. In fact, the Directive allows that the suitability of the financial products or instruments recommended with respect to the customer's profile may be assessed also as regards individual transactions (rather than the structure and composition of the portfolio as a whole at the time the service is provided).

However, the MiFID allows the authorities to extend the scope of supervision and to assess the advisory relationship between the intermediary and the customer that lead to the construction of the portfolio as a whole in broader terms, where said relations can be considered the provision of "general investment advice" services of a preparatory nature that are instrumental to the provision of recommendations on specific financial instruments.

Supervision of the behaviour of intermediaries continues to be focused on monitoring the actual quality of the investment services provided to retail customers also by looking at how

tests of appropriateness and suitability are carried out with relation to transactions in financial products and instruments, particularly the higher risky ones, and in any event, those that have elements of complexity that customers cannot easily identify, such as structured bonds with derivative components (including embedded) related to market and/or credit risk, including, therefore, subordinate bonds.

Carrying out this type of activity entails in-depth and wide-reaching analyses as to the real adequacy of the techniques used to record information on the customer's characteristics and to provide all of the elements needed to correctly profile individual parties, especially as regards propensity to risk and the time horizon of the investment, as well as how said elements match the level of risk and the recommended investment time horizon of the products distributed, as regards the potential returns on the same. Indeed it is clear that only when an adequate assessment of the risk-return profile of the product and the correct profiling of the customer are performed together, can the intermediary correctly perform his task of assessing suitability.

In conclusion, if during the two years subsequent to the implementation of the MiFID, Consob's objective was to "accompany" the industry in the complex process of adapting to the new regulation, the strategic objective for the next three years is to implement a series of initiatives to substantially verify that intermediaries are actually fulfilling their suitability obligations and therefore assess the impact of including the provision of investment advice within the regulated investment services – and

of the more rigorous controls envisaged for the provision of said service with respect to execution ones – in terms of raising the level of protection of investors. To this end, in line with past practice, Consob could adopt specific su-

pervisory initiatives also based on the quantitative models to measure and monitor the risk and potential returns developed within the "three pillar" approach illustrated in the Introduction.

4 Reforming the regulatory framework and implementing supervisory models for non-equity financial products and instruments

In order to eliminate the scope for regulatory arbitrage and to increase investor protection, Consob fosters the improvement of the summary information conveyed to investors at the point of sale of non-equity financial products and instruments. Furthermore, the supervision on the placement and the secondary market trading of non-equity financial instruments will be enhanced.

The above objectives outline the strategy that Consob intends to pursue as regards the supervision of securities intermediation and the provision of investment services. It is an approach that – in line with sector-specific regulations and the powers that the legal system has assigned the Authority – is focused on supervising the conduct of supervised entities and encompasses the whole spectrum of corporate decisions – strategies, organisation, operating procedures, the internal control system and the operating conduct adopted.

This supervisory approach based on checking the correctness of conduct of intermediaries must however, be flanked by a different formulation of the regulation and controls on “product” disclosures made at the time of solicitation and public offering in order to provide investors with elements that enable them to immediately understand the risk-return profile of the products and to compare it with similar products available on the market.

Improving disclosures to investors therefore continues to be an important aspect – especially as structured products characterised by very complex profiles – in a context, as indicated previously, of scarce availability of investment advice services and preference towards the “DIY” approach, which is very deep-rooted even among households that have invested a considerable proportion of their wealth in high-risk products (namely other

than deposits and domestic government securities). It is therefore important to take measures to ensure that investors who decide not to use investment advice services have easy access to simple and easy to understand information on the characteristics of the products they are subscribing.

In this case, we are essentially referring to so-called non-equity products, namely those other than shares and equity products of listed issuers, and in particular structured and complex ones. As illustrated in Chapter I, these products – such as bonds, insurance policies with financial content and investment management products – represent the main way in which Italian households invest their savings after deposits and government securities.

As shown in § 4 of Chapter I, the current European legislative framework, although in a phase of profound evolution, is still characterised by rules on transparency and conduct that are differentiated according to the legal form and distribution channels through which non-equity products are sold and by disclosure standards that are inadequate to provide an effective and concise picture of the risk-return profile of the products. This makes it difficult for retail investors to adequately assess to what extent a certain product meets their investment objectives, or to make an informed assessment as to the convenience of the investment compared to similar products. As mentioned in § 4

of Chapter I, these problems will be resolved only when the changes to the UCITS directive and the Prospectus directive become effective and when the project on PRIPs is concluded, but this is likely to take several years.

Consob fully agrees with the need to establish a standardised disclosure regime for non-equity products that eliminates opportunities for regulatory arbitrage and provides investors with essential information on the characteristics of the product, on its costs, on disinvestment procedures and on the risk-return profile in a clear and concise way.

The Authority has been working to implement this type of framework for some time, even within the limits permitted by Community regulations, partially leveraging moral suasion measures. For example, for insurance policies with financial content and mutual funds, the compulsory delivery to the investors of specific sections of the prospectus is envisaged (the "summary sheet" and the "simplified prospectus" respectively⁴⁶), which contain summary, standardised information on the product and on the risk-return profile. The extension of this approach to bank bonds would entail the inclusion of the same information in a section of the prospectus subject to compulsory delivery (the "summary note" for so-called "complete prospectuses" or the "final terms" for base prospectuses). An intervention of this nature would however find a limitation in the Community regulations that do not give Member States the faculty to intervene on prospectuses or on the possibility to make the delivery of offer documentation or a part of it mandatory (envisaged only "on the customer's request" by directive 2003/71/EC); Consob therefore has retained it necessary to launch a consultation, publishing a draft communica-

tion⁴⁷ in order to invite issuers to include standardised summary information similar to that envisaged for funds and insurance policies in the "summary note" or in the "final terms".

Furthermore, in a communication on the way to apply the regulations on rules of conduct in the provision of investment services, with specific reference to illiquid financial instruments⁴⁸, Consob recommended intermediaries to make an "information sheet" available to customers containing a set of information essential to assess the risk profile of the product⁴⁹. The Commission has clarified that the cited "information sheet" may be represented by the "summary sheet" and by the "simplified prospectus" for insurance policies and funds respectively; in the case of bonds, on the other hand, if the summary note or the final terms contain the essential information recommended in the cited Communication, the "information sheet" may be formed of said documentation.

Consob, therefore, has adopted some first measures aimed at pursuing the strategic structure outlined above, within the limits of the current legislative framework, by standardising information regarding funds and insurance policies and introducing several initial elements of standardisation also as regards the documentation that placement-intermediaries make available to customers. Some of these measures, however, take the form of recommendations that are not legally binding, and therefore cannot be enforced in the strict

46 Annex 1B of the Issuers' Regulation.

47 Consultation document dated 14 July 2009, regarding the Recommendation on the offering prospectus or of admission to trading of non-equity financial products, other than units or shares of UCITS and financial products issued by an insurance company: presentation procedure and content of disclosure on risk-return profile and on costs.

48 Communication no. 9019104 dated 2 March 2009.

49 In particular, it is suggested that some informative elements are indicated in a specific "information sheet" such as costs, fair value and means of disposal (with particular reference to the bid-ask spread and to liquidation execution times).

Consob intends to play an active role in the implementation of Community directives and in the initiatives related to the PRIIP project, by making suitable proposals to change the regulation in order to ensure better harmonisation of summary information and of the rules of conduct applicable to the placement of non-equity products.

sense. Furthermore, where these measures are not also adopted by the other European countries, they may penalise the domestic financial market and create room for regulatory arbitrage. The cited attempt to harmonise summary information for non-equity products does not apply to funds and bonds placed in Italy by foreign investment management companies and issuers on the basis of prospectus approved by the home country authority (so-called "passport" prospectus).

As clarified previously, the action taken by Consob should represent the first steps towards a more comprehensive structure, which, however, cannot be achieved without a far-reaching reform of the Community legislative framework.

As illustrated in detail in § 4 of Chapter I, this process is gradually taking shape, with the review of the UCITS directive and of the Prospectus directive and with the horizontal project on PRIIPs (which however will not involve the simpler non-equity products such as ordinary, so-called plain vanilla bonds).

In the cited Communication dated April 2009 on PRIIPs, the European Commission outlined, in general terms, a possible approach to reviewing Community provisions regarding non-equity products, which reflects the previously-stated objectives, as well as the need to eliminate room for regulatory arbitrage and to create a level playing field in Europe.

Consob fully shares the final objectives of the project proposed by the European Commis-

sion, which are substantially two:

- 1) standardisation and harmonisation of the content of the summary documentation provided to the investor;
- 2) full extension of the rules of conduct, conflicts of interest and incentives envisaged by the MiFID to insurance and investment management products.

It is a very ambitious project, which will be difficult to achieve and will require the joint efforts of some of the main EU countries. Consob retains it as strategically important because it is in line with the cited measures adopted at domestic level to counter the risks resulting from the specific nature of the financial intermediation sector which has established itself in Italy (high involvement of retail in bank funding, scarce availability of investment advice services and limited use of investment management services).

The success of the project also depends on a clearer and more comprehensive indication of the detailed legislative changes needed to achieve the two above-cited objectives.

In particular, Consob believes, on the basis of its supervisory experience, that legislative changes need to be introduced that will allow enforcement activities to be remodelled in order to eliminate preventive checks on the content of the information contained in prospectuses or in the documentation distributed to investors and to reinforce, on the other hand, checks on the correctness of conduct of inter-

mediaries in providing investment advice and distribution services.

To this end, a review of the legislative and regulatory framework is needed, focusing on several fundamental elements.

First of all, it would have been important to remove the obligation for the approval to publish prospectuses for solicitations regarding non-equity products. Consob has already implemented said provision for mutual funds and insurance policies, but cannot apply it to bonds, covered warrants and certificates due to the restrictions imposed by the Prospectus directive. The removal of the prior approval for bonds, covered warrants and certificates is justified by the fact that the systematic use of the base prospectus mechanism, which does not contain the detailed characteristics of the financial instruments to be issued, limits the Authority's supervision exclusively to the issuer's profiles and risks. As the issuers of these products are financial intermediaries, said profiles are already regulated by stability controls relating to limiting risk and sound and prudent management⁵⁰.

However, this approach was not shared at political level in the negotiations that led to the amendment of the Prospectus directive and therefore, for bonds, unlike that applied to funds and insurance policies, a different regime will continue to apply as regards the prospectus approval and publication procedure.

The second element is represented by the obligation to provide the investor, at the time

of placement and distribution of non-equity products, with a "product information sheet" or a "summary document". Said document should be taken from a specific section of the prospectus and contain clear and essential information, which enable the retail investor to easily evaluate the product's characteristics (costs, liquidation procedure, risk-return profile) and to compare it to other products which are similar from a financial perspective although with a different legal form. In order to eliminate room for regulatory arbitrage, the structure of this "product information sheet" should be characterised by a high level of standardisation, although maintaining some specific elements relating to the individual characteristics of the different types of products. Consob's supervisory experience shows that, especially as regards structured products and those with derivative components, synthetic indicators (both quantitative and qualitative) that are easy to understand even by investors with a limited level of financial education are preferable to a narrative and lengthy description of expected risks and returns.

As illustrated in § 4 of Chapter I, this is the approach that is currently being adopted in the Community, through the use of Key Investor Information (KII) for funds and the horizontal project for PRIPs, which should extend this structure to insurance products as well. In particular, KII reflects a structure based on a synthetic risk-return indicator, rather than on a narrative illustration of these aspects, which also in Consob's opinion is not appropriate. Consob has however tested, for the prospectuses of funds and insurance policies, the adoption of particularly sophisticated risk-return synthetic indicators – which have proven to be useful, not only in terms of information for investors, but also to support enforcement activities – based on probabilistic scenarios that compare the returns of the product with that of a risk-free security. Although this structure has not been implemented at Community level

⁵⁰ This arrangement is neutral with respect to the model to share supervisory responsibilities and could also be extended to equity instruments issued by banks and intermediaries subject to prudential supervision regimes. In the case of corporate bonds (in particular of issuers that do not have shares admitted to trading on regulated domestic markets) however it may be necessary to maintain the approval mechanism for the publications of the prospectus.

within level 2 measures on KII, Consob believes that, during the course of works on the PRIIPs project, further reflection is needed on the opportunity of introducing quantitative synthetic indicators at least for more complex structured products (structured bonds, covered warrants, formula-based funds and index-linked insurance policies).

As mentioned in the Introduction, Consob has developed a “three-pillar” approach based on quantitative synthetic indicators that capture the essential characteristics of financial products – the level of risk, the expected return and the optimal investment time horizon with respect to liquidity preferences. This model is used to reinforce the summary information provided to investors – and the cited action taken by Consob on the information prospectuses of domestic insurance policies and funds, bank and corporate bonds confirms this direction.

Consob also believes it is necessary to continue the in-house development and application of quantitative models to calculate and update the risk-return profiles of the non-equity products distributed to customers. Supervision of distributor intermediaries and of the full compliance with rules of conduct in customer relations could take this set of information into account. In particular, it could contribute to the more efficient and timely cataloguing of the intrinsic characteristics of the products distributed and, in this way, enable supervisory intervention, including inspections, to be more targeted and to be enforced, in the light of the resources available and the effectiveness expected of the same.

Lastly, the third element that should characterise the reform of non-equity product regulations is represented by the full extension of the rules of conduct, conflicts of interest and incentives envisaged by the MiFID to all financial products and instruments, as recom-

mended by the European Commission and CESR⁵¹, which has partially already been achieved in Italy. This is also a very important aspect, which could fill the legislative gap between our legal system and those of many other European countries, improving the current competitive disadvantage of domestic intermediaries.

Reinforcing supervision over non-equity products is a priority for Consob, by virtue, as already mentioned, of the widespread nature of these products as regards non-professional investors. However, pursuing this objective will necessarily require an increase in the financial resources available to the Authority. For the reasons illustrated in the Introduction, the Authority feels that there is little margin to reallocate currently available resources, as in order to be able to dedicate staff to this area of supervision, cuts would have to be made in the supervision of the equity instruments sector (meaning controls on the Stock exchange and the secondary market such as the supervision of issuers).

Unlike the organisation of supervision on shares and the stock market, which is mainly focused on events that regard the corporate sphere and affairs of the issuer (accounting, governance and ownership structure profiles, market disclosures etc.), as regards non-equity products, supervision focuses on the characteristics of the products themselves and on the conduct of the parties that provide investment services regarding said products, rather than on the affairs of the issuer (which is usually an intermediary subject to micro-prudential supervision).

51 Furthermore, as illustrated in § 4 of Chapter I, CESR has demonstrated how, for some profiles, the rules of conduct envisaged in insurance sector directives could represent a more appropriate point of reference than those envisaged by the MiFID (See CESR's report on Packaged Retail Investment Products, November 2009 - CESR/09-814).

Consob intends to strengthen the supervision on bond and other non-equity financial instruments trading in secondary markets.

Reinforcing the supervision of non-equity products requires high investments in terms of human resources and technology for a number of reasons, such as the extremely high number of products in circulation (in turn characterised by a high turnover linked to maturities and re-issues), the complexity of some structuring mechanisms, the high number of distributors and placement agents and, in the case of bonds, the fragmentation of exchanges on different trading platforms and on over-the-counter circuits that escape immediate detection by Consob.

In addition to reinforcing supervision of the distribution phase and of rules of conduct for intermediaries, as mentioned earlier, Consob will reinforce supervision on secondary market trading of bonds, not only to monitor the regular and ordered performance of transactions but also to reinforce the mechanisms that link regulations on rules of conduct for intermediaries and supervision of the conduct of intermediaries that operate on regulated markets and on multilateral trading facilities as market makers, given the fact, for bank bonds, that the roles of issuer, placement agent and market maker frequently coincide.

In order to set in place the cited supervisory measures in a systematic way and according to risk-based criteria, the Commission will equip itself with a structured database (updated in real time) of the non-equity products distributed in Italy. The data included in the summary document given to the investor and the quanti-

tative risk indicators will be used to classify products by level of risk and in categories of products with a similar economic-financial profile.

The main difficulties that will be encountered in setting up said database will regard bonds placed in Italy on the basis of "passport" prospectuses, as Consob, as already mentioned, is only provided with the base prospectus approved abroad, but not the final terms containing detailed information on the securities placed.

As part of the cited measures to amend the Community regulations, an obligation to notify the "host" Authority of the final terms is envisaged.

Another way in which the supervision of non-equity instrument markets can be reinforced is linked to the need to fully implement the legislative amendments that have extended market abuse regulations to financial instruments traded on multilateral trading facilities (MTF), instruments which are substantially made up of bonds. To this end, the Authority will extend the obligations on on-going disclosure and dissemination of inside information, modulating and scaling them appropriately, to issuers that have given their consent to having financial instruments traded on MTF in which there is a significant involvement of retail investors and will launch supervisory measures to check compliance with said obligations.

5 Enhancing transparency in the secondary markets

Consob will seek to raise the quality of the trading information available to the public by monitoring, through the development of computerised systems, the compliance with obligations on the content and the means of publication of information.

The trading fragmentation induced by the MiFID, as was illustrated in § 6 of Chapter I, had negative repercussions on the completeness and the reliability of information on transactions in financial instruments. Given the importance of the quality of information to verifying the regularity of trading and to supervising market abuse, Consob will set in place systematic monitoring that will entail three profiles.

The first concerns the correct interpretation and application in the domestic arena of the level 3 measures issued by CESR, and reiterated in subsequent Consob Communications, regarding the format and the means of publication of information, linked to complying with pre- and post-trade obligations.

The second profile regards reinforcing supervision by setting in place computerised systems able to systematically analyse the pre- and post-trading information published by the different trading venues and by authorised parties (or by the channel used), in order to verify its content, timing, means of publication, accuracy and accessibility to investors. The increasing fragmentation of trading and the numerous channels used to make information available to the public inevitably require recourse to computerised procedures, which will substantially be based on the cross-referencing of the information published by intermediaries and by the different trading venues with that contained in the transaction reporting database, in order to immediately detect any inconsistencies between the information made available to the public and that notified to the supervisory Authorities.

To this end, however, the correctness of the information provided to Consob by intermediaries for transaction reporting purposes (third profile) needs to be systematically verified. The reliability and the completeness of said information, as well as being crucial to supervising compliance with rules to safeguard the integrity of the markets (for example as regards market abuse and short sales), is also an essential prerequisite for supervising compliance with obligations regarding the content and means of publication of the information on transactions performed outside the market (OTC) or on multilateral trading facilities.

Consob will play an active role in monitoring the process to revise the MiFID, which will be launched through the award of specific mandates to CESR by the European Commission, with the objective of encouraging increased harmonisation in the interpretation and application of the Community directive (to reduce the risk of regulatory arbitrage and possible negative repercussions on the Italian stock exchange) and to counter the tendency to reduce the level of transparency of trading.

For the reasons illustrated in § 6 of Chapter I, the topics that Consob believes are most critical regard, in the first place, the regime of exemption from pre-trade transparency obligations for shares. In particular, it will need to be established to what extent any revision of the thresholds that define large scale orders, which benefit from transparency exemption because the relative execution is more exposed to the so-called risk of market impact, implies the risk of an un-

In the context of the MiFID review process, Consob will foster further harmonisation of transparency rules and the extension of the harmonised transparency regime to non equity markets.

justified rise in the level of opacity. Another area regards the possible revision of the regime of transparency exemption envisaged for systems in which the price is determined in relation to a reference price generated by another system (so-called reference price waiver).

As regards so-called trading venue regulation, the most important issues regard the potential improved uniformity of the organisational requirements applicable to regulated markets and to MTF and the clearer definition of the characteristics that qualify the trading activity of an intermediary as systematic order internalisation (also in the light of the limited number of intermediaries which have notified activities of this type in the current scenario). A further area regards the possible inclusion of specific forms of trading service organisation (in particular crossing

networks), which at the moment are not directly classified as MTF or as systematic internalisers, in the trading venues regulated by the MiFID.

Lastly, as regards the transparency of the trading of financial instruments other than shares (and in particular bonds), the feasibility of a post-trade transparency regime must be assessed, as desired by CESR⁵². Said regime would enable us to have a reliable framework of information on trading that mainly takes place on a bilateral basis outside of the trading venues regulated by the MiFID (so-called over-the-counter or OTC trading), allowing the Authorities to take more incisive action as regards supervising and monitoring market dynamics and intermediaries to more effectively implement best execution procedures.

⁵² Transparency of corporate bonds, structured finance products and credit derivatives, CESR 09/348. The Financial Stability Board also stated its opinion on the topic, in the April 2008 Report, recommending the Supervisory authorities and the industry to verify the feasibility of a system able to provide an adequate level of transparency on the prices and volumes traded on the secondary market of bonds and structured products.

6 Enhancing the effectiveness of market abuse regulations

Consob will enhance the effectiveness of the enforcement of market abuse regulations through measures aimed at strengthening the prevention of unlawful acts and the timely detection and repression of the conducts most harmful to market integrity.

Increasing the effectiveness of enforcement of market abuse regulations requires preventive and repressive action.

Firstly, Consob intends to increase so-called "on-going" supervision of the equity market – through adequate investment in specialised resources and technological platforms – in order to promptly detect potential cases of market manipulation by broker intermediaries or their customers or conduct aimed to alter the ordered performance of trading and market functioning. In particular, these investments will enable us to increase checks on irregularities in price formation (in cases, for example, of the automatic suspension of trading due to excessive price swings – so-called trading halts) and in trading volumes (for example in terms of the number of contracts concluded, the size of individual orders and changes in the liquidity and depth of the trading book); to detect "micro-manipulation" phenomena (crossed orders, recurrent counterparty transactions, book "scaling", cancellations of orders in specific market phases, such as the closing or opening auction); to verify the proper conduct of specialists and market makers. Improving controls in these areas will also enable the supervision of the market management companies to be improved, to which the legal system assigns "first level" control functions and tasks over the ordered performance of trading (for example, the Consolidated Law on Finance gives market management companies powers as regards decisions to suspend securities from trading).

From a prevention perspective, the risk of unlawful behaviour needs to be contained by

reducing, in particular, the circumstances in which information asymmetries and therefore insider trading phenomena may emerge. In fact, the dispersion of inside information creates opportunity for unlawful conduct and makes supervising the transparency and integrity of the markets and the ordered performance of trading more complex.

Therefore, Consob will set in place specific supervisory measures to improve the timeliness, completeness, consistency and continuity of market disclosures, to prevent unlawful conduct, as well as to identify and sanction cases in which disclosure obligations to the public are infringed. Lastly, systematic analysis will be made of the ability of listed issuers to guarantee the confidentiality of the information (especially in the case of important corporate events), through supervisory tools based on information and inspection. In particular, the internal procedures adopted by the company to manage inside information, to comply with internal dealing regulations and to keep the register of the persons that have access to inside information will be reviewed. Said review will eventually lead to the issue and subsequent verification of guidelines on procedures to ensure confidentiality of inside information.

As regards detecting a potential offence, Consob intends to improve the use of the informative elements resulting from the reporting obligations of various parties (data on internal dealing and company studies), making the control of this information flow more structured, also to ascertain alleged market abuse. Fur-

thermore, it intends to enhance supervision on the compliance by intermediaries of their obligations as regards reporting suspect transactions. As already mentioned, experience to date indicates considerable shortcomings in the content of the reports received and in the procedures used for said purpose by intermediaries.

Given the importance of reporting suspect transactions for the detection and enforcement of market abuse, the Authority will set in place schemes to improve the quality and increase the quantity of the same. Dialogue with intermediaries and the proper support of reporting activities represent the main instruments to make operators aware of the transmission of reports that contain all of the elements required by secondary law and that pass the test of reasonable suspicion⁵³.

Lastly, in order to increase the effectiveness of repressive measures, Consob believes it is strategically important to draw up a procedure on the basis of which enforcement activity can be modelled, based on a principle of priority, by virtue of which available resources will be employed in detecting and punishing conduct retained more serious and more damaging to market integrity. This principle was also recently reiterated by the courts⁵⁴, which when recalling the responsibility of every administration to draw up directives able to address criteria of effectiveness, efficiency and economic convenience, stated that Consob may address efforts to supervise, ascertain and repress unlawful acts on the basis of the priorities established according to the gravity of said unlawful acts⁵⁵.

53 The test of reasonable suspicion cannot be based on a literary formula, as it is now, but should instead entail an assessment of all elements internal and external to the intermediary, that the same can or should know.

54 Ruling of the Court of Appeal of Turin no. 874 dated 12.05.2009.

55 These issues are not limited to market abuse only, but transversally affect all of Consob's efforts to detect and repress unlawful behaviour. Furthermore, they are related to problems resulting from the use of resources to pursue unlawful acts of little significance, corresponding to formal infringements such as, for instance, slight delays in compliance with obligations to communicate data and information to Consob.

1 The sustainability of the strategic plan and the impact on the Authority's funding

As emphasised in the Introduction, Consob's ability to successfully achieve the objectives indicated in the previous chapter necessarily implies an increase in the financial resources available to the Authority, both to increase the number of staff and professionally train the same, and to make a series of investments in IT systems that are fundamental to sustain supervision in the previously-indicated areas. Again in the Introduction, it was also illustrated how the upward trend of Consob's operating costs must be maintained gradual in order to preserve the overall financial balance of the Authority's budget and to guarantee the sustainability of the level of contributions requested from supervised entities.

Even within these constraints, it is reasonable to envisage that at the end of the time-frame of this strategic plan, namely in 2012, it will have brought its staff reorganisation plan to a conclusion, passing from 556 employees at the end of 2008 to a maximum of 715 employees (in accordance with that envisaged by the Minister of the economy and finance decree dated 30 April 2008).

An increase of the workforce, as well as increasing staff costs, will also result in an increase in other costs for goods and services, linked mainly to logistical aspects. New premises have already been acquired, as there is no more room available in the offices in Rome and Milan, however new investment is needed in the IT sector and in staff training, detailed in the paragraphs below.

2 Impact on human resource management

Through targeted training courses and specific staff recruitment policies, Consob will acquire or enhance the technical-professional skills needed to ensure that the quality of human resources is adequate to achieve its strategic objectives. Management training courses will ensure the necessary coordination across the organisational structure.

The achievement of the strategic objectives stated in the previous chapter is largely dependent on the quality and level of professional preparation of Consob's human resources.

In the future, as indicated previously, the opportunity to complete the Authority's workforce, bringing the number of employees to 715, is a necessary, though not sufficient, condition to be able to possess adequate resources to monitor the risks resulting from changes in the reference framework and to guarantee the achievement of the stated strategic objectives. Consob needs highly qualified human resources, both in terms of technical and managerial staff, as it has to handle an external situation that is continually undergoing profound change and is characterised by a high rate of innovation and structural complexity.

Once the workforce is complete, a training plan must be immediately set in place, focused on specific topics that regard the sectors in which Consob intends to change its supervisory approach or new areas triggered by the radical changes in the regulatory framework. In some cases, training courses can be conducted to perfect or improve on knowhow that the Authority's staff already partially have, while in other cases, the need to acquire highly specialised knowhow regarding new areas of activity in a very short timeframe will require evaluating the appointment of new resources that have already acquired specific skills in particular sectors.

On the basis of the strategic objectives outlined in the previous chapter, training plans will address the following subject areas:

- a) improving skills in the measurement of risk for structured products (objective no. 4, relating, in particular to the re-definition of supervisory models for non-equity products);
- b) improving skills in fixed income and trading on bond markets (objective no. 4, relating, in particular to enhancing supervision of secondary market trading in bonds and non-equity products);
- c) improving the training of professional resources with suitable profiles with the ability to interact with staff of counterpart foreign authorities, with the objective, as indicated in the Introduction, of ensuring adequate participation in the European legislative process;
- d) developing professional resources to be employed as financial analysts able to supervise the completeness and timeliness of on-going information (objective no. 1 regarding reinforcing the supervision of on-going information in order to guarantee the integrity of the price formation process in secondary markets);
- e) increasing the quality and quantity of supervisory office staff, also through the

appointment of staff with front office or risk management experience from financial intermediaries specialised in the provision of investment services (objective no. 3 on verifying the consistency of the investment service strategies of intermediaries with the objective of serving the customer's best interests).

In addition to technical-specialist training, Consob believes it is strategically important to in-

crease training courses focused on enhancing and perfecting the managerial skills of executive staff, in order to ensure an HR management approach that guarantees the ability to best exploit the potential and the technical skills the Authority possesses and the effective coordination mechanisms needed to tackle the increasingly complex problems that arise, often of a transversal nature with respect to the traditional areas that characterise the allocation of responsibilities within the Authority.

3 Impact on information systems, databanks and process management

Consob will develop a data warehouse and an open IT platform able to improve the exchange of data with other Authorities and to support the growing needs of supervisory cooperation.

External factors of institutional change and strategic objectives in the supervisory and regulatory fields will have a profound influence on strategies in the IT sector and for data management.

In the Introduction, we highlighted the need to enhance supervisory cooperation, particularly with a view to a revision of the European architecture of regulation and control systems which, in the bills submitted by the European Commission, envisage the creation of a specific body (the Joint Committee) whose task will be to monitor the coordination and information exchange processes between national Authorities.

Consob already liaises and collaborates with numerous national and international Authorities and Bodies, although this is likely to increase both in terms of the number of parties involved and the volume of data and information shared. This will have complex repercussions from an IT perspective, as has already emerged with regard to the processes of data sharing and exchange at international level launched to create the transaction reporting system envisaged by the MiFID. This system is dedicated to the receipt of data on trading in financial instruments (wherever this takes place) by intermediaries and the sharing of said information with other Authorities through a centralised data exchange system managed by CESR. Consob has already made significant investments in this project; nevertheless specific applications to automate several data quality control functions need to be strengthened and developed to be able to support the supervisory initiatives illustrated in § 5 of the previous chap-

ter.

The likely growth in the need to exchange and share information with the external environment will require further investment to define an adequate IT platform, based on an "open" structure, able to dialogue and exchange data with other Authorities and supervised entities effectively and efficiently, guaranteeing quality and integrity at the same time.

In order to ensure the fluidity of data exchange, the safety, timeliness and continuity of interoperability with external parties, the automation of information flows and the relative standardisation according to predefined formats become indispensable⁵⁶.

Changes to the architecture of information systems will go hand in hand with a revision of the structure of the information assets available to the Authority through the creation of a structured data warehouse system which will enable sophisticated analyses to be conducted to support supervisory activities.

Like other Authorities and public administrations, Consob's data management is based on the creation of operational databases designed and built to be used by specific applications to support particular supervisory functions. However, this arrangement prevents information to be shared fully and to be used by other applications or for purposes other than supervision, lim-

⁵⁶ For example, XML and XBRL formats, where a semantic data sharing definition already exists, namely predefined templates to subscribe, receive and then aggregate information simply and automatically.

iting its potential use for more sophisticated, transversal analyses, which are becoming necessary as new situations and market scenarios emerge. It is therefore fundamental to abandon this arrangement and to create databases independent of the various applications that use them for supervisory purposes. A data warehouse system would enable the information of the various databases to be easily combined by correlating and cross-referencing flexible data.

More specifically, to sustain the objectives related to redefining supervisory models for non-equity products, the above project will entail, as a priority, the construction of a databank that registers products in circulation according to economic-financial criteria and makes products sold under different legal forms but with similar pay-off structures fully comparable. The collection of quantitative synthetic data on the risk profiles of said products will be essential to be able to compare the economic and risk conditions of similar products. This project requires considerable investment in IT, due to the need to set up a sufficiently refined and analytical product classification system to be able to accurately record the diversities of the current structures and at the same time sufficiently flexible to handle financial innovations. Lastly, developing an automated system to exchange data with supervised entities is essential to acquire basic information on product characteristics in a structured and automated way, directly during the investigative stage (for bonds) or the deposit of offer documentation stage (funds and insurance policies).

Other important IT projects regard improving efficiency and rationalising procedures and will entail automating investigative and liaison processes with supervised entities, extending the remote data collection system to all flows of data that have to be acquitted from supervised entities and defining the mechanisms for interaction with the external world, which will permit to complete elimination of paper.

In addition to the investments in the IT sector described above, Consob intends to set up a structured system of procedures for the most critical internal processes that are most exposed to various types of operating risk, in order to mitigate the same.

In actual fact, procedures represent the first level of supervision in the management of operating risk, as they standardise and capitalise on conduct and knowhow, minimising the likelihood that "similar cases" are treated differently (thus reducing any legal risks or potential disputes with external parties), and increasing the level of accountability and interchangeability of resources. The creation of procedures also enables the use and allocation of resources to be optimised, resulting in a better estimate of standard times for individual processes and enabling efficiency and productivity to be verified. These measures will therefore enable internal control functions set in place to verify the compliance of institutional activities to internal and sector level regulations to operate fully and correctly, based on the monitoring and management of internal operating risks.