CONSOB
COMMISSIONE NAZIONALE
PER LE SOCIETA' E LA BORSA

CONSOB ISSUES A CONSULTATION DOCUMENT ON THE REGULATION OF RELATED PARTY TRANSACTIONS

Summary of the Consultation Document*

Consob has issued for consultation a draft regulation on disclosure and fairness requirements for related party transactions entered into by Italian listed companies and issuers of shares widely distributed among the public (hereinafter together referred to as issuers).

Following a legislative mandate to adopt general principles that issuers must follow in setting out their internal codes on related party transactions, Consob is proposing a comprehensive new framework for such transactions, both providing for on-going and periodic disclosure requirements and introducing procedural steps issuers must comply with in order to ensure the entire fairness of related party transactions.

The draft regulation greatly enhances disclosure on related party transactions, by requiring their immediate disclosure when they are above some specified thresholds, and enlists independent directors to ensure the entire fairness of related party transactions.

An unofficial translation of the draft regulation is also available on Consob's website (www.consob.it).

Interested parties are welcome to submit their comments to the draft regulation, in English or Italian, and send their responses at the following address:

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or via e-mail at consob@consob.it. The consultation closes on 9 June 2008.

* This translation has been prepared for information purposes only. It is not intended to be nor does it constitute an official version of the text. For all legal purposes reference should be made to the Italian text.

1. Introduction and main conclusions

Background and objectives

1. Legislative decree no. 310 of 28 December 2004 introduced (art. 2391-bis, Italian Civil Code[1]) new rules on related party transactions entered into directly or through subsidiaries by companies listed on a regulated market and issuers of shares widely distributed among the public[2].

2. The new regulation grants Consob the regulatory authority to define general principles to ensure the transparency and the substantial and procedural fairness of related party transactions. These general principles must establish regulations as regards the decision-making power, the grounds and the documentation of related party transactions.

3. Because the decree did not provide for a deadline for the implementation, Consob has decided to implement the decree only once the regulatory framework provided by the so-called Law on Savings[3] has been completed, in order to include related party transactions provisions into a sufficiently stable and organic context for company regulation. In particular, Consob considered it necessary to adopt the new provisions for the composition and functioning of boards first, also in light of the active role that these are required to play in implementing the principles for related party transactions. Art. 2391-*bis* attributes a fundamental role to the self-regulation of individual companies, which, within the framework of the general principles provided by Consob, must establish precise and detailed rules on the subject.

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[1] Art. 2391-*bis* of the Italian Civil Code ("Related party transactions") so provides:
"1. The management bodies of publicly held companies adopt, according to general principles set forth by Consob, rules that ensure the transparency and substantial and procedural fairness of related party transactions and disclose such code in the report; to ensure fairness, companies may rely on the assistance of independent advisers, depending on the nature, the value and the characteristics of the transaction.
2. The principles set forth in the first paragraph apply to transactions entered into directly or through subsidiaries and regulate the transactions in question in terms of decision-making power, grounds and documentation. The board of auditors oversees compliance with the code adopted according to the first paragraph and reports on it to the shareholder meeting."

[2] The definition of "issuers with shares widely distributed among the public" is provided in art. 2*bis* of Consob Regulation implementing Legislative Decree no. 58 of 24 February 1998, concerning the regulation of issuers

[3] The law no. 262 of 28 December 2005 as amended by law no. 303 of 29 December 2006

Regulatory options

4. After the adoption of implementing regulations regarding boards in May 2007, Consob started to work on the possible regulatory options. To this end, various preliminary analyses were conducted, including:
   - an in-depth analysis of existing regulation in Italy regarding related parties, both in terms of disclosure requirements, so far the main focus of Consob regulations (art. 71-*bis* of the Issuers Regulation[4]), and of the substantial and procedural aspects of these transactions, at present covered by the Corporate Governance Code for listed companies. Furthermore, Civil Code rules on directors' interests were also taken into account (art. 2391, Italian Civil Code), together with the provisions established for companies subject to management and coordination activity of the parent company (articles 2497 ss., Civil Code);
   - an analysis of the regulatory regime in force in several foreign jurisdictions (namely UK, French, US and German law);
   - an evaluation of the main conclusions of the law and economics literature on the subject, in order to identify the main market failures in the specific context of Italian listed companies that the regulation of related party transactions must address;
   - an analysis of the experience in applying the regulatory framework currently in force in Italy, with specific reference to rules on on-going transparency set forth in art. 71-*bis* of the Consob Regulation on Issuers and the recommendations of the Corporate Governance Code.

5. The analyses mentioned above allowed Consob to gather the elements needed to assess whether the regulation in force regarding the transparency of related party transactions required any additions and/or amendments and to gain useful insights for the drafting of principles on the substantial and procedural fairness of related party transactions.

6. One policy conclusion is that a unitary framework of rules and principles on related parties should be enacted, covering both the disclosure requirements and the fairness principles. The rationale for establishing a single framework lies in the fact that disclosure requirements and the fairness principles complement each other.

[4] Consob Regulation no. 11971 of 14 May 1999 - Implementing the provisions on issuers of Legislative Decree 58 of 24 February 1998, available at http://www.consob.it/mainen/documenti/english/laws/reg11971e.htm

The review of disclosure regulation

7. A review of the current regulation on related party transactions' disclosure was therefore considered necessary. This was further justified, first, by the need to solve some interpretative questions that have emerged in the application of art. 71-*bis*, and second, by the need to implement art. 154-*ter* of the Italian Consolidated Law on Finance (TUF) regarding periodic disclosure on material related party transactions.

8. The proposed reform of current art. 71-*bis* entails:
   - a definition of material transactions mostly based on quantitative criteria, supplemented by specific qualitative criteria (leaving room for companies to establish more stringent criteria);
   - in situations characterised by a structurally higher separation between ownership and control[5], a reduction of the materiality thresholds for transactions with controlling parties;
   - the extension of the regulation on transparency also to issuers of shares widely distributed among the public;
   - a dual disclosure regime for material transactions:
     - on-going disclosure, by means of a circular to be provided promptly to the market after the resolution approving the transaction;
     - periodic disclosure, by means of an analytical indication in the half-year or annual report of the material related party transactions concluded in the reference period;
   - the possibility of excluding specific categories of transactions from the list of material ones, namely those to be concluded with subsidiaries, on condition that there are no interests of other related parties in those companies.

The implementation of art. 2391-*bis *of the Italian Civil Code: principles regarding procedures for related party transactions

9. Unlike the review of art. 71-*bis* (for which Consob's experience in its application

[5] Companies subject to management and co-ordination activity of the parent company, companies controlled by another listed company, listed companies that have issued non-voting shares or with limited voting rights and with a significant number of shares distributed to the public, companies whose articles of association provide for voting caps.

represented a good starting point), the implementation of art. 2391-*bis* of the Italian Civil Code required a more in-depth analysis of the possible regulatory solutions leading Consob to evaluate a wide array of options which we outline below.

Option A

10. The first option envisages the endorsement, in the Consob regulation, of the recommendations contained in the Corporate Governance Code. Referring to the principles contained in the Corporate Governance Code would imply that, in line with the provisions of art. 2391-*bis*, the board of auditors would be in charge of overseeing their effective implementation and therefore would also be responsible for their enforcement. This would represent a substantial change with respect to the rules of the Code, insofar as issuers would no longer have the faculty to comply with them or explain why they do not. Under this option, Consob would be in charge of a sort of back-up enforcement of the Code provisions, namely with the power to sanction the members of the supervisory body under art. 193 TUF if they fail to perform their duty to supervise on compliance with the principles.

Option B

11. The second option entails Consob directly establishing new principles on the transparency and substantial and procedural fairness of transactions pursuant to art. 2391-*bis*. Under this option, it was decided not to substantially change the current system of decision-making power allocation, but rather to reinforce the mechanisms of the decision-making process and to enhance the function of independent directors. In particular, option B envisages:
    - the award of decision-making power to the board of directors or, if the transaction can be delegated, to a committee of independent directors;
    - the independent directors playing a central role in the entire process (approval of procedures, conduct of negotiations, approval of the transaction, and the possibility of obtaining advice from independent experts at all stages);
    - a graduation of the procedures and of the intensity of the role of independent directors as a function of the materiality of the transaction (according to the definition provided for disclosure requirements) and of decision-making power allocation;
    - the option of exempting transactions that are also exempted from disclosure requirements as well as transactions for small amounts;
    - the possibility of adopting more streamlined procedures for material transactions performed by smaller companies (with low capitalisation) or recently-listed companies,

as well as issuers with shares widely distributed among the public;

- specific approval mechanisms for the resolutions adopted in shareholder meetings that guarantee alternatively that they are not approved by the vote of related parties (whitewash mechanisms) or that independent directors play a determining role in the approval of the proposals to be submitted to the shareholder meeting.

Option C

12. The third option entails the principle that the examination and the approval of material related party transactions is the responsibility of the shareholder meeting. Recourse to the prior or subsequent approval of the shareholder meeting is a solution adopted in important countries such as the United Kingdom and France.

13. To make the prevention of the risks of expropriation more effective, this alternative further requires:
    - the introduction of mechanisms that guarantee that the resolutions of the shareholder meeting have not been approved by the vote of related parties;
    - adequate prior information to shareholders attending the shareholder meeting to enable them to appraise the merits of the transaction (to be provided sufficiently in advance).

The cost-benefit analysis of the regulatory options

14. An impact assessment analysis of the three regulatory options has been conducted in order to identify the main effects of their implementation on the various categories of stakeholders and on the market as a whole. There is no standard methodology to conduct a cost-benefit analysis of specific regulatory options. Given how difficult it is to measure the expected costs and especially the expected benefits of this prospective regulatory solution, we decided to conduct a qualitative assessment of such costs and benefits. Specifically, we adopted an evaluation method that compares the various options to what is called option zero, namely maintaining the status quo. According to this method, values representing the incremental costs and benefits related to changes in current regulation have been assigned on the basis of the following comparative evaluation scale with respect to option zero.

COST-BENEFIT ANALYSIS: COMPARATIVE EVALUATION SCALE OF REGULATORY OPTIONS WITH RESPECT TO OPTION ZERO						
+3	+2	+1	0	-1	-2	-3
High benefits compared to option 0	Moderate benefits compared to option 0	Low benefits compared to option 0	No substantial change compared to option 0	Low costs compared to option 0	Moderate costs compared to option 0	High costs compared to option 0

15. A distinct evaluation was made with regard to different stakeholders: investors, issuers, the supervisory authority and the market as a whole, the last category comprising all the parties that are indirectly influenced by the various regulatory options. For each option, the sum of the positive scores attributed to the various items identified as benefits and the negative ones attributed to costs items provides a measure of the net benefits associated to every option, enabling us to:
    - compare each option to option zero, indicating the cost-effectiveness of changing the current regulatory framework only if net expected benefits are positive (i.e. the final score is higher than 0);
    - compare the various options one another, guiding the choice to a one with the highest net benefits.

    We also distinguish between initial costs (i.e. the one-off costs that are incurred to adapt to the new regulatory provisions) and permanent costs (i.e. that are structurally related to the regular functioning of the system). In this way, we can assess the benefits for the various parties involved both in terms of overall impact and with regard to a long-term scenario only, by considering the sole permanent costs.

16. This methodology has already been used by other supervisory authorities and undoubtedly entails considerable discretional elements, particularly as regards the assignment of scores to the specific types of costs and benefits identified (which are significant not in absolute terms, but exclusively in terms of their evaluation with respect to option zero).

The results of the cost-benefit analysis

17. The methodology described above was applied separately to the option of changing the regulation of disclosure of related party transactions and to the three options of new regulation on the principles of transparency and substantial and procedural fairness of related party transactions. Below, a short summary of the main conclusions of the cost-benefit analysis is provided, referring to the complete consultation document (available only

in Italian) for a more detailed description.

The regulation of disclosure of related party transactions

18. The option of changing the regulation of disclosure shows net positive benefits especially for investors, who would benefit from more efficient, timely and complete information on material related party transactions compared to the current situation. The balance is positive for the market as a whole, which would benefit from more efficient mechanisms of price discovery, and for the supervisory authority, which could pursue investor protection objectives more effectively. The majority of costs would be incurred, on the other hand, by issuers, who would have to establish specific procedures to identify material transactions and who could incur, on an on-going basis, higher information costs.

The implementation of art. 2391-bis *of the Italian Civil Code: principles on procedures for related party transactions*

19. The implementation of art. 2391-*bis* has required a cost-benefit analysis of the three options compared to option zero. Option zero, in this case, represents a purely theoretical point of reference, as the decree contained in art. 2391-*bis* requires Consob to regulate this matter. Therefore, unlike the above case of transparency, the option of maintaining the *status quo* is not feasible.

20. A comparison of the three regulatory options shows that, in absolute terms, Options B and C would entail higher benefits than Option A. Further, only options B e C would lead to a substantial increase in mechanisms to protect minority shareholders and more generally the market. However, while the benefits for those two solutions are high, the implementation of these two solutions is also more costly.

21. If we look at the net benefits, although the total net benefits of the three regulatory options do not significantly differ from one another, Option B prevails. The relative cost-effectiveness of this option appears to be higher if we exclude the initial costs of adjustment.

22. In short, the analysis conducted indicates a preference for Option B, which appears to offer an adequate solution to protect investors from related party transactions, enhancing the role

of independent directors. This approach is in line with international best practice, with the OECD Principles on Corporate Governance and with the Recommendations of the European Commission on the role of non-executive directors.

23. Experience acquired to date in the application of the current forms of self-regulation indicates that further and more stringent principles of transparency and procedural and substantial fairness are needed, therefore making option A, which exclusively focuses on compliance with the Code and its enforcement by the Supervisory Authority, little effective.

24. While the option of imposing shareholder approval of material transactions (option C), is highly effective in reinforcing mechanisms to protect minority shareholders, it appears to impose excessive burdens on listed companies. The costs and time required to convene shareholder meeting to approve material transactions could actually distort company operations, discouraging the performance of transactions that can be advantageous to listed companies. Empirical evidence and the theoretical considerations of several recent studies suggest, on the contrary, the need to focus on an effective balance between investor protection and the maintenance of sufficient scope for managerial discretion as regards related party transactions. In this view, our approach based on disclosure mechanisms vis-à-vis the market and on control mechanisms within the management bodies (as in option B) proves to be the most effective.

The draft regulation

25. On the basis of the regulatory impact analysis conducted on the various options, Consob submits to consultation a draft regulation providing an organic framework for related party transactions of publicly held companies. The proposal envisages the introduction in the Issuers Regulation of a specific chapter dedicated to related party transactions, containing both disclosure requirements and principles of transparency and substantial and procedural fairness for related party transactions.

26. A fundamental feature of this regulation lies in the identification of a new definition for “material” related party transactions, common to both regulatory systems, which is essentially based on quantitative criteria (five percent of one of various ratios, such as

capitalization, net assets, etc.). A reduction to one fifth of the quantitative thresholds of materiality has been envisaged for transactions performed with the controlling entities by companies subject to its management and coordination activity according to art. 2497 Civil Code and by companies characterised by a structurally high separation between ownership and control (companies controlled by another listed company, companies that have issued shares without voting rights or with limited voting rights, companies whose articles of association impose limitations to the holding of shares or to the exercise of voting rights). The purpose of this provision is to tackle the enhanced conflicts of interests that arise in the presence of deviation from the one share one vote principle, without interfering with the organisational choices of market actors.

27. As to disclosure requirements, the draft regulation (replacing the current art. 71-*bis*) provides for immediate disclosure to the market of material related party transactions, by means of circulars to be promptly issued after the transaction has been approved. It also provides for the inclusion in the half-yearly or annual report of detailed information on material related party transactions entered into the reference period.

28. With reference to procedural and substantial fairness and according to the guidelines identified in option B illustrated in paragraph 11, the draft regulation provides that companies adopt internal rules granting independent directors a determining role in the approval procedure, starting from negotiations. As regards related party transactions other than material ones, the independent directors must provide a binding opinion.

29. A relaxation of the proposed rules is provided for with regard to issuers with shares widely distributed among the public, small caps and recently-listed companies. These issuers are allowed to adopt more streamlined and flexible internal rules on related party transactions. As to issuers with shares widely distributed among the public and small caps the purpose is to avoid to burden them with disproportionate governance requirements. As to newly-listed companies, regardless of their size, the purpose is to give a sufficient period of time to bring the organisational structure of their boards in line with the functions and responsibilities required by the principles established by Consob.

30. Consob also holds that an amendment to the current regulation on “inhibitory conditions to the listing of shares of companies subject to management and coordination activity by other

companies" contained in art. 37 of the Market Regulation is warranted. For these companies (structurally characterised by a low degree of decision-making autonomy due to the fact that they are subject to the management and coordination activity of the parent), the purpose is to have more robust internal governance mechanisms in place with a view to ensure the transparency and procedural and the substantial fairness of related party transactions. In particular, the proposal envisages that these companies should have an internal audit committee entirely comprised of independent directors and that, if the party exercising management and coordination activity is a listed company, the majority of the board of directors must be independent.