CAPITAL INCREASES WITH SIGNIFICANT DILUTIVE EFFECT

Consultation paper

7 August 2014

Interested parties are welcome to submit their comments to the consultation paper:

on-line via SIPE – Integrated system for external users,

or at the following address:

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Comments should reach us by **30 September 2014**.

Comments received will be published on Consob website unless a specific request for non-disclosure is made.

1. Introduction

Starting from 2009, some issuers whose stock is traded on the Italian regulated market MTA, managed and organised by Borsa Italiana spa ("Borsa Italiana"), carried out rights issues with distinctive features. These operations (which can be defined as capital increases with high or significant dilutive effect) are characterized by a high ratio between the number of shares issued and the number of shares outstanding and by a significant gap between the subscription price of the new shares and the stock market price of the last trading day before the start of the rights issue (so called *cum* price – see paragraph no. 2).

During the subscription period of the new shares, anomalies have been detected in the trend of the share price (*ex* right), which, especially during the first days of the subscription period, was heavily overestimated. These anomalies seem to be caused by a number of factors, most of them technical in nature, which are linked to the characteristics of the rights issues. Moreover, the significant dilutive effect of the rights issue causes a stock squeeze which prevents the market forces from counterbalancing the stock market price (see paragraph no. 3)

Overall, from January 2009 to July 2014, 23 rights issues with significant dilutive effect have been carried out. Price anomalies have been particularly relevant on a few number of cases, the last one being the rights issue carried out by Banca Monte dei Paschi di Siena spa ("BMPS") (see paragraph no. 4).

Consob has monitored the phenomenon since its beginning, in order to detect the most appropriate solution to solve the above-mentioned price anomalies. A first public consultation has been launched in April 2010, followed by two additional consultations, more technical in nature and thus addressed to the industry, which have been carried out in April 2011 and April 2014. In the meanwhile, shortly before the start of the most relevant capital increases with significant dilutive effect, Consob has published specific Communications with the aim of warning the investors of the risk of price anomalies. At the same time, the usual supervisory activity on brokers' operations has led to initiate many disciplinary actions (see paragraph no. 5).

From the experience gained, it appears that there is only one solution potentially able to solve completely the price anomalies. It consists in the delivery of the new shares during each day of the subscription period (so called "rolling" model). This solution should address the stock squeeze and thus allow for the realignment of the stock market price to the fair value. Therefore, this is the solution which is under consultation (see paragraph no. 6). On this solution comments are sought through answers to the attached questions (see attachment no. 1).

2. Characteristics of capital increases with significant dilutive effect

Starting from 2009 some issuers whose stock is traded on the MTA carried out rights issues[1], in most cases with the goal of obtaining new financial resources mostly to safeguard going concerns.

These operations share the following common elements:

- a subscription price of the new shares which is well below the *cum* price;
- the issue of a high number of new shares compared to the existing shares.

The two said characteristics cause these operations to have a significant dilutive effect.

The degree of dilution is commonly measured by the K factor[2]. This factor, calculated by Borsa Italiana, is inversely proportional to the degree of dilution of the operation and, thus, the maximum level of dilution corresponds to a value of the K factor near to zero. The analysis carried out by Consob have led to set a very conservative threshold of the K factor, equal to 0.5, below which a rights issue can be considered as having a significant dilutive effect.

Borsa Italiana, at the end of the last trading day *cum* right, according to the international standards, calculates the theoretical *ex* right price (so called TERP or theoretical value) and adjusts (multiplies) the *cum* share price by the K factor. At the same time, the subscription rights are admitted to trading. In case of capital increases with significant dilutive effect, the greatest part of the market capitalization moves to the subscription rights. In the meanwhile, Borsa Italiana adjusts the derivatives instruments having as underlying the share under rights issue. In particular, the price of the derivative instruments (e.g. the strike price in case of options) and the quantities of shares to be delivered (lot size) are amended. If the share is the constituent of one or more indices, the index management company adjusts the index composition following the rules of each index[3].

During the highly dilutive right issue started by BMPS in June 2014, the new shares to be issued were equal to 5 billion, compared to roughly 116 million of existing shares. The subscription price of the new shares was set by the issuer to €

[1] When a rights issue starts, investors who are shareholders of the company at the record date receive a number of subscription rights which is proportionate to the shares held. On the first day of the subscription period (first "*ex*" day), the subscription rights are admitted to trading on the market for a period set by the issuer, which is usually equal to two weeks. At the end of the rights' trading period, an additional week is provided for the settlement of the latest trades on the rights. Subscription rights can be exercised within the end of the subscription period, which often lasts three weeks (i.e. the two weeks of the rights' trading period plus the additional following week). On the first business day after the end of the subscription period the newly issued share, stemming from the exercise of the rights, are delivered against payment of the subscription price. Subscription rights which are left unexercised are offered on the market in the following days.

[2] The K factor measures the ratio, determined in accordance with the principles of financial equivalence, between the theoretical price of the share after the detachment of the right, and its price before such detachment. In particular, the K factor is calculated as the ratio between the theoretical share price *ex* right and the last *cum* price. In turn, the theoretical price *ex* right depends on subscription price, number of new shares to be issued, market price on the last day *cum* right and number of existing shares. The adjustment made on the basis of the K factor entails the hypothesis that the rights issue has already been executed and has been entirely subscribed, even if the new shares will be available only at the end of the capital increase.

[3] It is worth noting that the rules governing the revision of the various indices are not harmonized across Europe. Thus, each index management company follow its own rules, and thus the dilutive effects of the rights issue on each index can differ depending on the rules governing the revision of that index.

1, compared to the reference *cum* price of € 24,64 of the last trading day before the start of the rights issue (i.e. 6 June 2014). The K factor for the BMPS rights issue was equal to 0,06248. Thus, the operation was extremely dilutive.

At the end of the last trading day *cum* right, Borsa Italiana adjusted the price of the share. The TERP price of BMPS shares was equal to € 1,54; it was calculated multiplying the last *cum* price (€ 24,64) by the K factor (i.e. 1,54 = 24,64 * 0,06248). The difference between the two prices – *cum* and TERP – corresponded to the theoretical price of the subscription rights, which was equal to € 23,1 (i.e. 23,1 = 24,64 – 1,54).

At the same time, Borsa Italiana adjusted the price and lot size of the derivative instruments, traded on the Italian derivative regulated market IDEM, having BMPS shares as underlying. As a result of these amendments, the lot size of the most traded derivative instrument increased from 50 to 800 BPMS shares (i.e. 800 = 50 / 0,06248). The same adjustment was made by the market operator of the German derivative regulated market Eurex Exchange with reference to derivative instruments on BMPS shares traded on that market.

BMPS shares are constituents to many financial indices. Thus, the management companies of that indices made the appropriate amendments. In particular, with reference to the main Italian financial index, the FTSEMIB, the index management company increased the number of BMPS shares composing the index from roughly 116 million to about 1.8 billion (i.e. 1.8 billion = 116 million / 0,06248). Afterwards, during the subscription period, the index management company made a second adjustment to the index composition in order to minimize the effects of the rights issue.

3. Price anomalies

As stated in paragraph no. 2, the market's management company, at the start of the subscription period, makes the amendments applying the K factor, according to the financial hypothesis that the rights issue has already been executed. However, the new shares will be issued only at the end of the subscription period. This clearly creates a stock squeeze during the subscription period.

During the highly dilutive rights issues, with the start of the subscription period, an increase in the share volume traded on the market is usually noticed, most likely due to the monetary value of each share *ex* right, which is well lower than the *cum* price. Thus, the same amount of money buys a greater number of shares *ex* rights[4].

Above all, especially in the first days of the subscription period, it was registered a marked overestimation of the market price of the shares *ex* rights compared to its theoretical value.

This marked price overestimation can be explained by a number of reasons, that is:

1) **Optical effect –** The market price, after the start of the rights issue, can be compared by some retail investors with the last *cum* price instead of its theoretical value. Thus, the retail investor can believe that the shares *ex* rights are available at particularly advantageous prices and, so, buy the securities. The lesser the K factor is, the greater the difference between the last *cum* price and the theoretical value will be, and, thus, more relevant this "optical" effect will appear.

[4] An investor willing to invest, for instance, € 100,000 on BMPS shares, before the rights issue would have bought about 4,000 shares at the *cum* price of € 24.64. After the start of the rights issue, the same investment would have entailed the purchase of roughly 65,000 shares at the theoretical price of € 1.54.

2) **Lower value of each share** – Given the significant decrease in the *ex* price, the same monetary amount buys – potentially – a greater number of shares. The shares available for sale, however, are equal to the existing share capital; this can cause an excessive demand for securities and, thus, an increase in price.

3) **Speculation** – During the capital increases with significant dilutive effect price anomalies have been quite common. Thus, some investors can be led to buy the shares relying on the fact that the price will increase and they will be able to "exploit" the uptrend by selling the shares at a higher price.

4) **Derivative effect (Call option)** – If the irregular price uptrend, caused by the above-mentioned factors, leads that market price to go beyond the strike prices of the existing call options, the option buyer finds profitable their early exercise. The option seller who is exercised by its counterparty hardly holds all the shares to be delivered, because the lot size of the derivative instrument has been increased due to the start of the rights issue; the option seller is therefore forced to buy the missing securities on the market, thus fueling the uptrend. Even in case there is no early exercise, the holder of the short position in derivatives can buy the underlying shares in order to hedge its open positions.

5) **ETF/Index effect** – If the shares under rights issue are constituents of a financial index, the ETF providers, which have to mirror passively the index composition, might buy shares on the market in order to mirror the index performance and being able to fulfill potential redemption requests. The same may happen when futures or similar derivative instruments on index with physical delivery are involved.

That being stated, these price anomalies could be solved through the arbitrage activity, which consist in selling the shares and buying the subscription rights and exercise them.

However, this arbitrage activity, in order to be compliant with the rules provided for by Regulation EU no. 236/2012 on short selling and some aspects of *credit default swap* ("*Short Selling Regulation*") and to avoid any failed delivery of shares in the settlement system (so called "fail"), should be backed by stock lending or alternative provisions.

The steep increase in the volume traded during the subscription period prevents the stock lending market from backing adequately the arbitrage activity. In the best case, only the shares of the "old" share capital are available for lending. Such shares, during high dilutive rights issues, represents a small percentage of the shares to be issued and of the shares traded during the subscription period.

Therefore, arbitrageurs are not able to enter into "covered" short selling and this prevents the re-alignment of the share price until the last three days of the subscription period, when it is possible to carry out arbitrage activities without turning to stock lending – this is because the new shares will be available in time for the settlement of the sales[5].

[5] Short sales carried out on the third business day before the end of the subscription period (usually a Wednesday) are settled 3 business days after, being the settlement cycle equal to 3 days (T+3). This day coincides with the date of availability of the newly issued shares (usually a Monday). With the migration of the Italian market to a settlement cycle of 2 days (T+2), starting from October 2014, arbitrage activity not backed by stock lending will be feasible only from the second to last day of the subscription period.

During these three last days there is a severe drop in the share market price, bringing the price in line with the theoretical value or the subscription price.

In the end, the highly dilutive capital increases lead to a steep increase in the market volatility, with a marked uptrend at the start of the subscription period and a nearly symmetrical downtrend at the end of that period.

It is worth noting that these price anomalies do not occur during the offering of the unexercised rights. This is due to the fact that this second offering is carried out after the end of the main subscription period and, thus, the stock scarcity has been solved thanks to the issue of the new shares stemming from the exercise of the subscription rights.

4. Relevance of the phenomenon

From a quantitative point of view, from January 2009 until July 2014, 23 capital increases with significant dilutive effect have been executed, corresponding to roughly 25% of all rights issues carried out by Italian listed companies during the said period. The highly dilutive rights issues have collected on the whole about € 11.4 billion, corresponding roughly to 22% of financial resources gathered by all rights issues.

In order to estimate the relevance of price anomalies, Table no. 1 shows, for each rights issue, the maximum increase in the stock official price compared to the theoretical value during the subscription period[6]. Therefore, this value represents the “peak” of the price anomalies.

Table no. 1 also shows a second indicator on the relevance of the price anomalies, which can be defined as the “value of the anomalies”. This indicator has been calculated as the difference between the stock market official price and its theoretical value for each day of the subscription period, multiplied by the number of shares traded. This indicator represents the “irregular” turnover effectively traded.

It should be noted that the two indicators shown in Table no. 1 represent only a part of the effects for the market of the price anomalies, i.e. the component which is easily and objectively measurable.

There is another part of disadvantages which cannot be easily measured – for instance, the effects on investors who held derivatives instruments and index products. Some investors holding short positions in call options, after the start of the uptrend, chose to close these derivative positions with their counterparty, bearing additional costs, instead of risking of being exercised and thus being forced to buy the securities on the market or find themselves unable to deliver the shares for settlement. Furthermore, the reputational impact for the Italian financial market caused by these anomalies cannot be easily measured.

[6] Theoretical value can be considered the “fair” price of the share if no corporate event with an impact on the value of the company happens.

Table no. 1 – Rights issues with significant dilutive effect

Rights issue	Year	Resources gathered (€ m)	K factor	Maximum price increase on TERP	Value of the anomalies (€ m)	Trading of Idem derivatives
SEAT PG	**2009**	**200**	**0,041**	**410%**	**57**	**YES**
TISCALI	**2009**	**180**	**0,057**	**579%**	**279**	**YES**
PIRELLI RE	2009	400	0,151	135%	29	NO
BANCA ITALEASE	2009	1.199	0,411	84%	9	NO
TAS	2010	21	0,086	358%	1	NO
STEFANEL	2010	50	0,115	544%	5	NO
INVEST. E SVILUPPO	2010	15	0,420	69%	0	NO
ZUCCHI	2011	15	0,242	124%	2	NO
BPM	2011	799	0,324	1%	0	YES
EMAK	2011	58	0,325	-1%	0	NO
JUVENTUS	2011	120	0,421	62%	2	NO
FONDIARIA SAI	**2012**	**1.100**	**0,026**	**334%**	**52**	**YES**
INVEST. E SVILUPPO	2012	5	0,195	288%	2	NO
UNIPOL	2012	1.100	0,200	32%	3	YES
MERIDIANA FLY	2012	119	0,271	116%	2	NO
MONDO TV	2012	11	0,298	90%	2	NO
MOVIEMAX	2012	5	0,434	44%	0	NO
SINTESI	2012	5	0,095	162%	1	NO
MAIRE TECNIMONT	2013	134	0,260	35%	1	NO
LVENTURE GROUP	2013	5	0,277	30%	1	NO
MEDIACONTECH	2014	19	0,269	71%	0	NO
BMPS	**2014**	**5.000**	**0,062**	**67%**	**204**	**YES**
BANCA CARIGE	2014	800	0,409	7%	4	NO
		11.360	0,234	158%	656	6 times
		(sum)	(average)	(average)	(sum)	(count)

As it is highlighted in Table no. 1, the greatest part of the price anomalies is focused on a narrow number of cases, i.e. the rights issues started by Tiscali spa and Seat-PG spa in 2009, Fondiaria-Sai spa ("Fondiaria-Sai") in 2012 and BMPS in 2014 (highlighted in bold in the Table). All this operations had a K factor lower than 0.1 and were characterized by the presence of derivatives instruments.

5. Activities carried out by Consob

Consob started its activities on the issue of capital increases with significant dilutive effect from the very beginning, in 2009. After a first phase of analysis and preliminary work, which took into account the outcome of the supervisory activities on brokers' operations, on 19 April 2010 Consob published a first consultation paper. In this paper the issue was described and it was proposed to provide for an additional time window for the delivery of the new shares on the third day of the subscription period (T+2), with the aim of mitigating the uptrend through the arbitrage activity between shares *ex* rights and the corresponding subscription rights. On 13 May 2010, during the consultation period, a meeting with the industry was organized in order to collect comments on this issue.

On 3 August 2010, at the end of the consultation period, Consob identified the rolling model – which consists in the delivery of the newly issued shares during each day of the subscription period – as the best preferred solution.

However, following further works carried out with the industry, it came to light that the rolling model – although it is the solution which provides for the greater chances of carrying out arbitrages activities and, thus, of solving the price anomalies – entails considerable costs and delivery time, which, inter alia, fall almost completely on one sector of the industry, i.e. the custodian banks.

It should be considered that every evaluation on the type of action has to take into account, among other things, the costs for the market compared to the benefits that the action should generate. Thus, also taking into account the number of highly dilutive rights issues executed, further works on the matter were conducted, which entailed many meetings with the industry and two additional consultations, more technical in nature, carried out in April 2011 and April 2014.

Thus, other solutions were detected and analysed, among which:
1. netting of fails on shares against those on derivatives;
2. suspension of early exercises of options;
3. in case of early exercise/maturity of derivative instruments, delivery of a basket composed of shares and subscription rights instead of the delivery of the shares only;
4. close-out at fair value of positions in derivative instruments.

In conclusion, it emerged that none of the above-mentioned solutions allowed to solve entirely the price anomalies. Many of the said actions held significant disadvantages, among which the risk of a relocation of trading activities on foreign markets, with the consequence of a reduction of liquidity and competitiveness for the Italian market, and, in the end, a decrease in the effectiveness of the solution. Table no. 3 (see attachment no. 2) summarizes pro and cons of each of the said solutions. The same Table also contains the outcome of the consultation held in April 2014; answers to the consultation are distinguished on the basis of the nationality of the respondent.

The only one solution, among the five mentioned, that does not entail relevant disadvantages is the netting of fails on shares against those on derivatives. This action reduces the amount of fails in the settlement system, but does not have any effect on the price anomalies on the market. This solution has been adopted by the Italian central counterparty Cassa di Compensazione e Garanzia spa ("CCG") during the highly dilutive rights issues started by Fondiaria-Sai in 2012 and BMPS in 2014.

In short, it was not possible to find a solution shared by all stakeholders.

It is worth highlighting that, while looking for a structural solution to the issue, Consob has carried out an intense activity consisting in forewarning the market and conducting market supervision and surveillance actions, with the goal of minimizing the price anomalies.

In particular, Consob has:

1. published, shortly before the start of the most relevant rights issues, specific Consob Communications aimed at warning the market about the beginning of the highly dilutive capital increase and about the risk of possible irregular uptrends in prices, given the rights

issue's characteristics (see for instance Communication DME/0047343 of 6 June 2014 on BMPS rights issue);

2. requested to Borsa Italiana and CCG to adopt measures with the aim of minimizing the likely price anomalies. With reference to the BMPS rights issue, Borsa Italiana banned the "at-the-market" orders and narrowed the price variation limits; CCG allowed the netting of fails on shares against those on derivatives;

3. ended, with the application of monetary penalties, 14 disciplinary actions for breaches to the pro-tempore rules on short selling and/or to the obligation to deliver the securities for settlement.

Thanks, among other things, to these actions, the price anomalies observed during the most recent highly dilutive rights issues (started by BMPS and Banca Carige) have been limited compared to the anomalies observed during the previous capital increases, as it can be noticed by looking at Table no. 1. However, the fact that, despite the intense activity carried out, some price anomalies occurred even on a company of international relevance as BMPS, compels to discuss further the adoption of a structural solution to the issue.

From the work thus far conducted, it appears that the rolling model is the only way to (potentially) solve completely the price anomalies. This solution is therefore discussed in greater detail in the next paragraph.

6. The rolling solution

The rolling solution consist in making available the new shares stemming from the exercise of the subscription rights during each day of the subscription period, instead of at the end of that period only.

This action has the goal to allow, during the subscription period, arbitrage activity between the shares and the subscription rights. In particular, if an irregular uptrend begins, the arbitrageur should be able to:

1. buy the subscription rights;
2. sell the shares; the sales realign the market price to the theoretical value, solving the price anomalies;
3. exercise the subscription rights and receive the newly issued shares;
4. settle the sales with the newly issued shares.

This arbitrage activity is already carried out in the last three days of the subscription period and the empirical experience shows that it is extremely effective in solving the price anomalies, bringing the market price down to its theoretical value.

Moreover, a similar arbitrage activity is already carried out on call options of American style, traded on the Italian derivative regulated market Idem, which can be exercised on each day until maturity. The main difference between the two arbitrage activities lies in the circumstance that, with the rolling model, the sales would be settled using the newly issued shares, while the arbitrage activity on call options is settled with shares already issued.

The sales of shares on the market carried out by the arbitrageur during the first day of the subscription period (“T”) permit the realignment of the market price to the theoretical value, except for what is described in point c) (see later). The possibility of receiving the newly issued securities during the subscription period avoids the need of turning to the stock lending market, which, during a highly dilutive rights issue, is not able to deal with the enormous increase in lending requests.

Thus, the rolling model represents the most efficient solution to the issue, and it appears to be the only way to (potentially) solve completely the price anomalies.

However, works on the issue have detected five disadvantages of the rolling model. They are:

a) delivery costs;

b) delivery time;

c) uncertainty on the possibility to carry out arbitrage activity on the first day of the subscription period;

d) legal aspects relating to shareholders’ information;

e) misalignment with EU standards on corporate actions.

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Regarding delivery costs, the industry, during the analysis, has estimated that the implementation of the rolling model – in terms of new IT software and other procedures - would cost to the entire Italian banking system roughly € 50 million *una tantum* plus maintenance costs equal to about € 7 million yearly and variable costs equal to about € 0.8 million for each rights issue.

These costs would fall on a specific industry sector – the custodian banks – and they could be netted – at aggregate level – if an adequate number of highly dilutive rights issues of relevant amount are carried out.

Moreover, it should be evaluated if the rolling model should be adopted only for highly dilutive rights issues, or it should be extended to all capital increases with the issue of subscription rights. During the works with the industry it was observed that having two different procedures in place – one for “normal” rights issues (i.e. the current model) and the other one for highly dilutive operations (i.e. the rolling model) – could lead to an increase in complexity of back office activities, with a rise in costs and operating risks.

Costs on issuers stemming from the implementation of the rolling model appear to be quite low[7].

No relevant costs or impact on the settlement and central securities depository system arising from the implementation of the rolling model have been detected.

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Regarding delivery time, it was observed that the Italian post-trading sector is heavily involved in the migration to the pan-European settlement system T2S. This migration should take place in June 2015.

The implementation of the rolling model would require a phase of analysis and definition of the detailed requirements, which could be carried out together with the migration to T2S, though the migration would be evidently prioritized. The subsequent phases of the rolling project (technical requirements definition, their validation from participants, tests and go live) could be carried out only after the migration to the pan-European settlement system. Thus, the rolling model would not be implemented before the second half of 2015.

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A possible limitation of the rolling model might consist in its potential ineffectiveness on the first day of the subscription period (day "T" of Table no. 2 – see later on).

According to the current rights issues operating model, if the rolling model is adopted, the newly issued shares would be available for the settlement day of T+4 (Friday), and, thus, not on time for the settlement of the sales carried out on day T.

This means that the sales carried out on day T would not be settled at the intended settlement day (T+3), which in turn implies that these sales would be considered "naked" short selling and thus they would be banned pursuant to Short Selling Regulation. Therefore, the sales of shares on day T would not be lawful.

The issue is represented in detail in the following Table.

[7] At the opposite, issuers could obtain advantages stemming from the early payments, done at the start of the subscription period, by investors subscribing the rights in the earliest windows of delivery of the new shares.

Table no. 2 – Arbitrage activity with the rolling model

T-1 (Fri)	T (Mon)	T+2 (Wed)	T+3 (Thu)	T+4 (Fri)
Last trading day of *cum* shares (ISD: Wednesday)	Start of the subscription period Price anomalies Sales of shares by arbitrageur (ISD: Thursday) Price realignment Purchases of subscription rights by arbitrageur (ISD: Thursday)	Settlement of trading activity of the last *cum* day Creation and crediting of subscription rights to *cum* shareholders	Settlement of subscription rights bought on T Exercise of subscription rights by arbitrageur and creation of newly issued shares with availability for T+4 Fails of settlement of sales carried out on T	Availability of newly issued shares Settlement of sales carried out on T using the newly issued shares

Note: T is the first day of the subscription period; ISD = Intended settlement day.

On this issue, the Italian central securities depository Monte Titoli spa ("Monte Titoli") has highlighted the possibility of adopting an ad-hoc solution, applicable to the first day of the subscription period only, which would grant the availability of the newly issued shares on time for T+3. This would permit the arbitrage activity to take place on T. For this purpose, the exercise of the subscription rights should be communicated to Monte Titoli by custodian banks within 13.30 CET on day T+3.

At the opposite, in the following days of the subscription period, the "ordinary" capital increase's operating model would be applicable. Thus, the newly issued shares stemming from the rights' exercise would be available the day after the exercise. This means that, from the second day of the subscription period onwards, the arbitrage activity would be "imperfect", because the arbitrageur would be required to buy the subscription rights on T+1 and sell the shares on the market on T+2. On this issue, it could be evaluated the extension of the abovementioned ad-hoc solution to the days following T.

Moreover, it appears that, as the subscription rights are exercised and the newly issued shares are delivered, the stock lending market could resume working properly. This in turn could reduce the need for the "imperfect" arbitrage activity and could solve the price anomalies as well.

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During the analysis, the industry observed that the rolling model could pose issues with a rule contained in Italian law on banking contracts, in particular with Article 1838 second paragraph, of the Italian civil code, according to which if securities held in custody provide for the exercise of subscription rights, then the custodian bank must ask in good time instructions to the account owner and has to execute them, where enough money has been provided.

Currently, banks inform their customers about the start, the final terms of the capital increase and the right of exercising the subscription rights, during the subscription period, as the delivery of the newly issued shares will take place only at the end of the said period.

At the opposite, with the rolling model, custodian banks should inform their customers in good time for the first window of delivery of the newly issued shares (T+3 or T+4).

On this point, it has been argued that the rolling model would expose the custodian banks to an increased risk of litigations with the customers in case of late communications. The bank might be considered liable for the “loss of profit” suffered by the client who has not been prepared to take advantage of the first window of delivery of the newly issued shares.

It should be observed that, according to a research carried out by the industry[8], more than half of all Italian retail customers uses information channels different from the “traditional” one (i.e. internet and mobile banking accounted, in 2013, for roughly 59% of *retail* clients, showing a growing trend). These channels allow for a timely information to clients at a limited cost when not totally free.

In any case, even if the litigation risk highlighted by the industry might not be completely avoided, at least in the short term, the adoption of the rolling model would be justified on the basis of the prevailing needs for the integrity of regulated markets and the orderly conduct of trading, needs which have a higher priority compared to the civil law issues highlighted by the industry.

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Finally, the last disadvantage of the rolling model is represented by the fact that the said solution does not appear to be in line with the European market standards for corporate actions processing.

It should be premised that the European Commission, in the last years, has fostered an intense harmonization activity on the post-trading sector, even at technical level, with the goal of encouraging cross-border activity. Part of this activity consists in issuing standards – developed by the European industry of post-trading – for the processing of corporate actions. These standards have been adopted also by the European Central Bank within the T2S project.

The standards regarding rights issues (“*Voluntary Reorganisations*”), in particular standard no. 12, provide for a period of at least 10 business days between the start of the rights issue and the deadline for the exercise of the subscription rights (so called *election period*). In case of multiple deadlines – as the rolling model would entail – this 10 days period should be calculated taking into account the earliest deadline. With the implementation of the rolling model, this period would be

[8] Research Abi-GfK Eurisko, on the 2013 dataset.

reduced to 2 days, where the deadline for exercising the subscription rights in time for the first window of delivery of the newly issued shares is set at T+3.

On this point, it appears that the deviation from the standard no. 12 is, after all, partial. The overall election period would have a length of 10 or more business days, in line with the standard, but this period would be divided into several parts.

Moreover, the above-mentioned standards represent best practices agreed upon by the industry with the support of the European authorities but they do not have force of law. Proof of this is that, irrespective of the adoption of the rolling model, the Italian market is not compliant with standard no. 11 on *Voluntary Reorganisations;* according to this standard, the issuer should publish the final terms of the rights issue at least two business days before the start of the subscription period. At the opposite, Italian law does not set a specific deadline and so, especially for rights issues where relevant resources are to be gathered, the final terms are often published the day before the start of the capital increase.

Therefore, these standards can be waived if a sound justification is provided; the safeguard of the orderly conduct of trading, ultimate goal of the rolling model, appears indeed to be a sound justification.

Attachment no. 1

Questions:

1. Should the rolling model be adopted for all rights issues or should it be adopted only for highly dilutive rights issues? In the latter case, how should highly dilutive rights issues be defined?

2. Are there other advantages or costs stemming from the implementation of the rolling model? Can you provide us with a quantitative evaluation of these additional advantages or costs?

3. In case the rolling model is implemented, do you think that the arbitrage activity would be an adequate way to solve the price anomalies? Are there other measures which could facilitate the arbitrage activity?

4. Do you agree on the fact that the litigation risk with customers for late communications should not be significant and, thus, should not prevent the adoption of the rolling model?

5. Which delivery time could be feasible for the implementation of the rolling model?

Attachment no. 2

Table no. 3 – Outcome of the consultation held in April 2014

No.	Action	Advantages	Disadvantages	Delivery time	Outcome of the consultation	Italian	Non - Italian	TOT
1	Automatic netting of fails on shares against those on derivatives	Reduces the number of *fails*. Limits brokers' liability. Negligible costs.	Does not solve the price anomalies.	2 months + Monte Titoli delivery time	Pro	8	2	10
					Cons	2	2	4
					Neutral	11	2	13
2	Suspension of early exercises of options	Neutralizes the derivative effect. Negligible costs.	Does not solve entirely the price anomalies. Poses competition issues with foreign markets. Increases risk for *market makers*.	4 months	Pro	7	1	8
					Cons	4	4	8
					Neutral	10	1	11
3	Close-out at fair value of positions in derivative instruments	Neutralizes the derivative effect. Scarcely relevant costs.	Does not solve entirely the price anomalies. Poses competition issues with foreign markets. Increases risk for investors.	4 months	Pro	4	2	6
					Cons	8	4	12
					Neutral	9	0	9
4	Delivery of a basket composed of shares and subscription rights	*Partially* neutralizes the derivative effect.	Does not solve entirely the price anomalies. Poses competition issues with foreign markets. Requires changes to internal procedure of CCG and intermediaries.	12 months	Pro	3	2	5
					Cons	8	3	11
					Neutral	10	1	11