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An overview of the theory of
Minority representation

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Abstract:

The Italian Savings Protection Act, as amended, also introduced Article 147- ter (3) to the Italian Securities Act. It provides that at least one member of the board of directors must be selected from among the candidates on the minority shareholders' list that is second in terms of number of votes cast at the general meeting.

If the company has adopted a dual corporate governance structure with a supervisory board and a management board, the representation of minority shareholders is guaranteed only at the supervisory board level.

Members of the board of statutory auditors must also be appointed using the same list-based voting system (Article 148(2) of the Italian Securities Act). All shareholders have the right to propose a candidate list (Article 144- sexies of Consob's Regulation on Issuers, implementing Article 148 of the Italian Securities Act), unless the company's by-laws have a minimum share ownership threshold, which may not be higher than the thresholds specified in the by-laws for purposes of electing the board of directors.

Introduction:

The board of statutory auditors (collegio sindacale) is a corporate governing body composed of a minimum of three standing members and two alternate members. It supervises the company's compliance with applicable laws and regulations, including the principles of fair and sound management and the internal organisational structure, in particular with respect to internal controls and administrative accounting structures.

The board of statutory auditors is vested with extensive powers for these purposes. Members of the board have the power, both as a group and in an individual capacity, to carry out inspections and audits, and to ask directors to provide information about corporate actions or business transactions, including those involving the company's subsidiaries; in that case statutory auditors may also ask for information directly from the corporate bodies of such subsidiaries.

Article 148 of the Italian Securities Act states that like the requirements governing the election of the board of directors, at least one standing member of the board of statutory auditors must be selected from among the candidates on the minority shareholders' candidate list that is second in terms of number of votes cast at the general meeting. In addition, the candidate elected by the minority shareholders must then be appointed chairperson of the board of statutory auditors.

If the company has a dual corporate governance structure, no separate board of statutory auditors exists. Instead, the supervisory board performs the functions of the board of statutory auditors and the minority shareholders are guaranteed representation on the supervisory board only.

The no-relationship rule

Pursuant to Articles 147- ter (3) and 148(2) of the Italian Securities Act, minority shareholders may propose candidate lists only if they are not related, either directly or indirectly, to any of the reference shareholders.

The rationale for this no-relationship rule is to guarantee the effective representation of shareholders who are truly minority shareholders by preventing

potential abusive conducts by controlling shareholders or shareholders who otherwise have enough voting power to exercise significant influence over shareholders' meetings.

With respect to the appointment of members of the board of statutory auditors, Article 144-quinquies of Consob's Regulation on Issuers - introduced by Consob on May 3 2007 with an amendment to the Regulation on Issuers implementing Articles 147-ter and 148 of the Italian Securities Act and effective for shareholders' meetings called and held after July 1 2007 - provides examples of circumstances in which a relationship would violate the no-relationship rule. These include situations where the minority shareholders and the reference shareholders are related individuals, own property or assets in common, are part of the same corporate group, are affiliates of one another or have other financial or contractual relationships that could significantly influence their decision making.

To avoid potential abusive conduct by reference shareholders, no shareholder (including shareholders that are part of the same corporate group or that are party to a shareholders' agreement regarding the company) may, directly or indirectly, through a third party or fiduciary, propose or vote for more than one statutory auditors' candidate list. The May 3 2007 Consob amendment to the Regulation on Issuers also specified the requirements and procedures for the proposal of statutory auditors' candidate lists.

Consob's Regulation on Issuers, on the other hand, does not specify the requirements and procedures for the proposal of board of directors' candidate lists (except for the minimum ownership thresholds), nor does it provide guidance as to which types of relationships disqualify a minority shareholder from satisfying the no-relationship rule in connection with appointments of board members. This regulatory gap has been subject to considerable speculation. The Italian Securities Act expressly empowered Consob to regulate appointments of members of boards of statutory auditors, but not appointments of members of boards of directors.

In the absence of specific guidance, legal commentators maintain that when determining whether a minority shareholder proposing a candidate list for the board of directors is

disqualified under the no-relationship rule, the proper approach is to apply by analogy the Consob conditions for appointments of members of the board of statutory auditors, as laid out in Article 144-quinquies of Consob's Regulation on Issuers.

After the initial round of shareholders' meetings applying the new Consob rules on the list-based voting system and the initial challenges by minority shareholders, Consob issued the 2008 Interpretive Releases to clarify the no-relationship rule. In addition, Consob has issued a further proposal for a new interpretive release (discussed below) to create a uniform set of rules for the appointment of directors and statutory auditors.

Consob's interpretation

Consob issued the 2008 Interpretive Releases in connection with the appointment of the board of statutory auditors of the listed insurance company Generali. The releases give useful guidance for evaluating whether significant relationships among shareholders disqualify minorities under the no-relationship rule.

Consob's intervention was solicited by the London hedge fund Algebris, which held a stake of about 0.5% in Generali, to disqualify a candidate list proposed by Edizione Holding on the grounds that Edizione Holding, a minority shareholder of Generali, was related to Mediobanca, the 15.6% majority shareholder. Algebris claimed that since Edizione Holding's parent company Ragione Sapa di Gilberto Benetton & Co was a party to a shareholders' agreement that controlled Mediobanca, Ragione exercised joint control over Mediobanca. As a result Edizione Holding was related to Mediobanca.

Algebris argued that if Mediobanca voted for a candidate list that was different from the list for which Edizione Holding voted, and Edizione Holding's candidate list placed second based on the votes cast, Edizione Holding's list should not be considered a minority shareholder's list under Article 148 and therefore should be disqualified.

In the 2008 Interpretive Releases, Consob clarified that being a party (directly or indirectly, including through any of its affiliates) to a shareholders' agreement amounts to a disqualifying relationship, if that agreement guarantees joint control over a reference shareholder and includes certain features. These features include giving the shareholders the ability to elect most of the members of the reference shareholder's corporate governing bodies, influence those members' representation on those governing bodies, control the reference shareholder's shareholder structure through share lock-ups, and take strategic decisions with respect to the reference shareholder.

Clarification

In reaching this conclusion Consob also evaluated a number of additional complex business relationships, such as the participation in a number of shareholders' agreements with respect to various companies and joint investments. Analysed together, they led Consob to conclude that the minority shareholder (Edizione Holding) was related to the reference shareholder (Mediobanca).

Given the range of potential relationships between shareholders, Consob decided to take a fact-based approach in determining whether a disqualifying relationship exists, enabling it to make interpretations on a case-by-case basis. Consob's approach indicates that, given the complex web of related interests that characterises Italy's financial system, a formalistic, rule-based approach to this issue is not the most effective means to protect minority shareholders and their right to be effectively represented on corporate governing bodies.

On April 29 2008, Consob took another significant step towards protecting the rights of minority shareholders by publishing a proposed new interpretive release that aims to close the gap in the current Consob Regulation on Issuers with respect to candidate lists for appointments to boards of directors. As mentioned above, Consob's Regulation on Issuers does not specify what constitutes a disqualifying relationship in this context, nor does it clarify the procedures for proposing such lists, except with respect to the minimum share ownership thresholds.

A complex maze

The Consob proposed interpretive release sets out uniform disclosure requirements regarding who may propose candidate lists for the appointment of members of both the board of directors and the board of statutory auditors. Most significantly, shareholders proposing a list

would need to disclose any relationship with a reference shareholder - including relationships of a contractual, professional, personal or financial nature - and explain why the relationship should not be treated as a disqualifying relationship for the purposes of the Italian Securities Act. These disclosures need to be filed along with the proposed candidate lists. The disclosure requirement would subject the appointment of members of the board of directors to the same no-relationship rule and interpretations applicable to the appointment of members of boards of statutory auditors.

Consob would enforce this disclosure requirement in two ways, according to whether the shareholder is or is not already subject to general Consob disclosure requirements. For the first group, Consob would use its existing powers to request information. For shareholders not already subject to Consob's disclosure requirements, Consob would recommend the disclosure of any relevant relationship.

The Italian financial system is characterised by a complex maze of cross-ownerships, cross-directorships and shareholders' agreements among a limited number of big Italian companies and financial institutions. Consob's 2008 Interpretive Releases and its proposed new interpretive release for more stringent disclosure requirements for disqualifying relationships

could enable minority shareholders to exercise greater influence over the management and control of Italian listed companies. Assuming that minority shareholders' activism continues to focus on increasing corporate efficiency, it is possible that the changes to Italy's financial system will in the long run create more value for shareholders.

Although improving the dialogue among shareholders and heightening the transparency of corporate governance systems are important objectives, Italian regulators should be careful about how they balance the interests of majority and minority shareholders. If the balance tips too heavily in favour of minority shareholders, shareholder conflicts and disputes (possibly resulting in litigation) could increase, leading to delays in executing corporate transactions and increased costs for companies and their shareholders. Such delays could ultimately scare off investors and damage the interests of all shareholders.

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