Reform of Italian Corporate and Securities Laws: The Investor Protection Act

Milan and Rome
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Prompted by a wave of financial scandals and inspired by legislation recently enacted in other countries under similar circumstances, the Italian Parliament has adopted the "Investor Protection Act," a set of rules designed, among other things, to enhance the rights of minority investors, the accountability of corporate directors and officers and the reliability of financial information of Italian listed companies[1] (the "Act"). The Act amends and supplements various provisions of Italian securities and corporate laws relating to matters such as (i) the appointment of directors and statutory auditors, (ii) the responsibility for preparing financial information, (iii) the appointment and dismissal of outside auditors, the scope of their audit, and the range of non-audit services they can provide, (iv) disclosure relating to affiliates located in certain blacklisted jurisdictions, and (v) the criminal penalties that attach to the violation of these laws.

The Act also overhauled the internal organization of the Bank of Italy, (including by replacing the Governor's life tenure with a six-year term of office) and transferred from it to the Italian Antitrust Authority the power to authorize bank mergers for purposes of Italian antitrust rules.

The Act generally took effect on January 12, 2006, except for certain provisions, including those that require amendments to a company's organizational documents (which will have to be amended by January 12, 2007) or further rule-making by CONSOB, the Italian securities regulator, or other administrative bodies.

This memo provides a brief overview of the most significant corporate and securities law changes introduced by the Act and does not purport to be definitive or complete. If you require specific information on any of these matters, please do not hesitate to contact us as indicated below.

[1] Law no. 262 of December 28, 2005.

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This memorandum was prepared as a service to clients and other friends of Cleary Gottlieb to report on recent developments that may be of interest to them. The information in it is therefore general, and should not be considered or relied on as legal advice.

I. Governance

In order to guarantee the representation of minorities on the boards of directors of listed companies, the Act requires these companies to adopt cumulative voting systems for the election of directors by January 12, 2007. These voting systems must ensure that at least one member of the board is elected from the slate presented by minority shareholders. Similarly, at least one statutory auditor of the company will have to be designated by minority shareholders, and this statutory auditor will act as the chairman of the board of statutory auditors.

In addition, where the board of directors of a listed company has more than seven members, at least one director must now meet certain independence requirements set forth by the Act.

With the aim of ensuring a more active role in the management and oversight of listed companies, the Act also provides that a member of the board of statutory auditors of a listed company may not act as director or statutory auditor for more than a specified number of companies.

In addition, directors of a listed company will have to meet the good-standing requirements that are already applicable to statutory auditors, such as not having been convicted of financial, bankruptcy-related or other crimes.

II. Shareholders' rights

The Act introduced new rules intended to empower shareholders and encourage their activism. Shareholders representing at least 2.5% of the capital stock of a listed company may add matters to the shareholders' meeting agenda. Further, the threshold percentage for the amount of capital stock shareholders must represent to initiate derivative actions against the directors of the company was also lowered to 2.5% from 5%.

III. Protection of retail investors

The Act also attempts to address at least in part a longstanding issue in Italy with privately placed securities ending up in the hands of inadequately informed retail investors. The Act provides that where an offering of securities is limited to professional investors and therefore exempt from disclosure requirements, any professional investor that resells such securities is liable to any retail purchaser in the event of the insolvency of the issuer within one year of the initial offering, unless such professional investor has delivered a prospectus to the purchaser.

In addition, the Act repealed a previously existing exemption from the disclosure requirements for securities issued by banks other than stock or securities conferring a right to purchase or subscribe to stock and insurance products offered by insurance companies, in an effort to increase market disclosure and protection of retail investors.

IV. Preparation of Financial Information

From January 12, 2007 Italian listed companies will be required to provide in their bylaws for the appointment of an officer responsible for the preparation of financial information (the "Accounting Officer").

Mimicking similar provisions of the U.S. Sarbanes-Oxley Act of 2002, the Act provides that the Accounting Officer and the *direttore generale* will have to certify the accuracy of financial information contained in any public document or statement of the company. Further, the Accounting Officer will be responsible for setting up adequate procedures for the preparation of financial statements and other financial information. The financial statements of the company will need to be accompanied by a report of the Accounting Officer and the chief executive officer (the *amministratore delegato*) certifying that these procedures are adequate and have been duly followed and that the information in the financial statements matches that contained in the company's books and records. In their capacity as such, Accounting Officers will be subject to the liability regime applicable to directors.

V. Outside Auditors

The Act also modified the existing rules relating to outside auditors.

Auditors of a listed company must now be appointed by the shareholders for a term of six years, as opposed to three years previously. The appointment of the audit firm may be renewed only once (provided the lead audit partner is replaced) and, thereafter, that same firm may be re-appointed only after a three-year period has elapsed.[2]

The Act further identifies a number of non-audit services that audit firms (and their affiliates) may not provide to their audit clients (or their affiliates). These include internal book-keeping, expert appraisal, outsourced internal control, selection, training and management of personnel, actuarial valuation, securities brokerage and investment advisory and investment-banking services. In addition, the Act authorizes CONSOB to enact rules defining the circumstances under which an accounting firm may

[2] The rule seems to provide that a firm may be appointed for a second six-year term only after a three-year period has passed, and that, following such second term, the same firm is barred from ever being appointed again by the company. However, we believe this language is the result of poor drafting and that the above interpretation represents a reasonable reading of the rule.

be otherwise barred from acting as external auditor of a company because of conflicts of interest.

Finally, the Act limits the ability of directors, officers and employees of the audit firm to be appointed or employed by their audit clients, and *vice-versa*, before a three-year cooling-off period has elapsed.

VI. Scope of the Audit

Other rules introduced by the Act are designed to address the fragmentation of responsibility for auditing corporate groups where different firms are appointed as auditors of various companies within the same group.

The Act provides that the firm auditing a listed company (or its non-public parent, if any) will be entirely responsible for the audit of its consolidated financial statements. In such capacity, it will receive the reports from any other firm auditing the client's subsidiaries and may undertake any inspections, investigations or controls on such subsidiaries as it deems appropriate.[3]

VII. Black-listed jurisdictions

The Act also imposes heightened disclosure obligations on listed companies that own subsidiaries in jurisdictions that are not deemed to ensure sufficient corporate transparency. These jurisdictions will be identified by the Ministry of Justice based on the adequacy of their corporate law provisions relating to, among other things, (a) the public availability of companies' organizational documents, (b) any minimum levels of capital stock, (c) the protection of stated capital stock, including by independent appraisal of the value of non-cash equity contributions, (d) the establishment of supervisory corporate bodies separate from those entrusted with the management of the company, (e) the preparation and publication of periodic financial statements, and (f) the liquidation of insolvent companies lacking prospects for recovery.

The act requires CONSOB to adopt rules defining the circumstances under which an Italian listed company may own subsidiaries in jurisdictions whose laws are deemed to be seriously inadequate. Further, the financial statements of an Italian listed company will have to be accompanied by the financial statements of any subsidiaries located in black-listed jurisdictions prepared in accordance with either Italian GAAP or IFRS, audited by the parent's auditors and certified by its directors, *direttore generale*, and Accounting Officer. In addition, financial statements of Italian listed companies controlled by, controlling or holding qualifying equity interests in companies located in black-listed jurisdictions will have to be accompanied by a report of the board of directors, *direttore generale* and Accounting Officer discussing any

[3] It is unclear to what extent these rules will prevent auditors of the parent from relying on the audit performed by the auditors of the subsidiaries.

existing relationships between the Italian company and those in the black-listed jurisdictions, including all transactions carried out during the reporting period. The rule also applies to Italian private companies that have substantial indebtedness for borrowed money and are controlled by companies located in black-listed jurisdictions.

VIII. Miscellaneous

The Act also undertakes to close perceived loopholes in miscellaneous other corporate and securities rules. For example, under Italian law, with certain exceptions, a company may not issue bonds in a principal amount exceeding twice the amount of its (adjusted) shareholders' equity. In the past, Italian companies were able to avoid this limitation by having a foreign affiliate issue bonds guaranteed by the Italian company. The Act expressly provides that the amount of any guarantee granted by an Italian company in respect of bonds issued by another entity counts towards the issuance limit.

Similarly, in order to prevent the circumvention of disclosure requirements, the Act provides that the merger of an unlisted company into a substantially smaller listed company requires the preparation of a prospectus equivalent to that required in connection with a public offering of equity securities.

IX. Criminal Penalties

Finally, the Act introduced a number of new crimes and increased the penalties for existing crimes relating to certain securities or corporate law violations. These include (i) failure of conflicted directors of a listed company to disclose their interest (or, in the case of the chief executive officer, to abstain from acting), where such failure causes actual damage to the company or third parties (up to three years of imprisonment), (ii) preparation by officers of the company of fraudulent prospectuses or tender offer documents (up to five years of imprisonment), and (iii) the issuance by auditors of fraudulent audit reports (up to seven-and–a-half years of imprisonment).

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