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HOW INDEPENDENT ARE INDEPENDENT DIRECTORS? THE CASE OF ITALY

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Abstract

In this article, we provide an interpretation for the voluntary independence requirements contained in the Italian Corporate Governance Code (Preda Code) checking them against a proxy for international best practice, the independence criteria provided in the EC Recommendation on non-executive and supervisory directors of 2005. We then check to what extent company disclosure for 2003 allows the verification of the independence of directors qualified as independent by the Italian 40 blue chips. We find that the Preda Code (currently under revision) should be updated in several respects in order to make it abreast with best practice in the European Union. We also find that for two key independence requirements (not to have business relationships with the company and not to have too many concurrent commitments outside of the company) the level of compliance is dramatically low (4% and 16% respectively). Overall, for only 5 out of the 284 directors declared as independent by the Italian blue chips is it possible to verify the respect of all the Italian independence standards (and for only 4 directors with respect to the EC standards). This raises the problem of who should monitor what listed companies declare.

HOW INDEPENDENT ARE INDEPENDENT DIRECTORS? THE CASE OF ITALY¹

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Abstract

In this paper we analyse and quantify the extent to which corporate disclosure for the financial year 2003 allows for verification of the independence of directors formally identified as independent by the 40 Italian blue chips. In order to do this, we used as a benchmark the voluntary independence requirements of the Italian Corporate Governance Code (Preda Code, 2002) and the voluntary independence requirements of the EC Recommendation (2005) on non-executive and supervisory directors (a proxy for international best practice). This is a new methodology that can be applied equally to any other country: to our knowledge so far nobody has systematically verified whether listed companies in fact apply the independence standards they declare that they follow. We find that, for the two key independence requirements of not having business relationships with the company and not having too many concurrent commitments outside the company, the level of compliance is dramatically low: 4% and 16% respectively. Overall, it is possible to verify compliance with all the Italian independence standards for only 5 out of the 284 directors formally identified as independent by their companies, and for only 4 directors with respect to the EC standards. The results of this study bring into question the effectiveness of securities market monitoring and call for further quantitative analysis of corporate governance.

Article key words (search engines):

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1. Introduction: the need for a new measure of director independence

Parties in control of a corporation are in a position to extract private benefits of control that do not accrue to non-controlling shareholders. Such private benefits can be of a psychological nature (community prestige, that is the pleasure managers experience being at the top of a large organization) but can also take the form of wealth extraction at the expense of minority outside shareholders. Wealth extraction can take several forms, from outright theft, to transfer pricing or diverting assets from the company at below market prices in favor of insiders, to managerial entrenchment.²

One important focus of the corporate governance literature is on the mechanisms that may help limit wealth extraction. This issue is important because financial development, that is the willingness of investors to provide funds to companies, is severely hampered in the absence of guarantees against wealth expropriation of outside investors.³

Adam Smith (1776), Berle and Means (1932) and Jensen and Meckling (1976), address the agency problem between managers and shareholders caused by dispersed ownership structure. The problem is that small shareholders lack economic incentives to spend resources to control management. As noted by Shleifer and Vishny (1997), large shareholders do have economic incentives to gather information and monitor management. By exercising their voting control, large shareholders do put pressure on management to act in shareholder interest. However, as showed by Demsetz (1983), Fama and Jensen (1985), and Grossman and Hart (1988), a concentrated share ownership structure also brings an incentive for controlling shareholders to expropriate minority shareholders. There is a danger that controlling shareholders use their influence to transfer corporate assets to themselves at below-market prices.⁴

The consequence is seen as having a direct impact on company economic performance, since in both cases the company is not run in the interest of (all) its suppliers of finance. Finally, even when a company manager pursues a profit-maximizing behavior, she may have incentive not to return the money to investors: for instance, instead of distributing dividends she may embark the company on costly investment projects.⁵

Inquiry into the dynamics of private benefits of control is the focus of Grossman and Hart (1988) and Bebchuk (1999): Grossman and Hart (1988) observe that the allocation of voting rights influences whether control will rest in the hands of a high private benefit party or a high security benefit party; Bebchuk (1999) observes that private benefits of control are an incentive for controlling shareholders to maintain a lock on control and to prevent the formation of dispersed ownership.

Empirical measures of private benefits of control

Empirical studies of private benefits of control try to measure whether the controlling votes are valued more than non-controlling ones.⁶

² Shleifer and Vishny 1997, p. 9-10.

³ Shleifer and Vishny 1997, La Porta et al. 1997 and 1998.

⁴ For a general introduction to the theory of conflicts of interest, see Kraakman, Davies et al. 2004, particularly chapters 1, 3, and 5.

⁵ Shleifer and Vishny 1997, p. 10.

⁶ Overviews of this subject are provided by Shleifer and Vishny 1997, Nenova 2003, and Dyck and Zingales 2004.

These studies take recourse to two different methodologies. A first group of studies measures the value of control-block votes, while a second group measures the value of a single vote.

Controlling block trades. One methodology is to focus on privately negotiated transfers of controlling blocks in publicly traded companies: “The assumption made is that the price per share an acquirer pays for the controlling block reflects the cash flow benefits from his fractional ownership and the private benefits stemming from his controlling position in the firm. By contrast, the market price of a share after the change in control is announced reflects only the cash flow benefits non-controlling shareholders expect to receive under the new management. Hence, the difference between the price per share paid by the acquiring party and the price per share prevailing on the market reflects the differential payoff accruing to the controlling shareholder.”⁷

As a result of such a methodology, countries are ranked according to a ratio of value of control to value of equity. The most recent estimates in this respect are those provided by Dyck and Zingales 2004.

Vote premium studies. An alternative methodology consists of linking the extraction of private benefits by controlling shareholders to their willingness to pay a premium price for voting shares at the moment of their acquiring control of the company. Some of the relevant studies in this field are Zingales (1994 and 1995a), Rydqvist (1996), Modigliani and Perotti (1998), and Nenova 2003.⁸

To sum up the findings of this literature, we may say that, although methodologies differ and the number of companies included in the various samples is limited, in some EU states there might be a significant level of private benefits of control. With particular reference to Italy, such benefits are the highest in relative terms in all the more recent and complete studies. In the Nenova study, the value of control-block votes in Brazil, Chile, France, Italy, and Mexico is one-quarter or more of firm market capitalization. Such figures are confirmed by Dyck and Zingales 2004 as regards Italy in particular, while France in this study shows a low level of private benefits. It should also be noted that while in general such studies are based on a small number of observations for each country, in one of these studies⁹ Italy is covered with a rather large set of cases.¹⁰

⁷ Dyck and Zingales 2004, p. 1.

⁸ According to the definition of such a method provided by Dyck and Zingales 2004, p. 9: “The second method of estimating the value of private benefits of control uses the price difference between two classes of stock, with similar or identical dividend rights, but different voting rights. If control is valuable, then corporate votes, which allocate control, should be valuable as well. How valuable? It depends on how decisive some votes are in allocating control and how valuable control is. If one can find a reasonable proxy for the strategic value of votes in winning control - for example in forming a winning coalition block - then one can infer the value of control from the relationship between the market price of the votes and their strategic role.” As underlined by Marcello Bianchi in a private interview, the main problem of this methodology is that prices of non-voting classes of shares often are highly variable due to the limited quantities traded.

⁹ Nenova 2003.

¹⁰ The latest available data are provided by the annual report of the Consob (the Italian stock market regulator) for 2003, p. 9: out of 21 cases identified, the average premium for the purchase of controlling blocks is 12.3%. Such findings are also confirmed from non-systematic findings reported in the press. For instance, Penati 2004a refers to recent cases in which controlling voting blocks in Italian listed companies have been paid a premium between 30% and almost 100% vis-à-vis their stock market price. For a general treatment on the importance of shareholder expropriation in Italian corporate governance, see Rajan and Zingales 2004 and Pinza and Zoppini 2004.

The role of independent directors in preventing shareholder expropriation

There is an increasing tendency in the financial, institutional and, to a certain extent, academic world to see independent directors as an important preserve against the opportunism of management and controlling shareholders.¹¹ For instance, according to Bhagat and Black (2001), p. 232, there is a “conventional wisdom that the board’s principal task is to monitor management, and only independent directors can be effective monitors.”

Practically all existing corporate governance codes or guidelines today contain a section on independent directors with varying (and, over time, increasing) proportions of independent directors recommended and with varying (and increasingly restrictive) definitions of independence.¹² This trend is acknowledged by supranational institutions: the OECD Principles of Corporate Governance of 2004 recommend that boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgement to tasks where there is a potential for conflict of interest,¹³ while the point of view of the EC Recommendation on the role of non-executive and supervisory directors of 2005¹⁴ (hereafter EC Recommendation) is that independent directors have a role to play both in companies with dispersed ownership, where the primary concern is about how to make managers accountable to weak shareholders, and in companies with controlling shareholders, where the focus is more on how to make sure that the company will be run in a way that sufficiently takes into account the interests of minority shareholders.

In the academic literature, the origin of the argument which conceives the role of independent directors to be that of checking management tendency to pursue selfish goals goes back at least to Fama and Jensen (1983), who observe that optimal board structures require inside directors to be complemented by outside directors¹⁵ who should be especially entrusted with advising and policing the board on strategic decisions. The authors observe that outside directors are most apt to carry out tasks that involve potential conflicts of interest between managers and shareholders as they are less likely to collude with management to expropriate shareholders.

¹¹ Of course, independent directors are not the only measure allowing the prevention of such opportunistic behavior. See Dyck and Zingales 2004, p. 5-7, for a list of other possible factors able to limit the extraction of private benefits of control by controlling shareholders, and Hermalin and Weisbach 2003, p. 5-8, who propose the idea that boards of directors originally emerged as a guarantee against managerial misappropriation.

¹² See Bhagat and Black 2001, p. 232, and OECD 2003, p. 62, for a list of institutions that recommend the presence of independent directors on company boards. The website of the European Corporate Governance Institute (www.ecgi.org) presents a complete list of the major corporate governance codes around the world. A comparison is provided by Weil, Gotshal & Manges 2002.

¹³ OECD 2004. It is interesting to note that the Principles were endorsed by the OECD Meeting at Ministerial Level in May 2004.

¹⁴ EC Recommendation of 15 February 2005, on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board, http://europa.eu.int/eur-lex/lex/LexUriServ/site/en/oj/2005/l_052/l_05220050225en00510063.pdf

¹⁵ According to Hermalin and Weisbach 2003, p. 2, “Inside directors are employees or former employees of the firm. They generally are not thought to be independent of the CEO, since the success of their careers is often tied to the CEOs. Outside directors are not employees of the firm and usually do not have any business ties to the firm aside from their directorships. Outside directors are typically CEOs from other firms or prominent individuals in other fields. Finally, about 10% of directors fall into neither category; often these are attorneys or businesspeople that have a longstanding relationship with the firm. These directors are usually referred to as ‘affiliated’ or ‘gray’ directors.”

Among the ensuing contributions to the debate, Lorsch and MacIver (1989) indicate that independent directors are crucial because they can objectively evaluate and monitor firm activity. Byrd and Hickman (1992) observe that independent directors are responsible for protecting and promoting the interests of minority shareholders. Millstein (1993) calls for a “constructive tension” between shareholders and boards and between boards and managers, achieved by an independent credible board.

In Black (2001), independent directors are listed among the few “useful institutions” who can help shareholders in identifying disclosure problems. Their role is considered as particularly useful since independent directors, as opposed to investment bankers, accountants, and securities lawyers, are part of the board and can have a more complete perspective on the management. Eckbo (2005) calls for “a vigorous corporate governance system” to prevent shareholder rights being expropriated by corporate insiders.

Finally, the main rating agencies’ focus of their corporate governance analysis is on the independence and effectiveness of the board of directors, of which the presence of a qualified number of independent directors is a key element.¹⁶

So independent directors are considered as one of the main instruments against shareholder expropriation and for that reason their presence is recommended by national corporate governance codes and supranational institutions.¹⁷ In Italy, where the degree of shareholder expropriation seems to be particularly high, the presence of independent directors on corporate boards of listed companies is constantly increasing.¹⁸ But are those independent directors really independent? To our knowledge, existing studies refer to board independence based on how many directors are qualified as independent by the issuer itself, and there are no systematic inquiries into whether listed companies in Italy¹⁹ really apply the independence standards they declare to follow.²⁰ The aim of this article is to check whether it is possible to verify independence through company disclosure. The paper is structured as follows: chapter 2 illustrates the methodology used; chapter 3 illustrates the results of our enquiry, and chapter 4 contains the conclusions.

2. Methodology used

The perspective we have chosen is that of the investor who should be in a position to verify, to a reasonable extent,²¹ the existence of the independence criteria of the corporate governance code the issuer declares to adopt.²²

¹⁶ For instance, Moody’s recommends (Moody’s 2003, p. 5) “a strong and clearly independent majority on the board, with audit, compensation and nominating/governance committees composed exclusively of independent directors.”

¹⁷ It is important to specify that the present paper does not aim at discussing whether independent directors are useful to prevent shareholder expropriation: it merely starts from the observation that, as said, multilateral organisms, national corporate governance codes, rating agencies and large part of the academic world deem it so. For a contrary voice on the usefulness of independent directors see Becht et al. 2002, particularly p. 42-45.

¹⁸ See Assonime 2005.

¹⁹ Or in any other EU country.

²⁰ This subject is actually at the frontier of corporate governance, at least in Europe, and it covers the wider field of whether regulatory authorities of some kind monitor the actual implementation of the various corporate governance codes that have been recently adopted in many EU countries. From OECD (2003), it emerges that such procedures do not exist or are not developed.

²¹ For instance, the EC Recommendation, which may be considered as an international standard, specifies that (art. 11.4): “When the appointment of a director is proposed, disclosure should be made of his particular

The population chosen is made up of directors declared as independent by the 40 listed companies that make up the S&P/MIB index.²³ As of December 2004, the index represented approximately 78% of the total capitalization of the Italian stock market (Borsa Italiana)²⁴. As for its composition, we relied on the composition of the index as of September 17, 2004, the last date available at the time the present research started (December 2004). The list of the companies that make up the index is reported in Annex A.

The independence standards are those provided by the Italian corporate governance code (Preda Code) and by the EC Recommendation on the role of non-executive and supervisory directors.²⁵

We chose as a first benchmark the Preda Code because it is the corporate governance code adopted by Borsa Italiana in 1999 and updated in 2002.²⁶ Although the provisions set by the Preda Code are not mandatory, the bylaws set by Borsa Italiana²⁷ require all Italian listed companies to present a yearly corporate governance report in which it must be mentioned whether and to what extent they have adhered to the Preda Code. It is an implementation of the comply-or-explain principle, which is aimed at allowing companies to apply corporate governance principles according to their own specificities. In 2003, almost all 40 companies belonging to the S&P/MIB index adhered to the independence requirements provided by the Preda Code.

We chose the EC Recommendation as a proxy for international best practice. The Recommendation, which is non-binding, concentrates on the role of non-executive or supervisory directors in key areas where executive or managing directors may have conflicts of interest. It includes minimum standards for the qualifications, commitment, and independence of non-executive or supervisory directors.

competences which are relevant to his service on the (supervisory) board. to enable markets and the public to assess whether these competences remain appropriate over time, the (supervisory) board should disclose every year a profile of the board's composition and information on the particular competences of individual directors which are relevant to their service on the (supervisory) boards."; and that (art. 13.3): "Proper information should be disclosed on the conclusions reached by the (supervisory) board in its determination of whether a particular director should be regarded as independent."

²² This is also the reference chosen by Borsa Italiana, as can be seen from Assonime 2004, p. 19: "La Relazione non può, in generale, limitarsi a una mera dichiarazione di adesione di principio al Codice di autodisciplina nel suo complesso e ai principi cui esso si ispira (creazione del valore per gli azionisti, centralità del CdA, ecc.), né può limitarsi a parafrasare il Codice di autodisciplina o a divulgare un eventuale Codice interno di comportamento; essa deve spiegare come la società ha applicato le singole disposizioni del Codice." Investor information is also the approach chosen by other systems. For instance in the UK, as stressed by Financial Reporting Council (2003), p. 7: "Under the UK Listing Authority's Listing Rules, a listed company incorporated in the UK is required to include in its annual report and accounts: a statement of how it has applied the principles set out in Section 1 of the Code, providing explanation which enables its shareholders to evaluate how the principles have been applied..."

²³ For details on the methodology with which the index is built, see <http://www.borsaitalia.it/pdf/it/mercati/indici/spmib/metodologiacompleta.pdf>

²⁴ Borsa Italiana, Titoli indice S&P/MIB, Capitalizzazione al 31.12.2004, www.borsaitalia.it

²⁵ EC Recommendation of 15 February 2005, on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board), http://europa.eu.int/eur-lex/lex/LexUriServ/site/en/oj/2005/l_052/l_05220050225en00510063.pdf

²⁶ http://www.ecgi.org/codes/code.php?code_id=66 Remark that a new version of the Code, adopted in February 2006, will be applicable starting from 2007.

²⁷ Istruzioni al Regolamento dei mercati organizzati e gestiti da Borsa Italiana S.p.A dell'8 ottobre 2004, <http://www.borsaitalia.it/opsmedia/pdf/14923.pdf>

The adoption of a double standard for independence allows us to account for the national (Italian) specificities in corporate governance and at the same time to take into account the convergence process underway among corporate governance systems.²⁸ Besides, it is essential to evaluate the degree of openness of Italian listed companies to international standards of finance, an essential precondition to gain access to globalized capital.

The empirical analysis was conducted on the basis of the documents referring to 2003, as published by the issuers and made available on the same issuers' websites or on the websites of Borsa Italiana and the Consob (the Italian stock market regulator).²⁹

We used three different kinds of rates: "yes" as an indicator of compliance with independence criteria: it means that it is possible to verify from company disclosure that the independent director satisfies the independence criteria set by the Preda Code and by the EC Recommendation; "no" means that it is possible to verify from company disclosure the inadequacy to the criterion despite the company's declaration that the director satisfies the criterion: it is an indicator of non-compliance;³⁰ "ns" means that it is not possible to verify from company disclosure the adequacy or inadequacy to the criterion (lack of disclosure). "Ns" should then be interpreted as a milder level of non-compliance than "no" that does not allow to assign a "yes" rate.

Both the Preda Code and the EC Recommendation contain general clauses referring to the fact that independence criteria have to be interpreted with reference to significance thresholds. Since neither Borsa Italiana nor any of the issuers provided more guidance, in each case we have provided a specific evaluation of such significance thresholds, making use of available empirical evidence (see Annex B).

For all the independence criteria for which an evaluation of the directors' CV is required, we consider a CV as complete whenever it allows the reconstruction of the professional and/or academic career of the director since its beginning. Particular attention is devoted to the coverage of the last 3-5 years, for which several Preda and EC criteria apply.

Finally, the purpose of the present study is not to verify that independent directors of Italian blue chips are not independent in their actual behavior; rather, it is to verify the extent to which listed companies justify compliance with independence requirements.³¹ As specified by the European Commission (2005), the determination of what constitutes independence should principally be an issue for the board itself to determine.³²

²⁸ On the last point, see Hansmann and Kraakman 2001.

²⁹ www.borsaitalia.it and www.consob.it More specifically, reference is made to: (i) annual reports for 2003; (ii) corporate governance reports for 2003; (iii) control agreements (where present); (iv) CVs of independent directors (where present): either from companies' websites or from cg reports or annual reports; and (v) company profiles provided on the Borsa Italiana and Consob websites.

³⁰ Of course, we take into account the motivations provided, if any, by issuers who declare they consider independent a director who does not satisfy a specific independence requirement.

³¹ In this we follow the general rule recommended by Higgs (2003), p. 37: "The board should state its reasons if a director is considered to be independent notwithstanding the existence of relationships or circumstances which may appear relevant to its determination."

³² Recital 18 of the Recommendation.

2.1 Preda criteria vs EC criteria

As seen in Table 1 and in Annex B, the Preda Code is made up of 5 different independence criteria, while the EC Recommendation is made up of 11 criteria. The object of the present study is to verify compliance with these 16 criteria.³³

Table 1. Comparison of Preda and EC criteria

| | |
|--|---|
| | |
| PR_A (business relationships) | EC_A (executive in the (assoc.) company) |
| | EC_B (employee of the (assoc.) company) |
| | EC_D (representing controlling shareholders) |
| | EC_E (business relationship) |
| | EC_F (external auditor) |
| PR_B (shares owned) | |
| PR_C (family ties) | EC_I (family ties) |
| PR_D (professional qualification) | EC_L (professional qualification) |
| PR_E (other commitments) | EC_M (other commitments) |
| | EC_H (permanence on the board) |
| | EC_C (additional remuneration) |
| | EC_G (cross-directorships) |

A first conclusion that can be made by comparing the Preda and the EC sets of independence criteria is that EC criteria are more explicit. In particular, criteria EC_A, EC_B, EC_D, EC_E, and EC_F are all comprised within PR_A. This means that EC criteria illustrate the same independence requirement (business relationship) by splitting it into its composing parts, although with two differences. On the one hand, the Preda Code specifies that members of executive committees are not to be considered executive directors, something the EC Recommendation does not specify; on the other hand, while in PR_A a relationship with an external auditor is relevant only as far as the previous year, in EC_F it goes as far as three years back.

The second conclusion is that the Preda Code considers three fewer independence criteria than the EC Recommendation: additional remuneration, cross directorships, and permanence on the board (respectively EC_C, EC_G, and EC_H). Finally, criteria EC_I, EC_L, and EC_M have an exact correspondence respectively in PR_C, PR_D, and PR_E.

Moreover, not all criteria, *per se*, allow for a thorough investor verification, short of investigative inquiries of some kind. The consequence is that the results of the present inquiry present an image of compliance to independence standards which could be more positive (or less negative) than the actual situation.

As we have seen, the Preda and the EC criteria are not mandatory. However, according to the full meaning of the “comply or explain” principle endorsed by both documents, issuers should declare which criteria they do not apply and explain why, something which Italian issuers rarely did in their disclosure documentation for 2003. The only exception was, in a few cases, the disclosure that related-party transactions involving independent directors had taken place

³³ It is also clear from Annex B that when two criteria have the same name they do not necessarily have the same content.

at market prices. However, even this disclaimer does not appear to be relevant, since the problem at issue here is not verifying that independent directors enjoyed private benefits from their position on the board by conducting transactions with the company at below-market prices, but that their independence is not conditioned by any economic link with the company other than their position as an independent director.

3. RESULTS

We examine here the rates assigned to our population of 284 directors³⁴ qualified as independent by their companies with regard to the independence criteria set by the Preda Code and by the EC Recommendation. With the exception of the EC_G criterion, we do not make any reference in this paper to the companies on whose boards such directors sit.

3.1 General results: Preda Code vs EC Recommendation

We examine here the rates assigned to our population of 284 directors with regard to the independence criteria set by the Preda Code and by the EC Recommendation.

Table 2
Adequacy rates by set of criteria
(Preda-EC)

| | Preda | | EC (7 criteria) | | EC (11 criteria) | |
|------------|------------|-----------------------|-----------------|-----------------------|------------------|-----------------------|
| | percentage | cumulative percentage | percentage | cumulative percentage | percentage | cumulative percentage |
| no | 16.27 | 16.27 | 16.15 | 16.15 | 12.55 | 12.55 |
| ns | 26.06 | 42.32 | 24.14 | 40.29 | 35.95 | 48.50 |
| yes | 57.68 | 100 | 59.71 | 100 | 51.50 | 100 |

We begin by examining the total rates assigned to all of the 284 directors on all 5 Preda criteria. As seen in Table 2 (in the first two columns), out of the total 1,420 rates for all 5 criteria (284 x 5), only 819 are “yes” rates (58%). In 26% of the cases, the result was “ns”, while for the remaining 16% the result was “no”. This means that, out of the remaining 42% of the total rates, roughly 1/3 is due to the non-compliance to Preda criteria which emerges from company disclosure itself: in these cases, issuers provide contradictory information on director independence. In the remaining 2/3 of cases, it is not possible to verify compliance with independence requirements due to the lack of disclosure.

As seen in Table 2 (in the fifth and sixth columns), the 284 directors of our population show compliance with the 11 EC independence criteria for only 51.5% of the cases. For 36% of cases, the result was “ns” while for the remaining 12.6% the result was “no”. The lower level of compliance compared to the Preda Code, as illustrated above, could lead to a first conclusion that the directors in our population have a lower rate of compliance with international (EU) best practice than with the Italian Preda requirements. This seems to be due to a higher percentage of “ns” rates, which is also responsible for the lower percentage of “no” rates.

³⁴ Please understand that in ten cases the same person sits on two boards of the S&P/Mib index, so that in the present study, 284 actually refers to the number of directorships.

A somewhat different interpretation is possible if we take into account that which is specified in par. 2.1: that 5 out of 11 EC independence criteria are summed up within PR_A. In order to allow for a full comparison between the Preda and EC criteria, it is then useful to substitute EC_A, EC_B, EC_D, EC_E, and EC_F with PR_A. The third and fourth columns (“EC 7”) in Table 2 show that in this case compliance with EC criteria is almost identical with Preda. The reason for the difference between EC 11 and EC 7 lies in the different drafting style chosen by the two sets of criteria: the EC Recommendation introduces, for the sake of clarity, 5 different criteria to describe a situation which in the Preda Code is compressed within a single independence criterion, PR_A. As a result, we have for EC a sort of “multiplier effect” which, unless corrected, prevents a full comparison of the two sets of requirements: lack of disclosure for one of the several profiles that make up the PR_A criterion may correspond to several, up to five, “ns” rates in EC, something which explains the higher percentage of “ns” rates in the EC 11 indicator shown in Table 2.

Hereafter, we will continue referring to the EC 11 indicator in order to have a deeper analytical view on the independence profiles of the directors considered within the present study, while referring to EC 7 to allow comparison between the EC and Preda criteria.

Table 3
Preda Criteria

| N° of criteria satisfied (“yes” rates) | N° of directors | percentage | cumulative percentage |
|--|------------------------|-------------------|----------------------------------|
| 5 | 5 | 1.8 | 1.8 |
| 4 | 18 | 6.3 | 8.1 |
| 3 | 201 | 70.8 | 78.9 |
| 2 | 59 | 20.8 | 99.6 |
| 1 | 1 | 0.4 | 100 |
| Total | 284 | 100 | |

A further indicator is given by the number of directors who show compliance with both Preda and EC criteria. As seen in Table 3, only for 5 directors out of 284, that is 2% of the total, is it possible to verify compliance with all 5 Preda independence criteria. Even considering those directors who show compliance with 4 out of 5 independence criteria, the total number of directors is 18, that is 6% of the total population. This means that the directors who show compliance at least with 4 out of 5 Preda criteria add up to 8% of the total population. The bulk of the directors included in the population (71%) show compliance with 3 requirements out of 5. Overall, for 92% of directors the level of compliance is between 2 and 3 criteria out of 5.

Table 4
EC Criteria (EC7)

| N° of criteria satisfied ("yes" rates) | N° of directors | percentage | Cumulative percentage |
|---|-----------------|------------|--------------------------|
| 7 | 4 | 1.4 | 1.4 |
| 6 | 13 | 4.6 | 6 |
| 5 | 92 | 32.4 | 38.4 |
| 4 | 106 | 37.3 | 75.7 |
| 3 | 60 | 21.1 | 96.8 |
| 2 | 8 | 2.8 | 99.6 |
| 1 | 1 | 0.4 | 100 |
| Total | 284 | 100 | |

The picture does not change much if we consider the number of directors who show compliance with EC 7 criteria (Table 4). Only for 4 directors (1% of the total) is it possible to verify compliance with all 7 criteria, while 13 directors show compliance with 6 out of 7 criteria. This means that directors who show compliance with at least 6 out of 7 independence criteria add up to 6% of the total number of directors considered in our inquiry. As for Preda criteria, we find the bulk of directors at the center of the distribution, in this case between 3 and 5 criteria out of 7, where we find 91% of the population. This can also be seen in Table 5, which shows that in the area between 3 and 5 EC Criteria and 2 and 3 Preda criteria we find about 91% of the total population of 284 directors.

Table 5
**Joint frequency
of criteria (%)**

| Preda criteria | EC 7 | | | | | | | | Total |
|----------------|----------|------|------|-------|-------|-------|------|------|-------|
| | criteria | 1 | 2 | 3 | 4 | 5 | 6 | 7 | |
| 1 | | 0.0 | 0.0 | 0.35 | 0.0 | 0.0 | 0.0 | 0.0 | 0.35 |
| 2 | | 0.35 | 2.11 | 9.86 | 8.10 | 0.35 | 0.0 | 0.0 | 20.77 |
| 3 | | 0.0 | 0.7 | 10.92 | 29.23 | 29.93 | 0.0 | 0.0 | 70.77 |
| 4 | | 0.0 | 0.0 | 0.0 | 0.0 | 2.11 | 4.23 | 0.0 | 6.34 |
| 5 | | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.35 | 1.41 | 1.76 |
| | Total | 0.35 | 2.82 | 21.13 | 37.32 | 32.39 | 4.58 | 1.41 | 100 |

The same result is visible if we consider the complete set of EC criteria (Table 6): in this case about 91% of the total population of 284 directors can be found in the area between 2 and 3 Preda criteria and about 74% of the 284 directors are between 4 and 6 EC criteria.

Table 6

| Joint frequency of criteria (%) | | | | | | | | | | | | Total |
|---------------------------------|----------------|------|------|-------|-------|-------|------|------|------|------|------|-------|
| Preda criteria | EC 11 criteria | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | |
| 1 | | 0.0 | 0.0 | 0.35 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.35 |
| 2 | | 0.35 | 2.82 | 8.45 | 7.39 | 1.06 | 0.70 | 0.0 | 0.0 | 0.0 | 0.0 | 20.77 |
| 3 | | 0.0 | 1.41 | 10.56 | 23.24 | 22.89 | 4.23 | 4.93 | 3.52 | 0.0 | 0.0 | 70.77 |
| 4 | | 0.0 | 0.0 | 0.0 | 0.0 | 0.35 | 1.06 | 1.06 | 2.11 | 1.41 | 0.35 | 6.34 |
| 5 | | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.35 | 0.35 | 1.06 | 1.76 |
| | Total | 0.35 | 4.23 | 19.37 | 30.63 | 24.30 | 5.99 | 5.99 | 5.99 | 1.76 | 1.41 | 100 |

Finally, the reason the results for Preda and EC criteria are very close is that, as shown in par. 2.1, out of the 11 criteria included by the EC Recommendation only 3 are different from the ones provided by the Preda Code. Table 7 compares compliance between the 5 Preda criteria and the 3 “new” EC criteria (EC_C, EC_G, and EC_H):

Table 7

| Independent directors (%) | EC* | | | | | Total |
|---------------------------|------|-------|-------|-------|--|-------|
| Preda | 0 | 1 | 2 | 3 | | |
| 1 | 0.0 | 0.0 | 0.35 | 0.0 | | 0.35 |
| 2 | 0.35 | 2.11 | 9.86 | 8.45 | | 20.77 |
| 3 | 0.7 | 10.92 | 29.23 | 29.93 | | 70.77 |
| 4 | 0.0 | 0.0 | 2.11 | 4.23 | | 6.34 |
| 5 | 0.0 | 0.0 | 0.35 | 1.41 | | 1.76 |
| Total | 1.06 | 13.03 | 41.90 | 44.01 | | 100 |

*cross-directorship (EC_G), permanence on the board (EC_H), additional remuneration (EC_C)

The table shows that the three “new” EC criteria impose a further selection. Considering, for instance, the 71% of directors who show compliance with 3 out of 5 Preda criteria, we observe that for only less than half of them it is possible to verify compliance with all three “new” EC criteria.

3.2 Compliance with Preda criteria

It could be said that, apart from “no” rates, lack of disclosure (“ns” rates) may be due to the difficulty in providing information to allow investors to verify compliance with independence requirements. The purpose of this subsection is to provide an answer to this observation by examining compliance for each criterion separately (Table 8).

- PR_A (business relationships) and PR_E (other commitments)

Respectively, 96% and 84% of the 284 independent directors do not show compliance with these two independence requirements. More specifically, for PR_A 11% of the directors receive a “no” rate while 85% of directors receive an “ns” rate. For PR_E, 69% of the directors receive a “no” rate while 14% of directors receive an “ns” rate.³⁵

- PR_B (shares owned)

The percentage of “yes” rates for this criterion is very high: 99%. This means that very few independent directors own controlling shares (or shares that give a considerable influence) in the company on whose board they sit.

- PR_C (family ties)

The percentage of “yes” is 79%. As specified in Annex B, for this criterion we relied only on issuers’ statements, something which explains the absence of “no”.

Even so, there is a sizable percentage of “ns” (21%) due to the fact that in such cases issuers did not state explicitly that independent directors had no family ties with subjects referred to in PR_A and PR_B.

- PR_D (professional qualification)

89% of directors show compliance with this criterion. As specified in Annex B, as this criterion is very difficult not only to verify but also to define, we adopted a rather “generous” interpretation.

The conclusion so far is that behind the general rate of compliance with the Preda independence criteria (58%), which is already rather low, lies a very diversified situation. First, there is a very low degree of compliance (as measured by the percentage of “yes” rates relative to total rates) for the PR_A and PR_E requirements. It is not necessary to stress that both criteria are essential prerequisites for director independence, or at least that without them it is not possible to talk about a director being independent.

Secondly, PR_A and PR_E are also two criteria that can be more easily verified (as shown in Annex B, par. B3), while two of the requirements that show the highest level of compliance (PR_C and PR_D) are also the less verifiable ones. The answer to the question we asked above is then that lack of disclosure is not connected with criteria that are difficult to verify.

³⁵ It is important to notice that for this last criterion the database available refers only to commitments in listed companies and large unlisted companies.

Table 8

| Preda code | N° of directors | Percentage | cumulative percentage |
|--|------------------------|-------------------|------------------------------|
| PR_A Business relationship | | | |
| No | 32 | 11.3 | 11.3 |
| Ns | 240 | 84.5 | 95.8 |
| Yes | 12 | 4.2 | 100 |
| Total | 284 | | |
| PR_B Shares owned | | | |
| No | 2 | 0.7 | 0.7 |
| Yes | 282 | 99.3 | 100 |
| Total | 284 | | |
| PR_C Family ties | | | |
| Ns | 59 | 20.8 | 20.8 |
| Yes | 225 | 79.2 | 100 |
| Total | 284 | | |
| PR_D Professional qualification | | | |
| No | 1 | 0.4 | 0.4 |
| Ns | 29 | 10.2 | 10.6 |
| Yes | 254 | 89.4 | 100 |
| Total | 284 | | |
| PR_E Other commitments | | | |
| No | 196 | 69.0 | 69.0 |
| Ns | 42 | 14.2 | 83.8 |
| Yes | 46 | 16.8 | 100 |
| Total | 284 | | |

From these two points we draw a first conclusion that, to an important extent, independence criteria are either not verifiable or are contradicted by company disclosure. Although, as specified above (par. 2), director independence should not be seen mechanically as compliance with independence criteria, these results still cast a strong doubt on the independence of Italian independent directors.

3.3 Compliance with EC independence criteria (Table 9)

We begin by examining the five EC criteria that correspond³⁶ to PR_A.

- EC_A (executive in the (assoc.) company)

As seen in Table 9, only 8.5% of directors show compliance with this criterion with the rest distributed between 66.5% of “ns” rates and 26.1% of “no” rates. The level of “yes” rates is very close to PR_A, something which tells us that EC_A mimics PR_A as far as compliance is concerned. The difference between EC_A and PR_A lies essentially in the higher percentage of “no” rates in EC_A which is attributable to the fact that the Preda Code explicitly excludes that directors belonging to executive committees be considered as executives, while the EC Recommendation does not.

³⁶ With the important point made in par. 2.1.

- EC_B (employee in the (assoc.) company)

In this case, compliance is at 21.5%, while 77.5% is made up of “ns” rates, with just 1% of “no” rates.

- EC_D (representing controlling shareholders)

Compliance here is at 89.8%, which allows the conclusion that the directors considered within our population are not related to or identifiable with controlling shareholders. This conclusion is also confirmed by the results in PR_B (see above par. 3.2).

- EC_E (business relationships)

This criterion presents a level of compliance very close to EC_A (and PR_A). Again, in this case, lack of transparency is the main factor (82.7%), while non-compliance is at 6.7%. Overall, EC_E replicates the lack of disclosure already seen for EC_A, which is essentially attributable to the fact that the directors’ CVs were absent or incomplete.

- EC_F (external auditor)

Compliance here is at 22.5%, while the remaining 77.5% is made up of “ns” rates. The latter result is attributable mainly to lack of or incomplete CVs, just as in EC_B and EC_E.

The conclusion on the 5 criteria that add up to PR_A is that the dramatically low level of compliance in PR_A is attributable essentially to lack of disclosure and to relationships of some kind (executive, business, employee) with the company or the associated company rather than relationships with controlling shareholders. Moreover, when there is mandatory disclosure, as in EC_A, the percentage of “no” rates becomes very significant.

Table 9

| | N° | Percentage | cumulative percentage |
|---|------------|------------|-----------------------|
| EC_A executive in the (ass.) company | | | |
| No | 74 | 26.1 | 26.1 |
| Ns | 186 | 65.5 | 91.6 |
| Yes | 24 | 8.5 | 100 |
| Total | 284 | 100 | |
| EC_B employee (associated) company | | | |
| No | 3 | 1.1 | 1.1 |
| Ns | 220 | 77.5 | 78.5 |
| Yes | 61 | 21.5 | 100 |
| Total | 284 | 100 | |
| EC_C additional remuneration | | | |
| No | 32 | 11.3 | 11.3 |
| Ns | 25 | 8.8 | 20.1 |
| Yes | 227 | 79.9 | 100 |
| Total | 284 | 100 | |
| EC_D controlling shareholder | | | |
| No | 7 | 2.5 | 2.5 |
| Ns | 22 | 7.7 | 10.2 |
| Yes | 255 | 89.8 | 100 |
| Total | 284 | 100 | |
| EC_E business relationships | | | |
| No | 19 | 6.7 | 6.7 |
| Ns | 235 | 82.7 | 89.4 |
| Yes | 30 | 10.6 | 100 |
| Total | 284 | 100 | |
| EC_F external auditor | | | |
| Ns | 220 | 77.5 | 77.5 |
| Yes | 64 | 22.5 | 100 |
| Total | 284 | 100 | |
| EC_G cross-directorships | | | |
| No | 33 | 11.6 | 11.6 |
| Yes | 251 | 88.4 | 100 |
| Total | 284 | 100 | |
| EC_H permanence on the board | | | |
| No | 27 | 9.5 | 9.5 |
| Ns | 85 | 29.9 | 39.4 |
| Yes | 172 | 60.6 | 100 |
| Total | 284 | 100 | |
| EC_I family ties | | | |
| Ns | 59 | 20.8 | 20.8 |
| Yes | 225 | 79.2 | 100 |
| Total | 284 | 100 | |
| EC_L professional qualification | | | |
| No | 1 | 0.4 | 0.4 |
| Ns | 29 | 10.2 | 10.6 |
| Yes | 254 | 89.4 | 100 |
| Total | 284 | 100 | |
| EC_M other commitments | | | |
| No | 196 | 69.0 | 69.0 |
| Ns | 42 | 14.8 | 83.8 |
| Yes | 46 | 16.2 | 100 |
| Total | 284 | 100 | |

As for the three criteria that differentiate EC from Preda criteria, we will examine first EC_C and EC_H and then move on to EC_G, for which a different approach is required.

- EC_C (additional remuneration)

This criterion presents a high rate of compliance (80%), while the remaining rates are distributed between lack of disclosure (9%) and non-compliance (11%).

- EC_H (permanence on the board)

This criterion presents a majority rate of compliance (60.6%). However, an important 39.4% of the cases is distributed between “ns” rates (29.9%) and “no” rates (9.5%).

The conclusion on the first two criteria that differentiate EC from Preda is that while a high percentage of directors does not have any additional remuneration from the company or associated companies, there is a significant percentage of directors who either were on the board for such a long time as to put into doubt their independence of judgement or for whom disclosure of the length of their permanence on the board is not given. It is important to have in mind that since, as specified in Annex B, disclosure provided by the Consob website in this respect goes as far as 1998, “ns” rates in this case were assigned to directors for whom their permanence on the board was not specified and who were reported by Consob website to be on the same board since 1998. So, in this case, “ns” rates could be seen as being close to “no” rates.

- EC_G (cross-directorships)

As seen in Table 9, 88% of directors show compliance with this requirement, while the remaining 12% show non-compliance.³⁷

It is also interesting to check which companies are involved in such cross-directorships established through independent directors (see Annex B for the illustration of this criterion). The logic is that cross-directorships are part of an underlying cooperative behavior between two or more companies, so that the specific directors involved are part of a wider game.³⁸ In Table 10, we have indicated the companies involved in cross-directorships links (thin arrows). In the first place, we find that 31 listed companies are involved in such cross-directorships, of which 22 belong to the S&P/MIB index. Moreover, this web closely corresponds to the web of shareholdings among the same companies as represented in the same Table 10 (arrows in bold).³⁹ The conclusion is that cross-directorships formed by independent directors follow relationships of cross-ownership. This suggests that the role of independent directors in such companies may

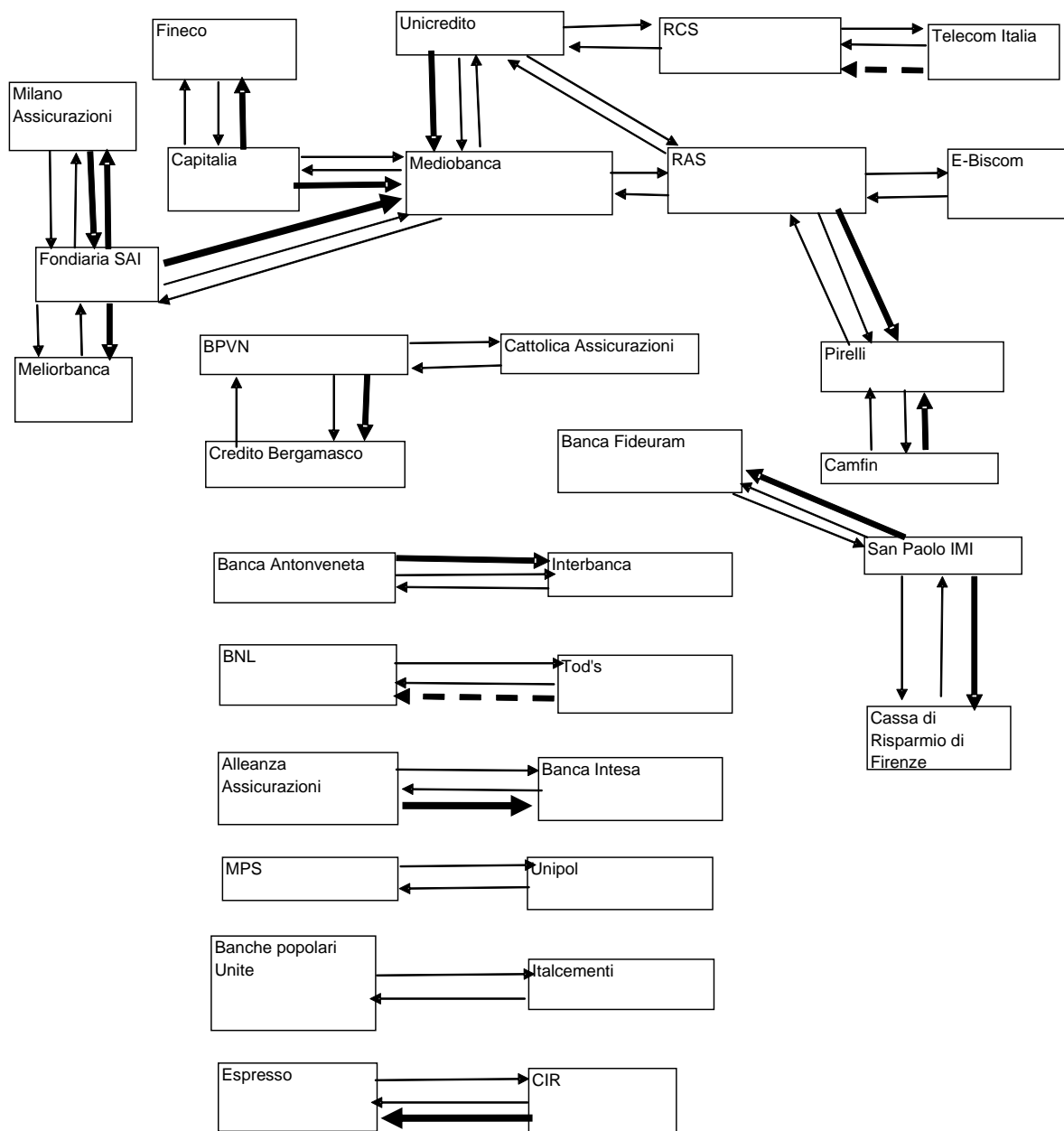
³⁷ It is important to remember that, as explained in Annex B, the database provided by Consob to verify this criterion does not include unlisted companies. It is then possible that there are other cross-directorships that went unnoticed in our inquiry.

³⁸ For an illustration of the logic of the most consolidated cross-directorships system in Italy, the Mediobanca system, see De Cecco and Ferri 1986.

³⁹ Arrows in bold indicate shareholdings of at least 2% considered by the Italian regulation (art. 120 (2) Italian consolidated law on financial intermediation, or TUF) as indicating a significant interest in the company; dotted arrows indicate shareholdings held by controlling shareholders of the company in question.

be influenced by controlling or significant shareholders, something which would contradict their independence.

Table 10
Cross-directorships and ownership links⁴⁰



⁴⁰ Thin arrows refer to cross-directorship links; arrows in bold refer to ownership links (above 2% of total voting shares); dotted arrows in bold to ownership links (above 2% of total voting shares) involving a controlling shareholder of the company.

3.4 Where are the watchdogs?

From the results described in the previous paragraphs, it emerges that there is a need for greater disclosure on what Italian listed companies declare about their independent directors. This being, to our knowledge, the first attempt to verify to what extent companies justify the independence requirements of their independent directors, it appears that until now the financial community and the Italian stock exchange have been satisfied by the present level of disclosure.

Verifying how independent independent directors are belongs to the wider subject of the actual implementation of voluntary corporate governance codes by those issuers that have announced they are adopting them. It is a subject on the forefront of the corporate governance debate. As reported by OECD (2003), the last decade has seen an effort by national and multilateral fora to identify what a corporate governance code should contain, including a reference to independent directors. This phase has found a first conclusion with the approval of the new OECD guidelines for corporate governance (OECD 2004) and, at the EU level, with the introduction of the EC Recommendation on independent directors (European Commission 2005). Presently, at the top of the agenda is the necessity of being sure that, once companies declare they have adopted a voluntary corporate governance code, they actually provide such a level of disclosure as to give investors the ability to verify such a declaration, to a reasonable extent.⁴¹

In its final provisions, the EC Recommendation invites EU Member States to take the necessary measures to promote the application of the principles set out in the same Recommendation. It is in the spirit of the Recommendation, if not in its letter, that Member States should also introduce procedures to verify adherence to the independence requirements by those issuers that have declared to have adopted them.

From one of the few success stories in this field, the British Cadbury Code⁴², it is possible to have an idea about the way to ensure adherence to such codes. The Cadbury Code has been adopted by a great number of companies listed on the London Stock Exchange (LSE). What is more important in this context is that the bylaws provided by the LSE delegate outside auditors to verify the actual implementation of the code.⁴³

More in general, it would be advisable that, once listed companies declare they have adopted some provisions of a corporate governance code, they give adequate disclosure.⁴⁴ In this respect, a recent Italian Law⁴⁵ states that Italian listed companies must disclose yearly (according to the modalities which will be established by the Consob), information regarding the adherence to Conduct Codes and the compliance with the requirements provided by the same Codes, explaining the reason of possible non-compliance (non fulfilment). Moreover, the law also introduces sanctions against directors who make false statements about the respect of the rules provided by conduct codes of listed companies. Finally, the same law gives the Consob the task to verify that companies' declaration regarding the respect of the requirements provided by the Codes they declare to adopt are true.

⁴¹ OECD 2003, p. 31-35.

⁴² The text can be downloaded free of charge from www.ecgi.org

⁴³ OECD 2003, p. 32.

⁴⁴ For the pros and cons of relying on control by financial markets vs. stock markets or public authorities, see Belcredi 2005.

⁴⁵ Law 262/2005 "Disposizioni per la tutela del risparmio e la disciplina dei mercati finanziari" which came into force on 12 January 2006.

3.5 A Remark on the role of independent directors

As pointed out in the introduction, the present paper does not deal with the theory of director independence: it is based on the observation that independent directors are widely considered a cornerstone of modern corporate governance even though there are a few authoritative voices who are sceptical that real independence may be achieved. However, the results of our study beg the following question: if it is allegedly so easy for companies to find independent directors who respect independence requirements formally but not substantially, why is it that they do not manage to reach a high level of disclosure?

4. CONCLUSION

In this article we have provided an interpretation for the independence requirements contained in the Preda Code and have checked them against a proxy for international best practice, the EC Recommendation on non-executive or supervisory directors of 2005.

We have also checked whether company disclosure for 2003 allows the verification of compliance with independence requirements. For only 5 out of all 284 directors declared as independent by the 40 issuers considered in our study is it possible to verify adherence to all independence criteria set by the Preda Code (criteria the directors and their companies declared to follow), and for only 18 directors out of 284 is it possible to verify adherence to at least 4 out of 5 criteria.

More in particular, looking at two key Preda criteria, for 96% of directors either it is not possible to verify the absence of business relationships with the company or an associated company or such independence is contradicted by company disclosure; and for 84% of directors, company disclosure either contradicts the requirement that independent directors have sufficient time to discharge their tasks or does not allow its verification.

Checking company disclosure against the EC Recommendation, it also emerges that: for only 4 out of 284 independent directors it is possible to verify the adherence to all EC independence criteria; there is a significant percentage of directors for whom it is either verified or there exists a possibility that they had such a long permanence on the board as to put into doubt their independence of judgment; and, finally, independent directors contribute to establish cross-directorships across listed companies along the same lines as cross-ownership, something which suggests that at least some independent directors play an ancillary role with respect to controlling shareholders.

The results of our study suggest that in almost all cases company disclosure either contradicts alleged director independence or does not allow to verify it. In this respect, a few possibilities exist. On the one hand, the financial community or public opinion in general should verify that the provisions of the Preda Code are applied, and the present article represents a contribution in this direction. Another possibility is that the Italian stock exchange or another authority monitor verify and disclose what issuers declare about their independent directors and adopt sanctions when needed. In this last respect, it is interesting to notice that a recent Italian law puts such a burden on the Italian stock market regulator (Consob).

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Annex A: companies included in our population

The following companies are included in our population. They made the S&P-Mib 40 Index as of September 17, 2004.

| Company | N. of directors qualified as independent |
|-----------------------------------|---|
| Alleanza Assicurazioni | 9 |
| Assicurazioni Generali | 13 |
| Autogrill | 4 |
| Autostrade | 4 |
| Banca Antonveneta | 3 |
| Banca Fideuram | 2 |
| Banca Intesa | 7 |
| Banca Monte dei Paschi di Siena | 16 |
| Banca Popolare di Milano | 20 |
| Banche Popolari Unite | 20 |
| Banco Popolare di Verona e Novara | 19 |
| Benetton | 3 |
| BNL | 11 |
| Bulgari | 3 |
| Capitalia | 6 |
| E.Biscom (Fastweb) | 2 |
| Edison | 3 |
| Enel | 6 |
| ENI | 7 |
| Fiat | 5 |
| Finmeccanica | 8 |
| Fondiaria SAI | 10 |
| Gruppo Editoriale l'Espresso | 6 |
| Italcementi | 6 |
| Luxottica | 3 |
| Mediaset | 4 |
| Mediobanca | 5 |
| Mediolanum | 3 |
| Mondadori | 3 |
| Pirelli & Co | 7 |
| RAS | 12 |
| RCS Mediagroup spa | 3 |
| San Paolo IMI | 12 |
| Seat Pagine Gialle | 3 |
| Snam Rete Gas | 2 |
| STMicroelectronics | 7 |
| Telecom Italia | 5 |
| Telecom Italia Mobile | 5 |
| Tiscali | 2 |
| Unicredito | 15 |
| Total | 284 |

Annex B: interpretation of the independence criteria

In this annex, we illustrate in detail our interpretation of the independence criteria set by the Preda Code and by the EC Recommendation. Such interpretation, although based on official documents, is to be considered as a free interpretation of the authors. It is not to be considered under any circumstances an official interpretation.

B.1: Preda criteria

PR_A (business relationships)

[Independent directors] “do not entertain, directly or indirectly or on behalf of third parties, nor have recently entertained business relationships with the company, its subsidiaries, the executive directors or the shareholder or group of shareholders who controls the company of a significance able to influence their autonomous judgement.”⁴⁶

We interpret the expression “indirectly” as involving not only the independent directors in person but also members of their families; professional partnerships of which independent directors are members; companies controlled by independent directors directly or indirectly; companies controlled by independent directors’ family members directly or indirectly; companies of which independent directors are executive directors⁴⁷ or managers; and companies of which independent directors’ family members are executive directors or managers.⁴⁸

In regard to the term “recently”, the Preda code (point 3.2, page 7) states that: “... In the case of earlier business dealings, reference should be made to the previous financial year and for work relationships and functions of executive director, to the three preceding financial years.” This means that the present criterion (PR_A) applies to the three previous financial years only when the independent director is at the same time executive director, consultant, employee, lawyer, representative of the company, the controlling shareholder, or the subsidiaries.⁴⁹ In this respect, a complete CV of the independent director is needed to allow verification of the present criterion.

We interpret the expression “business relationships” as including relationships with (i) a significant supplier of goods or services (including financial, legal, advisory, or consulting

⁴⁶ Preda Code, art. 3.1 (a)

⁴⁷ The Preda Code uses the more general term of “directors” (“amministratori” in Italian), which we interpret in this context more restrictively as executive directors.

⁴⁸ Such an interpretation is based on the following passage of the Preda Code: “For the purpose of assessing independence, ‘indirect’ business and shareholder relationships are also taken into consideration. It is therefore necessary to consider relationships between: on the one hand, directors, members of their families, the professional partnerships of which they are members, the companies they or members of their families control directly or indirectly, and the companies of which such persons are directors or managers and, on the other hand, the company in question, the shareholders who, directly or indirectly, control it, the executive directors, and the companies such persons control directly or indirectly.”

⁴⁹ On the other hand, the present criterion (PR_A) does not apply if the independent director is also the non-executive director or member of the Italian “collegio sindacale” of the controlling shareholder, associated companies, companies that the corporation consolidates. This interpretation is based on art. 3.1 (c) of the Preda Code (see below) which states that an independent director cannot be an immediate family member of executive directors of the company or of persons in the situations referred to in points a) and b) of art. 3.1. From this must follow that the independent director must not be *himself* an executive director of the company or a person in the situations referred to in points a) and b) of art. 3.1.

services), (ii) a significant customer, and (iii) organizations that receive significant contributions from the company or its group.⁵⁰

In all such cases, independent directors should not have business relationships with: the company in question (on whose board the independent director sits); controlling shareholders (directly or indirectly)⁵¹; the executive directors of the company on whose board the independent director sits; the companies controlled directly or indirectly by the company in question, or its controlling shareholders and its executive directors.

Concerning the term “executive directors”, the Preda code specifies that members of the executive committee are not to be considered executive directors.

We interpret the term “control” with reference to art. 1, par. 1, 7th Company Directive.⁵² The same for the term “subsidiaries”, defined in the Italian version of the Code as “controllate”. This means that we consider controlling shareholders those who appoint the majority of the board; and that in case of controlling agreements, all participants to such agreements are to be considered controlling shareholders.

PR_B (shares owned)

[Independent directors] “neither own, directly or indirectly⁵³ or on behalf of third parties, a quantity of shares enabling them to control⁵⁴ the company or exercise a considerable influence⁵⁵ over it nor participate in shareholders’ agreements to control the company.”⁵⁶

We interpret the term “significant influence” (or considerable influence) with reference to IAS 28: significant influence (influenza notevole) is the power to participate in the financial and operating policy decisions of the investee but is not control over those policies. An example of this case would be the participants in a minority shareholders’ agreement or a minority shareholder owning a sizable and relevant percentage of total shares. According to the Italian Civil Code, a “significant influence” in a listed company occurs if a shareholder, directly or indirectly, owns at least 10% of the total capital. However, we think that IAS 28 gives a better proxy for the requirement made by Assonime (2004), par. 6.2.3, in that “Independence in directors is a quality that must be assessed substantively, and not only formally, with respect to parameters listed in the Code.”

⁵⁰ This interpretation is based on the EC Recommendation on independent directors, Annex 1, e).

⁵¹ If the controlling shareholder is a state-owned entity, the economic link does exist if the independent director of the company concerned is a consultant, employee, executive director of another state-owned entity; it does not exist if the independent director of the company concerned is a non-executive director in another state-owned entity or is a public employee enjoying autonomous status (such as university professors).

⁵² http://europa.eu.int/servlet/portail/RenderServlet?search=DocNumber&lg=en&nb_docs=25&domain=Legislative&coll=&in_force=NO&an_doc=1983&nu_doc=349&type_doc=Directive

⁵³ With specific reference to the term “indirectly”, the Preda code states that: “For the purpose of assessing independence, “indirect” business and shareholder relationships are also taken into consideration. It is therefore necessary to consider relationships between: on the one hand, directors, members of their families, the professional partnerships of which they are members, the companies they or members of their families control directly or indirectly, and the companies of which such persons are directors or managers and, on the other hand, the company in question, the shareholders who, directly or indirectly, control it, the executive directors, and the companies such persons control directly or indirectly.”

⁵⁴ For the interpretation of the term “control”, see above explanation in first requirement.

⁵⁵ Reg. (EC) No. 2238/2004 of 29 December 2004.

⁵⁶ Preda Code, art. 3.1 (b)

PR_C (family ties)

[Independent directors] “are not immediate family members of executive directors of the company or of persons in the situations referred to in points a) and b).”⁵⁷

We interpret “close family member” according to the definition provided by Regulation 1725/2003, footnote 32 (clarifying the content of IAS 24): “Close members of the family of an individual are those that may be expected to influence, or be influenced by, that person in their dealings with the enterprise.”⁵⁸

We consider the present criterion to be satisfied by the company when specific and explicit reference to it is made in the relevant company documents (annual report or governance statement); we consider it not satisfied when the relevant documents of the company concerned make only general reference to the respect of the independence criteria of the Preda code as a whole, without specifying either that the independent director is not an immediate family member of the executive directors of the company or of persons in the situations referred to in points a) and b) or that the independent director satisfies the criteria established in article 3.1 of the Preda code.⁵⁹

PR_D (professional qualification)

Independent directors are required to be professionally qualified persons.⁶⁰

For the verification of the present criterion we decided, even in absence of a complete CV, to deduct professional qualification from the number and quality of present positions held by the independent director.

PR_E (other commitments)

“Directors shall accept their appointment to the board when they deem they can devote the necessary time to the diligent performance of their duties, taking account, among other things, of the number of positions they hold on the boards of directors or auditors of other companies listed on regulated markets, including foreign markets, financial companies, banks, insurance companies and large companies.”⁶¹

We interpret this requirement as meaning that the director should not hold more than 2 tasks involving directorships in companies (including the one held in the concerned company) and 2 tasks different from directorships in companies, such as being a university professor, a professional lawyer, and so on. In this last respect, we only consider full-time commitments and do not include honorary or part-time commitments, such as editor of a scientific journal or chairperson or member of the board of a museum or other not-for-profit entity. As a general rule, we assigned “yes”, “no”, and “ns” on the basis of present commitments as

⁵⁷ Preda Code, art. 3.1 (c)

⁵⁸ Commission Regulation (EC) No 1725/2003 of 29 September 2003 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council. http://europa.eu.int/smartapi/cgi/sga_doc?smartapi!celexapi!prod!CELEXnumdoc&lg=en&numdoc=32003R1725&model=guichett

⁵⁹ The present interpretation, which may seem formalistic, should be read keeping in mind the difficulty of verifying the present criterion, as illustrated in par. 2.5.

⁶⁰ Preda Code, paragraphs 2.1/2.2

⁶¹ Preda Code, paragraph 1.3

reported by the company's corporate governance statement and by the director's CV. In cases in which corporate governance statements did not report other commitments and there was no CV available, we assigned "yes". We assigned "ns" when there was no CV and the director had another commitment apart from being independent director in the company under scrutiny. The rationale was that in these cases it was not possible to exclude that the director had other extra-company, full-time commitments.

This interpretation is based on the results of an empirical study conducted by Protiviti (2004) on the commitments of directors in Italian listed companies. According to the study, independent directors who also sit on three other committees of the same company (audit committee, remuneration committee, nomination committee) have an average of 25 meetings per year. For independent directors who sit on three company boards, this would mean that they would have 75 meetings per year, roughly one every three working days. It is true that in several cases independent directors do not sit on all three committees at the same time. On the other hand, there is a high variance in the average number of meetings of the audit and remuneration committee. For instance, the average yearly number of audit committee meetings is 7, but the maximum is 17. For the remuneration committee, the average number of meetings is 4 but the maximum is 19. Moreover, in several cases Italian independent directors also sit on executive committees, whose meetings are not considered in the *Protiviti* count.

Our interpretation reflects the important workload that an independent director is supposed to take on each specific board where she serves. For instance, the corporate governance rules of the New York Stock Exchange⁶² identify the tasks involved in being a member of the nominating, remuneration and audit committees, stressing in particular the "demanding role and responsibilities" of being a member of the audit committee, going on to enumerate the numerous tasks that audit committee members are required to fulfil. Moreover, the same corporate governance rules require all "non-management directors" of a company to meet at regularly scheduled executive sessions without management. Finally, independent directors, irrespective whether they also sit on a board committee, are expected to systematically check all important management decisions to prevent conflicts of interest and to systematically review all company disclosure to catch disclosure problems that outside reviewers may miss.⁶³

Another empirical argument in favor of the present interpretation comes from a recent paper by Fich and Shivdasani (2004), who find that (p. 1) "When a majority of outside directors serve on three or more boards, firms exhibit lower market-to-book ratios as well as weaker operating profitability."

Finally, it should be considered that we assigned "yes" whenever the issuer gave an explanation why an independent director who has a higher number of commitments should nonetheless be considered compliant with this criterion.⁶⁴

⁶² <http://www.nyse.com/pdfs/finalcorpgovrules.pdf>

⁶³ Black 2001.

⁶⁴ In this we followed the general rule recommended by the Higgs Report (p. 37): "The board should state its reasons if a director is considered to be independent notwithstanding the existence of relationships or circumstances which may appear relevant to its determination."

B.2: EC criteria

In this paragraph, we illustrate our interpretation of the independence criteria set by the EC Recommendation. Such interpretation, although based on official documents, is to be considered as a free interpretation of the authors. It is not to be considered under any circumstances an official interpretation.

EC_A (executive in the (assoc.) company)

[The independent director should] “not...be an executive or managing director of the company or an associated company, and not having been in such a position for the previous five years.”⁶⁵

We interpret the term “associated company” as parent companies, subsidiaries and in general companies falling within the consolidation perimeter as defined by art. 1, par. 1, 7th Company Law Directive.

We interpret the term “executive” as including those board members who also sit on the executive committee (where present) of the same company. Such an interpretation is based on the fact that the EC Recommendation specifies that (art. 2.3): “the term executive director means any member of the administrative body (unitary board) who is engaged in the daily management of the company.” On the other hand, we observe that executive committees in Italian listed companies are entrusted with the daily management of the company.⁶⁶ We remind that such interpretation, as all interpretations to the Preda Code and the EC Recommendation provided in this study, engages only the responsibility of the authors and is not to be considered under any circumstances an official interpretation.

EC_B (employee of the (assoc.) company)

[The independent director should] “not...be an employee of the company or an associated company, and not having been in such a position for the previous three years, except when the non-executive or supervisory director does not belong to senior management and has been elected to the (supervisory) board in the context of a system of workers’ representation

⁶⁵ EC Recommendation, ANNEX 1. (a)

⁶⁶ To show that members of executive committees in Italian listed companies do have a role in the management of their companies, we report here the relevant parts taken from a couple of financial statements. The first one is from Banca Popolare di Milano, Bilancio sociale del gruppo Bipiemme per il 2004, p. 47. <http://www.borsaitalia.it/media/borsa/db/pdf/new/11317.pdf> : “Amministrazione. Al Comitato Esecutivo, in forza della delega, sono stati attribuiti prevalentemente poteri di proposta e di esame in materia di indirizzo strategico, di politiche generali, di bilancio, di previsione di spesa e di investimenti. Esegue inoltre tutte le delibere affidategli dal Consiglio di Amministrazione.” The second one is from Banco popolare di Verona e Novara, Relazione annuale sulla corporate governance per l’anno 2003, p. 98. <http://www.borsaitalia.it/media/borsa/corporgo/new/3605.pdf> : ““È stato costituito un Comitato Esecutivo, composto da 9 membri, il cui funzionamento è regolato all’art. 41 dello statuto sociale. Il Comitato si riunisce di norma nelle settimane in cui non si riunisce il Consiglio di amministrazione. Per esigenze di snellezza e di efficienza operativa, il Consiglio medesimo ha delegato al Comitato Esecutivo proprie competenze, in particolare in materia di: erogazione del credito; emissione di prestiti obbligazionari; personale (assunzioni, promozioni, provvedimenti disciplinari, ecc.) con esclusione dei dirigenti; locazioni; transazioni su partite in sofferenza o incagli entro limiti prestabiliti. Delle deliberazioni assunte dal Comitato Esecutivo viene data notizia al Consiglio di amministrazione nella sua prima riunione in conformità all’art. 44 dello Statuto sociale.”

recognised by law and providing for adequate protection against abusive dismissal and other forms of unfair treatment.”⁶⁷

We interpret the expression “previous three years” as to the previous three financial years.

EC_C (additional remuneration)

[The independent director should] “not...receive, or have received, significant additional remuneration from the company or an associated company apart from a fee received as non-executive or supervisory director. Such additional remuneration covers in particular any participation in a share option or any other performance-related pay scheme; it does not cover the receipt of fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with the company (provided that such compensation is not contingent in any way on continued service).”⁶⁸

For the term “associated company”, see the interpretation provided for EC_A.

We interpret “additional remuneration” as having received shares from the same company or from controlling companies as a remuneration or in any case without consideration. On the other hand, shares purchased by the director with her own means (whatever the number) are not relevant in this context.

We interpret the term “significant” as any sum larger than EUR 50,000. This sum is relevant vis-à-vis the average remuneration of independent directors. For instance, according to a survey quoted by Higgs (2003), the annual suggested pay for independent directors is between £40,000 and £60,000 for FTSE 100.⁶⁹ Moreover, the significance threshold fixed by Borsa Italiana for related party transactions is EUR 50,000.⁷⁰ The same applies also to the significant threshold established by PR_A and EC_E.

We interpret the term “in particular” as: not exclusively. This means that, as regards remuneration received from an associated company, additional means not necessarily stock options or other performance-related pay schemes.⁷¹

EC_D (representing controlling shareholders)

[The independent director should] “not...be or represent in any way the controlling shareholder(s) (control being determined by reference to the cases mentioned in Article 1(1) of Council Directive 83/349/EEC.)”⁷²

We interpret “represent” as also meaning executive director. See above for the definition of executive director.

⁶⁷ EC Recommendation, ANNEX 1. (b)

⁶⁸ EC Recommendation, ANNEX 1. (c)

⁶⁹ Par. 12.23, p. 56.

⁷⁰ Borsa Italiana, Regolamento dei mercati organizzati e gestiti da Borsa Italiana in material di internal dealing.

⁷¹ See Cappiello 2005, p. 107-110 for a survey of the academic literature on this criterion, with a particular emphasis on the positions favorable to allowing a certain degree of flexibility: according to the author, performance-related compensation could actually motivate independent directors to have a more adversarial attitude vis-à-vis executive directors.

⁷² EC Recommendation, ANNEX 1. (d)

EC_E (business relationship)

[The independent director should] “not...have, or have had within the last year, a significant business relationship with the company or an associated company, either directly or as a partner, shareholder, director or senior employee of a body having such a relationship. Business relationships include the situation of a significant supplier of goods or services (including financial, legal, advisory or consulting services), of a significant customer, and of organisations that receive significant contributions from the company or its group.”⁷³

We interpret the expression “within the last year” as the previous financial year.

We interpret the expression “business relationships” as involving: the independent director in person; professional partnerships of which independent directors are members; companies of which the independent director is a shareholder, director, or senior employee; the company in question (on whose board the independent director sits); and associated companies (see EC_A above for a definition of this term).

As for the meaning of “business relationships” in this context, the Recommendation mentions the situation of (i) a significant supplier of goods or services (including financial, legal, advisory, or consulting services), (ii) of a significant customer, and (iii) of organizations that receive significant contributions from the company or its group. We considered that there is no business relationship if the independent director is also non-executive director or a member of the Italian “collegio sindacale” of the controlling shareholder, associated companies, or companies that the corporation consolidates.

EC_F (external auditor)

[The independent director should] “not...be, or have been within the last three years, partner or employee of the present or former external auditor of the company or an associated company.”⁷⁴

We interpret the expression “last three years” as the last three financial years (see above).

EC_G (cross-directorships)

[The independent director should] “not...be executive or managing director in another company in which an executive or managing director of the company is non-executive or supervisory director; and not to have other significant links with executive directors of the company through involvement in other companies or bodies.”⁷⁵

This criterion was evaluated with reference to cross-directorships with listed companies, the only ones reported in the database of Consob website, while the criterion as set by the Recommendation refers in general to all other companies, not differentiating between listed and unlisted ones. So it is possible that behind some of the “yes” rates lie cross-directorships with unlisted companies.

⁷³ EC Recommendation, ANNEX 1. (e)

⁷⁴ EC Recommendation, ANNEX 1. (f)

⁷⁵ EC Recommendation, ANNEX 1. (g)

EC_H (permanence on the board)

[The independent director should] “not...have served on the (supervisory) board as a non-executive or supervisory director for more than three terms (or, alternatively, more than 12 years where national law provides for normal terms of a very small length).”⁷⁶

We interpret this criterion as not being satisfied also when the independent director in precedence has served on the board of one of the companies which merged into the present one.

With reference to Italy, we interpret this criterion according to the fact that directors are appointed for three-year terms. From this follows that this criterion is not satisfied when a director has been sitting on the same board for more than nine years.

EC_I (family ties)

[The independent director should] “not...be a close family member of an executive or managing director, or of persons in the situations referred to in points (a) to (h).”⁷⁷

We interpret “close family member” according to the definition provided by Regulation 1725/2003, footnote 32 (clarifying the content of IAS 24): “Close members of the family of an individual are those that may be expected to influence, or be influenced by, that person in their dealings with the enterprise.”⁷⁸

We consider the present criterion to be satisfied by the company when a specific and explicit reference to it, as defined by the national cg code, is made in the relevant company documents (annual report or governance statement); we consider it not satisfied (and therefore we assign “ns” rate) when the relevant documents of the company concerned make only general reference to adherence to the independence criteria of the national code as a whole, without further specification.

EC_L (professional qualification)

Non-executive or supervisory directors are required to have the right background and must be qualified individuals.⁷⁹

As already explained for PR_D, apart from a complete CV, for the verification of the present criterion it can be also sufficient that the competence result from the number and quality of present positions held by the independent director.

⁷⁶ EC Recommendation, ANNEX 1. (h)

⁷⁷ EC Recommendation, ANNEX 1. (i)

⁷⁸ Commission Regulation (EC) No 1725/2003 of 29 September 2003 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council. http://europa.eu.int/smartapi/cgi/sga_doc?smartapi!celexapi!prod!CELEXnumdoc&lg=en&numdoc=32003R1725&model=guichett

⁷⁹ EC Recommendation, Recital point (15) / (16) and EC Recommendation, SECTION III points 11. “Qualifications”

EC_M (other commitments)

“Each director should devote to his duties the necessary time and attention, and should undertake to limit the number of his other professional commitments (in particular any directorships held in other companies) to such an extent that the proper performance of his duties is assured.”⁸⁰

We interpret this requirement as meaning that the director must not hold more than 2 tasks involving directorships in companies (including the one held in the concerned company) and 2 tasks different from directorships in companies, such as being a university professor, a professional lawyer, and so on. In this last respect, we do not include honorary commitments.

Finally, the same interpretative arguments used in PR_E above apply also to this criterion.

B.3: Verifiability of Preda and EC criteria

Important aspects of the Preda and EC criteria are their verifiability and their measurability. Company disclosure should enable investors to verify the respect of independence criteria to a reasonable extent. Moreover, the more measurable the data provided in company disclosure are, the easier will be the assessment conducted by investors and financial analysts. In this respect, not all independence criteria are on the same ground. The purpose of this paragraph is to illustrate the characteristics of each Preda and EC criterion from the point of view of their verifiability and measurability.

As regards the Preda criteria, the least verifiable is PR_D, since in this case it is not entirely clear what should be intended for professional qualification. In this respect, neither the Preda Code nor the EC Recommendation provide guidance. As can be seen from OECD (2003), the debate on this point varies from contributions that stress the importance of financial literacy to others that stress the importance that company boards be made of directors with diversified skills and backgrounds.

More verifiable is PR_C, for which we decided to rely on company disclosure. However, given our methodological assumptions illustrated in par. 2, this requirement is very difficult for the average investor to verify short of embarking on an investigative enquiry, since in order to have “no” rates for this criterion directors should “confess” to being related to executive directors or to some other category considered by the present criterion. All the average investor can do is to rely on the issuer statement that the director satisfies this criterion. It should also be noted that often issuers themselves specify that they rely, on this point, on a statement provided by each independent director.

Finally, PR_A, PR_B, and PR_E are the criteria which allow for a higher quality of verification by investors through company disclosure: as regards PR_B, verification is made easier by disclosure made by all companies within our population of shares personally owned; as regards PR_A and PR_E, it is possible to consult the entire list of present commitments for each director, which issuers are required to include in their corporate governance statement by the Preda Code; to verify compliance with PR_A, a complete CV makes it also possible to check past commitments.

⁸⁰ EC Recommendation, SECTION III points 12. “Commitment”

As regards those EC criteria that, as specified in par. 2.1 above, are not included within the Preda Code, for EC_G (cross-directorships), the Consob database allows one to check only among listed companies; for EC_H (permanence on the board), the Consob database allows one to check only as far back as 1998; for EC_C (additional remuneration) Consob requires companies to disclose additional remuneration received by directors from the company and from associated companies.