EUROPEAN CAPITAL MARKETS AND BREXIT
THE ROAD(S) AHEAD

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KEYNOTE SPEAKER
MARIO NAVA Chairman, CONSOB(*)

INTRODUCTION

Whatever the outcome of the current Article 50 process, what is certain is that the new partnership of the European Union with the United Kingdom will not obscure the mutual cultural influence on each other.

While Brexit will require a "*new economic and regulatory arrangements for financial services, preserving the mutual benefits of integrated markets and protecting financial stability*"[1], both the UK and the EU will need to look at the other side of the Channel to understand the essential structures of financial markets, and their actual functioning.

It is abundantly clear now that the 2016 referendum in the UK has produced nuanced results – so that the demands for a second vote is growing day after day. This is maybe because the UK citizens are aware that the UK and EU financial services markets and the whole economies are highly interconnected, and also because the European *acquis* even in the UK is stronger than it was supposed to be.

Bearing this in mind, it is worth paying attention not only at the legislative initiatives undertaken by governments, but also at the cultural reactions to the financial crisis that is probably at the roots of the widespread discontent accompanying the Brexit debate.

So, before focusing on the specific aspects of the Brexit process that are relevant for the Consob, it may be interesting to draw attention to two literary works that can help us to understand the nature of capitalism, since they shed some light on some immanent themes of companies and markets. The first work is *In the company of men* by the English author Edward Bond, exploring the power of multinationals, producers of weapons, and the fight to take the control of a company. The second one is the *Lehman Trilogy* by the Italian writer Stefano Massini, dealing with the saga of the Lehman family from the origins to the collapse.

(*) L'intervento è a braccio. Per eventuali citazioni fa testo la parola pronunciata.

[1] *The future relationship between the United Kingdom and the European Union*, White Paper Presented to Parliament by the Prime Minister by Command of Her Majesty, July 2018.

What is interesting to underline here is that the Bond's comedy – after being rearranged by Luca Ronconi – reported a wide approval by the Italian audience in 2011. And, similarly, the *Lehman Trilogy* – adapted by the Oscar-awarded director Sam Mendes – is now a successful event in the UK at a symbol of British culture, such as the National Theatre.

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On this very general ground, it will easier to understand why I am going to deal with some governance and board structures themes, keeping an eye on the UK experience, which in fact is likely to be considered as a model even after Brexit.

So, in the first place I will consider the topic of the governance of the Italian listed firms – namely, their board structures – and, in the second place, I will present some remarks about the supervision of financial market infrastructures in the wake of Brexit.

[…]

1. DIFFERENT SYSTEMS OF BOARD STRUCTURES FOR LISTED COMPANIES. COMPARATIVE ASPECTS AND DEVELOPMENT LINES

Italy is one of the advanced countries with the lowest weight of the capital market in the financing of economy.

Italy is the ninth (or the eighth, in swing with Brazil) economy in the world in terms of product but, according to IOSCO data, only the seventeenth as a financial center.

In Italy, financial wealth is mainly allocated in debt securities and mutual funds and less in insurance products and equity securities.

These data reflect investment choices linked to structural features of our economic system that are increasingly belonging to the past.

Given the structural changes under way, the levels of interest rates, the recomposition (quali-quantitative) in the offer of financial instruments and in the distribution channels of the same ones induced by the recent regulations, it is likely that, in perspective, the weight of the securities debt in households' portfolios is reduced, freeing up resources that could be attracted by other types of activities, particularly actions, hopefully in the context of a diversification approach.

For those reasons Italy could be among the countries that will benefit the most from the implementation of the European Commission's Capital Markets Union (CMU) project.

The CMsU project is basically founded on two guidelines:

a) promoting the integration of the financial markets of member countries, in order to support competition and the free movement of capital;
b) encouraging the development of market-based mechanisms for the financing of the economy.

The ultimate goal is to revitalize investment spending, whose stagnation explains the low growth in many EU countries.

The CMsU project is based on the implementation of numerous and complex processes of reform of the community discipline and on the launching of discussion tables with financial market operators to stimulate autonomous initiatives by the private sector.

My brief intervention aims at suggesting other basic reforms, also functional to the pursuit of the objectives of the CMsU; such reforms refer to areas not covered by the Community discipline and for this reason our country could start in parallel and in synergy with the actions that the European Commission is undertaking.

These are reforms that, together with those envisaged by the CMsU project, could play an important role in promoting the development of the domestic financial market and, above all, in encouraging the listing of companies on the stock market.

A recent CONSOB study on medium-sized Italian companies shows that it is difficult to find out the economic rationale for staying off the list.

Compared to unlisted companies similar by sector and size, listed companies show higher profitability, greater financial solidity, higher growth rates and lower financial constraints; at the same time, there is no evidence that unlisted companies bear a lower tax burden or that they resort more frequently to earning management practices[2].

Yet Italian stock exchange is historically and structurally undersized and scarcely representative of the country's industrial structure.

It is therefore highly probable that the decision to go public is strongly influenced by the burden and complexity of the rules. However, since these rules are common to all European countries because they derive from Community law, it is difficult to explain why the Italian stock exchange is so undersized compared to other countries.

In fact, many central aspects of the law of listed companies reflect discretionary choices of national legislators. The specific nature of our company law can play a very important role in explaining the low propensity to listing of Italian companies.

[2] L. Giordano e M. Modena, *Implicazioni e possibili motivazioni della scelta di non quotarsi da parte delle medie imprese italiane*, Discussion Paper CONSOB, settembre 2017.

These specificities mainly concern the rules governing the operation and internal organization of companies, rules which, to this day, largely reflect the logical and cultural approach of the civil code of 1942.

In the case of listed companies with shares traded on globalized markets and with a growing rate of foreign investors, such rules are now, in many ways, obsolete and excessively complex.

Although, as mentioned, the area of company law is still largely not involved from the process of Community harmonization, in Europe and in the main advanced countries are now prevailing legal standards and corporate models well known by international investors, even downstream and by effect of the convergence of corporate governance self-regulatory codes.

Italian companies, on the other hand, are forced to adopt corporate "systems" with which foreign investors are unfamiliar or who are ill-suited to the fluid application of best practices deriving from the convergence of self-regulatory initiatives. This makes them less attractive and increases the cost of capital, discouraging the use of quotation and other forms of market-based finance.

To the rules of the civil code are added many special rules resulting from a stratification of interventions, sometimes impromptu and more often aimed at responding to contingent emergencies arising from financial crises or scandals, disengaged from a clear unitary design of reform. This resulted in an extremely complex regulatory framework and articulated, which, on the one hand, increases compliance costs and creates a competitive disadvantage for our companies, on the other, does not necessarily offer a level of protection of shareholders and creditors higher than that of other jurisdictions.

At the same time, it presents strong rigidity that does not allow to align the complexity of the corporate organization and the internal control system to the company size.

Against this background it seems useful to propose a series of legal reforms of Italian company law that have the following objectives:

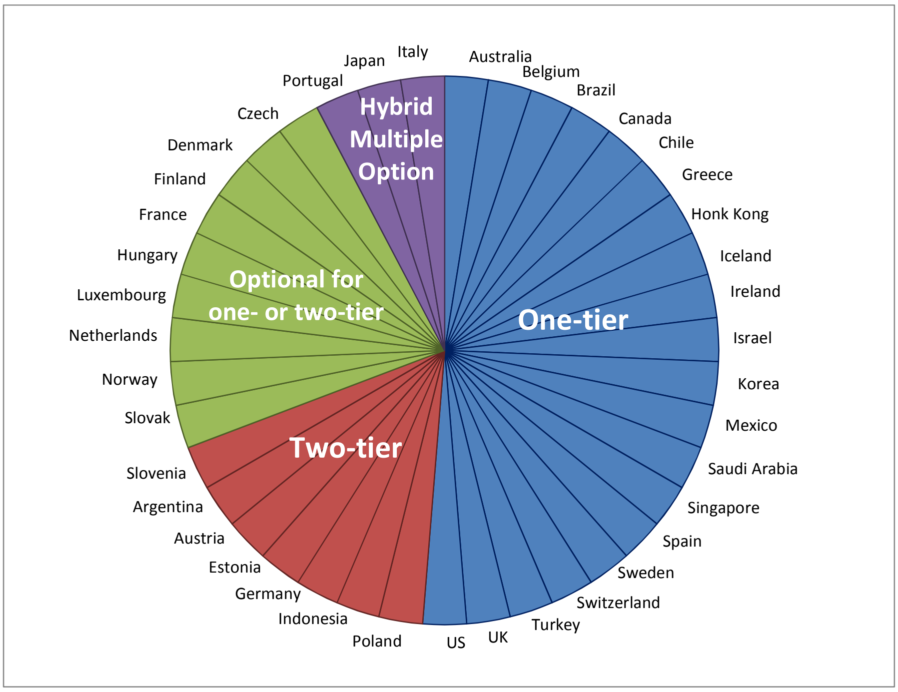
• align the rules with international standards;
• simplify the rules and allow them to be aligned to company size;
• give greater certainty to the legal framework.

In line with the goals of CMsU project the ultimate goal is to remove the hindrances and complexities deriving from domestic framework that can discourage companies’ decision to go public and to resort the capital market.

From this point of view a central theme seems to me that of systems of board structures for listed companies.

Almost all Italian listed companies adopt a model of administration and control based on the board of directors and the board of statutory auditors (so-called "traditional" model).

This model is now *unicum* on the international scene. Only Japan and Portugal have a system similar to the Italian one. On the other hand, all the other European countries and all the main advanced countries envisage only the monistic model (typical of the Anglo-Saxon countries and ofthose of the common law tradition) or the dualistic one (typical of many continental European countries with legal systems of Germanic derivation).



Administration and control models of joint stock companies in the OECD countries

This convergence of the corporate governance and control models towards two standards reflects a parallel process of harmonization of corporate governance self-regulatory codes towards principles and best practices whose application presupposes the adoption of such standard models. The same Community legislation and the European Commission, while recognizing and respecting on a formal level the existence of administrative models different from the monistic and dualistic (in Italy and Portugal), have always dealt with the issue of corporate governance essentially taking into account these two latter models.

With the corporate law reform of 2003, Italy has allowed companies organized as a joint stock company the possibility of adopting, as an alternative to the traditional system, the monistic and dualistic system. However more than eleven years after the reform, almost all the companies continue to use the traditional model based on the board of statutory auditors (97% of listed companies and over 99% of unlisted companies).

There is clear evidence that this depends on the fact that the provisions governing the monistic and dualistic models present elements of uncertainty and lack of clarity when they must be applied concreetely. In fact, these models are governed to a large extent by the normative technique of referral to the traditional system, but there are doubts and uncertainties regarding the concrete ways of applying the rules regulating the board of statutory auditors to alternative models.

Furthermore it is undoubted that the traditional administration and control model reflects the theoretical and cultural approach of the 1942 civil code (which, in turn, refers to models of the nineteenth century and in particular to the Italian Codice di Commercio of 1882), which proves unfit to face the evolution of the economic situation tackled by listed companies and also the contamination that this model has undergone by the self-regulatory code (which introduced the monitoring board, internal committees, independent directors, etc.).

In fact the result of this contamination of the traditional Italian system with institutions belonging to the Anglo-Saxon systems was the fact that our administration system is, in a way, monistic in management, but dualistic in surveillance, and that having regard the supervisory role on the general performance of the management carried out by the non-delegated board members, beyond the control exercised by the board of statutory auditors.

Furthermore the traditional model is not very suited to the management and organizational reality of large companies, since it concentrates the functions of strategic supervision, company management and most of the controls on the board of directors, without a clear definition of the duties of each corporate body and each member of such bodies designed in order to avoid concentrations of power that can, in some cases, prevent a correct internal dialectic. In fact, the civil law does not dictate any specific rule for what is at the heart of the governance of a public limited company, that is to say, the functioning and duties of the board of directors.

From this point of view, the corporate governance self-regulatory code adopted by Italian listed companies has filled a regulatory gap, defining the concrete ways in which the powers of strategic management, operational management and management control typical of the Board of Directors must be exercised. In doing so, however, the code has taken the monistic model as a reference, to align itself with the process of international convergence of standards and best practices mentioned above. As a result, as mentioned, there is an unavoidable tension and a potential ambiguity between civil law and self-regulation rules that contribute to increase compliance costs for listed companies adopting the traditional model.

To this is added the circumstance that a series of interventions following the 2003 reform, often implemented with a fragmented and disorganic logic, have contributed to determine inefficiencies and overlaps of the functions entrusted to the various bodies responsible for internal controls, imposing excessive constraints and costs to companies that adopt the traditional model.

The number of actors involved in the internal control function of listed companies has grown excessively, generating confusions that derive, at the same time, from potential overlapping of skills and from gray areas in the assignation of responsibilities.

It is therefore necessary to rewrite the rules of the civil code regarding the dualistic and monistic system in order to create a clearer legal framework, that in order to allow companies to choose the model of administration and control most suited for their needs.

It would therefore be advisable not only to rewrite the civil law in order to facilitate the adoption of alternative models, but, with reference to listed companies, the possibility of introducing a default choice towards the single-tier model; option from which one could exit with an opt-out clause.

This is for two reasons.

The first is that the one-tier system is the most widespread model of governance in advanced countries and therefore the best known by international investors. The adoption of a corporate model familiar to institutional investors would make the companies more attractive and could reduce the cost of capital, by encouraging and facilitating the listing process.

Secondly, the monistic model could help to make the overall system of internal controls more rational and efficient, by introducing a framework of rules that would guarantee a more fluid and easy application of the self-regulatory code and reduce duplication of roles and functions. This would result in a reduction in ongoing compliance costs related to the status of a listed company.

With the law n. 172 of 2017 the Italian legislator included the financial infrastructure sector within the perimeter of the “essential (strategic) interests” of our country for the purposes of the exercise of the so called *golden power*.

It is the first time that in Italy and in Europe the special powers of a State enter the financial sector to regulate foreign direct investment. This is not the case in the United States where the financial sector has always been seen as a national strategic sector to be safeguarded.

Law n. 172 is in line with two recent acts of the European Commission, namely the "Proposal for a regulation establishing a framework for the control of foreign direct investment in the European Union" and the Communication "Welcoming direct foreign investments while protecting the fundamental interests ".

The regulatory intervention of individual Member States has been supported by the European Commission itself (which, in fact, would like a Community discipline) in consideration of the significant increase of cases in which foreign investors, and in particular sovereign funds, tried to acquire strategic activities that allow them to control or influence European companies whose activities are crucial to security and public order. These include activities related to the operation or supply of technologies, infrastructures and production factors, sensitive information and, in fact, financial infrastructures.

This law could lead us to a reflection on the scope of the new rules in relation to the effects that Brexit may have on the Italian trading infrastructures infrastructures belonging to the London Stock Exchange Group.

2. Brexit and Borsa Italiana/LSEG merger

More than ten years ago (October 2007), Borsa Italiana and London Stock Exchange Group plc completed their merger thereby creating the leading diversified exchange group in Europe and the platform for additional strong growth on a European and global scale. The combined group has bring together two highly efficient and complementary businesses, coupling the strengths of Borsa Italiana in Italian cash equities, derivatives, securitised derivatives, fixed income products and efficient post-trade services with those of the London Stock Exchange in UK and international equities.

The London Stock Exchange Group plc owns the 100% of the London Stock Exchange Group Holding Italia SpA, which in turn owns the 99.99% of Borsa Italiana. Borsa Italiana owns the 98.82% of Monte Titoli, 100% of CC&G, 60.37% of MTS and 70% of EuroTLX. The London Stock Exchange Group is mainly owned by institutional investors (82%) and a majority stake of 10.3% owned by the Qatar Investment Authority.

Does Brexit create any challenges to the operation of the Italian market infrastructure and to the regulatory and supervisory powers of Italian competent authorities?

The regulatory and supervisory framework is already designed to make sure that – whatever (EU or non EU) the ownership - Italian market operators are well equipped and adequately structured to perform the tasks and responsibilities assigned to them by the law and to ensure transparency and orderly conduct of trading. The existing regulatory and supervisory framework already allows (and require) competent authorities to supervise and, where necessary, intervene where the market operator or the trading infrastructure is affected by significant changes, in the areas of shareholders or persons exercising significant influence over the management of the market, of management body, organizational and corporate structure as well as systems resiliency. Brexit would not affect the regulatory and supervisory approach in these areas.

The Italian market infrastructures affected by the merger have been required to set up and maintain an organizational and corporate structure designed to ensure the full responsibility and accountability for the core functions performed by market operators. Consob has constantly and carefully monitored the governance and organizational arrangements developed to make sure that any developments would have not increased the likelihood of materialisation of risks to investor protection and orderly markets.

To some extent anticipating what ESMA has clarified (July 2017) in its Opinion to support supervisory convergence in the area of secondary markets in the context of the UK withdrawing from the EU, the regulatory and supervisory approach already in place in Italy has assigned specific importance to:

- *Outsourcing arrangements*. ESMA Opinion addresses, in particular, regulatory and supervisory arbitrage risks stemming from trading venues seeking to outsource activities, and the principles identified in the Opinion are designed to make sure that the use of outsourcing arrangements by trading venues is subject to appropriate oversight especially when the activities outsourced are critical to the functioning of the trading venue. The importance of competent authorities' assessment in this area is not new in the Italian environment, where specific and ad hoc provisions have been adopted since MiFID I to avoid that complex operational and outsourcing arrangements may result in additional risks for trading venues thereby impacting the conditions for authorization, increasing operational risks as well as the risk of letter-box entities;

- *Cooperation agreements ("MoUs")* with the competent authority supervising the entity owning the Italian market infrastructure (Financial Conduct Autority – FCA). One of the core activities performed at the time of the merger and thereof during the last ten years have been the development (and application) of a specific MoU with the FCA, establishing the framework according to which the FCA and Consob agree to organise their cooperation for the fulfilment of their respective duties and powers for the supervision of the London Stock Exchange and Borsa Italiana in light of the merger. Again, the importance of such MoUs is not new and Consob is already engaged in the revision of the existing cooperation agreements to update and eventually reinforce their content.

3. BREXIT AND COMPETITIVENESS OF ITALIAN MARKET INFRASTRUCTURES

The impact of Brexit on EU markets and the Italian market in particular is still difficult to assess due to the uncertainties around the evolution of hard Brexit on 29 March 2018/transition phase until 31 December 2020 as well as around the decisions still to be taken by UK market participants. In such a scenario, the key factors able to potentially affect the outcome could be identified in:

- the extent to which it would be possible to preserve UK market participants access to EU trading venues;
- the costs that UK market participants faces to preserve the access;
- any potential "gap" between the UK regulatory framework and the EU one;
- the possibility to maintain access and control to the data on trading activity carried out by UK market participants of potential interest and impact for transparency and orderly conduct of trading on EU markets;
- the need to preserve and potentially increase the competitiveness of the Italian market.

A number of complex issues and challenges are going to be faced and need to be promptly assessed to be able to take advantage of the Brexit event. Among these, specific attention is currently paid to the following objectives and initiatives:

a) **Access of UK market participants to Italian trading venues in order to preserve and potentially create the conditions to increase liquidity on Italian trading infrastructures**. Brexit has the potential to have an impact on market liquidity, since a significant number of

UK market participants have access to of Italian trading venues contributing for about the 50% of the trading volumes.

There are specific rules around the access to trading on EU trading venues for extra-UE entities and Consob is working – in the remit of what is currently envisaged under the Italian regulatory framework - to make sure that Italian trading infrastructures could "export" their business in UK (as well as in other extra-UE countries). Such approach requires efforts to properly assess and monitor on an ongoing basis the equivalence of the regulatory framework in the extra-UE country as well as the development of specific cooperation agreement.

Potential concerns might arise in case the necessary recognition procedures are not fully finalized in time for March 2019. In such a case, it could be considered the adoption of a "*temporary permissions regime*" – such as those already developed by UK authorities – to let Italian trading venues allowing UK entities trading on their facilities subject to certain conditions.

b) **Competitiveness of Italian trading infrastructures by taking advantage of relocation initiatives.** A number of initiatives by Italian trading infrastructures are currently in place or under consideration to relocate business and trading venues currently operated in UK.

   Consob has already started working on that to finalise in a reasonable timeframe the necessary regulatory and supervisory activities involved. Specific attention and consideration is currently given to the requests received for submission of relevant documents in English.

c) **Keep adequate arrangements and procedures to ensure transparency, orderly conduct of trading and investor protection.** The EU regulatory and supervisory framework under MiFID II/MiFIR relies today on a significant number of complex procedures to gather, elaborate and publish market data and thresholds that are necessary to effectively implement the new obligations. Methodologies and thresholds have been designed without taking into account the Brexit event, i.e. methodologies and thresholds are going to be affected by the fact that UK might not contribute anymore in the future in the data gathering process. Brexit would have an impact on the transparency calculations and their application in both cases (hard Brexit and transitional phase). To give couple of examples:

   - the main effect of removing UK data from calculations appears to be that fewer instruments will have a liquid market. And this will affect all instruments, i.e. instruments issued in the EU27 as well as in the UK. Moreover, more orders/transactions may benefit from waivers/deferrals under the transparency regime;
   - for the tick size regime, determining an EU27 venue as the "most relevant market" where the most relevant market used to be a UK venue results in a situation where the ticks would not be based on the most liquid market, thereby leading to less competitive tick sizes determined for EU market participants;

4. CONCLUSION

We are going through a very uncertain phase. The UK Secretary of State Dominic Raab in his speech on planning for a no-deal Brexit (23 August 2018) first said he is "still confident that getting a good deal is, by far, the most likely outcome", but shortly after announced that the UK Government was about to publish a series of technical notices "to inform people and businesses in the UK about what they may need to do, if we don't reach a deal with the EU" .

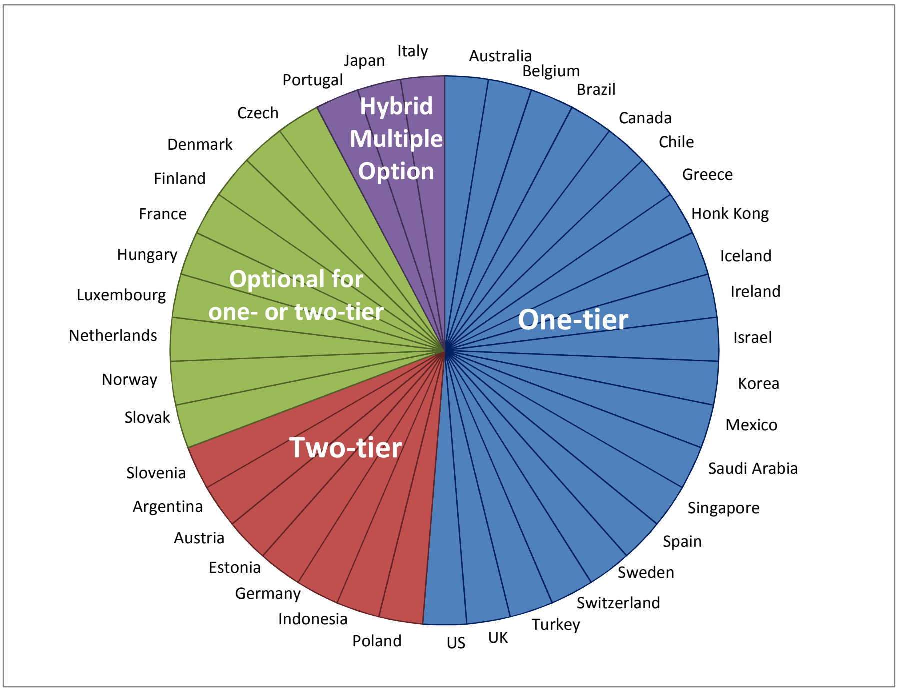
Besides, the European elections, called for May 2019, will have an unpredictable outcome.

Despite this foggy picture, I am strongly confident that the beneficial, mutual imitation between the UK and the EU will go on.

It has to be a race to the top and, being aware that 'one size does not fit all', it seems to me wise to look at the Anglo-Saxon best practices, including the one-tier model, that undoubtedly is the most widespread governance system in the world.

At the same time, as Chairman of a financial markets Supervisor I know that Brexit might bring some hindrances, but I am also convinced that even from the English perspective the success of the Milan Stock Exchange is a success for everyone.

Maybe, especially in the political arena some Britons still remember the legacy of Henry VIII — who triggered the English Reformation by not obeying a continental institution, the Pope – but I am sure that in the cultural, social and economic fields the vast majority of them are sensible and pragmatic enough to recognize the immense benefits of a full cooperation with the European partners.


Hybrid Multiple Option
Optional for one- or two-tier
One-tier
Two-tier
Italy
Japan
Portugal
Czech
Denmark
Finland
France
Hungary
Luxembourg
Netherlands
Norway
Slovak
Slovenia
Argentina
Austria
Estonia
Germany
Indonesia
Poland
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