CONSOB

COMMISSIONE NAZIONALE PER LE SOCIETÀ E LA BORSA

ANNUAL MEETING WITH THE FINANCIAL MARKET

SPEECH BY THE CHAIRMAN, LUIGI SPAVENTA

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Ladies and Gentlemen,

The Commission is grateful to the Chairman and Directors of Borsa Italiana for hosting our meeting in this magnificent hall of Palazzo Mezzanotte. It was here that the open-outcry auction used to be held before the Milan Stock Exchange became one of the first in the world to introduce electronic trading. Now that the hum of computers has replaced the clamour of the trading floor, may this splendidly renovated hall serve as a forum of reasoning and discussion.

Last June Salvatore Bragantini resigned from the Commission to return to a career in the financial industry. I thank him on behalf of Consob and personally for his impassioned contribution of expertise and ideas. Enrico Cervone, appointed to the Commission, brings a wealth of experience to Consob.

Renato Rordorf is to leave the Commission and resume service in the judiciary. Consob is deeply indebted to him. His intellectual rigour and the legal erudition he brought to bear on practical issues were of invaluable assistance to the Commission. Carla Rabitti Bedogni has been appointed to replace him and I warmly welcome her. It is a source of satisfaction for Consob and for his colleagues that Lamberto Cardia will serve a second term.

Since 1 May 2001 Consob’s headquarters in Rome have been in a new building where there is finally room for all the staff. Restoration work has begun on Palazzo Carmagnola, which the Municipality of Milan has made available for Consob’s office in this city.

The international financial system: strength and problems

1. Towards the end of last year, when the speculative bubble on “new economy” and telecommunications shares had finally deflated, global finance was rocked in swift succession by three major shocks: the impact of the attacks of 11 September, the Argentine crisis and the bankruptcy of one of the largest US corporations, which up to then had been held up as an example of the dynamism of corporate America. In the past one of these shocks alone would have had serious and widespread destabilizing consequences: I recall those produced by the closure of a medium-sized German bank or, more recently by the Mexican crisis and the collapse of a large hedge fund. Today the system has absorbed three such shocks without severe problems arising, demonstrating that it has a solidity and a flexibility of response that were perhaps unexpected and are certainly remarkable. The destruction of the Twin Towers did not bring down the payments system; the largest default ever by a sovereign borrower did not have systemic effects; the collapse of Enron, accompanied and followed by similar developments at other companies, has not overwhelmed the equity market and creditors have survived.

Many factors have contributed to this greater resilience. The investments in IT that were made in perhaps excessive fear of the consequences of the millenium date change proved useful in the wake of 11 September. The Argentine default was expected and the largest investors had at least partly protected themselves against it. Financial innovation and the new instruments of securitization in particular have improved insurance against risk and, above all, made it possible to spread risk more widely. After a decade of high profits, intermediaries were in excellent health, with capital that was not just adequate but abundant. Monetary policy promptly intervened to prevent systemic crises.

However, appreciation of the solidity and the flexibility of response shown by the financial system must not give rise to Panglossian complacency about the state of the world. Vulnerable points are becoming evident. The existence of substantial problems has been revealed to regulators.

2. Although the markets have assimilated the immediate financial consequences of the Argentine crisis, the possible collapse of that country's entire banking system and the reduction of foreign direct investment throughout Latin America and of bank investment in the developing countries could have wider repercussions. More serious problems could emerge if the decade-long deterioration in Japan's economic and financial situation were to spiral into a crisis.

The stock market correction has mitigated the earlier overpricing of equities. The sustainability of the current valuations depends on the quality and strength of the recovery, whose effects on profits and investment are still uncertain. At all events a return to a trend like that which had spoiled the markets until a couple of years ago is unlikely.

There remain unresolved sectoral problems. In telecommunications the process of winnowing out and corporate restructuring has not run its course; although the banks' exposure seems to be sustainable, it does not look as if we have reached the end of the story. We still do not have a sufficiently precise idea of the longer-run consequences of the recent events for the insurance sector.

3. The events of 11 September have starkly raised the question of the financing of international terrorism and, more generally, of illegal activities. It has been recognized at long last that many offshore centres, which before had been benignly tolerated as useful instruments of tax competition, provide safe havens beyond the reach of investigation by the judicial and regulatory authorities. A political will seems to be emerging at the international level to exert adequate pressure so that these centres open up to requests for cooperation. The International Organization of Securities Commissions is drafting the text of a multilateral memorandum of understanding in order to verify which national authorities are really in a position to comply with the obligations of mutual assistance; signatories subsequently found to be non-compliant would be censured. This could give rise to problems for Consob, to which the Consolidated

Law on Financial Intermediation assigns limited powers of investigation, less extensive than those assigned to other authorities in Europe and elsewhere.

The investigations of the financing of terrorist activities have brought two further problems to light: the inadequacy of the legal definition of market abuse and the difficulty of identifying the ultimate beneficiaries of transactions in financial instruments. The new European directive seeks to answer the former. The latter is more complicated and cannot be solved with isolated national measures, which could jeopardize the competitiveness of the intermediaries of the countries adopting them. Any effective solution has to be agreed and implemented by all countries.

The Enron collapse has raised graver questions of more direct concern for regulators.

The Enron case

4. By persistently eluding and seriously violating US Generally Accepted Accounting Principles (GAAP), for a long time the directors of Enron succeeded in providing a completely false view of the company's situation. A host of special purpose entities, created with the aid of important investment banks and as much as 97 per cent owned by Enron but not consolidated into its balance sheet, made it possible to simulate profits and hide losses of the parent company. Other dubious accounting practices, such as marking to market hypothetical earnings from the provision of future services, served the same end. Similar episodes occurred in at least one other important company, which suffered the same fate as Enron.

Financial institutions supplied the tools for building this house of cards. The outside auditors either did not see or failed to report the arbitrariness of fraudulent or negligent accounting. Internal controls did not work. The independent directors who sat on the audit committee did not perform the functions entrusted to them. The massive bonuses in stock options that the managers of Enron had awarded themselves led them to simulate profits that inflated the prices at which the shares could be sold at the appropriate moment: just before the crisis which they well knew was imminent, a flagrant case of insider trading.

5. It would be reductive to treat the collapse of Enron and similar episodes as pathological exceptions, attributable exclusively to gross negligence or fraud taken to unusual lengths. These affairs have revealed intrinsic deficiencies in the quality of disclosure, corporate governance and controls, with consequences and lessons that do not concern only the United States.

A first consideration regards accounting systems. As is now being recognized, comprehensiveness, the aim of completeness, the attempt to establish rules for every conceivable circumstance, which were praised as the strengths of the US accounting system, can create openings for avoidance. No matter how detailed the rules — and GAAP are that to the highest degree — they can never contemplate every possible contingency or keep up with the new circumstances generated by financial innovation. Detail creates room for conduct that is formally compliant but substantially evasive. Formulating more general principles is therefore preferable to the vain attempt to construct a map on a scale of one to one. This is the approach taken by the International Accounting Standards, with which all the European Union countries will comply within a few years but which the United States is reluctant to recognize. In this specific case, we can note that the proliferation of off-balance-sheet special purpose entities would not be possible in Europe, where the Seventh Directive requires that all *de jure* or *de facto* subsidiaries be included in the consolidated accounts, with very few exceptions.

A second consideration regards the limits of self-regulation. In the United States, the quality of external auditing has so far been controlled by peer review procedures within the profession, without any direct involvement of the Securities and Exchange Commission. These procedures have plainly proved ineffective: no negative opinion has been issued against a major auditing firm since they were instituted in 1977. It took the meltdown of Enron to overcome political resistance to the introduction of some form of public control.

The problem of external auditing is part of a more general question. As is well known, there are potential conflicts of interest between the manager of a company (whether a pure manager or a controlling shareholder) and the minority shareholders, who are in an inherently inferior position from the standpoint of information and decision-making. Legal protection, the rules of corporate governance, disclosure and transparency, and external monitoring serve to reduce that inferiority. Their effectiveness depends on internal controls and incentives that make the interests of the management and those of the shareholders more compatible.

The system of safeguards and rules constructed in the United States is celebrated for its excellence. In effect, the legal remedies available to minority shareholders against wrongdoing by managers are especially strong; the low concentration of share ownership stimulates investor activism; the courts are severe and quick to sanction breaches of fiduciary duties. Whether imposed by the authorities or by the markets, the rules of disclosure and transparency are very stringent. And yet this system was unable to prevent the Enron affair and others like it. Ultimately, the fault line was in the system of incentives underlying the rules. Instead of voicing opposition and acting as the necessary counterweight vis-à-vis management and for the protection of the shareholders, those responsible for ensuring compliance with the rules acted in their self-interest, often in collusion with management and, precisely for this reason, in conflict with the functions they ought to have performed.

Often, there are simple and far from praiseworthy explanations for the acquiescence of external auditors, for the failure of internal controls, for the unflagging optimism of analysts. They lie in lucrative consulting fees, in the willingness of outside directors to bow to management, which has the power to reappoint them, in the substantial business interests of investment banks that publish buy recommendations (and only rarely advise selling). Even the use (and abuse) of stock options, rather than giving management an incentive to align its interests with those of the shareholders, has produced the perverse effect of leading managers to conceal the company's true situation in order to keep the share price high before they sell. In the final analysis, as the chairman of the Securities and Exchange Commission said in his recent testimony before Congress, in the excesses of the "culture of speculation" of recent years "the moral imperative on those intended to provide the checks and balances has eroded and must be restored."

6. There's no need to invoke Bertoldt Brecht in order to doubt that trusting to a return to the "moral imperative" will be enough to repair the damage inflicted on the system of corporate governance by the play of so many hefty interests. The US Congress and, with greater incisiveness, the Securities and Exchange Commission have promptly begun to overhaul the rules to make them more cogent and stringent. The measures of the SEC, which will be rapidly implemented as regulatory provisions, concern the quality and timeliness of financial reporting and disclosure, with special reference to accounting practices, off-balance-sheet items, transactions with related parties and insider dealing by directors; accounting rules, with a move from detailed prescriptions to principle-based standards; controls on external auditors, which are no longer entrusted to self-regulation but to an independent entity overseen by the SEC; and accountability of directors. The SEC has asked Congress for legislation that will increase its own powers of control and sanction, make stock option plans subject to approval by the shareholders, and ensure that private litigation effectively serves, in the words of the chairman of the SEC, "to help investors, not their lawyers."

Enron has certainly revealed the existence of grave, unexpected flaws in the American system of investor protection; but we have seen that the authorities have reacted swiftly and vigorously to correct its defects. However, the problems that have come to light concern all corporate governance systems and are not limited to the United States. Recognizing this, the International Organization of Securities Commissions has established a committee of Commission chairmen, Consob among them, to evaluate the consequences that need to be drawn from what has happened. In Italy, the Minister for the Economy has opportunely set up a committee to examine the possible implications for Italian legislation and regulation.

Ownership and control structures

7. The problems of corporate governance and protection of minority shareholders take on partly different characteristics with regard to the ownership and control arrangements of listed companies.

It is well known that ownership is highly concentrated in Italy; after falling with the privatizations, concentration has returned to the previous levels. In 60 per cent of the companies listed on the stock exchange, one shareholder has the absolute majority; on a weighted basis, the average percentage held by the largest shareholder has risen back above 42 per cent; the share of free float in total market capitalization has diminished.

The presence of a strong shareholder, as against the Anglo-Saxon model of widespread ownership, is not in itself detrimental; the two systems' strengths and weaknesses are specular. A majority shareholder ensures more effective control of the management of the company in whose results he is directly interested; on the other hand, he has more opportunities to capture what are called private benefits of control, at the expense of the other shareholders.

This trade-off between the incentive to control management and the possibility of private expropriation improves when the discretionary power of the majority shareholder is limited by the presence of other shareholders, with smaller stakes but sufficient weight to prevent conduct prejudicial to the company. By contrast, it worsens when ownership is separated from control; when control rights exceed ownership rights, the opportunity to extract private benefits from the company persists, while the incentive to become involved in management in the interest of all the shareholders lessens.

8. Control leverage is especially high in Italy. After falling in the past decade, the ratio of control rights to dividend rights is rising again: among the ten largest listed groups, the average percentage of capital controlled is almost two and a half times that held. The exercise of control with a modest ownership stake is often obtained by resorting to complicated pyramidal structures. The market punishes the inefficiency of these arrangements with a large discount of the share price of holding companies with respect to the prices of the companies they hold. Consob estimates that the discount was around 20 per cent at the end of 2000.

Low turnouts of smaller shareholders at ordinary shareholders' meetings and the passivity of those with substantial holdings lower the threshold of ownership sufficient to exercise control. A recent study of the shareholders' meetings of 122 listed companies in 2000 found that an average of more than 85 per cent of the share capital represented at the meeting was attributable to the controlling shareholders and around 7 per cent to minority shareholders with interests of more than 2 per cent. The participation of small shareholders and institutional investors is less than modest; they account for just over 6 per cent of the capital represented, with an absentee rate of close to 90 per cent of the capital owned. The participation rates for the shareholders' meetings of several large companies in 2001 were only slightly higher. This aspect of shareholders' meetings in Italy is important for the purposes of achieving *de facto* control, which Article 2359 of the Civil Code defines as command "of sufficient votes to exercise a dominant influence in the ordinary shareholders' meeting" of a company. Certainly, such control is not found when the largest shareholder is flanked by other large minority shareholders who are active in shareholders' meetings and who, taken together, command a greater proportion of votes. In the case of widely distributed shareholding, by contrast, the very low rate of minority participation allows the largest shareholder to exercise control with far less than the majority of the capital.

9. The passivity of substantial minority shareholders has certainly not encouraged small investors to participate in corporate affairs. The average holding

of the second-largest shareholder in Italian controlled listed companies is relatively high at 8 per cent, with a substantial representation of financial institutions and institutional investors. However, there are no signs of activism on the part of these shareholders or of their monitoring the activity of the controlling shareholder. In effect, the investments of financial institutions are often acquired with the implicit or explicit aim of supporting the strongest shareholder. Perhaps because they are nearly all bank-derived, institutional investors almost always remain silent in shareholders' meetings and do not participate in corporate life. However, there are signs of change today. These need to be appreciated and encouraged by means, as I will make clear later, of appropriate changes in the rules.

All in all, the pattern of ownership and control and the conduct of strong minority shareholders have thus far objectively made it harder to find a satisfactory solution to the problems of corporate governance and shareholder protection in Italy.

The rights of shareholders

10. With the reservations set out above, it remains true that the quality of the protection of minority shareholders has been greatly improved by the innovations introduced by the Consolidated Law on Financial Intermediation of 1998.

Previously, a widespread (albeit highly questionable) index of the legal protection afforded to investors had given Italy the unflattering mark of one out of six. The reduction of the quorum for calling shareholders' meetings, for making complaints to the board of auditors and the courts, and for bringing a company action for liability; the increase in the quorum for the adoption of decisions in extraordinary shareholders' meetings; the provision for at least one member of the board of auditors to be elected by the minority shareholders; and the possibility of soliciting and collecting proxies have together raised Italy's mark to a more satisfactory five.

The means offered to shareholders to make their views carry more weight have hardly been used at all, however: only on one occasion have the minority shareholders called a shareholders' meeting, recourse has never been made to the possibility of making complaints or bringing company actions for liability, there has never been a solicitation of proxies. It would be unwise and dangerous, however, to dismiss the new mechanisms out of hand on the basis of this evidence.

Going to court is an extreme solution everywhere. The means of legal defence given to shareholders are nonetheless necessary, not least as a preventive measure, since they can act as an *ex ante* constraint on the directors. It has to be admitted, however, that the costs associated with these remedies is particularly high, above all owing to the time needed to resolve disputes in the courts. Moreover, the structure of ownership and control, together with the passivity of minority shareholders with substantial interests, aggravate what is known in the literature as the problem of collective action (which nobody begins because everybody relies on somebody else taking the initiative).

11. The effectiveness of remedies based on the shareholders' meeting is reduced for the same reasons. There have nonetheless recently been signs of greater activism on the part of institutional investors. The autonomy protocol promoted by Assogestioni establishes important principles of independence for asset management companies; the association is making itself heard more often by issuers, the market and Consob. These initiatives could be strengthened by managers formulating general criteria for the exercise of the voting and other rights attached to the shares in their portfolios and publicizing the positions they take in shareholders' meetings.

It is up to Parliament, instead, to enhance the scope for shareholder intervention by making appropriate amendments to the law in force. At present the procedures for collecting proxies are too cumbersome; now that shares have been dematerialized, the requirements for attending shareholders' meetings are uselessly burdensome, especially for institutional investors, who are obliged to immobilize their shares for an excessively long time.

12. The Consolidated Law on Financial Intermediation has established a good system of controls, entrusting external auditors with the task of auditing the accounts and internal auditors with that of checking that the activity of the directors complies with statutory and regulatory provisions; the internal auditors are required to inform Consob of suspected violations and have the power to submit reports to the judicial authorities. Consob supervises the activity of both, with the right to impose or propose penalties, to submit reports on the board of auditors to the judicial authorities and to challenge the annual accounts.

In order to prevent conflicts of interest, auditing firms are not allowed to engage simultaneously in the provision of consultancy services; their engagements last for three years and may not be renewed more than twice. It is nonetheless possible to get round the prohibition. There are differing views on rotation in Europe, while in the United States it is not considered to be desirable. At present Consob intervenes with respect to auditors when it finds evidence of anomalous situations. The resources available are not sufficient to permit the introduction of a system of regular controls on the quality of all audits.

Following the enactment of the Consolidated Law on Financial Intermediation, Consob has used its powers to challenge annual accounts four times; on three of these occasions the companies accepted the Commission's criticisms and amended their accounts as requested. Such challenges are for extreme cases, while Consob normally exercises preventive suasion aimed at establishing the disclosure requirements to be applied in particular circumstances.

Boards of auditors have found it hard to adapt to the new tasks entrusted to them by the Consolidated Law on Financial Intermediation. Recently, however, they have become more active in controlling how companies are run. Evidence of this is to be found in the increase in the number of reports of irregularities reaching the supervisory authority. Consob has issued a recommendation listing all the checks boards of auditors are required to carry out and report on, *inter alia* so as to avoid being censured. In more than one case Consob has proposed the imposition of administrative sanctions on auditors to the Minister for the Economy and in two cases reported the board of auditors to the courts, with the result that the members of the boards in question resigned.

13. When ownership and control are highly concentrated, the disclosure requirements for the transactions of listed companies that, at least potentially, could conflict with the interests of the minority shareholders are of special importance. As things stand today, directors must report on such transactions at least once every three months to the board of auditors, which, where it finds grounds for censure, must report them to the shareholders' meeting. These obligations are not sufficient to ensure that shareholders receive adequate information. The self-regulatory code of listed companies merely lays down that the board of directors must "pay particular attention to the supervision of situations of conflict of interest", and examine important transactions, "with special reference to transactions involving related parties".

Last year I stated that, in the absence of a regulatory initiative on the part of the Stock Exchange, Consob would have intervened to ensure continuous and timely information on transactions with related parties, even when they were not immediately classifiable as "facts likely … to have a significant effect on the price of the financial instruments". In the annual revision of the regulations implementing the Consolidated Law on Financial Intermediation, on which consultations are currently under way, provision has been made for listed companies to make information promptly available to the public on atypical, unusual or significant transactions concluded with related parties.

14. It is important that the public be promptly informed of purchases and sales of a company's shares by its directors. In the United States corporate insiders are required to report trades not later than the tenth day of the month following that in which they were concluded; in the wake of the Enron collapse, the SEC intends to impose more stringent obligations on companies, while a very recent

congressional bill provides for natural persons to make information available on a daily basis to the SEC, which would make it public the next day. In Italy companies are only required to disclose their directors' shareholdings once a year, in their annual accounts. Borsa Italiana could call for such information to be provided continuously by amending its rules for listed companies. It is to be hoped that the plans announced recently in this respect will rapidly lead to a satisfactory conclusion. If they do not, legislation would be desirable.

Markets and stock exchanges

15. In 2001 Italian share prices continued on the downward trend that had emerged in the second half of the previous year. The average fall over the year in the main indexes of the Italian Stock Exchange was on the order of 25 per cent, compared with a small rise in 2000. The fall in the index of the Nuovo Mercato was around 45 per cent, almost twice that recorded in 2000. In Italy and the rest of Europe the fall in prices was more pronounced than in the US, where the Dow Jones index declined by less than 15 per cent over the two years.

The downward revision of the prospects for growth in corporate profits, together with an increase (probably temporary) in the risk premium, explains most of the fall in share prices in the leading industrial countries.

The cost of equity capital has increased, causing a sharp contraction in the number of new listings everywhere. In 2001 only eighteen companies were admitted to listing on Italian regulated markets, compared with an average of thirty-six in the years from 1998 to 2000. Last year saw a decrease in the number of Italian companies with shares listed on regulated markets, already low in comparison with the other main markets of continental Europe. The concentration of the market increased, after falling without interruption in the five preceding years. The ratio of the market value of the first five companies to total market capitalization rose from 37 per cent at the end of 2000 to more than 41 per cent at the end of last year.

The anomalously small number of listed companies in Italy is not satisfactorily explained by the fragmentation of the productive system nor by the tax bias in favour of debt capital. Rather, the flow of new listings appears to be influenced primarily by stock price dynamics and the cost of equity capital. During the last century waves of new listings occurred in Italy in only two periods, 1905-07 and 1985-86, both of which were marked by substantial increases in real share prices. There was a third wave in 2000, when a large number of companies were listed on the Nuovo Mercato in response to the enormous and mostly unjustified rises in the share prices of companies in the so-called new economy.

The fall in share prices significantly reduced the total market capitalization, from 70 per cent of GDP in 2000 to around 50 per cent in 2001. Compared with the total for the euro-area markets, the capitalization of the Italian market fell from 14 per cent in 2000 to around 12 per cent last year. The volume of trading also declined, although the turnover rate remained well above one.

16. The transformation of stock exchanges into profit-making businesses accelerated with the listing of some of the leading European stock exchanges and the entry of shareholders other than financial intermediaries.

The technological and organizational revolution that has occurred in the world of stock exchanges in recent years is in sharp contrast with the immobility of the European regulatory framework with regard to markets and listing. The directives in force on listing requirements and prospectuses are based on a notion of "official market" that was consistent with the former public nature of stock exchanges but which has been completely outdated by their transfer to the private sector and the improvement in the quality of markets.

The more general concept of "regulated market" is fully embodied in Italy's Consolidated Law on Financial Intermediation, in which every distinction between official and other markets has been dropped. Under this law it is the stock exchange that verifies compliance with the listing requirements, while the supervisory authority is charged with vetting the prospectus.

This division of tasks between public and private-sector bodies raises well-known problems. The quality of the verification that listing requirements are satisfied is of interest to investors, but the cost of the service is borne by the companies concerned, in the form of fees paid to the stock exchange. There is thus the risk that the quality of the service will be lower than would be desirable. The risk is reduced by competition between markets, which imposes the maintenance of an adequate quality. It could be reduced even more by the stock exchange having an ownership structure and governance arrangements that ensured a proper balance between the interests involved.

The alternative of entrusting the public authority with the task of verifying that companies meet the listing requirements, while leaving the stock exchange free to impose additional requirements, would be a step back with respect to the recent tendency to privatize markets; on the other hand it would ensure homogeneous minimum conditions for listing and would facilitate the coexistence of a number of different regulated markets within the same country, as the UK experience shows.

The listing of stock exchanges on markets that they themselves manage raises the problem of how stock exchange management companies can perform on themselves the functions of public interest — admission to listing and subsequent supervision — they are entrusted with by law.

The protection of consumers of financial services

17. The Enron meltdown has drawn the attention of the public to a problem that was already known and which the Commission has addressed more than once: the reliability of research reports on listed companies and of the advice regarding the weight their shares should have in investors' portfolios. The problem has its origin in the existence of a potential or actual conflict between the need for impartial analysis and the business relationships between companies and the financial institutions that employ the analysts. The strength of these relationships all too

often breaches the Chinese walls erected by intermediaries' internal rules and intended to separate the highly lucrative activity of providing financial assistance and advice from the much less profitable one of doing research.

Well before Enron, and earlier than other supervisory authorities, Consob had addressed this issue, even though it has very little scope for action in this field: financial analysts are not specifically referred to in the law and Consob's ability to influence the organizational choices of the intermediaries for which they work is limited.

It has been made obligatory for intermediaries to disclose potential conflicts of interest and their causes in detail. Provision has also been made for research reports to be released promptly, so as to allow intermediaries and investors to assess their reliability and independence. Consob has issued recommendations regarding the conduct and methods to be followed in preparing and distributing research reports, so as to make underlying interests more transparent and distorted use of the information more difficult. Where these rules have been violated, Consob has initiated sanction procedures.

The effectiveness of the Italian regulations is undermined both by the persistent differences between national regulatory approaches, which encourages regulatory arbitrage, and by the absence of valid forms of self-regulation that would supplement and strengthen the regulatory provisions. In the United States, spurred by the Enron affair and solicited by the SEC, the National Association of Securities Dealers has recently decided to adopt new and more stringent rules of conduct. The International Organization of Securities Commissions intends to establish principles serving as the basis for the regulation of research reports.

In order to reconcile the need to protect investors from conflicts of interest with that of not penalizing Italian industry by imposing stricter rules than are in force elsewhere, Consob has re-examined the problem with the collaboration of the trade associations involved. The aim is to devise a system that does not impose one-size-fits-all obligations but impinges on intermediaries whose conduct diverges from industry best practice.

18. Between 1995 and 2001 the share of Italian households' financial wealth entrusted to the asset management industry rose from 10 per cent to around 30 per cent. There is increasing competition in the industry from foreign managers: the number of authorized products supplied by non-residents rose from around 400 in 1995 to more than 2000 last year. There has also been an increase in the share of products of management companies domiciled abroad, mostly in Luxembourg, but controlled by Italian banks and financial intermediaries.

The growing popularity of index products has brought significant benefits but is accompanied by potential risks: on the one hand it fosters greater liquidity and makes it easier to use hedging instruments, on the other it encourages herd behaviour, thereby amplifying trends and increasing short-term volatility.

Retail customers are now offered more complex and sophisticated products such as portfolios invested in funds and funds of funds. In theory these products broaden the range of efficient combinations of risk and return available to investors but they also involve risks of opaque costs and conflicts of interest. The widespread practice whereby companies managing funds of funds arrange to benefit from commission rebates granted by those that manage the funds held in portfolio may create incentives in conflict with investors' interests in terms of higher fee costs and less efficient investment choices. Consob has requested management companies to indicate the existence of such agreements in their prospectuses and to include the rebated fees in the calculation of the expense ratio.

Investors may also lack information when products are offered that are analogous in terms of management policy and style. This is physiological when there are obstacles to the merger of funds managed by the same company. In other cases it is necessary to assess whether the significant differences between the results of similar funds managed by the same company, often concentrated in very short periods, are the fruit of policies aimed at altering their relative performances, *inter alia* by means of transfers of securities at prices not in line with the market.

19. Notwithstanding these causes for concern, the stringent disclosure rules and mark-to-market requirements to which mutual funds and Sicavs are subject result

in their being among the most transparent financial products. By contrast, other financial instruments, such as insurance products with an essentially financial component and the structured bonds distributed by banks, have features analogous to those of mutual funds, but are subject to much less rigorous transparency rules, both at placement and subsequently. The insurance products are totally exempt from the rules on public offerings, while a prospectus is only required for bonds that envisage the subscription or purchase of shares and for those that are listed (less than one fifth of the total).

In the first six months of 2001 insurance products linked to mutual funds or indexes accounted for more than 55 per cent of the gross premiums of life insurance companies. At the end of September structured bank bonds (including those containing only call and put redemption clauses) accounted for nearly half of banks’ total issues and for around 9 per cent of households’ total domestic financial assets. In both cases the reference indexes or baskets are similar to those used in the management of mutual funds. In particular, the indexation mechanisms adopted for calculating interest and the principal to be redeemed at maturity for structured bonds are increasingly complex and often contain more than one reference clause. This can jeopardize the liquidity and efficient price formation of these instruments. In fact, issues for a total of around €1.7 billion have recently been withdrawn for these reasons.

Among the various types of structured bonds, those known as reverse convertibles appear to be on their way to extinction: in the first nine months of last year issues of such bonds amounted to no more than €300 million, compared with €3.4 billion in 1999 and €2.5 billion in 2000. As part of its investor education activity, Consob has posted a guide to the risks inherent in these instruments on its website. In addition, it has so far sent five reports to the judicial authorities on suspected manipulation of the prices of the underlying shares.

Towards a single European market in financial services?

20. Many of the problems that national market regulatory authorities face would be best resolved in the context of common European rules. In order to speed up the slow process of harmonization, a group of experts (the Lamfalussy Committee) proposed some changes to streamline the adoption of Community legislation in the financial field.

The turf war between European institutions over these proposals ended with a compromise. The Stockholm European Council accepted the recommended method: directives, approved under the co-decision procedure by the Council and the European Parliament, are to establish general principles; the drafting and subsequent amendment of technical rules are entrusted to secondary legislation to be prepared by the Commission, with the assistance of the Committee of European Securities Regulators, and approved by the Securities Committee made up of government representatives. The Commission established the two committees in June 2001. The European Parliament, hostile to the delegation of regulatory powers, succeeded in having a sunset clause introduced, whereby the right to adapt and update the level 2 rules for each directive has to be renewed every four years at the legislative level.

This is a compromise and not a stable and satisfactory solution, for two reasons. In the first place, the sunset clause, with a deadline calculated from the date of entry into force of each directive and not from the time of its transposition by the Member States, risks seriously reducing the possibility of adapting the rules promptly to changes in the securities markets without having to go through the whole legislative process. Secondly, and more importantly, the European Parliament tends to reappropriate the powers granted and reduce the scope of level 2 rulemaking, as has already occurred in its examination of the directives on prospectuses and market abuse.

21. The Financial Services Action Plan, for which governments renew their support at every European Council, has nonetheless made some progress.

Approval has been given to the Council Regulation on the European company, which will offer an alternative to the existing national models with effect from 2004. The European Parliament, albeit with some amendments that will require recourse to the conciliation procedure, has approved the proposed regulation on the adoption within the European Community of International Accounting Standards: with effect from 2005 listed companies will have to prepare their consolidated accounts applying these standards, while Member States are free to impose their application for the preparation of companies' individual accounts. The European Parliament's examination of the directives on prospectuses and market abuse is making heavier weather.

The proposed directive on prospectuses is intended to introduce a single passport for issuers on the basis of the home-country principle that would upgrade and harmonize disclosure standards, permit reference to be made to the registration document for subsequent issues and simplify the language regime. In its first reading the European Parliament made amendments that are highly questionable and which would completely distort the approach of the proposal. Reaching a satisfactory agreement with the Council and the Commission before the European Parliament's second reading will not be easy.

The proposed directive on market abuse broadens the definition of insider trading (also in the light of events connected with the 11 September terrorist attacks) and introduces common standards against market abuse. It also provides for an increase in the competent authorities' powers by introducing a system of administrative sanctions, while leaving Member States free to add penal sanctions. In its first reading, the European Parliament narrowed the definition of market manipulation, thereby making its repression more difficult, and restricted the investigatory powers to be given to competent authorities. The transposition of the directive into Italian law will in any case require the amendment of the provisions of the Consolidated Law on Financial Intermediation on insider trading and market manipulation, also in order to establish the size of the administrative sanctions and the procedure for imposing them.

The proposal for a new investment services directive is still being prepared by the Commission. Following the European Parliament's rejection, by just one vote, of the proposed directive on takeover bids, a high-level group of experts on company law has drawn up a report at the Commission's request. The recommendations of the report, which are mostly acceptable and in many cases already implemented in Italian law, go beyond the provisions of the proposed directive that was not adopted. The road leading to a political agreement still appears to be beset with obstacles.

The fragility of Europe's institutional arrangements continues to hinder the creation of a single market in financial services.

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Ladies and gentlemen,

The financial system is growing: markets are growing, more advanced techniques are being used, new products are being introduced. Not all financial innovations serve to enhance the growth and solidity of the economy, but the balance is certainly positive. One thing is sure, that the growth of the financial system increases the demands on regulatory authorities: investors are more easily lured by novelties; rulemaking is hard pressed to keep up; traditional situations take on a new significance.

The task of market regulatory authorities is made all the more difficult by their having two interlocutors, not just one: investors, whom they must protect, and issuers, intermediaries and asset managers, whom they must supervise, but without jeopardizing their ability to grow and compete. Both groups turn to regulators to satisfy a wide range of often incompatible needs.

Some complain of a lack of regulation, others of an excess. Some complain that the rules are excessively generic, failing to list every requirement and leaving too much to interpretation, others that they are over-elaborate and pedantic. It is difficult to strike a balance between demands that are all comprehensible but also conflicting. The Securities and Exchange Commission and the Financial Services Authority have adopted much more voluminous regulations than Consob. The Consolidated Law on Financial Intermediation lays down principles and grants Consob rulemaking powers with a margin of discretion. The three regulations implementing the Consolidated Law contain less detailed prescriptions than those they replaced. The market agreed with this choice in the consultations that preceded their adoption.

Rightly, Consob is required to respond rapidly even when, in the context of what jurists call atypical administrative activities, the law does not fix a time limit; this is the case, for example, of Consob's responses to queries, which have averaged about one hundred a year over the last four years. Yet, Consob is also required to establish rigid procedures for all its activities and not only those that involve the adoption of typical administrative measures, or is expected to treat all of its acts as typical, whether it is a question of recommendations, interpretations it is asked to provide or opinions that do not have direct binding effects. It is not easy to reconcile this approach with the need expressed by the market for more streamlined and efficient forms of consultation and collaboration.

Consultation and collaboration are to Consob's advantage because they alleviate and facilitate supervision. They have increased of late, with some market participants more than others. They must be further intensified, in a dialogue set in a completely transparent framework, with the necessary distinction of roles and responsibilities, but also with shared awareness that the quality, transparency and efficiency of the market must be the objective.