

NEW RULES ON ITALIAN BANKS' ORGANIZATION AND CORPORATE GOVERNANCE

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A supervisory regulation regarding banks' internal organization and corporate governance issued recently by the Bank of Italy may require Italian banks to amend their by-laws and adopt new internal regulations.

Since 2004, Italian corporate law has contemplated three different governance and supervision structures that stock corporations may choose from and adopt in their by-laws:

- (i) The traditional Italian model, comprising a board of directors and a board of statutory auditors (*collegio sindacale*) composed of independent members performing oversight functions;
- (ii) A one tier model, consisting of a board of directors, including a management audit committee (*comitato per il controllo sulla gestione*) composed of a majority of independent directors; and
- (iii) A two tier model comprising a supervisory board (*consiglio di sorveglianza*) and a management board (*consiglio di gestione*).

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In March 2008, the Bank of Italy issued a supervisory regulation regarding banks' internal organization and corporate governance (the "New Regulation"),¹ which implements the general guidelines set forth by Decree No. 200 of the Minister of Economic Affairs of August 2004 (the "Treasury Decree") on the principles to be followed by banks and other financial intermediaries adopting governance systems alternative to the traditional one.²

In line with better regulation standards, the New Regulation is divided into general principles and implementing guidelines. The principles set forth the organizational and governance goals that banks are free to achieve in the manner they choose depending on their characteristics, whilst the guidelines are intended to facilitate the implementation of the general rules in specific areas.

The New Regulation applies to both banks and bank holding companies (*capogruppo*) incorporated in Italy and sets forth the essential features that a bank or bank holding company³ (hereinafter, collectively referred to as "banks") must adopt in its corporate governance system to ensure the sound and prudent management of the bank.

The New Regulation uses the concepts of (i) "strategic supervision", (ii) "management," and (iii) "control" to identify the functions with which corporate bodies or their members need to be entrusted. This approach focuses on the powers and duties that are relevant for supervisory and corporate law purposes.

The New Regulation seeks primarily to draw a clear distinction between the control and management functions and clearly define each of them. In particular, the New Regulation addresses those situations where, depending on the governance system implemented in a bank's by-laws, the same (management or control) function is performed by more than one corporate body, or a single corporate body performs various functions. Indeed, the confusion generated by such situations could jeopardize a bank's sound and prudent management.

The principles set forth by the New Regulation are particularly relevant for the two tier governance system (as outlined in the Italian Civil Code), in which the risk of overlaps between the governing bodies is particularly acute.

In a speech given on January 19, 2008 commenting on, among other things, the draft of the New Regulation (the "Speech"), the Governor of the

Bank of Italy stated that: "It is necessary to guarantee a clear division of responsibilities, checks and balances, and a proper hierarchy of control. The supervisory rules provide, again with the aim of ensuring sound and prudent management, specific safeguards for cases in which, as practical experience has shown, civil law does not totally exclude the possibility of an overlapping or commingling of functions."⁴

To comply with the New Regulation, the by-laws of several Italian banks may need to be amended and new internal regulations may need to be adopted. The deadline for adapting banks' internal organization and corporate governance to the New Regulation is June 30, 2009. Banks will also need to comply with the criteria set forth in the New Regulation in drafting their compensation and incentive schemes.

CHOICE OF THE CORPORATE GOVERNANCE AND SUPERVISION MODEL

According to the New Regulation, banks shall choose the corporate governance model which is most likely to ensure the efficiency of operations and the effectiveness of controls, taking into account the costs involved in each model. The choice should be made on the basis of a self-assessment process, considering:

- (i) The bank's ownership structure and its recourse to the equity capital markets;
- (ii) The bank's size and the complexity of its operations;
- (iii) The bank's medium- and long-term strategic objectives; and, if applicable,
- (iv) The organizational structure of the group to which the bank belongs.⁵

Banks will have to (a) adopt, by June 30, 2009, (b) update upon the occurrence of any significant organizational change, and (c) file, upon request, with the Bank of Italy, a "corporate governance plan,"⁶⁻⁷ The corporate governance plan will need to be approved by the corporate body in charge of the strategic supervision function and adopted with the favorable

opinion of the body entrusted with the control function.

Each bank's corporate governance plan will need to detail (i) the reasons why the corporate governance model chosen by the shareholders is the most suitable to ensure efficient management and control, and (ii) the choices made with respect to the organizational structure of the bank (*e.g.*, tasks, powers and composition of the governing bodies; delegated powers; accounting audit system; incentive and remuneration schemes; and information flows), shareholders' rights (*e.g.*, withdrawal rights and quorums for shareholders' meetings to vote on resolutions and for challenging shareholders' or board resolutions), financial structure (*e.g.*, classes of shares and limits to their transfer, other equity-like securities, and segregated assets), and procedures for handling conflicts of interest (*e.g.*, related-party transactions, directors' obligations).

For banking groups, the plan prepared by the group parent company (*capogruppo*) will have to illustrate the measures adopted to ensure the adequacy of the management and control systems and the organizational choices made with respect to the banks belonging to the banking group. Group holding companies will need to detail the measures in place to ensure the interaction between the corporate bodies and functions of the various companies making up their group, in particular as regards the control systems. Banks belonging to banking groups are exempted from drafting a corporate governance plan if their organizational choices are reflected in the plan of their group parent company.

DISTINCTION BETWEEN THE CONTROL AND MANAGEMENT FUNCTIONS OF A BANK

Supervision and Management Bodies

The Bank of Italy has articulated a number of innovative positions with respect to the internal corporate governance of Italian banks, in particular when they adopt the two tier governance system. The level of detail and the prescriptive nature of the provisions concerning the internal organization and powers of banks' corporate bodies have been criticized by commentators because of certain significant restrictions imposed on banks' ability to fully

implement the governance systems provided for under the Italian Civil Code.⁸

The New Regulation requires that, where the strategic supervision and management functions are assigned to different bodies, the tasks and responsibilities of each body be clearly identified, with (i) the strategic supervision body being responsible for deciding the bank's strategy and monitoring its implementation, and (ii) the management body being in charge of the bank's management.⁹

Similarly, the New Regulation requires that a clear distinction be drawn between powers and roles of the individuals within the corporate bodies to which both supervisory and management functions are entrusted.

In particular, the chairman of the board of directors is supposed to have a key role in fostering debate within the board and ensuring an adequate balance of powers in a manner consistent with his or her duty to organize the work of the board and guarantee that the board members receive an adequate information flow.

The New Regulation requires that a similar function be vested — in banks that adopt the two tier model — in the chairman of the body in charge of strategic supervision. If the strategic function has been entrusted to the supervisory board, the chairman of the supervisory body must ensure a neutral stance among the functions attributed to him or her, so as to guarantee their objective and impartial integration (see below regarding the means to ensure neutrality).¹⁰

In order to implement such principles, the New Regulation requires, *inter alia*:

- (i) That the scope of delegated powers of the members of the management body be set out in a clear and precise fashion, especially with regard to quantitative limits, as well as the manner in which such powers should be exercised;
- (ii) That certain activities — in addition to those set forth by the Italian Civil Code — not be delegated to individual members or committees (*e.g.*, strategic guidelines and transactions, preparation of business and financial plans and appointment of the general manager, amendment of key internal policies, choice of the head of internal control and compliance functions);

- (iii) That the simultaneous presence within a board of directors of an executive committee and one or more chief executive officers be justified by the size and complexity of the bank's operations;
- (iv) That the chairman of the board of directors and, in the two tier model, the chairman of the management board when the supervisory board does not perform the strategic supervision function, have a non-executive role and not be involved, even *de facto*, in the current business of the company, except for exceptional circumstances, and provide a balance of power *vis-à-vis* the CEO or other executive directors; and
- (v) That the entrustment to the supervisory board of strategic supervision not lead to the involvement of the supervisory board in the management of the bank, thus changing its nature as a control body and limiting the independence of the management body.¹¹

The Control Function

The New Regulation emphasizes the importance of the body exercising the control function and contains a set of rules aimed at providing the controlling bodies under the two tier and the one tier models (respectively, the supervisory board and the management audit committee) with a degree of autonomy and independence.

The control body is responsible for the monitoring of the internal control system of the bank as well as risk control and management. In particular, the control body is responsible for monitoring the procedures in place to determine the capital adequacy of the bank, with regard to its internal organization and operational size. This body is also responsible for verifying the adequacy of, and compliance with, the internal capital adequacy assessment process (ICAAP) as required by the Bank of Italy, also taking into account the risks (*e.g.*, reputational and strategic risks) that are not covered by the prudential rules implementing Basel's Pillar I.

The control bodies of groups' parent companies (*capogruppo*) must verify, *inter alia*, the correct exercise of the strategic and management supervision performed by the parent company over its subsidiaries.

Banks adopting the one tier or two tier model are required to adopt in

their by-laws rules and organizational measures to prevent the controls from being flawed as a result of the co-existence of control and management responsibility in the same corporate body. To achieve this purpose, if a bank has adopted the two tier system, and (i) the strategic supervision function has been entrusted to the supervisory body, or (ii) the supervisory body has more than six members, an *ad hoc* committee must be established within the supervisory board (an internal audit committee), to act as a reference body for the internal control function and staff. The purpose of this committee is to reconcile the control and strategic supervision functions entrusted to the supervisory board so as to ensure the bank's sound and prudent management.

As guidelines implementing the mentioned principles, the New Regulation sets forth measures that banks should adopt with respect to, among other things, (i) reports that the internal audit and compliance functions must provide to the control function, (ii) coordination between the control body of the parent company and that of the controlled companies, and (iii) coordination between the control body and the external auditors, and requires that certain provisions be included in the by-laws of every bank. Among them, the New Regulation introduces a new prohibition whereby members of control bodies may not sit on corporate bodies (other than control bodies) at other companies of the same group, financial conglomerate or companies in which the bank holds a strategic participation.¹²

In addition, the New Regulation sets out, among other things, the following specific rules on the control function depending on the governance system chosen by the bank.

The One Tier Model

The by-laws of a bank that has adopted a one tier governance model must provide that the management audit committee of the board of directors be entrusted with the power to ensure compliance with laws and regulations, that the power of appointment and removal (such removal to be reasoned) of the members of the management audit committee be assigned to the shareholders — contrary to the general rule set forth in the Italian Civil Code, which contemplates this as an option¹³ — and that the management

control committee be given the power to conduct inspections and take other monitoring actions at any time.

The Two Tier Model

As to banks that have adopted a two tier governance model, the New Regulation provides that (i) the supervisory board may carry out inspections or other control measures at any time (without disrupting the ordinary business of the bank), *provided that*, when it comprises more than six members, a separate internal audit committee be established and be responsible for conducting inspections; (ii) the supervisory board members may ask the management board to be informed about the bank's business or about specific transactions and must identify the manner in which such power may be exercised without disrupting the ordinary business of the bank; and (iii) the removal of the supervisory board members or (only) the removal of the internal audit committee members, if any, must be reasoned.¹⁴

In addition, according to the New Regulation, where the supervisory board is entrusted with the strategic function and an internal audit committee is created, (at least) one member of such committee must participate in the meetings of the management board. In the absence of an internal audit committee, this function must be entrusted to the member of the supervisory committee who is most qualified because of his or her experience and independence.¹⁵

COMPOSITION OF THE GOVERNANCE BODIES

The New Regulation highlights the key roles and functions, within the corporate bodies, of non-executive¹⁶ and independent directors, as well as special committees within the body performing the supervision function. The New Regulation also recommends that the size of corporate control and management bodies be adequate in light of the size and complexity of the bank but, at the same time, not comprise too many individuals. This could reduce the incentive of each person to be directly involved in the performance of the corporate body's function and could even hamper the functionality of the body.

In particular, the New Regulation recommends that an “adequate” number of non-executive members be appointed, with well-defined roles and duties to counter-balance the executive members and the management of the bank and foster a debate within the corporate bodies, especially where a single body exercises several different functions (such as strategic supervision and management).¹⁷

Furthermore, the body performing the strategic supervision function must also comprise independent members supervising the business in the interest of the company, consistently with the bank's sound and prudent management.

Also, the New Regulation recommends any bank with a large size and complex business, to set up — within the body charged with the strategic supervision function — special committees (with advisory and proposal powers) comprising independent directors in those areas where conflicts of interest are most likely to arise.

Among the guidelines implementing the above principles, the New Regulation provides that:

- (i) The limitations on the number of offices that members of corporate bodies may hold should be defined in the bank's by-laws or in internal regulations;
- (ii) Where the supervisory board is given strategic supervision powers, it would be reasonable that the management board comprise a restricted number of members (mostly executives, directly involved in the management of the bank);
- (iii) Within the corporate body performing the strategic supervision function, an adequate number of independent members should be present;
- (iv) In the one tier model, in order to ensure effective controls, the management audit committee should be composed of at least three members; and
- (v) In the two tier model, where an internal audit body has been appointed, its members should all be independent and the chairman of the supervisory board, when such body has strategic supervision functions, cannot be a member of such internal audit body, to preserve a neutral stance among his or her roles.

COMPENSATION AND INCENTIVE MECHANISMS¹⁸

Pursuant to the New Regulation, the mechanisms aimed at enhancing the competitiveness of a bank by way of providing remuneration to its directors and management must be structured so as to avoid generating interests that may conflict with the long-term risk profile of the bank. Also, incentive mechanisms linked to financial instruments such as stock options or linked to the bank's performance must be related to the risk taken by the bank and structured so as to avoid incentives conflicting with the long-term interests of the bank.

In particular, banks' by-laws are required to entrust the shareholders meeting with the powers to determine the compensation of the corporate bodies it appoints directly and approve (i) compensation policies for directors, employees or independent contractors, and (ii) plans based on financial instruments (*e.g.*, stock options). The consistency of the policies and the plans with prudent risk management and long-term strategies of the bank must be evidenced in the resolution approving them.

Larger banks should create, within the committee determining the compensation of board or management committee members performing specific functions, an advisory committee composed of a majority of independent members to propose and advise on management compensation and remuneration criteria. The compensation for specific roles performed by supervisory board members is to be resolved upon by the shareholders.

Compensation based on financial instruments and bonuses linked to corporate performance may not be used for members of internal control bodies. Incentives should also be avoided for non-executive directors and, in any case, they need to represent a very limited part of such directors' overall compensation. People in charge of internal control functions, such as the head of internal audit, compliance or risk management, as well as managers in charge of the drafting of the bank's accounting documentation must be adequately compensated for the responsibilities they assume, but their compensation should not be in any manner linked to the financial performance of the company (although it can be linked to financial instruments to a certain extent), except in extraordinary circumstances.

With respect to top management's compensation, the New Regulation

requires that the basis on which the amount of compensation is determined be clearly specified, objective and easy to monitor. Further, the ratio of the incentive-based component *vis-à-vis* the overall compensation must be defined and carefully assessed.

INFORMATION FLOWS

In accordance with Article 2381, paragraph 6, of the Italian Civil Code pursuant to which directors must act in an informed manner, the New Regulation sets forth guidelines that banks should follow to implement complete, timely and precise information flows among the bodies performing the strategic supervision, management and control functions, as well as among the members of a given body.

Pursuant to the New Regulation, banks must adopt procedures specifying: (i) the timing, form and content of the documentation to be transmitted to the members of the various corporate bodies in order to allow them to adopt an informed decision on the items on the agenda; (ii) the identity of the individuals charged with the duty to inform, on a regular basis, the governing bodies (with particular emphasis on the control function); and (iii) the minimum content of any information notice, which must include the level and trend in the exposure of the bank *vis-à-vis* any kind of risk and any deviation from applicable policies.

NOTES

¹ See http://www.bancaditalia.it/vigilanza/banche/normativa/disposizioni/provv/en_disposizioni_040308.pdf.

² Prior to the issuance of the New Regulation, banks were entitled to adopt one of the two non-traditional governance systems. However, in the absence of the general guidelines and principles set forth in the New Regulation, they had no guidance on the governance structure that was acceptable to the Bank of Italy. Since 2004, at least four of the largest Italian banks (Intesa San Paolo S.p.A., Unione di Banche Italiane Società Cooperativa per Azioni, Banco Popolare Società Cooperativa per Azioni and Mediobanca — Banca di Credito Finanziario S.p.A.) have adopted the two tier system.

³ Bank holding companies are, in particular, responsible for the overall consistency of the corporate governance at a group level and the creation of adequate connections between bodies, areas and functions (control functions in particular) at the various group member companies.

⁴ See http://www.bancaditalia.it/interventi/integov/2008/forex_190108/en_080119_forex_bari.pdf.

⁵ According to the Speech, "Once the rules have been issued, banks will be expected to make, in accordance with the principle of proportionality, a detailed self-assessment to verify the compliance of their corporate governance systems with the new rules. A suitable transition period will allow intermediaries [i.e., banks] to make any adjustments that may prove necessary."

⁶ In its paper illustrating the outcome of the public consultation on the draft New Regulation (the "Paper") the Bank of Italy clarified that each bank is free to decide whether to publish in whole or in part the corporate governance plan or classify it as confidential and deliver it only to Bank of Italy. See http://www.bancaditalia.it/vigilanza/banche/documcons/consnorm/resoconto_040308.pdf.

⁷ The corporate governance plan also needs to be filed at the time of (i) the establishment of a bank, and (ii) a change of the existing corporate governance model. Mutual banks (*banche di credito cooperativo*) adopting the standard by-laws prepared by their association and reviewed by the Bank of Italy will not be required to prepare a corporate governance plan.

⁸ The Bank of Italy in its Paper addresses these criticisms, stating that it has been delegated sufficient powers (by the Italian Banking Act and Treasury Decree No. 200 of 2004) to enable it to influence, in the interest of the sound and prudent management principle, the contents of bank by-laws, including by way of restricting the choices granted to companies by the Civil Code.

⁹ In the Speech, the Governor confirmed the rationale for this provision: "The supervisory board can combine and in fact usually does combine guidance functions, typical of the shareholders' meeting, strategic supervision functions, vested in the board of directors, and control functions, characteristic of the board of auditors. The supervisory rules [i.e., the New Regulation] will ensure a clear distinction between strategic supervision reserved to the supervisory board and management reserved to the management board and will erect defences to protect the impartiality and efficiency of the controls performed by the supervisory board. This is the rationale for the provisions that call for the detailed identification of the powers of the supervisory board and the management board, which are also reflected in the latter's composition."

¹⁰ For example, the Chairman of the Supervisory Board of Mediobanca — Banca di Credito Finanziario S.p.A., despite being empowered by the current by-laws of

the bank to participate in the meetings of the bank's Management Board (the bank adopted the two tier system in June 2007), has informally agreed with the Bank of Italy that he would delegate such power to another member of the Supervisory Board, who is also President of the bank's Internal Audit Committee.

¹¹ The New Regulation provides for a number of measures to be included in the by-laws of banks that have adopted the two tier system in order to ensure an adequate balance between the strategic and management functions. In particular, the New Regulation and the Paper require that banks' by-laws, among other things: (i) clearly set out the functions of the supervisory and management boards, respectively, and exclude the possibility of expanding such functions on a case-by-case basis, (ii) identify the nature and content of the decision-making powers entrusted to the supervisory board, compared to the powers entrusted to the management board, and (iii) set out the key strategic transactions in connection with which the supervisory board may formulate its guidelines to the management board.

¹² A participation is deemed "strategic" when it represents at least 10 percent of the share capital or the voting rights of the participated company and five percent of the consolidated regulatory capital of the banking group (or stand-alone regulatory capital for banks not belonging to banking groups).

¹³ See Article 2409-*octiesdecies* of the Civil Code.

¹⁴ According to the Paper, the Bank of Italy does not require that the reasons for the removal amount to a just cause (*giusta causa*) for dismissal; accordingly, it did not intend to hinder through this rule the acquisition of control over a bank with a one or two tier governance system.

¹⁵ This provision has triggered a vast debate on the rights and powers of the Bank of Italy to set forth rules that conflict with the provision of the Civil Code (article 2409-*terdecies*, fourth paragraph) entitling each supervisory board member to participate in the meetings of the management board.

¹⁶ In line with the Civil Code, the New Regulation defines as "non-executive members" the individuals who are not members of the executive committee, do not receive any delegated power and do not perform, not even *de facto*, functions relating to the management of the bank.

¹⁷ In particular, the New Regulation provides that the non-executive members shall, *inter alia*, (i) acquire through internal committees information on the manner in which the bank is managed and organized, the management, the internal audit and other control functions; (ii) not be involved, even *de facto*, in the actual management of the company and avoid conflicts of interest; and (iii) take part in the processes of appointment and removal of the persons responsible for the internal control and risk management functions (in particular, internal audit and compliance).

¹⁸ The terms “remuneration,” “compensation” and “incentive” are broadly defined by the Bank of Italy. In particular, they include, *inter alia*, supplementary pension schemes and other monetary benefits, including those payable in the event of dismissal or revocation of mandates or assignments.