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# Corporate governance reforms, interlocking directorship and company performance in Italy

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ABSTRACT

We analyze the effects of corporate governance reforms on interlocking directorship (ID), and we assess the relationship between interlocking directorships and company performance for the main Italian firms listed on the Italian stock exchange over 1998–2007. We use a unique dataset that includes corporate governance variables related to the board size, interlocking directorships and variables related to companies' performances. The network analysis showed only some effectiveness of these reforms in slightly dispersing the web of companies. Using a diff-in-diff approach, we then find in the period considered a slight reduction in the returns of those companies where interlocking directorships were used the most, which confirms our assumption on the perverse effect of ID on company performance in a context prone to shareholder expropriation such as the Italian one.



## 1. Introduction

The Italian corporate governance system features – at shareholder level – large ownership concentration and the presence of control-enhancing mechanisms in such a way which is conducive to controlling shareholders' dominance at the expenses of minority shareholders (Barker, 2010). In 1998 a structural reform of corporate governance was implemented in order to open up the market for corporate control and to protect minorities (the Draghi Law). At director level, the Italian corporate governance system is characterized by the widespread recourse to interlocking directorships (thereafter ID). In this respect, self-regulation provisions during the period 1998–2007 attempted to reduce interlocking directorships.

The purpose of this paper is to assess the effect of interlocking directorships on company performance (measured by ROE and ROA), and to understand whether the regulatory reforms had any influence on interlocking directorship. Using the instruments of network analysis, we find that after these regulations the concentration of the Italian network of companies decreased only slightly. In particular, the reforms implemented during this period were only partially effective in reducing the pathological cases of interlocking directorships: the companies at the center of the director network managed to reduce their peripheral links while keeping their strategic connections. Moreover, applying an econometric technique (diff-in-diff) that allows to treat reforms as a "natural experiment", we find that, coherently with the our assumptions about the purpose of ID in the Italian stock market of expropriating shareholders, the resilience of a core network of highly interconnected listed companies did not allow such companies to increase their performance. Indeed, in the period considered there was a small significant negative effect on the performance of those companies that relied the most on ID.

This work calls for strengthening the reforms enacted in the 1998–2007 period with further regulation on ID, which actually took place with new law provision in 2011: article 36 of the "Save Italy" Act ruled out interlocking directorships within the same industry, effective from 2012. Further studies will have to tell if the

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last wave of reforms finally managed to break the perverse incentives of ID on company performance in Italy. With respect to other works, this is the first study that implements a quasi-experimental technique–which provides causal evidence - to address the impact of this kind of corporate governance reform. This evidence is complemented by a network analysis that, although it cannot provide causal claims, helps to measure and visualize the dispersion of the linkages among interconnected companies.

The paper is organized as follows. Section 2 reviews the characteristics and the legal changes in the Italian corporate governance system, whereas Section 3 discusses the literature on interlocking directorships and company performance and derives the hypotheses to test. Section 4 presents the methodology and data. Results are discussed in Section 5. Section 6 concludes.

## 2. The Italian corporate governance system: history and reforms

In Italy corporate control is exerted by "industrial families" through alliances based on cross participations, yielding stability in control, in a context in which pyramidal groups have been exploited as a way to separate ownership from control, using capital provided by third parties in order to fund growth. This allows controlling families not only to keep control over the group but also to control the majority of shares in all companies belonging to the pyramid with direct ownership concentrated at the highest level of the control chain, minimizing the amount of capital invested in order to control the whole group. Italian listed companies also issued shares with limited or without voting rights in order to increase capital without diluting the control of the parent company (Zattoni, 1999; Melis, 2000).[1] Furthermore, when additional capital was required, control has been maintained by forming coalitions with other groups (Amatori and Brioschi, 1997; Barca, 1997; Gianfrate, 2007).[2] This is a long-standing feature of the Italian corporate system: Rinaldi and Vasta (2005) document the widespread recourse to director interlocks and to cross-shareholdings for the post-World War II period, Vasta and Baccini (1997) and Drago et al. (2013) provide evidence for the period before World War II, with an emphasis on the bank-industry relationships.

Di Pietra et al. (2008) analyze the effect of interlocking directorships on share prices in a panel of 71 non-financial Italian companies from 1993 through 2000 and find a limited positive effect. Dyck and Zingales (2004) emphasize that in Italy private benefits of control are higher than in France, Germany and the UK, due to lower investor protection, poorer accounting rules, lower tax compliance and a less independent press. In Italy, expropriatory high private benefits of control affected the preference of controlling families in keeping control as a tool to guarantee these benefits over time. In order to limit these abnormal benefits of control, corporate governance reform should increase minorities' rights and their enforcement. If this does not happen, ownership does not open up, and firms do not grow.

Two main legislative reforms have characterized the Italian corporate governance system: the Draghi Law[3] (Consolidated Law on Finance, TUF) in 1998 and the Vietti law reform of 2002–2004,[4] with some marginal addition by the Law on Savings in 2005.[5]

The Draghi Law was born out of the consolidation of financial market laws into a single act in order to "amend the laws on listed corporations with specific regard to the board of internal auditors, minority shareholder rights, shareholder voting agreements and intra-group transactions, with a view to strengthen the protection of savings and minority shareholders." (Article 21, Para. 4, Law 52/1996). The Law streamlined the legal framework for securities offerings, takeover bids, disclosure obligations, and audit firms. Minority shareholders representing a minimum threshold (ranging from 1 percent to 10 percent of the outstanding shares) were granted governance rights and remedies previously either unavailable (two-thirds majority required in extraordinary meetings and shareholder representing 5 percent of company's capital may sue directors derivatively) or subject to higher ownership thresholds (shareholders representing 10 percent of company's capital may request that a meeting be convened and shareholders representing 5 percent of company's capital may file a complaint to the Court asking for the appointment of an inspector). Disclosure on ownership structure was extended by requiring full disclosure of all shareholder agreements. A "mini-breakthrough" rule was introduced, declaring shareholder agreements by which parties restrict their own freedom to sell shares ineffective in the event of a takeover bid. The lift of a ban on proxies came together with heavy regulation of proxy solicitation and a provision allowing mail voting on an opt-in basis. As to audit functions, the Law completely reshaped the role, composition, and powers of the board of internal auditors: representation of minority shareholders was mandated, its powers and the powers of individual members strengthened, and its mission clarified by focusing on internal controls. A restyling of the legal regime of audit firms was implemented, by clarifying their tasks. Finally, Consob's statutory objectives in supervising issuers were spelt out (investor protection, efficiency and transparency of the market for corporate control and of capital markets), its regulatory authority broadened and its powers to request information, execute on-site inspections and impose ad hoc disclosure duties extended.

The Draghi Law had both signaling and concrete effects. For the former, it improved the perception of Italian capital markets abroad, at a time of increasing competition for capital.[6] Therefore it signaled the new stance on corporate governance that policymakers mostly followed in subsequent reforms. A number of idiosyncrasies characterizing the Italian regulatory framework were abandoned in favor of regulations similar to international standards. For instance, the internal board of auditors was retained as a separate body within the company, but its functions were streamlined to replicate those of audit committees in the US and the UK. The takeovers regime was reshaped drawing inspiration from the UK model: first, a complete ban on defensive tactics was replaced by a rule requiring a shareholder meeting authorization to adopt them; second, a mandatory bid rule triggered by the crossing of a 30 percent threshold replaced a mandatory partial bid rule triggered by the acquisition of control. Rules on shareholder agreements, a traditional tool for control in which dominant families and financial institutions have built blocks and cross-holdings in the major Italian listed companies, were weakened by imposing a maximum duration of three years and by introducing a "mini-breakthrough rule" allowing parties of shareholder agreements to

[1] Cross-ownership of up to 2% for listed companies and up to 10% for non-listed firms is permitted. Special shares with right to vote only in extraordinary meetings are allowed up to 50% of capital.

[2] However, Faccio and Lang (2002) documented that out of 208 listed firms 12.98 were widely held, 59.61 family-held, 10.34 state-held and 0.72 held by cross-ownership, therefore emphasizing the role of families and putting aside the role of coalitions.

[3] Legislative Decree No. 58/1998.

[4] Legislative Decrees Nos. 61/2002, 6/2003, and 37/2004.

[5] For overviews of these reforms see Ferrarini (2005), Melis (2006) and Enriques (2009).

[6] Shleifer and Vishny (1997) stated that "[i]n many countries today, the law protects investors better than it does in Russia, Korea, or Italy").