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The relationship between independent minority directors and Related party Transaction disclosure

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PREFACE

The thesis investigates the role minority shareholders' representation plays on detrimental and abusive Related party transactions (RPT) in Italy. The purpose is to analyse the impact that the slate-vote system can exercise on the fairness of the RPT procedure and the transparency of its disclosure.
The role of RPT is central in the literature debate, also considering conceptual difficulties in defining and measuring its consequences. Mainly, academic research has been interested in the potential economic and social impacts of these peculiar transactions.
There are conflicting views on whether RPTs are beneficial or detrimental to stakeholders.
A review of the existing academic literature will be proposed (Chapter 1) to analyse the prevalent approaches that fuel academic debate: some studies give priority to risks over the benefits arising from the transaction (conflict of interest hypothesis); others emphasize the natural ability of RPT to compress monitoring costs (efficient transaction hypothesis); a more recent part of literature overcomes this dichotomy, offering a new perspective of RPT under contingency theory.
Chapter 2 will show the most common legal techniques usable to tackle the risks of self-dealing RPT. Disclosure requirements and the procedures for approval by the board and/or shareholders, external independent advice, and ex-post standard-based tools are described in detail.
In Italian institutional setting characterized by high concentrated ownership entities, independent directors do not have the actual effectiveness in fostering corporate transparency since they lack the mandate, the incentives, and the ability to be an efficient monitoring mechanism.
In this context - in any setting that shares the same features and critical issue - the presence of objective, disinterested outsiders' members on boards of directors can represent an effective corporate governance solution to reduce the risk of opportunistic

behaviours, overcoming the limits traced to the appointment of independent directors and disclosure requirements.

The abandonment of the single-winner model – according to which the shareholder who holds most of the voting rights has the power to elect the entire board –in favour of a new multiple winner election systems (also known as 'slate-vote-system') – in which the appointment of the members of the board is also an expression of the will of the minorities – may therefore represent an effective mechanism to alleviate the principal-principal conflict and risk of majority shareholders can expropriate value to the detriment of minority ones (endemic issue of Italian setting).

The appointment of at least one director by non-controlling shareholders reinforces the board independence from the corporate controllers (the management or the block-holder in case of high-ownership concentration) and ensure that at least some of the relevant resolutions of the company are adopted with the involvement of the minorities.

The analysis will illustrate in Chapter 3 the Italian Regulation to steam the risk of detrimental RPT. In particular, procedures of fairness as rules to be followed in the decision-making process of the competent bodies (substantive Regulation) and transparency obligations, i.e., disclosure obligations that the company must fulfil periodically or immediately, to convey all necessary information to the market (transparency regulation) will be shown in detail.

In the last part of the thesis, content analysis is conducted on RPT information documents to infer the influence that minority shareholders' representativeness could exercise on the immediate disclosure on the highly material transaction (Chapter 4). It evaluates the relationship with the ability of RPT communication to convey valuable information for all stakeholders, limiting self-serving managerial disclosure. The contribution restricts analysis to narrative disclosures 160 information documents on material RPTs approved by non-financial Italian listed companies to capture the influence of minority directors on impression management of RPT corporate disclosure.

From the methodological point of view, besides the general descriptive aspects and statistics that allow the observation of the phenomena, qualitative and quantitative

tools will be cross-sectionally and sometimes jointly used in carrying out the research objectives.

The findings of this thesis contribute to the advancement of knowledge on the role of minority directors: this could be the basis for future suggestions related to the legislative framework and future insight for academics and practitioners.

CHAPTER I
A REVIEW OF RELATED PARTY TRANSACTION LITERATURE

1.1 Introduction

In recent years, the centrality of Related Party Transactions (RPTs) in many corporate scandals has fuelled the debate on their potential benefits and drawbacks.

Enron, Adelphia and Parmalat crises shed light on inherent risks, as related party transactions emerged as a powerful instrument of financial frauds, shareholders' expropriation, turning the veil from the many relevant loopholes affecting existing requirements (Pizzo,2013). Therefore, the phenomenon - for a long time ignored - has raised considerable concern among academics and practitioners.

The controversial evidence has led to the development of different interpretations of the phenomenon. All criteria for a related party definition significantly differ among the various accounting and governance academic studies and regulatory principles. In general, two different perspectives prevail in the description of RPT.

The first approach defines a transaction as RPT based on the nature of the parties' relationship in the transaction (whether an actual or legal relationship, based on the exercise of control or significant influence). Consistently with this idea, some scholars define these dealings as transactions between a company and a related person operating within company boundaries, introducing the *qualified insider* concept (Young, 2005; Pan & Hsiu-Cheng, 2007). Others extend this interpretation, including all subjects connected to the company with formal (patrimonial or contractual) or informal agreements. Otherwise, the second approach traces the meaning of RPT to the substance of the transactions in place, identifying as transactions between related parties those carried out without address the requirement of the arm's length character.

Consistently, the standard setters provide their interpretations of RPTs. FASB (1982) describes RPTs as transactions between a company and related entities as subsidiaries, affiliates, principal owners, officers, and directors. Under this perspective, a party is related when he/she has a relevant influence on the operating policies of transaction parties or holds an interest of ownership in one of the transacting parties. Some years later, IASB (2009) confirms this thesis defining RPT as *a transfer of resources, service, or obligations between a reporting entity and a related party, regardless of whether a price is charged*.

Under this description, a related party *is a person or an entity that can control the reporting entity or exercise significant influence in taking operational and financial decisions*. The standard-setter describes which forms the operation can take in the ordinary course of business and how a single transaction carried out on arm's length conditions.

The regulator approach is consistent with the control or significant influence from which to draw an analytical list of the numerous subjects defined as related parties, ignoring the substantial analysis of the type of transaction executed.

In this regard, it is worthy to note that control does not depend on the share's weight but derives from an agreement stipulated between two or more subjects. In this perspective, a party can be defined as related if, directly or indirectly, including through subsidiaries, trusts or intermediaries, can exercise significant influence over its operational and financial decisions (Esposito, 2010). This definition of the related party also includes executives with strategic responsibilities and their close relatives, entities in which they hold significant shares of voting rights, including pensionfunds set up favouring company employees, obviously without excluding the firms belonging to corporate groups (Liace, 2016).

Thereby, the parties that control the company can be the actors that directly govern the company, as dominant shareholders or managers, or other subjects that exercise their influence indirectly.

Indeed, RPTs involve a party not independent of the firm that can generate a potential conflict of interest and cause malfunctioning of the financial market (Marchini, Mazza & Medioli, 2018). Thus, these dealings play a critical role in several recent high-profile accounting scandals in Us settings and the European market. Various self-dealing transactions occurred in Europe and specifically in Italy. The widespread outrage in response has thrown up critical issues for RTP (OECD, 2012), increasing the suspicious attitude and the negative perceptions that generally accompany these operations. In most of these frauds, managers or majority shareholders engage RPTs to generate misleading financial statements or enrich a related party, damaging others actors by misappropriating assets of different types (Swartz & Watkins, 2003). The frequent abusive use of RPTs has prompted national jurisdictions to provide specific rules to deal with their risk.

In particular, to minimize the negative potential of RPT, regulators and standard setters have strengthened the current rules and principles by establishing new requirements and bans to RPT discipline, decreasing the discrepancy in treatment between those who hold power and those who can only be a victim. While considerable evidence has reported on the negative consequences of RPTs (declines in shareholder wealth, lowered accounting quality and an increased likelihood of financial fraud), not all RPTs entail value-expropriation. Apart from the self-dealing transaction, RPT can assume a shape and action that is sometimes necessary and even physiological to achieve specific strategic and corporate objectives. Indeed, RPTs are not undesirable per se, but they are unpleasant when instrumental *tunnel* firm resource. The ambiguous use of transactions between related parties has determined deep rifts in both the literature and practice.

1.2 Criticisms and opportunities of RPTs

RPTs as exploitation tools are associated with severe agency problems, especially in settings where investor protections and corporate governance mechanisms are relatively weak. More specifically, there may be concerns of RPTs between managers and shareholders (*Agency conflict I*) in dispersed ownership settings (Berle & Means, 1932; Jensen & Meckling, 1976) because they can be used by the former at the expense of the latter. In highly concentrated ownership capital market, RPT can be also an abusive mechanism used by the majority shareholders to raise their profit by exploiting private benefits of control at the expense of minority shareholders (*Agency conflict II*) (Coffee, 2005; Demsetz & Lehn, 1985; La Porta, Lopez-de -Silanes, Shleifer, & Vishny, 2000)

Indeed, a high ownership concentration gives rise to type II agency problems, exacerbating the risk of expropriation of resources of minority shareholders by their controlling owners (Kohlbeck & Mayhew, 2010).

The undue appropriation, can be classified according to the type of transaction – in tunnelling or perquisites - and transferability of private benefits of control (Ehrhadart & Nowak, 2003). *Tunneling* is the transfer of resources out of a firm and towards the principal shareholders, away from the minority shareholders (Johnson, La Porta, Lopez-de-Silanes, & Shleifer, 2000) and represents one of the most frequently studied ways of extracting private benefits. There are different techniques used to tunnel resources. RPTs can be instrumental in depriving the company and investors of profit (*Cash flow tunneling*) and productive assets or the pro-rata value of their claim to such assets (*Asset tunneling*) or equity (*Equity tunneling*) (Atanasov, Black, Ciccotello & Gyoshev,2010)[1]. Another approach is to infer tunneling by linking ownership

[1]In particular, (1) some examples of equity tunneling include dilutive offerings, creeping acquisitions freeze-outs of minority shareholders, and insider trading;(2) few examples of asset tunneling are the transfer of productive, long-term tangible or intangible assets from the firm to the related party for less than market values, such that the transfer has a permanent effect on firm operations; (3) finally, cash flow tunneling takes shape as a transfer of cash flow out from the company, including transfer pricing (sale of outputs to related party below-market prices; or purchase of inputs from a related party at above-market prices) and excessive executive salaries or perquisite consumption.

structure to prices paid in related party transactions or changes in firm equity value under unique settings.

In different ways, *tunneling* masks a firm's performance and hides the controlling shareholders' private control benefits from outside investors, with negative consequences for non-controlling shareholders (Liu & Lu, 2007; La Porta et al., 2000; Claessens, Djankov & Lang, 2000; Aharony, Yuan, & Wang, 2005; Johnson et al., 2000; Lemmon & Lins, 2003; Faccio, & Lang, 2002; Bertrand, Mehta, & Mullainathan, 2002) reducing the stock market values and returns for those firms that have access to such transactions (Johnson, Boone, Breach, & Friedman, 2000; Jian & Wong, 2010; Pizzo, Moscariello, & Vinciguerra, 2010).

RPT is a prevalent vehicle of expropriation in many frail corporate governance systems (La Porta et al.,2000; Claessens et al., 2000). However, the empirical bases of the opportunism of these transfers of assets and profits extend from the emerging economies (Jian & Wong, 2003; Jiang, Yue, & Lee,2005; Chang, 2003; Nenova, 2003) to European countries (Faccio & Lang, 2002; Johnson et al., 2000 a, b; Bighelli & Mengoli, 2004) or to American institution setting (Shastri & Kahle, 2004; Gordon, Henry & Palia, 2006).

The high concentrated ownership (Bona-Sánchez, Pérez- Alemán, & Santana-Martín, 2014; Chen, Chen, & Xiao, 2011; Peng, Wei, & Yang, 2011; Qian, Pan, & Yeung, 2011; Ying & Wang, 2013) and weak legal enforcement, incentive the tunneling motivation RPTs (Baek, Kang, & Lee, 2006; Yeh, Su, Ko, & Lee, 2005).

In these circumstances, allowing the company to deal with the controller related parties can provide more inducement to dominant shareholders to tunnel resources out of the firms and transfer corporate wealth to firms in which they have a majority ownership position (Johnson et al., 2000).

In particular, Bertrand et al. (2002) shed new light on tunneling in India, especially in transfer pricing contracts and asset sales or even outright cash appropriation. Many other studies (Bhutta, Knif, & Sheikh, 2016; Ullah & Shah, 2015) find a strong expropriation in family-owned firms in Pakistan where major shareholder transfer resources damaging corporate and minority shareholders.

In the Italian scenario, the value-diverting behaviours via RPT are pervasive and difficult to identify and mitigate enough to become a traditional and endemic corporate governance issue (Belcredi, Bozzi, Ciavarella, & Novembre, 2014).

Indeed, the separation between *cash flow* and *control rights*, the weak legal shareholder protection together with the widespread use of control enhancing mechanisms (CEMs) – such as pyramids, shareholders agreements, and dual-class actions – exacerbates the risk of an undue appropriation of private benefits of control that impairs minority shareholders *(Self-dealing transactions)* (Cappellieri, 2020; Anderson & Reeb, 2003; Leuz et al., 2000).

Although many RPTs are observed around the globe, no discipline intends to prohibit this phenomenon. An actual ban would not steam the risk of value diverting butcould only shift tunnelling to other techniques (Enriques, 2014).

Thereby, regulations on RPTs issued by governments and market regulators have provided specific rules to address the critical issues and avoid potential conflicts. Therefore, specific legislative provisions are established to alleviate conflicts of interest that may arise from these transactions.

Consistently, regulators and standard setters prefer imposing the disclosure requirement of these dealings rather than limiting the execution (Gordon, Henry & Palia, 2004).

Thus, it is necessary to use an efficient internal control system to execute an effective monitoring system and mitigate the risk of opportunistic behaviours of related parties in RPTs (Kohlbeck & Mayhew, 2010) without limiting the possibility to carry out an efficient RPT for the company. The empirical evidence demonstrates that only effective corporate governance could mitigate the conflict of interests between investors and insiders.

The nature of RPTs and corporate governance mechanism aimed to reduce their opportunistic purpose vary across regulatory bodies and settings.

All regulators, market participants, and other corporate stakeholders' actions provide provision to compress RPT risks that can compromise management's agency responsibility to shareholders or undermine a board of director's monitoring function (Gordon, Henry & Palia, 2004). It is worth to note that the type of transaction makes

it hard for outsiders to discover questionable or fraudulent RPT, distinguishing them from those operations executed with a related party to pursue the interest of companies and all shareholders. This phenomenon has raised considerable concern among market participates and regulators on undisclosed or undetected abusive RPTs.

While considerable evidence has reported on the negative consequences of RPTs (declines in shareholder wealth, lowered accounting quality and an increased likelihood of financial fraud), not all RPTs erode firm value.

In some cases, they can serve as value-enhancing operations through the reduction of transaction costs, improving efficiency, increasing enforcing property rights and imperfect contracts in as called propping hypothesis (Coase, 1937; Khanna & Palepu, 1997; Shin & Park, 1999; Fan & Goyal, 2006; Wong & Jian, 2003). In some circumstances, the main shareholders can transfer their resources to firms via RPT *(propping*), using their private funds to benefit minority shareholders (Friedman, Johnson & Mitton, 2003).

Pacces (2018) provides evidence of the cases of RPT that pursue a business purpose and can be value-increasing distinguishing from value-destroying ones[2].

In light of these considerations, it is also possible to comprehend the reasons why no country completely forbids RPT considering the portion of these transactions that can be value-enhancing (Djankov, La Porta R, Lopez-de-Silanesc, Shleifer, 2008).

Under contracting perspective, these transactions are parts of efficient contracting with related parties. In other terms, these transactions can be of several forms. They can be favourable to the business if appropriately used and offer opportunities for management to misuse them. The lack of an arm's length transaction can determine the emergence of agency costs assumed by agency theory.

This controversial double meaning has been widely debated in the economic-juridical literature.

[2] He explains that company A purchasing equipment from company B comprehensively owned by the CEO of company A, pricing the equipment highly, on the one hand, might be instrumental to expropriating investors. On the other hand, it may also compensate for the extraordinary tailoring of the equipment to the buyer's needs, which might increase the buyer's profit.

More specifically, national or international RPT disciplines aim to guarantee the substantial and procedural fairness of related party transactions and enhance disclosure transparency of this information (as investors should be fully informed about every material RPT). Even if the impact of RPTs is also a function of the industry characteristics and political of cultural environments of the setting where it occurs (Huang & Liu, 2010). In the Italian setting, the company has to adopt procedures that prevent the subtraction of resources by the controlling shareholder. The Italian regulation attempts to set the basis for a corporate governance system that can guarantee that the RPTs (as a preferred abuse instrument of majority shareholder for an undue appropriation of company resources) are always comprehensively subordinated to comply with the company's interests.

1.3 Related party transaction a central debate in Corporate Governance

The role of RPT is central in the literature debate, also considering conceptual difficulties in defining and measuring its consequences.

Considerable analysis of the nature and objectives of RPTs has been published over time. Mainly, academic research has been interested in the potential economic and social impacts related to these peculiar transactions.

There are conflicting views on whether RPTs are beneficial or detrimental to stakeholders. However, all interpretations – even if different - refer to the ability of a part to affect the terms and conditions of the dealing.

A review of the existing academic literature shows that RPTs can be observed from three alternative relevant perspectives: some studies give priority to risks over the benefits arising from the transaction (*conflict of interest hypothesis*); others emphasize the natural ability of RPT to compress monitoring costs (*efficient transaction hypothesis*); a more recent part of literature overcomes this dichotomy, offering a new perspective (*contingency theory*).

According to the first view, related party transactions are conflicts of interest or opportunistic instruments and determine agency issues of the type considered by Berle

and Means (1932) and Jensen and Meckling (1976). In contrast, a large body of literature argues that related party transactions may produce benefits to a company and optimize the allocation of corporate resources, both reducing information asymmetry (Kohlbeck & Mayhew, 2010) and transaction costs.

These opposite perspectives offer very different implications of the potential costs and benefits of transacting with related parties and open the way to the emergence of a theory that rejects mutually exclusive interpretations. Thus, the third recent perspective developed by Pizzo (2013) lies between agency theory and the efficiency perspective, stating that RPT has to be evaluated based on contingency factors and disclosure on RPT represent a possible way to reduce the conflict of interest.

1.3.1 The conflict-of-interest theory: a critical perspective

The hypothesis based on the conflict-of-interest view supports the idea that these deals between an entity and one (or more) of its related parties mask the interest of one party to enrich at the expense of others not directly involved in the transaction (Nekhili & Cherif, 2011). In this perspective, RPT is a vehicle for shareholder expropriation, giving opportunities to transfer wealth between the firm and related parties (El-Helaly M., Georgiou I, Lowec A., 2018).

Enriques (2014) defines "*related parties*" as counterparties that may secure better terms for themselves than arm's-length bargaining, employing their influence over corporate decision-makers.

To this extent, such a view encompasses the conflicts of I and II types consistently with the agency perspective (Berle & Means, 1932; Jensen & Meckling, 1976). These critical transactions produce benefits for the insiders to the detriment of the weaker outsider by diverting resources for their personal use, reducing firm value.

Indeed, Gallery, Gallery, and Supranowicz (2008) argue that RPTs are value-destroying dealings executed by directors and managers for their benefit at the expense of shareholder interests. The controlling shareholders, officers and directors tunnel the firm's resources through RPT and impose a significant risk to other shareholders (Baek et al., 2006; Cheung, Rau, & Stouraitis, 2006). Prior studies suggest that most expropriation of minority shareholders' wealth is conducted through the related party

transactions (RPTs) (Johnson, Boone, Breach & Friedman, 2000; La Porta et al., 2000). However, Fooladi and Farhadi (2019) find that all RPTs revealed in their study are harmful transactions to the firm.

A large corpus of literature analyses the conflicts between principal-principal, shedding new light on the Abusive RPTs used as vehicles by insider shareholders to exploit outsider shareholders (Emshwiller, 2003; Ryngaert & Thomas, 2012, Cherif, 2017). Several types of RPT can have different negative implications very debated in the literature.

Many pieces of evidence on the entrenchment role of RPTs comes from intragroup sales. The results suggest that transfer profits and assets via transactions between firms belonging to the same group are widespread practices.

The structure of business groups incentivises self-dealing transactions and makes it difficult for outside investors to monitor these transactions. Thereby, group firms have more means to destroy resources via RPT at the expense of minority shareholders than independent firms (Marchini et al., 2018).

Bae, Kang & Kim (2002) argue that controlling shareholders of Korean entities tunnel resources from firms with lower ownership to firms where they have higher one by conducting intragroup asset acquisitions.

Concerning RP sales, Cheung, Jing, Lu, Rau & Stouraitis (2009) posit that publicly listed firms enter into deals with related parties at unfavourable prices to transfer resources away from the minority shareholders of publicly listed firms to the hands of their controlling shareholders. More specifically, firms acquire assets from related parties, pay a higher price than in similar arm's length deals, or sell assets to related parties at a lower price than in parallel arm's length deals.

It would be wrong to presume that all related-party sales are carried out at nonmarket prices (Lo, Wong & Firth, 2009), but the empirical evidence suggests that transfers often occur at not arms' length condition (Chan & Lo, 2004). The manipulation of transfer pricing unfair to the government (e.g., to cheat on taxes), unjust to minority shareholders (e.g., to the tunnel), and unfair to other investors or creditors (e.g., to expropriate wealth away from lenders and other creditors) has several different types of implications.

It can become a mechanism to manoeuvre profits around with an outward income shifting to other companies. Thus, the transfer of corporate resources damages minority shareholders due to the reduction of profit attributable to shareholders and the firm value.

Due to mixed evidence from the extant literature, it is still an open question concerning the impact of related party sales/purchases (normal RPTs) on corporate going. In contrast, some RPT - as related party loans - are mainly associated with negative consequences. Indeed, RPTs can be used to obtain loans on more advantageous terms than those imposed on loans to non-related parties (La Porta, Lopez-de-Sinales & Zamarripa, 2003). Related loans have lower interest rates than arm's length loans and are more likely to default and lower recovery rates after default. To do so, they use the firm's assets as security for their loans or even dilute the interest of minority shareholders by acquiring additional shares at preferential prices (Johnson et al.2000 a,b). Generally, related party loans are usually deemed as *tunneling* oriented dealings. Consistently with previous findings, Berkman et al. (2009) demonstrate that a "*related- party loan guarantee*" is a straightforward and direct method of *tunneling* related parties to expropriate wealth from minority shareholders. They also show these transactions are prevalent in the Chinese setting but do not occur likely in state-controlled companies. According to Jiang, Yue & Lee (2010), controlling shareholders use intercompany loans to siphon funds from Chinese-listed companies.

Riyanto & Toolsema (2008) enrich the existing literature by identifying *tunneling*, referring to related-party transactions which move funds from a lower-level firm to a higher-level firm in the pyramidal chain. Almeida and Wolfenzon (2006) and Friedman et al. (2003) show that in pyramidal groups, the phenomenon of *tunneling* is more pronounced. Wealth transfer goes from firms located at the bottom of the pyramid towards those located at the top. These companies' ownership rights of the principal shareholders are higher (Bebchuk, Kraakman, & Triantis, 2000).

Often, the parent company establishes the manner of wealth shifting into the pyramidal group.

This mechanism can lead to an undue appropriation of private benefit at the expense of the minority shareholders of one of the group companies.

Companies' declaring these transactions as bad or unrecoverable debts represent another common method used by companies to divert fund to related parties. More specifically, empirical evidence has demonstrated that the positive relationship between bad debts reported in a period and amounts due from related parties in the previous period represent an "alert" of diversion of funds (Mahtani, 2019), implying higher audit fees for the firm involved in RPT (Habib, Jiang, & Zhou, 2015).

Gao and Kling (2008) support this idea using the difference between accounts receivable and accounts payable to related parties as a proxy for tunnelling and show that this measure is associated with corporate governance features.

Such resource transfer may be costly not only for minority shareholders but also for the transparency of the whole economy (Azim, Mustapha & Zainir, 2018).

There is a large body of literature that provides evidence of the influence of these transactions on many financial crises (Swartz & Watkins, 2003; McTague, 2004; Zalewska, 2014). Beasley, Carcello, Hermanson, & Neal (2010) argue that the higher frequency of related party transactions related to corporate fraud suggests that the execution of RPT can heighten fraud risk. Furthermore, the relationship between related party transactions and abnormal stock returns is also demonstrated (Cheung, et al., 2006). The greater use of these dealings in corporations with weaker corporate governance systems is evidence of its abusive purpose (Gordon, Henry, & Palia, 2004 a-b; Kohlbeck & Mayhew, 2004). In companies with ineffective monitoring mechanisms, RPTs and periodic performance are negatively related (Chen & Chien, 2007).

In this regard, research on the board composition documents that RPTs may undermine non-executive directors' functions, turning them into *affiliated* or *grey* directors who are not independent anymore (Denis & Sarin, 1999; Klein, 2002; Vicknair, Hickman, & Carnes, 1993; Weisbach, 1988). From an operational view, they can exploit political connections to take advantage of minority investors and achieve specific purposes (Habib, Muhammadi, & Jiang, 2017).

Enriching the steam academic conflict-of-interest literature, Kohlbeck and Mayhew (2017) find that RPTs serve as "*red flags*" that warn of potential financial misstatement, signalling that the firm's insiders are open to self-trading and opportunistic behaviours.

In this respect, there is a large body of research that shed new light on the opportunistic use of RPT as an enabler of earnings management (Aharony, Wang, & Yuan, 2010; Jian & Wong, 2010; Thomas, Herrmann, & Inoue, 2004).

Indeed, such transactions are often misused to alter and influence reported earnings (Mahtani, 2019) by one-off transactions, manipulating the timing and recording of dealings or only transfer prices. While the manipulation of accounting accruals transfers profits for one fiscal year to the subsequent and reported earnings of future years are not be affected by this movement, the alteration of the transfer price of RPT is a permanent earning modification. Given the high risk of manipulation, transfer pricing with related parties is widely regulated in many institutional settings.

The controlling shareholders may be manipulating the information disclosure (Cheung, Jing, Lu, Rau, & Stouraitis, 2009) through falsification of financial statement (Huang & Liu, 2010) to hide expropriation. In these cases, controlling shareholders are motivated to mask the economic substance that is rent-seeking in nature, as occurred in the Enron scandal (Gordon, Henry, Louwers, & Reed, 2007). Additional evidence also shows fraudulent financial reporting is more likely when a firm discloses related party transactions (Beasley et al., 2010).

For this reason, the execution of RPTs has become a commonly used proxy for earnings management analysis in recent years (Fan, Guan, Li, & Yang, 2014).

In general, there is also evidence that RPTs are more likely to be used as a standalone tool to manage earnings acting as a substitute for real earnings management (El-Helaly et al., 2018).

Among various use-cases, many studies provide empirical evidence on several forms of an intragroup transaction aimed to manipulate earnings (Bertrand et al., 2002; Bae et al., 2002; Khanna & Yafeh, 2007; Chang & Hong, 2000; Friedman et al., 2003; Johnson et al., 2000)

Consistently, many scholars (Jian & Wong, 2003; Jian & Wong, 2010) infer that Chinese firms belonging to business groups have ample opportunities to engage in earnings management through related sales (notably trading goods and services).

The results imply that controlling shareholders employ related party sales to prop up earnings and substitute for accrual earnings management. Later, Chen, Cheng, & Xiao (2011) provide several examples of conflicts of interests between controlling and minority shareholders that drive opportunistic earnings management-oriented RPTs. Another study (Aharony et al., 2010) adds to previous literature, providing some evidence of the use of RPT to earning management in the pre-IPO period (i.e., prop up) followed by *tunneling* opportunities in the post-IPO period.
The reason that leads companies to show biased accounting earnings figures via RPTs - in addition to accruals earnings management - is detected in the desire to avoiding losses, earning declines and negative forecast errors (Thomas et al., 2004). Later, Wang & Yuan (2012) report a lack of earnings informativeness for firms with a high level of abnormal RP sales (a proxy for opportunistic RPTs). These results are justified because RPTs violate the arm 's-length assumption of regular transactions and impair accounting data's representational faithfulness and verifiability. Indeed, Marchini et al. (2018) find a positive relationship between the presence of RPTs and the probability to report a slight earnings increase. In some settings, management may have an incentive to shift income to maximize their performance-linked bonuses or avoid losses. In this case, the inflated contemporary earnings are biased signals of their current performances. They are biased proxies of their future earnings, as related party sales take the form of opportunistic earnings management vehicles, accruals based (Jian & Wong, 2010; Chen et al., 2011) but can also be cash-based. In particular, the firm may use RPTs, accrual earnings management, real earnings management or a combination of more than one tool to manage reported earnings (El-Helaly et al., 2018).
In general, many authors infer that the companies involved in these operations tend to report lower performance (Gordon et al., 2004) than non-RP firms that report marginally lower subsequent returns. Cheung et al. (2006) find that companies that engage RPT show a decline in value during the 12 months following the announcement of transactions that are a priori likely to result in the expropriation of minority shareholders. These findings are another evidence that related-party transactions destroy shareholder value. According to this view, investors seem to react to RPT

announcements and lower current and future share prices for firms that carry out these transactions (Kohlbeck & Mayhew, 2004).

1.3.2 The efficient transaction theory

In contrast with the conflict-of-interest perspective, the idea that RPT is not always necessarily harmful had gradually emerged. Although RPTs can be used as a vehicle to expropriate firm wealth, an extended corpus of literature demonstrates that some of these dealings can benefit the firm. Therefore, the efficient transaction hypothesis assumes that RPT is a sound business exchange, able to fulfil the economic specific needs of the firm by securing in-depth skills and expertise between parties who have built up trust relationships and have shared private information (Gordon, 2004). Some studies demonstrate that RPTs can be motivated by reasons other than entrenchment. In this perspective, they are efficient contracting arrangements that increase firm value, maximizing shareholders' wealth (Riyanto & Toolsema, 2008). Gordon et al. (2007) state that they are a natural part of the business and detect that many such transactions are executed by firms not involved in accounting and financial fraud. Consistently, Bell and Carcello (2000) find no evidence of the increase of fraud risk associated withthe execution of RPT.

There is extensive steam of studies that empirically documents the positive side of RPTs (along with the negative side).

Embracing this approach, RPT is depicted as value-enhanced operations that companies can carry out to reduce transaction costs and increase firm efficiency (Khanna & Palepu, 1997; Shin & Park, 1999; Fan & Goyal, 2006; Wong & Jian, 2003; Chen, Wang & Xiaoxue, 2012; Jian & Wong, 2010; Khanna & Palepu, 2000). Such a view of the RPT is consistent with the transaction cost theory (Coase, 1937; Williamson, 1985).

Under efficient transaction theory, RPTs have at least lower dealer cost comparing to arm's length transaction and could be value-enhancing by creating a strategic partnership, promoting risk-sharing and facilitating contracting (Ge, Drury, Fortin, Liu, & Tsang, 2010).

Furthermore, Stein (1997) demonstrates that corporate managers' self-interested and empire-building type behaviour is not always a drawback of the internal capital market. Depending on managers' span of control, the self-interested tendencies act as a tool to maximize the shareholder value.

It is also demonstrated that contracting with an inside board member could improve activities and information flows. Some consideration from the board composition studied can enrich the interpretation of the related party's role.

Indeed, Fama (1980) and Fama & Jensen (1983) recognize the equal relevance of executive and non-executive directors for optimal board composition. Because while outside members contribute with their independence and monitoring skills, the inside ones bring in-depth knowledge to support the decision-making process.

Consistently with previous studies, Bushman, Chen, Engel, & Smith (2000) argue that the industry-specific expertise is beneficial for the board of directors and the whole firm. For this reason, the related party that possesses an in-depth knowledge of firm-specific activities and expertise that the company demands can provide the service more effectively than an outsider that does not have these competencies (Gordon & Henry, 2005).

Thereby, this type of RPT that involves a board member may mitigate hold-up problems in the contracting process and facilitate investment in firm-specific relationships.

In general, related party transactions rationally fulfil several economic demands and represent a mechanism that binds the party to the company. Eventual family ties can compress hold-up problems significantly, renegotiating a contract's terms (Riyanto & Toolsema, 2008). Under specific conditions, intragroup trades with family members and other social actors are relatively cost-saving (Khanna & Yafeh, 2007).

Besides, when a related party has a large ownership stake in the firm (as block-holder), he has financial incentives to make firm-specific investments and avoid a value-reducing hold-up (Klein, Crawford, & Alchian, 1978; Fee, Hadlock, & Thomas, 2006). According to this approach, there is a perfect alignment between self-interest and corporate interest. RPT is interpreted as a useful mean to fall the information asymmetry between the firm and related party compared (compared to the transaction

between the firm and the unrelated party), not exacerbating the risk of an undue appropriation but acting to mitigate agency costs (Fooladi & Farhadi, 2019). Moreover, RPTs may implement internal capital markets that supplement inefficient external markets (Khanna & Palepu, 2000), leading to a better allocation of financial resources and consequent positive effects for all shareholders (Moscariello, 2012).

More specifically, the companies may exploit the advantages of the internal market-related diversification (e.g., *vertical integration*), interrelationships among affiliated firms, capturing synergistic effects by supporting and complementing each other's activities (Davis & Duhaime, 1992; Markides & Williamson, 1994). Due to limited contract enforcement and inefficient judicial systems in emerging economies, the transaction costs dealings between unrelated parties are very high. For this reason, business groups in emerging markets, by combining their upstream and downstream operations with respective business units, make up for imperfect markets (Chang & Choi, 1988).

The merit of related diversification increases where internal markets are more feasible and cost-effective (George & Kabir, 2012; Ramaswamy, Purkayastha, & Petitt, 2017). In this regard, RPT can facilitate operating and financing activities, reducing hold-up problems, with lower information asymmetry and transaction costs (Fisman & Wang, 2010; Coase, 1937; Jorgensen & Morley, 2017).

Thus, they can resolve difficulties or delays that often befall in contracts and agreements with third parties (Loon & Ramos, 2009).

In addition to firm profitability and value, related party trades (sales/purchases) fit the efficient contracting perspective of RPTs and lead to lower audit fees and misstatements (Kohlbeck & Mayhew, 2017). Palepu (1985) finds that a related diversification strategy is more likely to bring efficient resource allocation and economies of scale by exploiting core competencies, leading to higher firm performance. As indicated in Bae, Kwon, and Lee (2011), related diversification in a firm affiliated with a large business group is associated with higher firm value. In this case, due to economies of scope and better resource allocation, RPTs are more likely to be efficiency-driven. Khanna & Palepu (1997) find a positive relation between RPTs and corporate performance and posit that internal capital markets can benefit the entire

group when external funds are limited and uncertain. In general, decreasing transaction cost and increasing capital allocation efficiency represent the main benefits for business groups to execute RPTs.

The scale and scope of groups and the de facto property rights enforcement within groups in emerging countries allows overcoming some of also difficulties that impair production in underdeveloped regions (Fisman & Khanna, 2004).

This efficiency-enhancing argument has been primarily developed in the context of operating. Chang & Hong (2000) argue that several forms of internal business transactions - such as debt guarantee, equity investment and internal trade - are widely used for cross-subsidization. The extensive integration within a group more than enables a reduction of transaction costs serves to exchange technological resources. Sharing technological skills and advertising, associated with available group financial resources, contributes to profitability, supplementing inefficient capital markets (Moscariello, 2007).

The execution of operations between firms belonging to the same group may allow the creation of an internal market for capital that is also beneficial, mainly when external funding is scarce or inadequate (Claessens et al., 2000). More specifically, in a pyramidal structure, a shareholder who controls the capital can use related party transactions to transfer resources to firms at the bottom of the pyramid. In these circumstances, RPT increases the value of the firm (Friedman et al., 2003). In some cases, the intra-group transaction may be carried out to pursue the final aim of minimizing the overall rate of tax payable and at the same time maximizing the wealth of both minority and majority shareholders (Pizzo, 2013). Wong, Kim and Lo (2015) empirically demonstrate that related party sales improve firm profitability and value due to efficiency enhancement and transaction cost reduction.

In 1996, Lincoln, Gerlach and Ahmadjian, studying the Japanese institutional setting, provided evidence that belonging to the business group enables steam the risks of the bankruptcy of member firms.

Analyzing this setting, Keister (2000) demonstrates that affiliation to the group enables the development of productivity and improvement of performance.

More recent research enriches the previous studies, arguing that Chinese-listed firms prop up earnings by using related sales to controlling shareholders to maintain their listed status (Jian & Wong, 2010). This evidence shows that the increase in associated sales is associated with higher operating profits, and these dealings are beneficial to damp negative industry earnings shocks.

Moreover, an alternative argument supporting this approach is enhancing firm values by propping as an act beneficial to minority shareholders. This flip side of *tunnelling*, known as "*propping"* (Friedman, Johnson & Mitton, 2003), aims to revive the firm and preserve controlling shareholder options.

While *tunneling* is a practice executed by controlling shareholders to take over the wealth of minority shareholders, propping is a mechanism enable to produce positive implication for shareholders (Ani &Aria, 2019). There is a piece of evidence on propping because, differently from *tunnelling*, minority shareholders and debtholders do not protest if *propping* occurs. Nevertheless, presuming that investors distinguish the behaviour of entrepreneurs and assuming that there is sufficient trading based on insider information, stock price performance can provide evidence on propping situations.

This mechanism may have relevant implications on how firms operate in countries with a weak legal system: controlling owners in these settings sometimes rescue their financially distressed firms - i.e., engage in *propping* - contributing their future debt financing. In these circumstances, transactions with related parties can benefit the company and its minority shareholders, acting as insurance for them.

Many other studies contribute to the literature on the topic investigating the main case-uses of the emergent economic market.

Cheung et al. (2006) provide evidence of some limited examples of propping in the Hong Kong context.

Consistent with previous findings, Ying & Wang (2013) analyze the transactions among the related parties demonstrating that they are entered to prop the economically distressed firms.

Generally, a positive market reaction follows the announcement of connected transactions disclosed by firms that had shown negative performance in the preceding

fiscal year. In this case, RPTs are interpreted by the shareholders as an efficient mechanism of resource allocation to minimize the risk of delisting and to maintain the right to issue new equity (Peng, Wei, & Yang, 2006; Cheung, Jing, Lu, Rau, & Stouratis, 2009).

In the current scenario, many multinational enterprises are developing different models of business based upon RPTs. In some cases, the parent companies can provide new technology and know-how; in other circumstances, they can assist their subsidiaries financially whenever required. In these circumstances, RPT may represent a mechanism to raise the revenue and profit earnings of the entities and sustain the prosperity of the business (Roy, Roy & Kar, 2020).

Although a stream of research shows several advantages arising from the execution of these transactions, the risk to enter RPT for opportunistic purpose is high. Related party transaction is not always a source of conflict of interest, but it is misused frequently. Therefore, ignoring the potential risks of RPTs is not possible. The agency problems limit the potentially beneficial effects of internal markets of groups (Claessens, Fan & Lang, 2006). Not surprisingly, the rules affecting related party transactions disclosure and monitoring have been primarily influenced by the conflict- of-interest theory and the agency rather than the efficient transaction hypothesis (Pizzo, 2013).

1.3.3 RPTs under a contingency perspective

For a long time, the controversial evidence has led to developing two dichotomous approaches in the academic literature on the topic.

Starting from the findings of Aguilera, Filatotchev, Gospel, & Jackson (2008), Pizzo (2013) proposes a novel contingency-based framework to examine causes and consequences of RPTs in the light of the impact of organizational contexts and social factors and the influence of complementarity/substitution between governance factors. Based on circumstances, these dealings may in some cases fulfil sound business needs and, in others, pursue deceptive or fraudulent purposes.

This interpretation stems from the limitations of the perspectives that deal with the issue embracing a predetermined view.

This approach is invoked to cover up some of the embarrassing ambiguities in the universalist methods (Otley, 1980) that cannot provide the always appropriate solution to problems in organizational control (Otley, 2016).

From the theoretical point of view, the contingency hypothesis supports the idea that there is no single best way to manage organizing and decision-making processes (Lawrence & Lorsch, 1967; Luthans, 1976). It emphasizes the importance of both the leader's personality and the circumstances in which that leader operates (Fiedler, 1964). Over time, this approach had become always more prominent in both organization theory and management accounting (Thomas, 1991).

In the RPT domain, adopting this new perspective relies on the fundamental role that a firm's internal and external factors play in shaping the nature and purposes of similar transactions.

Embracing this third perspective allows interpreting RPTs through the new lens of contingent factors, organizational contexts or institutional environments. In particular, contextual factors (like geographical and cultural differences, corporations' industry and size) and governance mechanisms (like board approval, independent directors' involvement, external appraisal, etc.) can affect the operation's objective. In such a scenario, any a priori theoretical scheme that analyzes the definition and structure of RPTs could always be biased and may bring about insufficient disclosure or monitoring solutions. Pizzo (2013) demonstrates that conflict of interest and efficient transaction perspectives providing almost opposite interpretations are methodologically biased. Fitting the controversial hypothesis allows capturing all different aspects that this transaction can assume. These two theoretical frameworks can coexist together, and RPT cannot be analyzed separately from governance variables.

As already mentioned, social factors also play an essential role in the issue, making these exchanges and their implications peculiar in each nation.

The potential risks and benefits associated with specific categories of RPTs should be weighted, taking into account the existing relations with other contextual factors and governance mechanisms, and adapt requirements accordingly.
Some years later, Otley (2016) support this argumentation, demonstrating the importance of comment and evaluate factors in context without isolating them from their background.
All these factors make these exchanges and their implications peculiar in each setting. For this reason, RPTs should be studied in the context of each nation's legal system (Gordon et al. 2007) to investigate the impact that they have on firm performance and shareholders value. Prior studies examine RPT considering ownership structure (Mitton, 2002; Baek, Kang, & Park, 2004; Cheung et al., 2006) and corporate governance (Trivun, Silajdzic, Mahmutcehajic, & Mrgud, 2012; Liu & Lu, 2007; Gordon et al., 2004; Nekhili & Cherif, 2009; Henry, Gordon, Reed, & Louwers, 2007; Lo et al., 2010; Ge et al., 2010; Moscariello, 2012; Hu, Li, Xu, & Fan, 2012; Yeh, Shu, & Su, 2012; Pizzo, 2013).
As already mentioned, In the Italian institutional context, lack of solid legal protection of minority investors exacerbates the risk of expropriation of minority investors by controlling shareholders (Lemmon & Lins, 2003; Joh, 2003; Baek et al., 2004; Gopalan & Jayaraman, 2012; Chen & Chien, 2007).
Dyck and Zingales (2004) find that in companies with highly concentrated ownership, an increase of the risk that RPT will be a mean in the hands of controlling shareholders to extract private benefits of control at the expense of minority shareholders is detected. Almeida and Wolfenzon (2006) and Faccio and Lang (2002) find that a strong separation between ownership and control rise (for instance, in the pyramidal group) this risk of misused RPT consistently with the agency theory.
Instead of being an independent variable, related party transactions not fulfilling sound economic needs stem from a mixture of opaque control, weak protection of external shareholders, inadequate disclosure and concentrated ownership (Jesover & Kirkpatrik, 2005).
Other studies, for example, have attempted to explain the dynamic of corporate governance over the company life cycle (Filatotchev, Toms, & Wright, 2006;

Filatotchev & Wright, 2005; Johnson, 1997) as well as the diversity of corporate governance arrangements across countries (Gospel & Pendleton, 2005; Bruce et al., 2005; Buck & Shahrim, 2005; Schmidt & Spindler, 2004; Aguilera & Jackson, 2003). Di Carlo (2014) adds to studies on the topic investigating the importance of interest of the business group and the directing activity of the subsidiaries by the parent company in the interpretation of RPT.

Later, Marchini, Mazza, and Medioli (2018) extend the corpus of previous studies, testing the contingency hypothesis empirically. Their pieces of evidence support the idea that some RPTs are used opportunistically - in line with the agency theory point of view - and other operations are carried out to pursue an intent of efficiency. Their purpose is always a function of other factors. Any interpretation that ignores these circumstances can my incomplete and biased.

CHAPTER II

LEGAL MECHANISMS AGAINST TUNNELING VIA RPT: THE *SLATE-VOTE SYSTEM*

2.1 Anti-tunneling tools to mitigate the risks of RPT

RPTs are neither intrinsically beneficial nor detrimental operations to the corporation. RPTs can be subject to abuse by executive management or controlling owners, negatively affecting the company (its minority shareholders and its creditors). On the other hand, they can be a valuable tool to reduce transaction costs, increasing firm efficiency. Therefore, different RPTs' purposes drive all jurisdictions to issue many legal actions to mitigate drawbacks without smothering potentialities. Thereby, these normative deterrents target to compress only harmful RPTs without undermining beneficial ones. In this perspective, a question arises: *How can legal systems prevent RPTs from being used for tunneling purposes protecting shareholders?*

The critical point is trying to minimise opportunistic RPT without cancelling value-creating transactions and, more generally, without imposing excessively high costs. The controversial RPTs' nature justifies the intention of regulators not to prohibit or limit the execution of RPT that represents only one of the many techniques that controllers can use to enrich themselves at the expense of their company minority shareholders and other stakeholders (Enriques, 2014). By the way, an effective ban would lead only to shift *tunneling* to other techniques. In other terms, it turns out necessary to have rules that are effective enough to give rise to few false negatives (i.e., value-decreasing transactions that proceed because the RPT review is ineffective) and avoiding false positives as much as possible (i.e., value-increasing RPTs that fail to move and arguably efficient strategic choices that fail to be implemented because of opposition from influential non-controlling shareholders) (Enriques, 2009; Pacces, 2018).

Therefore, the potential costs imposed by RPTs require efficient monitoring on such high-risk transaction, which thereby have to be disciplined by a peculiar Regulation in the effort to limit self-dealing and protect investors.

Since the early 2000s and in RPTs' approval process, a critical global trend in corporate governance has been the empowerment of shareholders in the corporate decision-making and monitoring processes as an additional mechanism to mitigate the risk of potential abusive RPTs (Bianchi, 2018).

In general, the law traditionally protects shareholders by enhancing their rights to sell, sue and vote.

However, identifying the best corporate governance solution valid for any jurisdiction proves not possible because several context-specific factors influence the procedures and generate different types of issues and conflicts.

In the following sections, the chapter to address the previous question will show the most common legal techniques usable to tackle value diversion via RPTs. It will focus on disclosure requirements and the procedures for approval by the board and/or shareholders, external independent advice, and ex-post standard-based review. In many cases where there is a requirement for board or shareholder approval, there are also quantitative materiality thresholds in place that distinguish the relevance of RPT and thereby the procedural enforcement or disclosure obligations. In the last section, the research will propose a new *anti-tunneling* instrument.

2.2 Related party transaction disclosure

The RPT disclosure requirement is a widely used technique to address the risk of potential conflict of interest arising from these transactions. It aims to promote greater transparency precisely on those transactions engaged with key actors, able to influence decision-making centres or to enter into a dealing that pursues opportunistic purpose damaging for non-controlling shareholders. Regulatory bodies in many countries have imposed several disclosure requirements to provide information about its convenience, the impact on firm value and risks related to the transaction.

There are two types of disclosure requirements on RPT the periodic and immediate ones. Almost all jurisdictions have adopted IAS 24 or US GAAP to disclose related party transactions in periodic financial reports. In addition to financial statements with ex-post nature of reporting, some national jurisdictions have considered these mechanisms insufficient for corporate governance disclosure, introducing complementary requirements concerning ongoing disclosure of material related party transactions. In this case, the regulators require listed companies to disclose additional information on RPTs in a periodic corporate governance report. In other terms, the international accounting standards obligate the company to convey information on the material RPTs executed, and national jurisdictions introduce additional requirements for ad hoc detailed immediate disclosure.

In some cases, this obligation can be drawn as a part of the approval process, as a further screening mechanism by allowing the intervention of financial analysts and activist investors to obtain better terms for (minority) shareholders or even abandon the transaction altogether. In other circumstances, it constitutes an ex-post requirement once the transaction has been entered into (as in the Italian institutional setting) that reinforces the monitoring role of periodic disclosure (Enriques, 2014).

Ad hoc disclosure differs from periodic one: since while in IFRS-compiled financial statements, RPTs of a similar nature may be disclosed in aggregate (form except for peculiar cases), conferring far-reaching discretion to the company on how to communicate them, ad hoc disclosure provides the communication of the details about the individual transaction, increasing the possibilities actually to intercept the self-dealing or inconvenient transaction.

In particular, some disciplines obligate the disclosure of RPT above a fixed threshold, which often leads to companies incurring transactions less than this threshold to avoid the communication of this information to the market (for example, in Italy, permit non-disclosure of related party transactions below 5%). The impact of these undisclosed transactions remains hidden to direct stakeholders' decisions. The firms to hide a value-destroying behaviour could prefer to carry out a small-sized transaction than a highly material one.

In the first case, disclosure exemption is provided, and independent shareholders' approval is not required. In contrast, the highly material transactions are subject to more stringent and more detailed disclosure requirement that provides independent shareholders intervention into the decision-making process.

Consistent, the market reacts differently to an RPT based on the incumbent disclosure requirement. Lei and Song (2011) demonstrate that the market reacts negatively to corporate transactions with disclosure exemptions but positively to connected and disclosable transactions.

In this perspective, the mandatory periodic or immediate disclosure has traditionally been to cast light on potential self-interested transactions, even if with a different screening capacity. Djankov, LaPorta, Lopez-de-Silanes & Shleifer (2008) argue that disclosure requirements in annual reports and periodic filings represent a helpful mechanism to facilitate the scrutiny of related-party transactions by outside shareholders. The academic literature confirms this assumption arguing that increasing transparency, disclosure, and presentation of RPT represent one solution to minimize abusive RPTs (Utama & Utama, 2012).

More flexible disclosure requirements could aggravate agency conflicts and increase information asymmetry. The lack of a legal deterrent can contribute to the imbalance of power in business transactions, biased business transactions and may encourage risk-averse investors to discount stock prices (Elkelish, 2017).

The disclosure of RPT represents a shareholders protection mechanism, as the transactions are better analyzed and monitored before being conveyed to the market. The disclosure anti-tunnelling solution reinforces the independence of the internal decision-makers. More specifically, they act more assertively if they know the RPT they may approve will be subject to public scrutiny, actually facilitating private and public enforcement against abusive uses (Enriques, 2014). The disclosure requirement on RPT represents a screening mechanism to stimulate companies to operate in fairness. Therefore, the quality of RPT disclosure can be a proxy for the transparency of the transaction.

According to traditional agency theory, there is a strong correlation between corporate governance and disclosure crucial for the functioning of an efficient capital market (Healy & Palepu, 2001).

Beekes and Brown (2006) assume that companies that present better corporate governance provide more informative disclosures. Consistently, an extended body of literature demonstrates a strong relationship between convenience, the purpose of RPT, and its disclosure quality.

In particular, some scholars (Utama, & Afriani, 2014) demonstrate that *tunneling* RPT is associated with less information disclosure than propping-up operations.

Later, Utama and Utama (2012) find that higher-level RPT disclosure is associated with a lower likelihood of abusive RPTs. In this case, the relationship between the size of RPT and performance is positive, whereas, for firms that show a lower-level RPT disclosure, the association is negative. Thus, less information disclosure can suppress some information related to abusive RPTs and consequently reduces firm value (Cheung et al., 2009b).

In alignment with this approach, many other empirical studies demonstrate the value-destroying related party transactions are shown to the market by significantly less informative disclosure compared to other RPTs. In general, international evidence suggests that RPT disclosure laws are associated with more developed stock markets, which imply disclosure helps mitigate the harmful effects of self-dealing (La Porta et al., 2006). Many studies infer that public disclosure, taken in isolation, may be insufficient to prevent *tunneling* (Jiang, Lee & Yue, 2010; Cheung, Jing, Lu, Rau, & Stouraitis, 2009). They recognize the extensive disclosure and approval by disinterested shareholders and private enforcement as the most reliable solutions to avoid self-dealing.

Indeed, without relevant legal enforcement, RPT communication could be a potential "*impression management*" vehicle, showing the transaction as a convenient dealing for the company by emphasizing positive effects (*enhancement*) or obfuscating negative results (*concealment*) deriving from the operation. This information could be easily biased mainly to distort the perception of third parties on the risks related to this type of transaction. In detail, it is possible to manipulate this disclosure by ignoring or

underplaying the potential risk of the RPT or exaggerating the advantage for the company arising from the dealing.

Despite shreds of evidence on related-party transactions' impact on the quality of reporting, there is a gap in research on this issue. Many studies on the topic shed new light on the need to have regulations to control these transactions and enforce enhanced disclosure requirements given the conflict of interest related to RPTs.

Some Authors argue that corporate disclosure does not covey enough information on RPT's purpose compliant with corporate's best interest (Gordon et al., 2004), its economic and patrimonial effect and related risks.

The disclosure can no longer play the central role recognized in current rules or codes as monitoring should prevail. The communication should progressively focus on screening policies and procedures rather than the transaction (Pizzo, 2013), describing implemented policies and practices that lead to efficient screening ex-post of corporate behaviour.

2.3 Good Corporate Governance to fight abusive RPT

The agency theory suggests good corporate governance is one of the most critical controlling systems to monitor every firm's operation and align the individuals' goals with those of the firm, reducing the conflict of interests (Brickley & James, 1987).

Consistently with previous findings, Huang and Liu (2010) shed new light on the critical role of corporate governance to monitor the process of RPTs and protect the interests of investors and creditors. It follows that a weak corporate governance system provides more expropriation opportunities via RPTs to the detriment of non-related parties. The academic literature also identifies a significant association between *tunneling* or wrongdoing and poor corporate governance practice (Chen, Wan, & Zhang).

Chien and Hsu (2010) provide evidence of a positive moderating effect of corporate governance mechanisms on the relationship between related party transactions and firm performance. They argue that effective corporate governance mechanisms translate conflicts of interest-oriented RPTs into efficient transactions.

The most important monitoring system suggested by agency theory to reduce the Conflicts of I and II types is an efficient corporate governance system. It monitors the firm's performance to align those who control those who own the residual claims in a firm.

Many studies argue that the existence of an appropriate controlling mechanism such as CG - as board independence and audit quality- can monitor the process of RPTs and moderate the negative effect of abusive RPTs on firm performance (Wahab, Haron, Yahya, & Lok, 2011).

Good governance should reduce transfer pricing manipulation and as evidenced by several court cases filed by minority shareholders in various countries (Lo, Wong and Firth, 2010), to avoid the costs associated with the manipulation.

It is also demonstrated that a good governance system decreases the use of RPT in the effort to manage balance sheet values (Lo et al., 2010). Hasnan, Daie and Hussain (2016) argue that the existence of RPTs represents a potential conflict of interest, which provides greater incentives to related parties to expropriate minority shareholders, thus managing earnings to mask up such value extraction. The presence of an adequate corporate governance system has a moderating effect on the relationship between RPTs and earnings quality, mitigating the positive association between the presence of these transactions and earnings management (Marchini etal., 2018).

Other researchers focus their attention on the relationship between RPT and corporate governance or market behaviour (Ge et al., 2010; Hu et al., 2012; Liu & Lu, 2007; Moscariello, 2012; Nekhili and Cherif, 2009; Trivun et al., 2012; Yeh et al., 2012).

However, Gordon et al. (2004) document that firms that engage in RPTs present in many cases weaker corporate governance practices.

In contrast, Fan and Wong (2005) emphasize the weakness of the conventional corporate governance tools to moderate agency conflict of the second type, suggesting that external independent auditors could be employed as bonding mechanisms and monitoring, with an effective governance role to protect minority shareholders.

2.3.1 The regulatory framework for independent directors

The monitoring procedures ex-ante can prevent potential value expropriation. For this reason, in many jurisdictions, the board approval mechanism has been evolved towards a more substantial involvement of independent directors.

Independent directors' involvement (detailing the information to be provided and its timeliness, their role in the decision-making process and the possibility of obtaining qualified external expertise and appointing their trust professionals) could represent a valuable tool to steam the risk of an undue value-diverting transaction. Several different disciplines require the involvement of independent directors in the approval process for intra-group transactions, some dealings with controlling shareholders or, more in general, any RPTs.

Independent director involvement occurs in existing national jurisdictions with different degrees of intensity.

In some cases, the discipline establishes an independent directors' non-binding advice on RPTs' approval (in Italy only for non-material transactions), not preventing dominant shareholder and non-independent directors' involvement decision-making process. Even though the independent judgment is not binding, the fairness opinion must be conveyed to the market. This mechanism represents a type of private enforcement tool to support shareholder interests by giving them a piece of evidence of potential tunneling before the court. Moreover, the publication of opposing advice can prompt the entire board of directors to align with the independent directors' opinion. An eventual misalignment poses the issue to explain what leads to a decision that is contrary to independent fairness opinion.

In other cases, the legislator establishes that the fairness opinion of independent directors is binding for approval of transaction (in Italy for material transactions). The screening mechanism to protect shareholders (mainly minority ones) becomes stronger, enhancing the accountability of decision-makers. Independent directors' binding advice recognizes their actual veto power over RPTs, impeding the approval of those transactions deemed value-destroying for the company.

Consistent, there is a large body of literature that depicts board independence as an effective mechanism to mitigate agency costs and to reduce the threat of resource

diversion and transfer of value from minority shareholders. Di Carlo (2014) demonstrates that independent directors guarantee that RPTs execution occurs in a transparent manner, satisfying the criteria of substantial and procedural fairness. Due to reputational concerns and legal responsibilities, independent directors have strong incentives to monitor the controlling shareholder's actions, making it more difficult and costly for the block-holder to extract private benefit, positively impacting corporate value (Dahya, Dimitrov & McConnell, 2008). However, the findings are controversial. Empirical evidence also shows that in a high-ownership concentrated context, the appointment of a high proportion of independent directors on the board might not be a sufficiently effective mechanism to mitigate the agency costs (Erickson, Park, Reising, & Shin, 2005; Cho & Kim, 2007).

The dominant shareholder might select outside directors less likely to control managers from self-satisfying behaviours or exercise his influence to direct their decisions. Directors appointed by controlling shareholders might be even threatened with dismissal if they operate against the interests of those shareholders (Dahya, Dimitrov, & McConnell, 2009). In other terms, the strong influence of the controlling shareholder mitigates the role of independent directors in monitoring self-dealing transactions and undermines their independence over time by making them affiliated or grey directors (Yeh & Woidtke, 2005; Dong-Song & Zootae, 2007; Pizzo, 2013). A more intense monitoring activity by independent directors to be efficient requires at the same time effective communication between the board of directors and the investors together with strong legal protection of shareholders rights (Kim et al. 2006) More generally, board independence is recognized as a determinant factor of board efficiency to protect the shareholders' interests (Abdullah, 2004) and alleviate agency conflicts. Still, only these board members are genuine independent directors from controllers. Only in this case, we can expect them to act in the corporate interest, free from political conditioning.

The critical issue is complex to solve because the independent board members are very rare, in some cases only a theoretical assumption. In this case, their presence does not break the vicious circle between directors and majority shareholders. The power of

independent directors' appointment conferred to controlling shareholders undermines these directors' status of independence. The empirical evidence shows that they are often associated with the controlling shareholder and/or the CEO and recruited through personal contacts or friendships (Mork, 2008). Furthermore, it is necessary to consider if their decision is made in the same room and at the same time as the board's decision, whether in the presence of interested directors and especially the CEO or the dominant shareholder (Enriques, 2014).

The independence is traced to only an individual's assertiveness, ability not to succumb to boardroom biases (Keay, 2014; Enriques et al., 2010) and reputational or career concerns. In this case, it is very complex testing the independence of their opinion.

These circumstances undermine the screening role that they are urged to take. In general, the influence of controlling shareholders on the board may limit the effectiveness of the board's role in the RPT approval process.

The effectiveness of the corporate governance mechanism is strictly related to the actual non-relation of every so-called independent board member. The efficiency of this *anti-tunneling* tool to protect shareholders' interests depends mainly on the directors' substantial independence but secondarily on their genuinely free access to information. The availability of data and the possibility to recur to the assistance by some experts (lawyers, investment bankers, etc.) of their own choice at the company's expense and the phase of the negotiation process where they are involved are essentialfactors of the effectiveness of the tool.

2.3.2 Mayority of Minority

More recently, another legal mechanism to reduce the approval of abusive RPT is represented by empowering shareholder meetings.

Many countries with a mandatory shareholder approval procedure for material related party transactions also provide that shareholder with a material interest in the trade should abstain from voting at the shareholder meeting, endowing the majority of the minority - where minority means all *disinterested* shareholders – the transaction's approval. It performs as one of the most effective procedural safeguards against

tunneling as veto power over RPTs for most shareholders other than the related party itself (a majority of the minority- MOM) (Enriques 2014, Bianchi, 2014).

According to Erinques (2014), MOM requirement ensures the approval of only fair RPTs, just if at least four conditions are satisfied:

1. Minority shareholders have a real opportunity to cast their vote.
2. Shareholders vote sincerely, e.g., being *truly unrelated* to the related party and having been paid no bribe to vote in favour.
3. The MOM approval is the outcome of a well-informed decision-making process, following full disclosure of all material information about the RPT- because they often have restricted access to internal knowledge and cannot influence directors' decisions.
4. Shareholder voting takes place at the moment in time when vetoing the RPT is still a viable choice for the corporation.

In Italy, the approval of material RPTs by the board of directors with the binding favourable opinion of a committee of independent directors, thus granting to the committee of independent directors a veto power on material RPTs, which may be overcome only with a positive vote of the majority of the *unrelated* minority shareholders (so-called "*whitewash procedure*").

This anti-tunnelling instrument has many intrinsic potentialities, but it has to be accurately regulated to compress the risk of possible misuses.

On the other hand, low free-float levels in some markets can negatively affect the side, conferring disproportionate powers to minority shareholders, which can compromise companies' competitive position.

2.4 The inadequacy of the existing corporate governance mechanisms leaves room for introduction of new CG tools: minority directors

In recent years, many regulators have reinforced the previous RPT discipline by introducing new requirements. A more detailed disclosure and new provisions on independent directors and/or audit committee are legal actions aimed to conveniently mitigate risks that RPTs can distract resources and generate frictions between insiders (managers or controlling shareholders) and (minority) shareholders. These legal deterrents aim to prevent the damage of shareholders and the negative impact on the function of the capital market as a whole. A comprehensive system of mandatory disclosure and other procedural obligations based on enhancing independent directors could be not sufficient the alleviate expropriation risk. The distraction of resources of the firm for opportunistic purposes is complicated to detect and assess. A more detailed disclosure can be an effective resolution mechanism only within a highly reliable system of governance - such as dispersed ownership, with active institutional investors and professional managers (Aguilera, Filatotchev, Gospel, & Jackson, 2008). As already mentioned, especially in companies with concentrated ownership structures, independent directors do not have the actual effectiveness in fostering corporate transparency since they lack the mandate, the incentives, and the ability to be an efficient monitoring mechanism (Gutiérrez & Sáez, 2013). A more intense monitoring activity by independent directors to be efficient requires solid legal protection of shareholders rights (Kim et al. 2006). Many limitations lie in these corporate governance mechanisms.

Therefore, we can infer that the effectiveness/efficiency of RPTs disciplines may depend on other governance factors. Consistently, the results of Maglio et al. (2019) show that the presence of adequate enforcement mechanisms may be necessary for more efficient development of the protection for minority shareholders and a sustainable corporate governance system.

The presence of objective, disinterested outsiders' members on boards of directors can represent an effective corporate governance solution to reduce the risks of opportunistic behaviours, overcoming the limits traced to the appointment of independent directors and disclosure requirements.

When regulation provides involvement of minority shareholders for the election of directors (like in an Italian setting), substantial independence is guaranteed.

The appointment of the NCS-dependent directors (also called 'special interest directors') by the non-controlling shareholders represents an effective mechanism to reinforce the board independence from the corporate controllers (the management or the block-holder in case of high-ownership concentration) and to ensure that at least some of the relevant resolutions of the company are adopted with the involvement of the minorities (De Poli & De Gioia Carabellese, 2017).

In Italy, the abandonment of the *single-winner model* – according to which the shareholder who holds most of the voting rights has the power to elect the entire board –in favour of a *new multiple winner election system* (also known as '*slate-vote-system'*) – in which the appointment of the members of the board is also an expression of the will of the minorities – may therefore represent an effective mechanism to alleviate the principal-principal conflict.

The appointment of 'minority directors' might prevent the corporate controller from adopting opportunistic behaviours and protect minority shareholders from the discretionary activity of the block-holder. In other terms, allowing minority shareholders to pick at least one director can acts to compress agency conflicts and positively affect firm value.

In the RPT domain, minority directors not performing executive functions (independent-outside minority directors) might play an essential role in monitoring self-dealing transactions compressing costs related to the potential appropriation of private benefits of control by majority shareholders.

Thus, minority directors might play an important monitoring role on detrimental RPT (Claessens, Djankov & Lang, 2000; Johnson, La Porta, Lopez-de-Silanes, & Shleifer, 2000; Kang et al., 2014; Fera, 2020). Strict scrutiny by minority directors on RPTs procedures might incentivise controlling shareholders to engage a greater commitment to not undertaking operations to diverge corporate resources.

In fairness procedure, the assessment of professionals (shareholders or directors) who review the transaction ex-ante and have, in principle, a strong incentive to approve it only if it is efficient is an anti-tunneling tool. Supporting this thesis, Pacces (2018)

recommends a different procedural standard that tries to cope with the issue by empowering non-controlling shareholders. In this new regime, minority directors (non-controlling shareholder-dependent directors – NCS-directors) become a new fundamental player in the boardroom able to carry out a procedural screening of related party transactions (RPTs) and, so doing, to steam the risk of value diversions to the detriment of minority shareholders.

In other terms, allowing minority shareholders to have representatives on the board can represent an important mechanism to promote greater directors' accountability and ease the tension between corporate controllers and outside investors (Enriques, 2009; Belcredi & Enriques, 2014). In particular, they might prevent the corporate controller from adopting opportunistic behaviours and protect minority shareholders from the block holder's discretion (Cappellieri, Moscariello, & Pizzo, 2019).

Indeed, the empirical evidence collected so far mostly confirm the positive impact of minority directors on firms' corporate governance, financial performance and corporate disclosure, highlighting the importance of minority directors as a mechanism to protect minority shareholders' interests.

As to the relationship between minority directors and corporate governance performance, Bianchi, Ciavarella, Novembre, and Signoretti (2011) find that the actual level of compliance to the Corporate Governance Code for the Italian listed companies is systematically higher in firms in which minority shareholders have appointed one or more directors. In particular, the quality of the procedures for identifying and approving RPTs (the so-called CoRe indicator) is positively influenced by the presence of minority directors on the board. These findings are also consistent with Bianchi, Ciaravella, Enriques, Novembre, and Signoretti (2014) that show a direct relationship between the representation of minority shareholders within the board and tighter internal procedures for transactions with related parties: 1)companies with at least one minority director on the board are more likely to opt for lower thresholds than those defined by the Consob RPTs Regulation to identify material transactions between related parties; 2) stricter choices on the de minimis amount (whether in absolute or relative terms) below which a transaction is qualified as a 'small' RPT with a consequent full opt-out from the RPTs regulation; 3) lower percentage of non-interested shareholders for the general meeting approval for the independent shareholders' veto to be effective in case of a '*whitewash*' procedure; 4) higher

budget limits for the fairness opinion independent directors might require for transactions below the materiality threshold; 5) stricter rules concerning possible exemptions from the procedural regime in case of urgency (for example, in the case of financial distress). Mainly, in frail and highly ownership concentrated setting – such as the Italian capital market - introducing an independent director appointed by a minority can alleviate therisk of the *tunneling* and reduce information asymmetry.

2.5 Literature review on minority directors

The empirical evidence collected so far mostly confirms the importance of minority directors as a mechanism to protect minority shareholders' interests and increase firm value, reduce the risk of earnings management, and improve corporate disclosure.

Minority directors also play a fundamental role in structuring remuneration schemes that can provide incentives for executives to work for the best interest of shareholders and mitigate agency costs. In this regard, by examining all Chinese share non-state-owned enterprises from 2008 to 2013, Zhou, Fan, An, and Zhong (2017) find that the board representation of non-controlling shareholders has a positive impact on executive pay-for-performance sensitivity. At the same time, Melis et al. (2012) document a positive influence on stock option plans (SOPs) when minority directors are part of the board. Boards with a higher proportion of directors appointed by minority shareholders are more likely to design SOPs explainable by optimal contracting theory (rather than rent-extraction reasons) as they are characterized by:

1) the absence of beneficiaries with a relevant proprietary interest in the firm, ii) long vesting plus lock-up period; and 2) the presence of either a performance-conditioned vesting or a market-indexed exercise price. Still, concerning the fairness of the remuneration policies, Belcredi, Bozzi, Ciavarella, and Novembre (2014) recognize a higher probability of shareholders dissent on executives' remuneration policies where minority directors sit on the Board and/or in the Remuneration Committee.

Regarding corporate governance performance to financial performance, some papers have already stressed a positive relationship between firm value and minority directors. Lefort and Urzua (2008), analyzing a setting characterized by high ownership concentration, find that an increase in the proportion of outside directors (elected with minority shareholders' votes) positively affects company value (as proxied by Tobin's Q) and performance (measured by the ROA accounting ratio). Ten years later, Moscariello, Pizzo, Govorun, and Kostyuk (2018) – by examining a sample of 104 non-financial Italian firms, from 2007 to 2012 (624 firm-year observations) – find supporting evidence about a positive relationship between the proportion of minority directors and firm value (as proxied by Tobin's Q). Focusing on the bank sector, Barry, Lepetit, Strobel, and Tran (2018) demonstrate a positive relationship between board structures that include directors related to minority shareholders and market valuation. Minority directors appear to have a positive impact on both earnings' quality (in terms of lower discretionary accruals) and the amount and quality of firm disclosure. Consistently, according to Cornett, Marcus, and Tehranian (2008) and Marchetti, Siciliano, and Ventoruzzo (2018), minority-appointed directors are associated with lower earnings management and a richer disclosing environment. Moreover, previous literature also highlights that a higher corporate governance quality positively impacts the earnings quality (Klein, 2002; Peasnell et al., 2005; Cornett et al., 2008). In addition, consistently with the findings in Bianchi, Ciavarella, Novembre, & Signoretti (2014), Marchetti, Siciliano, and Ventoruzzo (2017) document that directors appointed by minority shareholders are more likely to dissent and that market prices react slightly negatively when a minority-appointed director votes against the majority. The authors conclude that these findings suggest a certain degree of 'trust' of the market in minority-appointed directors. Indeed, minority directors act as a conduit of information to the market by facilitating further engagement by active shareholders, promoting better communication and reducing disclosure manipulation. These analyses suggest a certain degree of trust of the market in minority-appointed directors (Bianchi, Ciavarella, Novembre, & Signoretti, 2011). These findings shed light on the crucial role played by minority directors in fostering corporate transparency. Other studies on the topic confirm this thesis by demonstrating that allowing minority

shareholders to have representatives on the board can be an essential mechanism to foster disclosure transparency, corroborating the hypothesis that minority directors play a positive role in investors' protection (Marchetti et al., 2020).
All these results seem to support the fundamental role played by minority directors in alleviating agency costs associated with the risk of self-dealing transactions by the corporate controller and, in turn, in increasing firm value.

2.6 The *darkside* of minority shareholders' protection

Although a large body of literature supports the crucial role of minority directors in the board and firms' corporate governance, many studies shed new light on the dark side of shareholder protection and potential drawbacks associated with minority shareholders' representativeness. Indeed, they could strengthen the risk of potential hold-ups by minority shareholders, threatening the profitability of idiosyncratic investments made by the majority shareholder and favouring an undue appropriation ex-post of the relative quasi-rent (Williamson, 1979; Burkart, Gromb & Panunzi, 1997). Even the minority director is not a priori extraneous to conflicts of interest. Minority shareholders are other self-interested actors, and therefore their representativeness on the board can be aimed to protect their private benefits rather than preserve general corporate interests (Murphy, 2008; Gelter, 2011).
Belloc (2013) and Qi (2015), analyzing potential drawbacks associated with minority shareholder protection, address this thesis, demonstrating the negative impact that minority shareholders' representativeness has on firm value. Based on the above evidence, the minority director would appear to be praesidium of the only minority shareholders, ignoring the interest of other shareholders and the company.
The presence of special-interest directors might lead to balkanization, a strong split of the board due to the emergence of internal conflicts, slowing down procedure and undermining the quality of the decision-making process. Indeed, the introduction of minority directors could grow shareholder short-termism and limit the ex-ante incentives for the controlling shareholders to undertake not-verifiable and not-

contractible firm-specific investments that result in destroying firm value (Williamson, 1979; Hart & Moore, 1990).

Consistent with previous findings, many studies support the idea that the appointment of minority directors does not necessarily lead to an improvement in financial disclosure. Minority directors often do not have the necessary information suitable for fostering the improvement of the financial reporting process. In closely held firms, information is generally in the hands of the controlling shareholder and, at times, by the directors close to him. Therefore, the presence of minority directors may lead to a deterioration of the innate factors of the reporting quality (Francis et al., 2005).

In the RPT domain, the slate-vote system could be a useful legal tool to mitigate the risk of self-dealing transactions by majority shareholders, protecting minority shareholders but, on the other hand, may give rise to additional and new forms of value extraction.

Consistently, far-reaching governance rights of non-controlling shareholders - i.e., MOM vote that confers a veto right upon non-controlling shareholders - can be used by hedge funds to veto efficient value-increasing RPTs (Pacces, 2012).

When the regime's effectiveness is dependent on far-reaching governance rights of non-controlling shareholders, the latter may end up being overly empowered compared to what is optimal for a particular company, reducing the risk of false-negative but at the same time increasing the risk of false-positive (i.e., efficient RPTs that fail to be implemented because of opposition from powerful minority directors or non-controlling shareholders) (Pacces, 2018).

Therefore, monitoring costs cannot be ignored, and "black" areas may also be accepted, as additional costs are not outweighed by assumed benefits. It follows that it is necessary to test if the presence of minority directors as a monitoring mechanism for RPTs leads to an efficiency loss of such operations (Pizzo, 2013).

In conclusion, on the one hand, minority directors can represent an effective corporate governance mechanism to protect non-controlling shareholders from the distortion and extraction of private benefits of control (*bad private benefit*); on the other hand, they can become a way to expropriate the block-holders of idiosyncratic benefits (*good*

private benefits), limiting the remuneration of entrepreneurial talent and thereby inhibiting the investments of the dominant shareholders.

2.7 The Italian institutional setting and the regulatory framework for minority directors

Italy is a typical European civil-law country with a highly concentrated ownership capital market. The ownership structure of the Italian listed companies is in fact characterized on average by the presence of a dominant shareholder able to monitor and influence the companies' senior managers (Melis, 2000; Volpin, 2002; Barucci & Falini, 2005). In such a scenario, the ownership concentration – together with investor unfriendly corporate governance systems, ineffective enforcement systems and the widespread use of control enhancing mechanisms (such as pyramids, shareholders' agreements and/or dual-class actions) – encourage the corporate block-holder to extract private benefits to the detriment of minority shareholders. For these reasons, the Italian market has been effectively depicted as a setting with '*weak managers, strong blockholder and unprotected minority shareholders*' (Melis, 2000).

However, in the last fifteen years, the Italian institutional setting has been involved in important legal reforms aiming at strengthening shareholder protection and at increasing the accountability of block-holders (Enriques, 2009; Belcredi & Enriques, 2014). In this context, the slate-voting (*Voto di lista*) is a peculiar feature of the current Italian corporate governance regulation that gives minority shareholders the right to appoint at least one member of the board of directors (De Poli & De Gioia Carabellese, 2017; Bianchi, Enriques, & Milic, 2018).

With the aim to improve the governance structure of state-owned companies in order to make them more attractive to private investors, slate-voting was first introduced in Italy by the Legislative Decree n. 332/94, converted by the Law n. 474/94 (*Legge sulla privatizzazione*) which regulated the privatisation of state-owned enterprises. For the Italian privatized listed companies, this norm required directors to be appointed on the

basis of shareholders' proposal of alternative slates of candidates and that at least one-fifth of the members of the board had to be elected from a slate presented by one or more minority shareholders.

With the Legislative Decree n. 58/1998, the same procedure of voting became mandatory also for the election of statutory auditors of all listed companies of the Italian Stock Exchange, and in 2005 (Law n. 262/2005 – *Legge sul risparmio*) the Italian law encouraged all listed companies to adopt the slate-vote system for the election of statutory directors in order to prevent possible abuses by the block-holder to the detriment of minorities shareholders. In 2007, June 30th, the slate-vote system became mandatory for all listed companies: firms must allow minority shareholders to appoint at least one member of the board; minority shareholders, however, may choose whether or not exercise their voting rights.

Specifically, the law requires that at least one of the members of the board of directors must be elected from a list that is not connected – even indirectly – with controlling shareholders. Specifically, the system develops into two different models:

- *'majority' method*, which allows the allocation of the majority of seats to the list with the highest number of votes, and a certain number of seats – indicated in the bylaw – to candidates drawn from the second most voted;

[… *Once the Stockholders' Meeting determines the number of Directors to be elected, the following procedure shall be applied: 1. all the Directors except one shall be elected from the slate that has obtained the highest number of votes, on the basis of the numerical order in which they appear on the slate; as provided by law, one Director shall be elected from the slate that has obtained the second highest number of votes, on the basis of the numerical order in which the candidates appear on the slate* …] (Exor, *Annual Report on Corporate Governance*, 2017).

- 'proportional' method, according to which the votes obtained by each list shall be divided by integers from one to the number of directors to be elected ('quotient' method). The resulting quotients are then allocated, one each, to the candidates on that list, in accordance with the order in which their names appear there, and those with the

highest quotients (with direct corrective to ensure the constraints of the law and the bylaws are met) are declared elected, until all the directorships up to the number set by the General Meeting have been filled.

[… *At the end of voting, the votes obtained from the lists are divided by whole consecutive numbers from one to the number of directors to be elected. The quotients obtained in this way are attributed to the candidates of each list, following the order in the list. The quotients attributed to the candidates of the lists are then put in a single ranking in decreasing order. Candidates with the highest quotients are elected until the total number of directors established by the Shareholders' Meeting is reached. The foregoing is without prejudice to the candidate ranking first in the second list obtaining the highest number of votes and who is not related in any way, even indirectly, to shareholders that have presented or voted for the list that ranks first by number of votes being elected. Therefore, if the aforesaid candidate has not obtained the quotient necessary to be elected, the candidate who, in the first list, obtained the lowest quotient will not be elected and the candidate in first place on the second list obtaining the highest number of votes will be elected to the Board* …] (Mediaset, *Annual Report on Corporate Governance*, 2017).

The proportional method does not attribute any majority premium. Consequently, a slate receiving only a 'relative majority' vote may well appoint less than 50% of board members. For this reason, firms often adopt a 'mixed' method, according to which the slate obtaining the highest number of votes appoints the large majority of board members, while the remaining directors shall be drawn from the other slates.

[… *The procedure for electing the Directors is to be as follows: a) seven-tenths of the Directors to be elected, rounding down any fraction to the unit, shall be drawn from the slate that has obtained the most votes cast by the shareholders in the order in which they are listed on the slate; b) the remaining Directors shall be drawn from the other slates; for this purpose, the votes obtained by these slates shall be divided successively by one, two, three and so forth according to the number of Directors to be elected. The numbers obtained in this way shall be attributed to the candidates of such slates in the order in which they rank in the slate. The numbers thus attributed to the candidates of*

the various slates shall be arranged in decreasing order in a single ranking. The candidates who have obtained the highest numbers shall become Directors ...] (Enel, *Corporate Bylaws*, www.sec.gov).

As to the *quorum* required for the presentation of the lists by the shareholders, art. 147-ter of the Consolidated Law recommends a maximum interest share of 2.5%. However, the law also allows the Italian Security Exchange Commission to indicate different thresholds that – on the one hand – guarantee minority shareholders' right to appoint outside directors even when they hold a small fraction of equity relative to the firm size, and – on the other hand – limit abuses of minority power.

Therefore, in accordance with art. 147-ter of the Consolidated Law and without prejudice to any lesser percentage established in the Articles of Association, the Consob Issuers' Regulation (art. 144-quarter) provides several thresholds in terms of market capitalization, floating and ownership structure of the listed companies. In fact, according to the Italian Securities Market Authority, the interest share required for the presentation of the lists of candidates for the election of the board of directors is:

- 0.5% of the share capital for companies with a market capitalization in excess of fifteen billion euro;
- 1% of the share capital for companies with a market capitalization in excess of one billion euro and less than or equal to fifteen billion euro;
- 2.5% of the share capital for companies with a market capitalization is less than or equal to one billion euro.

The investment share is instead equal to 4.5% of the share capital for companies for which the market capitalization is less than or equal to three hundred and seventy five million euro where the following conditions are all met:

a) floating capital is in excess of 25%;

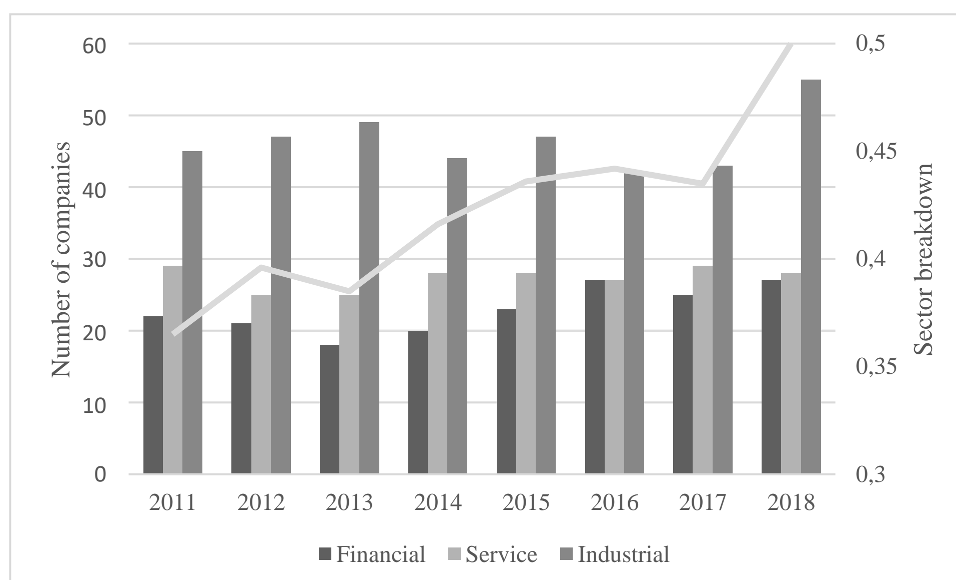
b) there is no shareholder or more than one shareholder adhering to a shareholders' agreement which have the majority of the voting rights that can be exercised in the meeting resolutions concerning the appointment of the members of the administrative body.

When the two above-mentioned conditions are not met, the investment share needed for the presentation of a list is lowered to the 2.5% of the share capital. In other terms, according to the Consob Issuers' Regulation, shareholders holding between 0.5%-4.5% of a company's share capital are entitled to present a slate of candidates. Listed firms cannot adopt a threshold higher than the one set by Consob, but they can set a lower threshold.

[… *Pursuant to Article 144-quater of the Issuers' Regulations, Consob issued Resolution no. 19856 of January 25, 2017, which set the quota of participation applicable to the Company at 4.5%.* […] *The slates may be submitted by shareholders which, alone or together with other shareholders, hold a total number of shares representing at least 2% of the share capital with voting rights at the Ordinary Shareholders' Meeting, or such lesser amount required by Consob regulations* …] (Prelios, *Annual Report on Corporate Governance*, 2016).

According to the latest Consob Resolution (January 24, 2018), the average quorum for the submission of slates for the Board of Directors is low and quite stable (2.40%). It makes infrequent that there is no minority shareholder who may submit a minority slate. However, the percentage of firms with at least one minority directors sitting on the board - although slightly increasing over the 2011-2018 period - does not exceed 50% (Figure 2.1) (CONSOB, 2019; Assonime, 2020).

Figure 2.1 - *Number of companies with at least one minority directors*



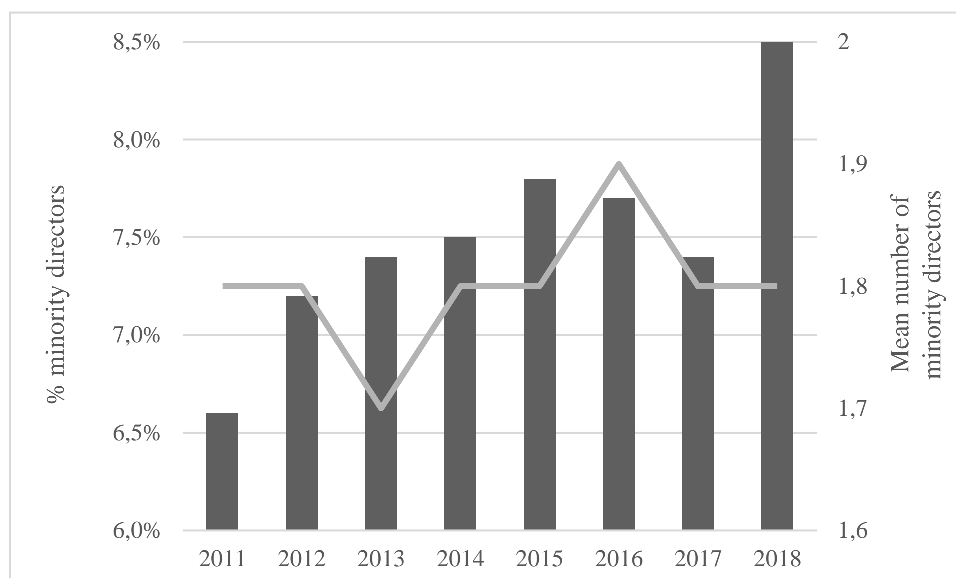
Considering that minority shareholders may choose whether or not to exercise their voting rights, we can interpret this 'apathy' that seems (only 110 companies - as shown in Table-2.1), therefore, to be linked to investors having little interest in presenting their own slate, rather than being the quorum too high (Assonime, 2016).

Table 2.1 - *Companies with at least one minority director*

	2011	2012	2013	2014	2015	2016	2017	2018
Total Number	96	93	92	92	98	96	97	110

When minority shareholders take the opportunity to submit a slate, the average number of minority directors appointed is approximately two that represents 8,5 % of the board members. The Figure below shows an upgraded trend over the 2011-2018 period (Figure 2.2). The minority shareholders' representativeness changes considerably based on firm size (2.5 directors in the FTSE MIB; there are 1.7 among the Mid-Caps and 1.3 among the Small Caps) and belonging sector (2.5 in the banks) (Assonime, 2020).

Figure 2.2 - *Number of minority directors on board*



Source: Consob 2019

These results highlight that – if a minority shareholders' slate of candidates is presented – several bylaws have opted for going above the minimum legal requirement

of 1 director and have made room for two or three minority-appointed directors.

The controversial intra-group acquisition: the Parmalat Lactalis case - study

In the following lines, the box will illustrate one of the most recent scandals, which involved two relevant companies operating in the dairy sector to clarify the potential use of RPT as a dangerous expropriation vehicle and the role of minorities in harmful transactions.
More in general, the single-case study can be used to determine whether a theory's propositions are correct or whether some alternative set of explanations might be more relevant. (Yin,2014) This explanatory case study provides evidence of the inherent risks of RPT and the impact of shareholder activism as a tool to limit the effects of the self-dealing transaction.
The French Lactalis group, through a public tender offer completed in 2011, reaching 83.3% of the share capital of Parmalat, taking control of the whole company. In fact, by the conclusion of this action, the French group Lactalis became the majority shareholder of Parmalat spa. In 2012, Parmalat Spa acquired Lactalis American Group, Lactalis Brazil and Lactalis Mexico, companies belonging to the Lactalis Group and operating in the American market. This acquisition represented a transaction with related parties because both the acquiring company and acquired were managed and controlled by the same entity, i.e. the parent company of the Lactalis Group (Bsa S.A.). The demonstration of the economic and strategic convenience of dealing for the company has entailed the transaction approval.

[*…The deal aims to achieve two strategic objectives: to extend the presence of the Parmalat Group in geographical areas where it is not present, such as the USA, Brazil and Mexico, and to increase the weight in the portfolio of products with higher added value. It will allow Parmalat to enter the most significant international dairy market, the U.S. one. It will take place through LAG, a group that has shown a strong capacity to grow revenues and profitability in the last decade and has already launched a relevant strategy to accelerate growth. Regarding the increase in the weight of high value-added products, it is worthy to note that LAG Group operates in the profitable segments of soft and fresh cheeses, which are currently substantially absent from the Parmalat product portfolio. It will allow the Parmalat Group to enrich other Group companies, particularly Canada, with significant production, sales and distribution know-how. Parmalat management believes that the dealing will also result in better positioning in Latin America, extending the presence of Parmalat in new markets such as Mexico and Brazil and opening up Venezuela and Colombia markets to LAG products…]* (Parmalat, Rpt Information Document, 2012)

According to procedure requirements, the transaction approval by Parmalat Board of Directors involved the expression of a favourable binding opinion of the independent Internal Control and Corporate Governance Committee, assisted by an expert who issued its fairness opinion (Mediobanca Banca di Credito Finanziario S.p. A). The acquisition process fuelled a debate. The fairness of consideration established by the parties - on the value of the French group's companies - was discussed. This transaction was able to stimulate shareholder activism and the use of legal tools to protect minority interests. In these circumstances, a minority shareholder (the Amber Capital L.P. fund) presented a complaint to the Court, recognizing in the transaction "*a debt acquisition aimed at transferring the liquidity of the subsidiary Parmalat SpA to the parent company BSA S.A., with a price higher than the fair amount.*" The acquisition price judged as inappropriate was a central discussion. According to the critical interpretations, the acquisition was a liquidity transfer from Parmalat to funds of Lactalis to reduce - at least partially - its excessive exposure to debt. Under this perspective, Parmalat can be considered part of the cash pooling structure of the Lactalis group, i.e., treasury sharing, which favouring the transfer of liquidity from the hands of Parmalat into the hands of indebted Lactalis spa. Adjusting the acquisition price higher than the one defined under normal market conditions could be seen as instrumental to tunnel resources and extract value favouring the majority shareholder. After the intervention of a minority shareholder, the price of the transaction – that was deemed inappropriate compared to the value of the companies acquired - became subject to corrective measures, following the administrative proceeding under Article 2409 of the Civil Code.

CHAPTER III
ITALIAN REGULATION ON RELATED PARTY TRANSACTIONS

3.1 Italian scenario: an ideal setting

Italy represents an ideal setting to analyse all potential risks of RPTs and the role of regulation to limit them. The Italian institutional scenario has been depicted as a context with weak managers, strong block-holder, and unprotected minority shareholders (Melis,2000). Indeed, in a concentrated ownership setting, the presence of a dominant shareholder can monitor the company's senior managers and compress information asymmetry between managers and shareholder (Barucci & Falini, 2005), shifting this conflict between majority shareholders and minority shareholders (Volpin, 2002). This *principal–principal conflict*, also known as *Agency Problem II*, represents the major corporate governance issue of Italian concentrated ownership companies (Dharwadkar et al., 2000; Bebchuck et al., 2000; Villalonga & Amit, 2006; Young et al., 2008; Renders & Gaeremynck, 2012). The separation between control rights and cash flow rights can generate significant agency problems and costs related to the potential appropriation of private benefits of control by majority shareholders at the expense of minorities (Shleifer & Vishny, 1997; Faccio & Lang, 2002; Federowicz & Aguilera, 2003; Gospel & Pendleton, 2005; Thomsen, Pedersen, & Kvist, 2006). Besides, the weak legal shareholder protection, together with the widespread use of *control enhancing mechanisms (CEMs)* – such as pyramids, shareholders agreements, and dual-class actions – exacerbates the risk of an undue extraction of value to the benefit of controllers. In these circumstances, controlling shareholders could transfer resources from the firm for their benefit carrying out self-dealing RPTs (Johnson, La Porta, Lopez-de-Silanes, & Shleifer, 2000), undermining minority shareholders' protection. This form of *tunnelling* represents a traditional feature and an endemic corporate governance issue in the Italian institutional setting (Belcredi et

al., 2014). For this reason, the higher risk associated with RPTs has contributed to increasing the need to reinforce protection for non-controlling shareholders. Both research and practice have demonstrated that better corporate RPT disclosure is required to mitigate the information asymmetry, compress agency costs, and guarantee the fairness of RPTs. In general, in a concentrated ownership setting related party transactions (RPT) may imply moral hazard and may be carried out in the interest of the controlling shareholders to extract wealth from outside investors (Demsetz & Lehn, 1985; Shleifer & Vishny, 1997). Therefore, the recent shocking events have also led regulators and Standard Setters to strengthen the current rules and principles by introducing new requirements and bans to RPT discipline. Consistently with this view, the CONSOB has introduced strict rules (Resolution n. 17221, as amended), emphasizing the monitoring role of independent directors and their active involvement in the negotiation phase and making disclosure rules stricter.

3.2 Italian RPT regulatory and legislative framework

The inspiring rationale of the Italian RPT disciplines is to ensure the substantial and procedural correctness of transactions in which directors or controlling shareholders have a personal interest that can oppose until harm interest of the corporation to the detriment of non-controlling shareholders. Given that not all transactions pursue fraudulent purposes, the Italian legislator - as provisions of most other legal systems – does not intend to inhibit the execution of transactions between related parties. Still, it acts to guarantee the fairness of procedure and transparency of its disclosure to the market.

For this reason, the Italian RPT discipline intervened to introduce procedures of fairness as rules to be followed in the decision-making process of the competent bodies (*substantive regulation*) and transparency obligations, i.e., disclosure obligations that the company must fulfil periodically or immediately, to convey all necessary information to the market (*transparency regulation*).

The Italian regulatory framework has referred to the international accounting standard to define *related parties* of these transactions. Indeed, the introduction of IAS 24

- *Related Party Disclosures*, has presented theoretical and definitory aspects of the subject and has also disciplined the periodic information on RPT. The accounting principle regulating the minimum content of RPTs in the Financial Statement aims to ensure the conveying of all supplementary information necessary to define the impact these transactions could have on the business management. More specifically, since 2005, transposing the international principle, Italian listed companies have to guarantee that their *Financial Statements contain the disclosure necessary to monitor the possibility that reported financial position and results could have been affected by the existence of related parties.* In contrast, the art. 2427 - 22-bis of Civil Code (e art. 38, lett. quinquies del D.Lgs. n. 127/1991 / Legislative Decree no. 173/2008) has required to NON-IAS adopter the indication of transactions with related parties in Notes of Financial Statement only when two requirements are satisfied at the same time: i) operation must be material and ii) executed at not arm's length conditions.

Consistent with the primary intention, all Italian provisions aim to ensure greater disclosure transparency and enhance risk assessment procedures in decision-making processes.

Over time, many legislative actions have attempted to compress the risk of *tunneling* via RPT by requiring timely information regarding characteristics and the reason for the completion of dealing.

Since 1993, CONSOB has addressed the issue related to disclosure transparency regarding the information relating to related party transactions. More specifically, by Communication no. 93002422/1993 the Supervisory Authority recommended, as part of the review process relating to transactions with *non-independent parties, to acquire sufficient and appropriate audit evidence regarding the purpose, nature and relevance of such transactions on the economic situation balance sheet and financial position of the audited company*

To do this, the subsequent communication of 20 February 1997, no. DAC / RM / 97001574 (*Recommendations on corporate controls*) has established the disclosure of qualified information on *critical* transactions carried out and suggested to the Board of directors and the Board of Statutory Auditors to direct particular attention RPT to comply fundamental accounting concept of *substance over form*.

Since 2001 the summary sheet of the control activity carried out by the boards of statutory auditors also has to be transmitted to CONSOB provides evidence of the most

highly material economic, financial and equity transactions carried out by the company and their compliance with the law. More in detail, the auditors have to specify *whether the operations are considered manifestly imprudent or risky, in the potential conflict of interest, in contrast with the resolutions passed by the shareholders' meeting or such as to compromise the integrity of the corporate assets* (n. 1025564/2001 *Comunicazione sui contenuti della relazione del collegio sindacale all'assemblea* di cui agli artt. 2429, comma 3, del Civil Code 153, comma 1, del d.lgs. 58/98 – *Scheda riepilogativa dell'attività di controllo svolta dai collegi sindacali*).
In 2002, Consob inserted the RPT procedure among regulatory decisions by adding art. 71-bis to the Issuers Regulation (now repealed by the Regulation of 2010), aimed at ensuring detailed disclosure to the market after the execution of transactions with relevant related parties. In such cases, the Issuers Regulation required the publication by listed companies of a specific information document containing detailed information about the characteristics, the conditions of the transaction, the underlying economic reasons, and the methods for determining appropriateness.
Furthermore, in the context of the application to Italian listed companies of Regulation no. 1606/2002 on international accounting standards, CONSOB requested highlighting the balance sheet, income statement and cash flow statement, the number of positions or transactions with parties related resulting from non-recurring events or transactions. Finally, from 2007, transposing the *Transparency EU Directive*, the art. 154-ter of TUF grants Consob the power to define by regulation the content of the disclosure obligations for Highly Material Transactions. In other terms, this legal intervention provides for significant disclosure obligations and procedural requirements by conferring to the CONSOB the power to discipline the framework.

Thus, since 2010, the CONSOB issued a comprehensive regulation on listed companies RPTs, with toughened procedural requirements and heightened disclosure obligations. In particular, Regulation n.17721 on Related Party Transaction has overhauled the rules on RPTs for Italian listed companies - whose scope includes Italian companies that make use of the risk capital market - according to the definition in art. 2325-bis of the Civil Code. This new regulatory approach has introduced different procedural requirements traced to independent directors' involvement and disclosure obligations based on the magnitude of the transaction. In other terms, RPT discipline varies based on the materiality of the transaction, defined as the size of operation relative to that of the company.

In the same years, soft law sources also regulated the issue of related parties. In 2002, the revised version of the Corporate Governance Code dedicated article 11 to deal with the transactions with related parties, the principles of which were widely implemented by the legislator in art—2391-bis of the Civil Code 22 and then by Consob in the Regulations. In 1999, the first version of the Preda Code provided a reservation favouring the entire board of directors to resolve transactions with related parties.

3.3 IAS-24 Related party disclosures

According to the theoretical interpretation of transactions between related parties, the general orientation is not to prohibit or discourage their implementation but rather require adequate information to reduce information asymmetries and conflicts of interest between insiders (controlling shareholders and managers) and outsiders (minority shareholders and other stakeholders). Consistently, the international accounting standard allows identifying related parties and the transactions between them, focusing on the information aspects of these particular operations. The IAS principle 24 - *Related party disclosures* - provides the structural framework of the RPT discipline.

Specifically, IAS 24 focuses on the rules relating to transparency: disclosing the financial statements about transactions between related parties and the latter's ability to influence economic and management policies.
The international accounting standard principle does not regulate the assessment of the substantial correctness of the transaction nor how it is implemented but only governs the information the parties must provide. The *ratio* of intervention stands to favour the interpretation of the transactions in question by external stakeholders, facilitate the analysis of the reasons that led to their implementation, and assess their impact on the annual financial statements.
Therefore, IAS 24 addition to provide a clear definition of RPT more times recalled governs the reporting and disclosure of RPTs for IFRS adopters.
Comprehensive information is required to be communicated for each transaction with any related party. The minimum disclosure requirements under IAS 24 include the nature of the related party relationship, the amount of the transaction, outstanding balances (including off-balance sheet commitments) between an entity and its related party, provisions for doubtful debts related to exceptional and guarantees given and received (IAS 24.18).
Its purpose is to guarantee that the entity's financial statements include all information about how these transactions might affect its financial position.
IAS 24 requires the presentation of the information on RPT separately for each type of party involved (unconsolidated subsidiaries, ultimate parents, joint ventures or associated companies), under the assumption that the effects of RPT vary acrossthem (IAS 24.19). Following this principle, the related party transaction is any transfer of resources, services or obligations between a reporting entity and a related party, regardless of whether a price is charged. Definition of a related party is set out in paragraph 9 by referring to any person or entity related to the entity preparing its financial statements. More specifically, a person or a close member of the same family is a related party of a reporting entity if:
(i) has control or joint control over the reporting entity;
(ii) has significant influence over the reporting entity;

or (iii) member of the key management personnel of the reporting entity or a parent of the reporting entity.

It can also occur that an entity is related to a reporting entity if any of the following conditions occur:

a) The entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others).

b) One entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member).

c) Both entities are joint ventures of the same third party.

d) One entity is a joint venture of a third entity, and the other entity is an associate of the third entity.

e) The entity is a post-employment benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity.

f) The entity is controlled or jointly controlled by a person identified in (a).

g) A person who has control or joint control over the reporting entity has significant influence over the entity or is a member of the entity's key management personnel (or a parent of the entity).[3]

In particular, IAS 24 requires supplementary information on existing relationships, transactions and balances with related parties (including commitments) to be provided in the consolidated and separate financial statements of a parent, a participant in a joint venture or an investor. Indeed, the information on an entity's transactions and relationships with related parties can affect the assessment of its assets by the users of the financial statements and evaluate the risks and opportunities that the entity faces. A relationship with a related party can affect the economic-financial and equity situation of the entity involved. It may result in transactions that independent parties

[3] For the sake of clarity, the content of IAS 24 reports some example of transactions to disclose if carried out with related parties to clarify some potential critical points: purchases or sales of goods (finished or unfinished); purchases or sales of property and other assets; rendering or receiving of services; leases; transfers of research and development; transfers under licence agreements; transfers under finance arrangements (including loans and equity contributions in cash or in-kind); provision of guarantees or collateral; commitments to do something if a particular event occurs or does not occur in the future, including executory contracts (recognised and unrecognised); and settlement of liabilities on behalf of the entity or by the entity on behalf of that related party

would not finalize and which, in any case, may not be carried out at arm's length as at the same condition between independent parties.

3.4 The discipline for *IAS-adopter*: CONSOB Regulation N.17721/2010

In 2010, following the rapid expansion of several corporate scandals, the Italian regulatory body (CONSOB) issued a comprehensive regulation on Related Party Transaction. Indeed, Consob Regulation no. 17721 has overhauled the entire rules on RPTs applicable to all Italian listed entities toughening procedural requirements and heightening disclosure obligations at that moment in being.

Before its enactment, the proposal of Regulation has been amended after two consultations with operators (respectively, 2008 and 2009). The first draft of the Regulations subject to consultation, together with analysis on the economic impact of the then issued discipline, among the most relevant innovations, provided for the active participation of independent directors "*in the conduct of negotiations and the investigation of the deliberation"*. This approach proved excessive after consultations. The authority issued the final version of the RPT Regulation in 2010.

The entire regulatory framework consists of few mandatory forecasts and several optional provisions *(opt-in / out clauses),* which should guarantee operators the possibility of compressing the risk of extracting private benefits and keeping costs low. It has reinforced the previous RPT rules by arranging an ad hoc procedure to RPT approval - granting a central role to the committee of independent directors - and intensifying the disclosure obligations concerning each intra-company flows that have third parties on the market as recipients.

In fact, in addition to providing a defining framework relating to the notions of "*related party*" and "*related party transaction*", the primary purpose of the Regulation is to prepare an organic set of rules containing:

- the procedural principles that companies must adopt to ensure the conditions of fairness in the entire process of approval of the RPTs (*procedural rules*);

- the disclosure obligations for this type of transaction (*transparency rules)* to compress information asymmetry costs (art.4 CONSOB Regulation)[4].

These obligations intend to promote greater transparency precisely on the transactions, whose nature can incentivise a value expropriation to pursue an opportunistic purpose not aligned with the company's interest.

The primary aim of this legislative intervention is to strengthen the protection of minority shareholders and other stakeholders by counteracting any abuses that may arise from those transactions in the potential conflict of interest.

The Regulation structure, as a whole, is significantly limited by the simultaneous presence of several regulatory solutions that, intertwining with each other in a tangle of provisions, do not facilitate the issuers in the elaboration of individual measures and their concrete enforcement.

Concerning the profiles of communication to the market, the Regulation introduces a double transparency regime for highly material RPTs, applying more stringent disclosure obligations than those provided for in the previousregulations:

- *Immediate disclosure*, by publishing an *Information Document* to convey to the market within seven days of the transaction's approval by the competent body or of the stipulation of the contract, or within 15 days in the event of accumulation of several dealings with the same related party. The document must include all information about characteristics of the transaction, economic reasons and convenience for the company of the transaction, methods of determining the consideration, opinions of independent experts and any consultants;
- *Periodic disclosure* as part of the interim or annual management report. In particular, the companies must provide analytical information in the management report on the single highly material RPT carried out in the financial year, specifying those that significantly affect the economic and financial situation. Moreover, they

[4] In particular, with the term substantial fairness, the legislator refers to the correctness of the economic operation, which occurs when the transfer price of an asset aligns with the market price; differently, procedural fairness indicates compliance with regulated procedural obligations.

must disclose any changes or developments in RPT described in the latest annual report that has had a significant effect on the economic and financial situation.

This set of rules have introduced different procedural requirements and disclosure obligations based on the magnitude of the transaction, i.e., its *materiality*. The proportionate approach classifies related-party transaction into *Highly Material Transactions* and *Less Material Transactions,* setting a special procedure for the formers and a general one for the letters (*Related party transaction and minority shareholders)*. The *threshold* of 5% of at least one or more parameters represents the measure to identify the materiality of transactions. For Transactions of Inconsequential Amount - transactions of joint-stock companies, smaller companies, newly listed companies, and the transaction subject of resolution (*delibere-quadro*) - a shortened procedure established.

3.4.1 Identification of Material RPT

A preliminary analysis conducted by CONSOB (*Consob Consultation Paper on the Regulation of RPTs*) showed that the magnitude of RPTs differed significantly between companies. For this reason, the Regulation has provided two different procedures: one for the approbation of less material RPTs (*general procedure*) and another for highly material ones (*special procedure*). At the operational level, the procedure classifies a material related party transaction as one in which at least one of the following metricsexceed the materiality threshold:

1) *Transaction Value Ratio* is calculated as the value of the transaction on the *shareholder's equity* reported in the most recent published balance sheet (consolidated, if drafted). For listed companies, the company's *capitalisation* recorded at the end of the last market day open included in the reference period of the most recent published periodic accounting document (annual or half-yearly financial report or interim management report), whether higher. In the case of banks, it is computed as the value of transaction over *regulatory capital*.

$$\frac{Transaction\ Value}{Equity\ (or\ capitalization)} \geq 5\%$$

More specifically, if the economic conditions of the transaction are determined, the transaction value is measured: i) for cash components, the amount paid to / by the contractual counterparty; ii) for components consisting of financial instruments, the fair value determined, at the date of the transaction, following the international accounting standards adopted with the Regulation (CE) n.1606 / 2002; ii) for financing or granting of guarantees, the maximum amount deliverable. In contrast, if the economic conditions of the transaction depend on other unknown metrics, it becomes the maximum admissible or payable value under the dealing.

2) *Asset ratio* is the ratio between the *assets involved in the transaction* and the company's *total assets*. All data are collected from the most recent published balance sheet (consolidated, if drafted).

$$\frac{Asset\ of\ the\ transaction}{Total\ Assets} \geq 5\%$$

For acquisition and divestments of participation in companies - not affecting the consolidation area - the numerator is equal to the value of the operation increased by the liabilities of the company acquired, eventually assumed by the buyer (in the case of investment) or to the consideration for the business sold (in the case of divestments).

For the acquisition and sale of other activities (different from the shareholding acquisition), it is computed as the higher number between the consideration and the book value that will be to the asset (in the first instance) or the book value of the asset (in the second one).

1) *Liability ratio* the ratio of liabilities of the transaction on total assets of the company. All data are gathered from the most recent published balance sheet (consolidated, if drafted).

$$\frac{Liabilities\ of\ the\ transaction}{Total\ Assets} \geq 5\%$$

The choice of the method depends on the characteristics of the transaction. While evaluating commercial transactions, the first ratio is commonly used; acquisitions can be assessed through the second ratio, whereas the third ratio is more appropriate for loans (Bava & Trana, 2016). A transaction is highly material when at least one of the materiality indices exceeds the 5 per cent threshold. Although the discipline fixes a threshold of 5%, the firms can decide to set lower levels in their internal codes for transactions that may affect the management autonomy of the issuer. In derogation from the general principle, a reduction of thresholds to 2,5% is provided in the dealings with the parent company or its related firms to limit improved incentives to abuse RPTs. For some large Italian companies, the value of a transaction that is considered material might be several hundred million euros. In the case of cumulation of more transactions, the companies determine the relevance of each transaction based on the index or indices. Then, the results for each index add up to verify that they exceed thresholds. When it is impossible to calculate the transaction's value, the operation is identified as a highly material one unless the companies motivate that this qualification is unjustified due to specific circumstances.

3.4.2 The procedural rules concerning transactions with related parties

The procedures for the approval of RPTs consist of different phases and involve several actors necessary to guarantee the fairness and transparency of the process. Generally, it is required first to identify the subject called upon to give an opinion on the convenience of the transaction to the board of directors. More specifically, an RPT committee - specifically constituted and composed exclusively of independent directors - has to provide its fairness opinion on the approval of this transaction.

When the board of directors consists of less than three independent directors, the resolutions are approved with the favourable opinion of the independent directors. They may be present or, in their absence, with the non-binding opinion of an independent expert. Subsequently, the second phase of the process consists of providing such mandatory opinion to the corporate - under art. 4 paragraph 3 of the Regulations - which can be favourable or unfavourable. In the event of a favourable opinion, the provision does not exclude that it can be conditional on adopting specific

changes or suggestions. In contrast, when the opinion expressed by the committee is unfavourable, the reasons to support this judgement have to be explained. Finally, the board of directors or the supervisory board in companies that adopt the two-tier system must approve the procedures. At the end of this phase, the definitive internal RPT system of entity - following the art. 4 paragraph 7 of the Related Parties Regulation - must be published on the company's website without prejudice to the obligation of advertising the annual management report.
Specifically, depending on the materiality of transactions with related parties and the type of company involved, different types of procedure are distinguished, which will be extensively analysed in detail in the following paragraphs.

<u>General Procedure</u> – *for less material transaction*
Less material RPT are those transactions different from material or small amounts governed by Article 13 of the Regulation itself. In other terms, less material RPT are dealings do not exceed the materiality threshold of any the parameters indicated by the regulations for the recognition of transactions of greater importance (*market capitalization or equity, total assets, total liabilities*).

The *general discipline* for less material transactions applied to companies that adopt traditional and monistic administration, and control systems (art. 7) represents a streamlined procedure compared to material transactions.

More specifically, it provides that:

- The transaction approval of the Board of directors involves the expression of a reasoned opinion from the Related Parties Committee – composed by only non-executive and uncorrelated directors, mostly independent - on completing the transaction. The Committee's view includes evaluations on the interest of the company in carrying out the transaction and the convenience and substantial correctness of its agreements. However, this opinion is not binding for the Board of directors that may equally approve the dealing even if the advice of the Committee is unfavourable.

- The Committee may be assisted, if necessary, by one or more independent experts of its choice, at the company's expense.

A piece of complete and adequate information must be provided ex-ante well in advance to the Board of directors and the Committee.

- The company, if it does not have a sufficient number of independent directors (at least two), can adopt procedures that ensure equivalent praesidium to protect the substantial correctness of the transaction

- The minutes of the approval has to report an appropriate motivation regarding the company's interest to carry out RPT as well as the convenience and substantial correctness of the related conditions

- An information document containing the indication of the counterparty, the object and the consideration for dealings approved in the reference quarter despite unfavourable opinion has to be disclosed. Simultaneously, the potential reasons that could orient the decision to not align with the expressed view have to be conveyed in the document. For greater clarity, the independents' opinion must be attached to the information document or the company website.

However, art.7 recognizes the possibility to fit this procedure to that for material transactions (art.8), identifying further obligations not established by the Regulation.

<u>Special procedure</u> – for material transactions

In contrast with the previous definition, art.4 of Regulation describes the material transaction as dealing that exceeds the materiality threshold (according to Appendix 3).

For these transactions, the Regulation provides a special procedure more rigorous than that envisaged by for not material ones.

In particular, in addition to what is indicated by general procedure, it provides that:

In these circumstances, the Related Party Committee, composed exclusively of unrelated independent directors, is involved in many phases of the RPT decision-making process. In the negotiation or investigation phases, they have to receive a complete and timely information flow from executives, with the faculty to request other information or giving their views to the parties tasked with conducting these

stages. Independent directors must be effectively involved in the negotiation phase and the preliminary investigation phase of the transaction when RPT is material.

– The transaction approval of the Board of directors involves the expression of a reasoned opinion - that is mandatory and binding - from the Related Parties Committee on the completion of the transaction and the advantage and substantial correctness of its conditions.

- In these circumstances, the independent directors become holders of real veto power on the execution of dealing. In this case, the Board of directors can approve the operation only after consulting the RPT Committee and confirming the fairness of the transaction, with its favourable advice.

– If the Board of directors intends to proceed despite the contrary opinion of the independent directors, procedures may also include mechanisms for overcoming this veto by reserving the ultimate competence to decide to the shareholder meeting. The statute may provide that the Board of directors can proceed despite unfavourable opinion, submitting the decision for approval by the shareholders' meeting, where a majority of unrelated shareholders approve it (according to the provisions of article 11, paragraph 3).

The special procedural rules introduce this new shareholders' protection mechanism (so-called *whitewash mechanism*) to prevent the completion of the transaction if the majority of independent voting shareholders votes against the approval. However, only if the independent shareholders present at the meeting represent at least a given portion of the share capital with voting rights - not exceeding 10 per cent - they may prevent the transaction's approval. In particular, this mechanism pursued the aim to sterilize the voting rights of the shares held by the majority of interested shareholders, with a consequent balance of decision-making power favouring minorities.

Therefore, the Regulation provides minimum rules governing the functioning of the whitewash:

• A *constituent quorum* of unrelated shareholders present, in any case not exceeding 10%. The envisaged quorum of incorporation is only optional and referred to a discretionary assessment of the single issuer which can not only evaluate whether to

make use of it but identify the percentage up to the maximum measure set by Consob in 10;

• A *deliberative quorum* that corresponds to the majority of unrelated shareholders. Instead, it is mandatory (i.e., its achievement precludes the completion of the operation).

In other words, if the RPT Committee's opinion is negative: a) the board may decide to modify critical points based on advice provided by the RPT Committee and submitting it again to independent directors; or b) convey a general meeting where the majority of unrelated shareholders is necessary to approve it, with the risk that the transaction is rejected again by unrelated shareholders.

Even in this case, if the companies do not have a sufficient number of independent directors, they can adopt procedures that guarantee equivalent controls. Similar rules apply to the two-tier model: the opinion can be issued by a committee of independent supervisory board members or, if any, by independent management board members.

3.5 The disclosure rules concerning transactions with related parties

Periodic disclosure

The Regulation in art. 5, paragraph 8, whose content substantially reproduces that of art. 81 of the Issuers' Regulation (repealed simultaneously as the adoption of the CONSOB Regulation) governs the periodic information. The discipline mentioned above provides that if the transaction is carried out by an issuing company having Italy as a member state of origin, it must be guaranteed - under art. 154-ter of the TUF - the inclusion in the interim management report and the annual management of a set of information, such as:

- the individual transactions that are highly material executed in the reference period (Article 5, paragraph 8, letter a));
- other transactions with related parties concluded in the reference period that significantly influenced the financial position or the results of the company (Article 5, paragraph 8, letter b));

 Any modification of RPT described in the last annual financial report has had a significant effect on the financial position or results of the company (Article 5, paragraph 8, letter c)).

Immediate disclosure

Concerning the immediate disclosure profiles to the market, the CONSOB has introduced a significant strengthening of disclosure obligations, providing a more accentuated diversification of these duties than that envisaged in internal relations depending, of course, on whether they refer to transactions of higher or lesser materiality. This intervention pursues the aim to avoid excessive information burdens for transactions that are not very relevant for the market.

Thereby, the main novelties on the subject concern the information activity onhighly material transactions. Indeed, the new Regulation has introduced a double transparency regime, providing for more stringent disclosure obligations than the previous discipline (according to Article 71-bis of the CONSOB on Issuers). Rules in according to art. 5 of the Regulation applies to all material transactions between related parties as those of lesser importance remain subject to the rules set out in art. 114 of the TUF, without prejudice to the so-called discipline price sensitive.

When the material transactions are approved, the discipline establishes a piece of immediate information with periodic disclosure. In this case, an RPT document has to be drawn up under Annex 4 (CONSOB Regulation no.17221,2010;2017) to disclose to the market all relevant information of the transaction.

More specifically, the CONSOB Regulation no.17221 (2017) establishes that the RPT information document must contain:

1. the indication of the risks associated with potential conflicts of interest deriving from the transaction;
2. the description of the characteristics, methods, terms, and conditions of the deal;
3. the definition of related parties and the economic reasons and convenience of the transaction for the company. When Board of Director approve it despite the

unfavourable opinion of Committee, the description of motives that lead to this decision is required;

4. the identification of the methods to determine the consideration for the transaction, assessing its consistency with market values of similar operations. Any opinions of independent experts supporting the appropriateness of the remuneration are attached to the information document.
5. the illustration of the economic, financial and patrimonial effects of the deal, providing evidence of at least the ratios adopted for the significance test;
6. the details of possible variation of the directors' remuneration following the transaction or, in the alternative, a declaration stating that there are not variations;
7. the indication of the financial instruments of the same issuer held by them and their interests in extraordinary transactions, when the related parties involved are the members of the Board of directors or Control Bodies;
8. the evidence of directors who have conducted or participated in the negotiations, those who have approved the transaction and their role (independent directors, if any);
9. in the hypothesis in which the relevance derives from the accumulation of several transactions carried out in the same year with the same related party, the Board of directors have to disclose all information for each operation.

RPT information document publishment must occur within seven days after the approval of the dealing or the stipulation of the contract or at the time of the conclusion of the contract - even preliminary - if the latter decides to submit a contractual proposal. This document must be made available to the public at the registered office and in the manner indicated in the Issuers' Regulations in Articles 65 et seq.[5]
Furthermore, those transactions carried out with the same related party, which only cumulatively exceed the significance threshold when they are homogeneous or aim to realise a unitary plan are subject the disclosure obligation. In the case of accumulation

[5] It is essential to observe how CONSOB reconciles the value of information certainty with the confidentiality requirements of the company in the other to identify the moment of dissemination of the document, the same certainty of the news with the *"public good"* of their homogeneous diffusion. Suppose the basic time criterion for the disclosure of the IT document is that of the transaction's approval. In that case, this moment is postponed to completing the transaction with the counterparty if negotiation is in progress, not to hinder its management and avoid the influx of information into the markets that are not characterized by sufficient certainty. However, the effectiveness of the art. 114 co. 1 of the TUF, which guarantees the parity of information of market operators, is always entrusted

of more transactions with the same related unitary information document, the period for publication is extended up to fifteen days from the transaction's approval or from the conclusion of the contract that determines the exceeding of the relevance threshold. It contains information and an aggregate basis for homogeneous transactions on all the transitions considered for accumulation.
The companies make available to the public in the terms above described as an attachment to the information document or on the company's website, any opinions of independent directors and external experts.
Therefore, the Italian CONSOB Regulation’s *ratio* is ensuring that negotiations and transactions involving related parties are carried out appropriately, following the same procedures of similar transactions executed on the market between *unrelated parties*.

Episodic Information

The communication mentioned above on RPTs does not exhaust all the disclosure obligations that, under the law of the Consolidated Law, weigh on companies involved in transactions with related parties. It is necessary to coordinate the requirements previously examined with those provided according to art—114 co. 1 and 5 of the TUF, as applicable on a residual basis. Information relating to extraordinary transactions represents an "*episodic*" form of communication. The information document, in fact, outright fulfils the information under art. 70 and 71 of the Issuers' Regulation, in cases in which transactions with related parties take the form of significant mergers, demergers by incorporation or non-proportional, capital increases through the transfer of assets in kind, or the acquisition and sale of equity investments, business company or other assets.
The obligation to publish a single information document - that simultaneously meets information requirements providing by Annex 4 and those by Articles 70 and 71 - addresses this coordination problem. In the event, RPT - regardless of whether it is of higher or lower materiality - also constitutes inside information, subject to the

disclosure obligations provided for by art. 114, paragraph 1, of the TUF, is governed by art. 6 of the Regulations. In this case, there is no possibility of concentrating in a single document the information that companies are obliged to disclose, providing that the content of the immediate information is integrated to strengthen its effectiveness.

3.6 The role of independent in the procedure

Over the last years, the role of independents has been strengthened, empowering them in all those cases where unconditioned and independent judgment is necessary.

The discipline of the CONSOB Regulation confirms the choice of attributing a central role to independent directors in the RPT procedure, to ensure that the transactions are carried out in the company's interest. The Regulation recognizes the qualification "*independent director*" to who meet the requirements of independence as established by art.148 of the TUF - i.e., the absence of causes of ineligibility and incompatibility. The independent directors called to give their opinion must carry out the assessment (in the Committee for transactions with related parties) to disclose in the minutes of approval of the dealing according to art. 7, paragraph 1, lett. e) of the Regulations (where applicable) and the minutes of the committees themselves.

In other terms, the entire assessment of compliance with the principles of procedural and substantive correctness in the implementation of RPT has been entrusted to independent directors. They play a central role in the decision-making process and assess the convenience of the transaction for corporate. Their part is to monitor the achievement of the corporate interest by executive directors, preventing any opportunistic behaviours that can damage the company and its shareholders. As seen in previous chapters, an RPT can hide an extraction of private benefits by the majority shareholders to the detriment of the minority shareholders and the company. This agency problem arises from conflicts of interest between controlling shareholders and non-controlling ones.

Therefore, they must participate in the decision-making process of the Board of directors with a judgment that is autonomous and independent. Thereby, the

independence requirement appears to be essential for objective assessments released from the will of controllers.

Hence, independent directors must not negotiate and approve transactions with related parties but only participate in the negotiation stage after receiving a timely and complete flow of information from the management bodies. Thus, they can express their opinion on procedural and substantive correctness.

It follows, therefore, that any liability for damage caused by having approved an operation contrary to the corporate interest lies either with the decision-making board or becomes the collective responsibility of the entire Board.

Independent directors may be held accountable not for the transaction approval - except as members of the Board of directors under art. 2392 of the Italian Civil Code - but of the violation of the specific obligations that the regulatory discipline requires them to fulfil.

Therefore, the existence of a mere favourable opinion from the independent directors does not exonerate the decision-making body for the performance of Related Party Transactions from any liability. They composing an RPT committee are called to deliver a fairness opinion on the transaction's approval. Generally, the independent directors that give an advisory opinion following diligently RPT discipline are exempt from liability. Otherwise, if they assume obstructive behaviour by adopting adverse advice arbitrarily, they are personally responsible for the damage caused to the company and the shareholders.

If they do not express a favourable opinion, the Regulation recognizes the Board of directors the possibility to submit the final decision of approbation to the shareholders' meeting. It has the opportunity to resolve the execution of dealing with the majority of unrelated shareholders vote in favour of it (so-called *whitewash*).

The real innovation of the Regulation consists in the adoption of alternative deliberative procedures. On the one hand, the discipline attaches particular importance to independent directors that have to participate in the several phases of the transaction's approval process, with different level of engagement. On the other hand, it introduces in the decision-making process the whitewash mechanism aimed at

devolving the approval decisions to shareholders, preventing opportunist behaviours, depurating the shareholders' vote of any individual interests of some shareholders.
In the shareholders' resolution, the majority of the "unrelated shareholders" can limit the transaction's approval.
In particular, the *whitewash system* is regulated by art. 8 paragraph 2 of the Related Parties Regulation, which states that *without prejudice to the statutory provisions required by law, the Board of directors may approve the highly material transactions despite the contrary opinion of the independent directors. In this case, the decision has to be authorized by the shareholders' meeting*, which resolves under provisions of article 11, paragraph 3. To shareholders protection, the procedures "[...] *have to contain rules aimed at preventing the completion of the transaction if the majority of unrelated voting shareholders -that represents at least a particular share of the share capital with voting rights, in any case not exceeding ten per cent - vote against the transaction* ".
Generally, in the absence of a favourable opinion of independent Committee, the Board of directors can make the appropriate changes to re-submit the decision to the independent directors; or call the assembly to approve the transaction despite the opposing advice of independent directors, with a high risk of reject by unrelated shareholders. In these circumstances, if the majority of "*unrelated shareholders*" cast a vote against completing the transaction, it will not be approved.

3.7 The discipline for *NON-IAS adopter*: Civil Code rules

Regarding subjects who do not adopt the international accounting standards, the discipline differs in part from that proposed by the European standard setter.
Specifically, for unlisted companies - contrary to what provided for listed companies and those that prepare consolidated financial statements, which must always and in any case provide information relating to the transactions with related parties - the article 2427, paragraph 1, no. 22-bis of the Civil Code establishes the obligation to provide relevant information on related party transactions in the notes "*if they are*

material and executed to not arm's length conditions". It follows that the disclosure requirement in Notes to Financial Statements is applicable only if two necessary conditions are satisfied: namely that the transaction is highly material and executed at a non-arms-length state.

Regarding the first point, identifying transactions that should be considered highly material is sought through a reference to the indices identified by CONSOB and previously widely discussed.

However, it is easy to infer that the thresholds identified by CONSOB could sometimes be incompatible in the context of the book values that characterize Italian small and medium-sized enterprises and, therefore, would entail the determination of material transactions which are not significant. For small and medium-sized Italian companies, the relevance or otherwise of dealings with related parties must be assessed concerning the current financial year and, considering qualitative and quantitative factors:

- *Quantitative factors* that represent the size of the economic effects of the transaction, or another event concerning the balance sheet magnitudes
- *Qualitative factors* that regard the peculiar characteristics of this dealing, whose relevance can reasonably influence the economic decisions of the addresses/recipients of the company's financial statements.

Concerning the second condition identified by art. 2427, paragraph 1, n. 22-bis of the Italian Civil Code, i.e.it must first be specified; arms-length transactions are not the only transaction price function.[6] It is necessary to analyse the reasons that prompt to carry out the transaction with a *related party* rather than with *independent third parties*. More specifically, the regulation refers to the provisions on tax matters regarding the determination of the normal value, i.e., the article above 9, paragraph 3, of Presidential Decree no. 197/1986 to identify a criterion for determining transactions carried out not at the market conditions.

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[6]As a concern, the definition of normal market condition, a supplementary document of OIC 12, is necessary to consider not only price making. The Explanatory Report to Legislative Decree No. 173/2008 establishes that: "normal market conditions should not be understood only considering the price of the transaction, but also the reasons that led to the decision to carry out the dealing and to conclude it with related parties rather than with third parties

In conclusion, the implementation of transactions at normal market conditions that deviate from the regular trend of the same - especially if in terms of price - can take on relevance in measures to combat tax evasion and avoidance, predominantly through the phenomenon of transfer pricing. Therefore, the Italian legislation has paid particular attention to the phenomenon, sometimes by referring to non-specific provisions that create many issues in evaluating the transactions' adequacy between related parties.

3.8 SHRD II: The Governance Decree and the amendments regarding transactions with RPT

The current regulatory provisions, of primary rank, regarding transactions with related parties and the remuneration of the members of the administrative and control bodies and managers with strategic responsibilities of companies with listed shares, were amended in 2019 to work legislative decree May 10 2019, n. 49, implementing Directive (EU) 2017/828 (Shareholder Rights Directive II, "SHRD 2"), which amended Directive 2007/36 / EC as regards the encouragement of long- term commitment of shareholders.

On December 10, 2020, Consob published Resolutions no. 21623, n. 21624 and n. 21625 aimed at adapting secondary legislation (*Regolamento Emittenti*), Related Party Transactions Regulation CONSOB N.17221, Market Regulation) to Directive (EU) 2017/828 on shareholder rights (see Shareholder Rights Directive 2 - SHRD II), which amends Directive 2007 / 36 / EC (see SHRD I).

Furthermore, the Legislative Decree no. 49/2019 introducing new paragraph 3 of the art. 2391-bis of the Italian Civil Code delegates to Consob the responsibility of identify:

- the significance thresholds for transactions with related parties taking into account quantitative indices linked to the value of the transaction or its impact on the company's size parameters. Consob can also identify criteria of relevance that take into account the nature of the dealing and the type of related party;

- procedural and transparency rules that are proportionate to the materiality and characteristics of the transactions, the size of the company or the type of firm that recourses to the capital market (as well as the cases of exemption from the application of general rules);
- if directors and the shareholders are involved in the transaction abstaining from voting is required to protect the company's interest.

Under the transitional provision contained in art. 3 of resolution no. 21624/2020, the amendments to RPT Regulation will come into force on July 1 2021. Before that date, i.e., by June 30 2021, the companies will have to adapt their internal procedures, weighing, as underlined by the Consob, the potential organizational and management repercussions and involving the related parties committee (or the independent directors appointed to do so) for the related prior opinion.

The Italian legislative and regulatory framework regarding transactions with related parties is already largely aligned and consistent with the provisions on "*Transparency and approval of transactions with related parties*" included in the new art—9-quarter of the SHRD (as introduced by SHRD 2 Directive).

The main changes made to RPT discipline concern:

- The *definition of the related party*. In RPT Regulation on 2010 opted to crystalize the definition of "*related party* "as included in the international accounting standard IAS 24 in force to prevent that definition can change automatically when the principle varies. The new provision expressly delegates Consob to identify "the definition of a related party in line with international accounting standards" but introducing a mobile reference to the "*pro tempore in force*" definition of the international accounting standards in force at the time (in particular IAS24 - Financial statement information on transactions with related parties). Thus, the perimeter of the associated parties coincides with the relevant one for accounting information.

-*Obligation to the abstention of directors "involved" in the operation and whitewash*. Furthermore, the transposition of SHRD 2 also amended Article 2391-bis of the Italian Civil Code, introducing the identification of cases in which the directors "involved in the transaction" have to abstain from voting on the RPT itself (be it material or non-material). The main change introduced in art. 2391-bis of the Italian Civil Code in the implementation of SHRD 2 concerns identifying the director involved in the transaction, recipient of the obligation of abstention. On his own or behalf of third

parties, this administrator is interested in conflict with the company's one[7]. Following the amended Articles 7 and 8 of the RPT Regulation, the abstention concerns both minor and significant transactions. This provision has a relevant impact on the corporate governance system, modifying its decision-making process. In this perspective, it is possible to explain postponing for six months the entry in to force of the amendment, to allow companies to innovate their Board of directors.

On the other hand, companies with widespread shares have been excluded from the scope of the obligation to abstention, which is not recipients of the Directive, which only concerns companies with shares listed on regulated markets. The disposal appears to provide that these directors could participate in the discussion and then abstain from the actual vote in lack of explicit reference. They should be excluded from the calculation of deliberative but not the constitutive quorum.

-*the reserve of competence to pass resolutions for the approval of material RPT* on the part of the Board of directors is also extended to smaller listed companies, newly listed companies and those with widespread shares as well as cases of urgency;

About the approval procedures, there are new requirements for transactions of highly material: the duty of the independent directors to check in advance the independence of any expert-selected; the timely involvement of independents in the negotiation phase and the preliminary stage of a transaction of greater importance; obligation to attach the independent opinion. As regards the relevance indices, the Consob Regulation is already substantially aligned with the provisions.

On the occasion of transposition of the Directive, Consob also proposed to make some amendments to the Regulation to improve shareholders protection and increase enforcement effort.

Based on experience in its supervisory activity since 2011, Commission proposes to modify the provision set out in RPT Regulation related to the role of independent

[7] The Consultation Document reports some significant examples: any directors of the issuer who have a conflicting interest as they are (also) the direct controlling shareholders or, as more often happens, indirect shareholders of the issuer; directors of the issuer who have a conflicting interest as they are also directors of the parent company; directors of the issuer who have a conflicting interest as they are consultants of the parent company

directors (i.e., the RPT committee) in the approval process of transactions with related parties (be they highly material or less material).

Despite Regulation no. 17221/2010 required that the committee of independent directors express the fairness opinion before its approval, the empirical evidence has shown that the essential terms of the transaction are set without the expression of the independent directors' advice. In light of these new developments, several measures are adopted by the CONSOB proposal when the infringements regard provisions for which it supervises compliance, clarifying that the opinion of the independent directors must be provided, even before defining the terms of the deal.

This integration disposal can modify the decision-making process and procedures laid down by CONSOB in its regulations, especially for non-material transactions.

The authority specifies that the committee must be involved "*from the initial stage*" of the negotiations and in the preliminary phase enforcing existing obligation in the Regulation, limiting the risks of late involvement of independent directors (only in the final stage of the discussion).

There is no modification provided for RPT disclosure obligations. The only notable change recommended by Consob after its experience is an amendment to art. 6 of the Regulation seeks to clarify that RPT press releases must include the information under this article and a "*description of the operation*". The obligation lies regardless of the *price-sensitive* nature of the information relating to RPT and the applicability of Article 17 of Regulation (EU) no. 596/2014.

CHAPTER IV

THE IMPACT OF INDEPENDENT MINORITY DIRECTORS ON RPT DISCLOSURE: A CONTENT ANALYSIS

4.1 Research objectives and hypotheses development: the impact of minority directors on corporate disclosure

In recent years, some studies shed new light on the role of minority directors in the amount and quality of corporate disclosure.

Consistently with the findings in Belcredi et al. (2014), Marchetti, Siciliano, and Ventoruzzo (2017) document that directors appointed by minority shareholders are more likely to dissent and that market prices react slightly negatively when a minority-appointed director votes against the majority. Indeed, minority directors act as a conduit of information to the market by facilitating further engagement by active shareholders, promoting better communication and reducing disclosure manipulation. These findings suggest a certain degree of trust of the market in minority-appointed directors (Bianchi et.al,2011). According to Cornett, Marcus, and Tehranian (2008) and Marchetti, Siciliano, and Ventoruzzo (2018), minority-appointed directors are associated with lower earnings management richer disclosing environment. Other studies on the topic confirm this thesis by demonstrating that allowing minority shareholders to have representatives on the board can represent an important mechanism to foster disclosure transparency, corroborating the hypothesis that minority directors play a positive role in investor protection (Marchetti et al., 2018).

Moreover, the positive relationship between minority directors and disclosure quality is consistent with the positive impact exercised by minority directors on corporate governance performance (Marchetti et al., 2017). This evidence confirms the positive relationship between firms' financial disclosure quality and the quality of firms'

corporate governance (Forker, 1992; Eng & Mak, 2003). According to traditional agency theory, this existing strong correlation between corporate governance and disclosure is crucial for the functioning of an efficient capital market (Healy & Palepu, 2001)

Beekes and Brown (2006) assume that companies that present better corporate governance provide more informative disclosures to their stakeholders. In general, corporate governance effectiveness limits the incidence of financial fraud (Dechow et al., 1996; Beasley, 1996) and positively affect the quality of disclosure (Botosan, 1997; Klein, 2002).

All these findings shed light on the critical role played by minority directors in fostering corporate transparency and thereby on the screening procedures.

As to the relationship between minority directors and corporate governance performance, Bianchi et al. (2011) find that the actual level of compliance to the Corporate Governance Code for the Italian listed companies is systematically higher in firms, where minority shareholders have appointed one or more directors. In particular, the quality of the procedures for identifying and approving RPTs (the so-called CoRe indicator) is positively influenced by the presence of minority directors on the board. These findings are also consistent with Bianchi, Ciaravella, Enriques, Novembre, and Signoretti (2014) that show a direct relationship between the representation of minority shareholders within the board and tighter internal procedures for transactions with related parties. Companies with at least one minority director on the board are more likely to opt for:

1. Lower thresholds than those defined by the Consob RPTs Regulation to identify material transactions between related parties.
2. Stricter choices on the de minimis amount (whether in absolute or relative terms) below which a transaction is qualified as a 'small' RPT with a consequent full opt-out from the RPTs regulation.
3. Lower percentage of non-interested shareholders for the general meeting's approval for the independent shareholders' veto is effective in the case of a 'whitewash' procedure.

4. Higher budget limits for the fairness opinion independent directors might require for transactions below the materiality threshold.
5. Stricter rules concerning possible exemptions from the procedural regime in case of urgency (for example, in financial distress).

The presence of minority directors in the board could integrate current RPT discipline and increase the quality of the procedures for identifying and approving RPTs (the so- called CoRe indicator) and the level of compliance to the Corporate Governance Code, making RPT internal codes stricter. More specifically, the Italian slate-vote system by improving the quality of Corporate Governance and enhancing the quality of RPT disclosure enriches the entire discipline that regulates these transactions, thereby reinforcing shareholder protection.

This study fills the gap of literature by testing this hypothesis:

H1: Companies where minority directors sit on the Board of Director report more transparent RPT disclosure

In particular, the contribution carries out a critical survey on the role that the mechanism plays in on RPTs entered with opportunistic purposes in Italy, analysing its impact on the transparency of RPT disclosure - compliantly to CONSOB Regulation - in the Italian institutional setting.

The research can enrich the existing literature investigating whether minority shareholders' representation, enforcing the solidity of corporate governance, could improve corporate disclosure quality and transparency. I have the opportunity of testing the impact of an important feature of Italian corporate governance (*slate-vote system*) that allows the appointment of a limited number of directors selected by minority shareholders or, more generally, by shareholders different from the controlling shareholders. The analysis is conducted on RPT disclosure under the CONSOB regime to infer the influence that minority shareholders' representativeness could exercise the immediate disclosure on the highly material transaction.

By the way, it infers whether the appointment of minority directors could improve the ability of RPT communication to convey valuable information for all stakeholders, limiting self-serving managerial disclosure.

The contribution restricts itself to narrative disclosures on RPT information documents that contain all information on material RPTs approved by companies, thereby facilitating an analysis of the influence of minority directors on *impression management* of RPT corporate disclosure. These are mandatory disclosures released by companies to the market following CONSOB regulation. The content of the RPT information document is largely - but not wholly - regulated. This weak enforcement makes communication easier for managers to manipulate the information disclosed therein and a potential vehicle for impression management. Thus, their influence on user perceptions is arguably far more than those of other accounting disclosure vehicles. It's possible to expect a positive effect of minority directors on the transparency of RPT disclosure because the mutual monitoring and the transaction costs of agreeing on the distribution of private benefits among coalition members reduce exploitation of private benefits of control through RPTs and thereby the risk of controlling or manipulating the attributions or impressions in the information document on material RPT transactions.

From the methodological point of view, qualitative and quantitative tools will be cross-sectionally and sometimes jointly used in carrying out the research objectives. Firstly, I conduct a content analysis on the Risk sections of RPT information documents, dedicated to indicating the risks associated with potential conflicts of interest deriving from the transaction. This information can be biased to distort the perception of third parties on the risks related to this type of transaction. More specifically, the manager could manipulate the corporate disclosure by ignoring or underplaying the potential adverse outcomes of the RPT or exaggerating the force of some corporate governance mechanisms aimed to protect shareholders and to avoid the self-dealing transaction.

The RPT risk sections are processed to generate appropriate counting measures that can objectively quantify risk disclosure to assess the communication.

The study also contributes to the literature of financial reporting analysis, developing a holistic framework for risk communication analysis. I contend with the mainstream idea that the quantity of disclosure is not a good and sufficient proxy for the quality of disclosure. In the proposed framework, the transparency of communication depends on the amount of information disclosed and the richness offered by additional information. In particular, three areas of concern are addressed:

1) an analysis of *risk sentiment* of the section;

2) an evaluation of *tone*;

3) an investigation of *argumentation ability*.

Through an impression management theory lens, I argue that such disclosures primarily serve as impression management tools and may not be helpful for the readers.

4.2 Background on the quality of corporate disclosure and a framework for the analysis of risk communication

The literature on content analysis in accounting reveals its comprehensive and expanding application as a research method, particularly for examining social and environmental disclosures (Guthrie & Parker, 1989; Milne & Adler, 1999; Zeghal & Ahmed, 1990). In this regard, the utility for making valid inferences from texts allow examining the reports and narratives used to disclose the outcomes of accounting activities (Frazier, Ingram, & Tennyson,1984) and to guarantee the functioning of an efficient capital market. Many scholars (Kohut & Segars, 1992; Aerts, 1994; Abrahamson & Amir, 1996; Smith & Taffler, 2000; Clatworthy & Jones, 2001; Short & Palmer, 2003; Rutherford, 2005) use content analysis to investigate the narrative portions of annual reports and other accounting-related communications. There is an extended body of literature that concerns the nature of corporate social reporting (Guthrie & Parker, 1990; Gray, Kouhy, & Lavers, 1995), the information content of accounting narratives (Kohut & Segars, 1992; Abrahamson & Amir, 1996; Smith & Taffler 2000), international differences in approaches to accounting disclosures

(Hooghiemstra, 2001, Guillamon Saorin et a1, 2012) and the use and forms of "*impression management*" (Sydserff & Weetman 1999, 2002; Metts & Grohskopf, 2003, Stanton et a1 2004, Aerts 2005; Osma & Guillamon Saorin, 2011, Guillamon-Saorin, Isidro, Marques, 2017).

Many studies acknowledge the issue of ambiguous meaning in content analysis (Morris, 1994, Deegan & Rankin, 1996; Unerman, 2000; Guthrie, Boedker, & Cuganesan, 2004), and some offer guidance on how can address it (Milne & Adler, 1999).

In general, high-quality disclosure guarantees full access to helpful information for all stakeholders, making them aware of possible scenarios of the company, value-creating decisions and risks related to the firm operation. Sengupta (1998) argue high-quality disclosures are timely and detailed information that compresses shareholders' default risk perception. Verrecchia (1990) supports the idea that disclosure quality is an uncertain event's distributional variance or characteristics.

Beattie, McInnes, & Feanley (2004) recognize several different dimensions of disclosure quality, though assuming that does not exist a unique set of quality attributes or ranking always applicable.

The perception of quality represents a subjective measure strongly related to the context and the type of document object of analysis. For this reason, comparisons between authors' practices and the identification of "*best practice*" is not possible. Each researcher must make different choices from a methodological point of view to address his research question.

For the assessment of corporate disclosure transparency, evaluating the amount and quality of risk disclosure represents a significant concern for academics.

Prior academic literature shed new light on the risk disclosure defined as the communication vehicle of information strategies of the firm, characteristics, business operation, and external factors of firm that could impact the firm in the future (Beretta & Bozzolan, 2004).

A form of communication commonly used is represented by the description of uncertainties that firms have to face.

The quality of risk disclosure is central to the literature debate, considering conceptual difficulties in defining and measuring its intensely subjective nature.
The high-quality information about corporate risk is efficient information that helps investors to make informed decisions (Lindqvist, 2016). In other terms, high-quality disclosures correspond to the type of information that fulfils requests from shareholders driving investment choices more conscious of future scenarios of the company.
The literature suggests that the relationship between the length of an item of corporate disclosure and the firm's financial performance is not univocal, but it depends on the context.
On one side, Botosan (1997) argue that the quantity of disclosure is often used to measure disclosure quality because regulation and litigation threats, as well as reputation effects, will ensure that all disclosure is of high quality. On the other side, in an experimental setting, increased amounts of accounting information, that is, notes in addition to financial statements, do not improve loan officers' decision making, possibly because of information overload (Casey, 1980).
The accounting literature uses many several measures in assessing the quality of firm risk disclosure. Many of these studies apply quantity as a sound proxy for the quality dimension of the disclosure. A large amount of risk items implies a high-quality level of exposure. In particular, counting the words or sentences describing risks in corporate reports can be used to measure the "*quantity*" of risk disclosure.
In support of this argument, Abraham and Cox (2007) document a positive correlation between the quantity and quality of disclosure on risk.
Consistently with previous findings, many empirical studies show that more disclosure items equal higher quality disclosure.
Li (2008), counting the words' *risk*' and '*uncertainty*' found in the annual report, capture the risk sentiment demonstrating that its increase is associated with future earnings decrease and providing evidence that investors underreact to the risk disclosure.

Similarly, Kravet and Muslu (2010) find that increased risk disclosures are associated with growths in earnings forecasts and increases in trading volume, more dispersed and divergent forecast revisions.

Subsequently, in 2013, the authors demonstrate that the variation in the number of risk sentences in the entire 10-K is correlated - before and after risk section - with changes in the stock market and analyst activity around the filings. There are some drawbacks associated with a quantitative approach.

The risk disclosures often include some graphical elements (such as pictures and risk charts) or other narrative aspects that are difficult to capture, adopting only this methodology. Beretta and Bozzolan (2004) support this idea, arguing that quantity alone is not a sufficient measure for the overall quality of risk disclosure.

Another academic approach aims to overcome this limitation of subjective evaluation of the weight to attribute to each item disclosed to differentiate quality (Botosan, 1997; Wallace, 1988; Wallace & Naser, 1995) or to the type of measure associated with the information revealed (Guthrie, Petty, Ferrier, & Wells, 1999). Consistently, many studies enrich the prior literature measuring the risk disclosure quality through a mix of several dimensions.

Beretta and Bozzolan (2004) propose a new framework for the analysis of risk disclosure that includes four different but complementary dimensions: the content of information disclosed; the economic sign attributed to expected impacts (that communicates the direction of the effect that risks could have on the future performance of the firm); the type of measures used to quantify and qualify the impact expected, using either monetary or non-monetary scales; the outlook orientation of risk communication (the time orientation of the information disclosed referring to the actual state or projecting into the future) and the managerial approach to the management of risks (information can communicate general hypotheses or expectations concerning the future, or provide information concerning management programs or action to be taken to face exposed risks). Beattie, McInnes and Feanley (2004) propose a new computer-assisted methodology for documenting the nature of voluntary narrative disclosures based on a four-dimensional framework. In particular,

it captures each text unit not only the topic but also three type attributes (time orientation, financial orientation and quantitative orientation).

Miihkinen (2013), on the other hand, use the number of disclosure items (Abraham & Cox, 2007), coverage of disclosure (evenly distributed risk information) (Beattie et al., 2004) as a proxy for the assessing of quality.

Many other studies use these indicators in the risk disclosure field. Similarly, Geraldina (2017), inspired by previous results, provides four attributes - i.e., coverage, depth, and outlook profile of firm risk management - to capture the level of quality of risk disclosure.

Conceptually, there are many potential variables of interest in this risk disclosure and shed new light on the managers' hidden and opportunistic behaviour. The amount of disclosure, tone and transparency (or readability) of disclosures are some of the more commonly proxies used in these studies. On the other side, in the last years, a further aspect of risk disclosure that became the focus of an increasing body of research involves analyzing the risk disclosure from a broad perspective and disaggregating the construct into several categories. It is possible to detect a variety of approaches to categorize and identify several risk types.

Bao and Datta (2014) define risk types as general factors that present risk factors to a corporation. One of the first studies on the topic is Mirakur (2011) that manually categorize 29 risk types for 122 randomly selected firms.

Specifically, Campbell, Chen, Dhaliwal, Lu and Steele (2014), after having extracted the appropriate subsection to study, use a predefined dictionary to quantify five risk types in 10-K forms: idiosyncratic, systematic, financial, tax, and litigation risks. More specifically, they compute for every analysis: (1) total word count, (2) total keyword count, and (3) keyword count by risk subcategory.

Huang and Li (2011) propose a supervised learning method to automatically categorize risk factors reported in section 1A of 10-K forms into 25 risk types.

Differently, Bao and Datta (2014) use the unsupervised learning method to estimate rather than predefine a set of categories (risk types) and simultaneously assign sentences (risk factors) to those categories. Moreover, Lehavy, Li, and Merkley (2011)

analyze the readability of 10-K filings learning that affects analyst forecast dispersion, accuracy, and effort.

Consistent with these findings, You and Zhang (2009) demonstrate that investors underreact to disclosures provided in longer and more complex 10-K filings.

In general, many critics have expressed some perplexities concerning the namely actual ability of the risk section to be informative.

Moving beyond risk disclosures to financial disclosure, prior academic literature on corporate disclosure suggests that managers have a self-serving bias to disclose favourable information about the firms and are likely biased against providing unfavourable disclosures (Kothari, Li & Short, 2009). The communication of all information regarding risks and uncertainties that the company must face represents a form of disclosure where all the news is unfavourable.

The establishment of disclosure requirement could be not an efficient and sufficient mechanism to protect shareholders from opportunistic behaviours of managers aimed to conceal some material risk factors, providing vague and boilerplate risk disclosures. More specifically, the lack of precise requirement incentives information asymmetry providing management with opportunities to *manage impressions*. More specifically, this attitude could make disclosure not informative about the firm's specific risks, limiting to convey only generic risk factor that could relate to any company.

4.3 Exploring the nature of disclosure: an impression management perspective

Impression management appears for the first time in the psychology literature (Schlenker, 1980; Schneider, 1981) as a technique used by individuals to control the impressions of others (Leary & Kowalski, 1990). In the corporate reporting field, impression management results from reporting an entity's selection of information to convey to the market, disclosing them in a manner that distorts readers' perceptions of corporate achievements (Neu, 1991; Neu et al., 1998) and orients their investments decisions.

The behaviour of stakeholders that base their assessments of management's performance on what reported by managers (Lambert, 2001) encourages thought

different impression management tools. In particular, management acts to distort the perception of third parties either directly, by managing the financial statements or indirectly, by manipulating other corporate communications to improve the perception of performance or, at least, to depreciate the consequences of negative news (Subramanian, Insley, & Blackwell, 1993). In detail, the desire to orient market decisions proves in behaviour to hide poor firm performance (Adelberg, 1979) or to obfuscating their failures and underscore their successes.

Many accounting studies of impression management argue explicitly or implicitly that management could pursue the aim to show a self-serving view of corporate performance (Neu, 1991; Neu et al., 1998). In other cases, they select the information to display or present that information in a manner that distorts readers' perceptions of corporate achievements' (Godfrey, Mather, & Ramsay, 2003).

The empirical evidence also demonstrates that managers can distort perceptions exaggerating the corporate situation, and underestimate the risks to which the company is exposed using different techniques (Diouf & Boiral, 2017; Martınez-Ferrero et al.,2019).

Management manipulates themes by disclosing more positive and less negative information in the form of accounting narratives. In this regard, Courtis (1995) tests the obfuscation hypothesis and demonstrates that management is not neutral in presenting information, preferring to hide bad news instead of shed light on them in disclosure.

Consistent with previous findings, many studies (Krische, 2005; Schrand & Walther, 2000) argue that management reports the most favourable items within the whole range of information available.

In particular, they direct attention to positive outcomes using positive language (as opposed to neutral or negative) to convey a favourable view of performance or emphasise positive results. It represents a common practice in corporate reporting.

A large corpus of literature has shed new light on various tactics used to influence stakeholders' perceptions to protect, restore or improve their image and reputation (Bansal & Kistruck, 2006; Bolino et al., 2008).

In some cases, rhetorical devices or visual and presentational techniques can be used to exaggerate positive performance or downplay negative performance up to conceal adverse organisational outcomes (Beattie & Jones, 2002; Bowen, Davis, & Matsumoto, 2005; Cheng & Courtenay, 2006).

More specifically, accounting disclosure can include performance comparators and strategic benchmarks that can improve the company's perception, show management and the firm in the best possible light, most favourable manner.

Jameson (2000) finds that discourse has both verbal and visual elements that interact with one another. In general, we can conclude that there are three different ways of emphasising disclosures in narrative financial reporting documents:

1) visual emphasis occurs when companies use presentation techniques to make a piece of information more evident to readers. Examples of such visual emphasis include locating or positioning disclosures or emphasising text using bullet points, bold text, colour, etc. (So & Smith, 2002; Curtis, 2004). Visuals such as graphic highlighting, headings, bulleted or numbered lists, colour, shading, logos may foreshadow verbal discussion or reinforce key points

2) repetition, which materialises when an item is repeated. In contrast, Courtis (1996) considers repetition as redundant information.

3) reinforcement is a form of emphasis which occurs when a piece of information is highlighted by using a qualifier (as an additional word to add emphasis to a keyword, e.g., "*strong growth*" – "*growth*" is the keyword, "*strong*" is the qualifier). As is the case with qualitative information, repetition of quantitative information is also a common practice. It consists of reiterating the same amount in the same document to capture the attention of the reader.

3) location/positioning/presentation of quantitative information, which traced to when positive amounts are disclosed in the most-emphasised section, sometimes located in the first pages.

The literature review provides evidence that impression management represents a form of the agency problem, satisfying the need for self-presentation. In corporate narrative reporting, the board members as self-interest directors tend to self-enhancement. More specifically, they ascribe the accountability of poor performance to external factors or

other circumstances outside its control (*self-protection*), otherwise towards could take the credit while good performance to internal factors (i.e., their good management) under their management (Frazier et al., 1984).

Aerts (2005) confirms that self-serving attributional tendencies in annual report narratives represent impression management behaviour. Managers can act to maximise their utility, better informed about the firm's actual performance managing impressions of themselves on their audiences (Goffman, 1959). This information asymmetry exacerbates the risk of adverse selection and moral hazard issues by management (Beaver, 1998). For its peculiarities, impression management mainly is widespread in less regulated narrative disclosures about interpreting financial outcomes, but it is also prevalent in regulated ones. For this relevant spread, impression management of document is central in the literature debate on the quality of corporate disclosure. It should represent a significant concern for academics and regulators to reduce the risk that this misrepresentation can steam in damage for shareholders.

Discretionary disclosure strategies, such as disclosing Pro-forma earnings or adopting a positive tone, incorporate narrative documents representing impression management tools. More specifically, changing the tone of specific types of disclosure or engaging in obfuscation is a typical persuasive instrument to influence a corporation's audience in cases of scandals, safety issues, human rights violations or environmental disasters (Brennan & Merkl-Davies, 2013; Siddiqui & Uddin, 2016). The tone represents the affect or feeling of communication. A more positive tone can be achieved in two different ways by:

- focusing on positive outcomes
- describing outcomes in a positive way
- offering a positive comment about future performance.

More in general, the tone is a generic function of both content and word choice.

In the accounting and finance literature, four different word lists have been extensively used by researchers to capture the tone of the text:

- The first-word list we are aware of that was created for financial text specifically is Henry (2008). The strength of these word lists is that they were built by analysing earnings press releases for the telecommunications and computer services industries.

The limitation of her dictionaries is the low number of words included in the list (only 85 negative ones).

- Another dictionary also very common in accounting and finance studies is Harvard's GI, Diction. Its widespread use is justified by the ready availability of word list and the introduction of inflexions (i.e., different forms of the same word) in the dictionary. The Harvard negative word list contains 4,187 words.
- Loughran and McDonald (2011) – last version 2018 - created six different word lists (negative, positive, uncertainty, litigious, strong modal, and weak modal) by studying word usage in a large sample 10-Ks during the period 1994–2008. Their approach was to "*create a relatively exhaustive list of words that makes avoidance much more challenging*". They build the sentiment lists based on the most likely interpretation of a word in a business context. The Loughran and McDonald (LM) word lists are quite extensive: their dictionaries contain 354 positive and 2,329 negative words. The dictionary LM, unlike the Henry (2008) list, they are relatively comprehensive. Generally, no commonly appearing negative or positive words are missing. Second, the L&M lists were created for financial communication and have become predominant in more recent studies (Kearney & Liu, 2014). Typically, scholars have used the LM word lists (primarily negative words) to gauge the tone of the business communication

These impression management techniques are subtle and sophisticated, and therefore complex, a detailed content analysis. Osma and Guillamon Saorin (2011) propose a holistic measure based on quantitative and qualitative data in corporate narrative disclosures for analysing impression management and detecting bias introduced into corporate narratives due to impression management.

4.4 Argumentation Mining: Rhetorical manipulation in accounting narratives

There is a stream of impression management research based on the obfuscation hypothesis. Management makes linguistic choices and uses rhetorical devices to conceal negative firm performance by using low argumentation units. Argumentation is the verbal, social, and rational activity aimed at convincing a reasonable critic of the

acceptability of a standpoint by putting forward a constellation of propositions justifying or refuting the proposition expressed in the perspective of reporting entity. Together with argumentation, rhetorical manipulation involves the exercise of linguistic choices to influence meaning. Rhetoric is defined as the art of using language to persuade or influence others; elaborating speech or writing exposed in terms calculated to persuade or impress (often in a depreciatory sense) means artificial or ostentatious expression (Oxford University Press, 1989).

Llewellyn (1999) observes that the extent to which the point of a story is persuasive/convincing/credible depends on its rhetorical power, which is a function of linguistic techniques such as plots, labelling, metaphor and platitude. To date, there has been little research examining rhetoric and argument in financial reporting (exceptions include Warnock, 1992, 2000).

Management may use rhetorical devices to conceal adverse organisational outcomes or emphasise positive aspects of corporate going, distorting the readers' impressions. Covaleski, Dirsmith, and Samuel (1995) define accounting disclosure as an instrument for representing an economic reality and a rhetorical device, conversation or argument in which the attempt is to persuade an assumed sceptical audience (Thompson, 1991). This perspective justifies the interest in rhetoric and the protocols of argumentation. Brennan and Gray (2000) examine disclosures in profit forecasts and takeover documents from the perspective of rhetoric and argument to show how managements use accounting information to defend their position and refute the other side's arguments.

The analysis of argumentation can be interesting to discover the capacity of reporting entity to support own thesis, and it can be instrumental in evaluating the quality of disclosure.

In particular, the literature demonstrates that *Argumentation Mining* provides several different stages of analysis:

- Identify argumentative text (o portion of text), partitioning an argumentative text (o portion of text) into a unit as playing a specific role – or none – in the argumentation. *Argumentative units* do not necessarily correspond to sentence.

Thereby, when *Argumentative Units* are composed of more than a single sentence, they are challenging to process.

- Recognise the minimal argumentation units, span multiple full sentences, or be shorter than a sentence, and thus we can characterise argumentative discourse units (ADU). This is the phase of tokenisation of the content consists of Identifying the role/function of ADUs and relations between ADUs.

Often the purpose of this stage of analysis is not on classifying claim and evidence individually in the relation between them. In this case, the issue declines in identifying the discourse relation, as studied in frameworks like Penn Discourse Treebank (Prasad, 2008) or RST (Mann & Thompson,1988). Linguistic connectives may explicitly signal these relations in text, or they may be only implicit.

In this regard, Biran and Rambow (2011) compiled a list of connectives from the annotated RST Discourse Treebank (Carlson Marcu & Okurowski, 2003). They selected 12 coherence relations that they considered as likely to a claim-support constellation. The set of 69 explicit indicators was used indirectly to get a handle also on implicit associations. Some years later, Eckle-Kohler Kluge and Gurevych (2015), starting from a pre-defined list of connectives, determined their potential utility, working on a small German corpus of documents to decide which connectives introduce claim support and attack.

Villalba and Saint-Dizier (2012) directed attention to some of the different means of expressing coherence relations. They pointed out that even-non-argumentative coherence relations can require an argumentative role when involving evaluative expressions found, for example, in product reviews.

These studies can be interesting for the entire financial reporting to comprehend the relations the connect the different AGU in an argumentative text. The number of AGU can demonstrate the quality of disclosure to illustrate the topic.

4.5 The research questions and contribution

This research can enrich the existing literature by investigating the impact that the appointment of minority directors can produce on transparency of RPT disclosure. I propose a new framework for the analysis of risk disclosure, assuming that a high amount of information about potential risks and uncertainties of RPTs, correspond a stronger shareholders' protection.

I referred to a not informative communication as a piece of information that does not adequately warn investors of risks arisen from the approved material related party transaction.

More specifically, three aspects of corporate disclosure are evaluated:

- the *risk sentiment*
- the *tone* of the section
- the *argumentation ability*

The contribution reveals the possible improvements in informativeness of disclosure and the potential changes in the *"impression management*" traced to the presence of minority directors on the Board of directors. The analysis is conducted on the narrative information content of the risk sections of 160 RPT reports. More specifically, the study enriches the literature identifying the impact the appointment of minority directors can have on the (*pessimistic*) tone of the document, the quality of risk communication and its argumentation, distinguishing the case in which minority directors sit in the Board from the contrary case. Interestingly, to the author's knowledge at the moment, there is no available research that investigates this relationship.

The analysis is conducted to test the following hypothesis:

Hypothesis 1 (a): *the appointment of at least one minority director has an impact on the risk sentiment of disclosure.*

Hypothesis 1 (b): *the appointment of at least one minority director has an impact on the tone of disclosure.*

Hypothesis 1 (c): *the appointment of at least one minority director has an impact on argumentations of disclosure.*

In other terms, analysis of the RPT risk disclosure pays attention not only to how much is disclosed and what but also to how it is communicated.

The chapter contributes to stream of prior literature in different ways:

1. The research on the role of the minority in the disclosure of RPT information document can shed new light on the efficiency of corporate governance mechanism to protect minority shareholders' interests.
2. This study adopts three content analysis techniques: *Sentiment Analysis*, *Argumentation Mining* and *Analysis of Risk disclosure*.
3. New technique Argumentation Mining is applied for the first time in financial reporting studies.
4. As far as we know, no previous works attempt to use unsupervised clustering methods for analysing corporate RPT disclosures.
5. Basing the content analysis on RPT immediate disclosure adds to the previous research to a new communications format.
6. Analysis of Italian text and consequent build Dictionaries for the Italian Language represents further contribution for future research.

4.6 Sample selection procedure and data

This empirical analysis was conducted on a sample of highly material related party transactions carried out by Italian non-financial listed companies from 2010 (first-year CONSOB Regulation) to 2019. Table 4.1 shows every step of the sample selection process.

I started from an initial set that included 409 disclosed RPT in according to Consob Regulation No. 17221 of March 12, 2010 (Related-party Transaction Regulation). I collected all RPT information documents published over the investigation period. They were gathered primarily from the 1INFO SDIR & STORAGE and E-Market Storage websites. Secondarily, every corporate website (investor relation section) was

seen to collect the information documents that were not available from the first sources. This process ensured that all RPT information documents issued by Italian listed firms were collected.

The idea behind this approach is to systematically analyze documents of firms with the same profiles, in terms of geographical and institutional context, excluding those that are not adopting the same financial reporting system and corporate governance policy.

Therefore, the transactions undertaken by firms that refer to the GICS 40 (financials) were excluded from the initial set of 409 observations because of their peculiar financial reporting rules. The analysis focuses only on RPT carried out by non-financial companies listed on the Italian Stock Exchange. Corporate governance and accounting data were gathered for all non-financial companies that execute RPT in the ten-year investigation period. In particular, I dropped from the initial sample those related-party transactions engaged by firms with a lack of historical accounting and corporate governance data in the year of RPT approval.

It results in a final sample of 160 disclosed RPTs and corresponding information documents published. I use this sample to test the relationship between minority shareholders' representativeness and corporate RPT disclosure transparency.

Table 4.1 - *Sample selection process*

Population of disclosed RPT	**409**
RPT engaged by banks and financial companies	-156
RPT engaged by companies whose financial market and accounting data are not available	- 46
RPT engaged by companies whose corporate governance are data not available	- 47
Basic sample	**160**

This table shows all steps to obtain the basic sample.

Since the research intends to perform various analyses with different approaches and objectives, I collected quantitative and qualitative data from different sources.

Financial-market and accounting data of companies that carried out and disclose these transactions were obtained from Thomson Reuters Datastream and AIDA. Corporate governance data were hand-picked from the Italian Security Exchange Commission (Consob) online database and annual reports on corporate governance and ownership structure.

At the conclusion of data collection, I proceeded to a *meaning* and *formal-oriented* content analysis of the RPT information documents.

Starting from categories provided by OIC 12 principle, the sample RPT were classified into ten groups based on the type of the operation executed: *1) Sales and Purchases of a tangible and intangible asset, 2) Sales and Purchases of equity investments,3) Merger, Spins off and Conferment of business units, 4) Loans, 5) Equity transaction, 6) Lease agreement and Leasing, 7) Performance of actions and services, 8) Assignment of security 9) Settlement agreement, 10) Transfer and conversion of credits, 11) Other.*

The last item, "*Other*", was defined as a residual category to include all RPT that cannot include in one of the categories mentioned above (for example, sponsorship).

Table 4.2 shows the different type of RPT disclosed from 2011 to 2019.

The empirical evidence highlights that the most frequently disclosed RPT are *loans* (30%) followed by *sales and purchases of equity investment* at 12%.

Equity transaction, Lease agreement/ Leasing, and extraordinary transactions (as *Merger, Spins off and Conferment of business unit*s) represent, respectively, 11% of the sample.

Table 4.2 – *Type of Related Party transaction*

Type of Related Party transaction	***Obs***	***%***
Sales and Purchases of tangible or intangible asset	16	10%
Sales and Purchases of equity investments	19	12%
Merger, Spins off and Conferment of business units	17	11%
Loans	48	30%
Equity transaction	18	11%
Lease agreement and Leasing	18	11%
Performance of actions and services	6	4%
Assignment of security and Settlement agreement	8	5%
Transfer and conversion of credits	3	2%
Other	7	4%
Total	160	100%

Table 4.3 addresses the relationship between the reporting entity and the related party involved in the transactions. As emerged from the analysis, 29% of sample RPT involved directors or majority shareholders. Many operations are carried out with the Parent company (28%) and between two companies subject to common control (17%).

Only a low percentage of transactions are carried out with associate companies.

Table 4.3 – *Type of Party engaged in the transaction*

Related Party	***Obs***	***%***
Directors and majority shareholders	46	29%
Parent company	45	28%
Associate	9	6%
Common control	27	17%
Subsidiary	19	12%
Other	14	9%
Total	160	100%

160 RPT involve 67 Italian non-financial companies over the investigation period. It's worth note that a firm can carry out two or three different RPT that exceeds the materiality threshold of 5% under Consob Regulation in the same year.

As shown in Table 4.4, RPT included in the sample are mainly executed by firms belonging to the Consumer Cyclicals (41%). Many operations primarily also focus on Industrials (23%). The third-largest sector of the sample is Healthcare (14%), followed

by Technology (9%), while each of the other sectors has less than ten observations and represents less than 6% of the sample.

Table 4.4 – *Industries breakdown*

Industries breakdown	***N.companies***	***Obs***	***%***
Consumer Cyclicals	27	66	41%
Utilities	7	10	6%
Energy	3	5	3%
Technology	6	14	9%
Industrials	14	36	23%
Consumer Non-Cyclicals	3	5	3%
Healthcare	3	16	10%
Basic Materials	2	3	2%
Telecommunications Services	2	5	3%
Total	67	160	100%

Table 4.5 highlights the stock exchange indices in which these firms are listed. The two largest indices are Small Caps and Star representing 50% and 23% of the sample. Mid Cap and the FTSE MIB represent, respectively, 16% and 10% of the sample.

Table 4.5 – *Stock exchange indices breakdown*

Stock exchange indices breakdown	***N.companies***	***Obs***	***%***
Small Cap	25	80	50%
Mid Cap	10	16	10%
FTSE MIB	12	27	17%
STAR	20	37	23%
Total	67	160	100%

As emerged in Table 4.6 below, most disclosed RPTs were carried out in 2013 (20%). To follow, a high percentage of operations took place in 2015 (14%) and 2017 (13%).

Table 4.6 – *Year of reference*

Year	*N.companies*	*Obs*	*%*
2011	10	10	6%
2012	9	14	9%
2013	13	32	20%
2014	6	15	9%
2015	9	23	14%
2016	7	19	12%
2017	4	21	13%
2018	7	17	11%
2019	2	9	6%
Total	67	160	100%

4.7 Methods used to content analysis

This section discusses the approach adopted to carry out the meaning and form-oriented content analysis[8] to the description that management provides of risks arisen from highly material RPT. To evaluate disclosure - based on different drivers - and study the role of impression management in the context of RPT reporting, I have developed an appropriate coding structure consisting of an inclusive set of attitudinal indicators (*positive, negative, uncertain* and *risk*).

Every thematic category includes a list of keywords.

Problems can arise with ambiguous definitions of categories and the rules of coding. In defining the categories, it is essential to include exhaustive attributes; having a particular defining attribute does not exclude the possibility of another.

The research synthesises some textual units into several broad mutually exclusive thematic categories.

Following prior literature, positive, negative, uncertain, risk and linguistic connectives are acquired from keywords of previous studies to address the research questions.

[8] Attribution of organisational outcomes – meaning-orientated thematic studies An alternative to syntactic analysis is thematic analysis. Prior literature using this approach forms two distinct groups: meaning-oriented and form- oriented studies (Smith and Taffler, 2000). Form-orientated studies are discussed further on in connection with attribution in narrative financial reporting. Meaning-oriented studies using thematic analysis, summarised, investigate patterns of causal reasoning and attribution used to explain corporate performance.

For a thematic analysis that allows the study of texts for themes or tones of expression, computer-based techniques typically rely on software that lists the frequency of occurrence of words afterwards coded by researchers (for example, Abrahamson and Park, 1994). In general, the adoption of manual and computer-assisted coding depends on the complexity of categories. As emerged from previous studies, identifying "*best practice*" is impossible, and each researcher must make different decisions from a methodological point of view. In this case, the computer approach represents the best process as categories are "*easy to operationalise*" because they are built starting from previous dictionaries inherited from literature integrated with other terms added based on the specific purpose of the study.

Computer-aided textual analysis has several advantages over manual methods traced to larger data sets, reliability, speed, and lower cost (Duriau et al., 2007).

Although its utility, the computer-assisted analysis may lead to include coding mistakes.

For this reason, manual and computerised approaches have not to be considered alternatives. In this study, the manual analysis supports and integrates the computer one. More specifically, the content analysis is conducted using the computer program LIWC (*Linguistic Inquiry and Word Count*), which is specially designed to analyse texts automatically, ideal to thematic assignation studies. Manual content analysis is carried out (on 20% of sample RPT risk section) to validate the results of the computer-assisted investigation, comparing the findings and evaluate their consistency. All RPT reports to analyse - only attainable in hard copy format - were transformed into Word documents using a scanner and OCR software to conduct the computer-assisted content analysis. Once the documents were converted in Word format, a system of visible separators between the text clauses was added using the find and replace function in Word. Reliability in the coding process is reinforced by using the formal Weber procedure.

After the reports had been transformed and coded based on different categories, the number of text units related to each subcategory is uncovered using the word count function of LIWC. The results of the coding process are then transferred to Excel,

where they are aggregated and analysed accordingly. As a guiding rule, all narrative content will be considered relevant to the analysis.

We use a lexicon-based approach for content analysis. The lexicon-based perspective assesses the semantic orientation based on the frequency of words or phrases with a particular semantic direction that occurs in the document. It relies on pre-defined dictionaries of opinionated words, such as a list of positive or negative words.

In particular, to test my hypothesis, I used three custom dictionaries:

1) *Sentiment Dictionary*. I use the 2018 Loughran and McDonald (LM) dictionary[9] (initially developed in Loughran and McDonald (2011) to assess the sentiment and uncertainty in the risk sections of the relevant sections in our baseline analysis.

I translated Loughran and McDonald (2018) sentiment dictionary in Italian these three different word list (*Positive, Negative, Uncertain*). I included these sentiment domain-specific words derived from my manual content analysis on 20% of sample documents. In light of the different inflexions of the Italian language, the final new sentiment dictionary comprises 359 uncertain, 560 positive, and 2.702 negative words.

2) *Risk Dictionary*. I picked up the Risk Keywords list (Cambell,2014) to measure the frequency the risk items. All 423 *risk* keywords included in Cambell (2014) list are translated to Italian. They are classified into five different risk types categories: Financial (69 risk words), Other- Idiosyncratic (138), Legal and Regulatory (75), Other-Systematic (109), Tax (32). In particular, I used the classification of Cambell (2014) to quantify different words associated with sub-categories related to financial, litigation, tax, other-systematic, or other-idiosyncratic risk types. In this way, it has also been possible to conduct a meaning-oriented content analysis on which risks are more disclosed.

3) *Discourse indicators picked up from Italian LICO - A Lexicon of Italian Connectives*. This list contains several categories and sub-categories of linguistic connectives that introduce a different type of Argumentative Units. In particular, LICO includes about 170 discourse connectives used in the Italian language, together with their orthographical variants and their semantic relation (according to the Penn

[9] The 2018 version of the dictionary comprises sentiment word lists in several categories, including 2,355 words in the negative category, 354 words in the positive category, and 297 words in the uncertainty category.

Discourse Treebank relation catalogue) (COMPARISON Contrast, Similarity, Concession; CONTINGENCY Cause Condition, Negative condition, Purpose; EXPANSION, Conjunction, Disjunction, Equivalence, Instantiation, Level-of-detail, Substitution, Exception, Manner; TEMPORAL, Synchronous, Asynchronous, ALTRO). In the first level, the class level, the relations are grouped into four major classes: TEMPORAL, CONTINGENCY, COMPARISON and EXPANSION. The second level, the type-level, specifies further the semantics of the class level. Assigning every linguistic indicator to their different relation-type categories, it is also possible to infer the type of argumentation detected.

4.7.1 Some methodological issues: the construction of Italian Dictionaries

At operational level, the construction of Dictionaries followed three steps:

- In the first stage, I translated sentiment or subjective lexicon from the source language (English) to the target language (Italian), building a lexicon-based classifier in the target language. All initial set of keywords (seeds) with positive, negative, uncertainty, risky, argumentative orientation is translated from English to Italian due to RPT information documents are written in Italian. The number of keywords increases considering the different suffixes provided for the feminine, masculine, plural and singular in the Italian language.
- In the second phase, I added further domain-specific keywords to the list based on a review of RPT information reports. In other terms, starting from the seed list of words connected to a general-purpose, explore other sentiment words and orientations that come from a domain corpus. I manually collected from 20% of the sample documents new domain-specific terms to integrate the seed list. The iterative process ended when there were not more new words were found.
- Finally, I carried out a manual inspection to clean up the list.

4.7.2 The content unit: risk section of RPT information document

The RPT information document issued by a corporation is a relevant source of information for its stakeholders to obtain a detailed picture of the material transaction, its convenience, impact on firm performance and the risks of conflict of interest arising from the transaction.

RPT information documents are CONSOB regulated disclosures released by companies to the market to inform immediately on the execution of highly material transactions. In 2010, the CONSOB required all firms to convey a document after highly material RPT's approval, establishing a specific section to discuss the most significant risk factors from the peculiar transaction. More specifically, the CONSOB Regulation makes the publishment of the RPT information document mandated for all Italian listed companies, requiring them to issue a prospectus in a well-defined format to benefit of investors.

The content of these documents is mostly - but not wholly - regulated. Indeed, Consob Regulation n. 17221 requires Italian companies listed in the Italian stock exchange or other European Union countries to comply with to ensure the transparency and the substantial and procedural correctness of transactions with related parties carried out directly or through subsidiaries. More specifically, Appendix 4 regulates the minimum content and, therefore, the structure of the information document but does not define in detail the minimum information content of every single section that compose it, granting a wide-ranging discretion to directors. The open-ended nature of Regulation could represent a strong incentive for managers to manipulate the information disclosed therein, reduce its informativeness. All these considerations make the RPT immediate disclosure a potential vehicle for impression management. In particular, the management can distort the transaction's perceptions as a convenient dealing for the company emphasising positive outcomes (*enhancement*) or obfuscating adverse effects and risks (*concealment*) arisen from the transaction. Conferring greater prominence to some aspects rather than to others could also change the reader's perception of the nature and purpose of the transaction.

I used a paragraph as a coding unit to test the relationship between non-controlling directors and the informativeness of communication. I divided the document into nine sections based on the content of Annex 4 of CONSOB Regulation.

The analysis focuses only on the risk section because the board of directors must explain the risk related to the approved RPT in this paragraph.

By focusing strictly on the risk factor section during the period after the entry into force of Regulation, the analysis has the tools to assess the merits of the new risk factor disclosure section and the potential drawbacks of this type of disclosure.

Although Consob Regulation regulates the structure of the entire prospectus (Appendix 4 CONSOB), the risk disclosure section appears as a free-form textual segment, i.e., completely unstructured text.

The choice to analyse only the risk section derives from the desire to direct attention to the unique part of the document, describing all drawbacks and potential negative implications of the transaction and thereby is the most likely to be manipulated.

Thereby, the focus on risk section facilitates the investigation of the implications of minority directors on transparency disclosure and indirectly on the entire RPT approval process.

The analysis aims to count the word - that corresponds to the measuring or counting unit - in this paragraph and the dictionary keywords. The final purpose is to capture the section's tone, risk disclosure and the number of argumentation units presented in the text.

4.8 Descriptive findings

In this section, I will process and describe collected data to develop preliminary observations on the subject, such as the trend of the phenomenon and state of the art.

In the following, the chapter will present descriptive findings of content analysis of risk section focusing on:

- the length of the section (in terms of number of total words)
- the risk sentiment computed as the sum of uncertain and risk terms on the total number of items

- the net tone of the text that is the difference between the proportion of positive words and the proportion of negative words
- the number of Argumentation units calculated as the frequency of discourse indicators included in the section.

In particular, every disclosure's aspect is analysed based on the type of RPT and the related party involved in the transaction.

A descriptive analysis of corporate disclosure is conducted according to the content of the RPT information document, grouping sample RPTs into 11 categories of type of transaction carried out :1) *Sales and Purchases of a tangible and intangible asset*, 2) *Sales and Purchases of equity investments*,3) *Merger, Spins off and Conferment of business units*, 4) *Loans,* 5) *Equity transaction*, 6) *Lease agreement and Leasing*, 7) *Performance of actions and services*, 8) *Assignment of security* 9) *Settlement agreement*, 10) *Transfer and conversion of credits*, 11) *Other*.

Regarding the type of related party involved in the transaction, the analysis divides the sample observations into five different categories: 1) *Directors and majority shareholders*, 2) *Parent company*, 3) *Associate* 4) *Common control* 5) *Subsidiary* 6) *Other*.

4.8.1 Risk disclosure under the quantity approach

The first proxy for firm risk disclosure is the total number of words provided in the risk section. From the analysis of results emerges that reporting entities write 348 words in the risk section on average. Data with a large variation are presented below (Figure 4.1). The risk sections of information documents on *related parties' sales and purchase of equity investments* show the highest number of items (681 words), following by *Equity Transaction* (647). The lowest frequency of items that appear in the risk section is equal to 203 terms (*Lease agreement and Leasing*)

Figure 4.1- *Word count of risk section for types of RPT*

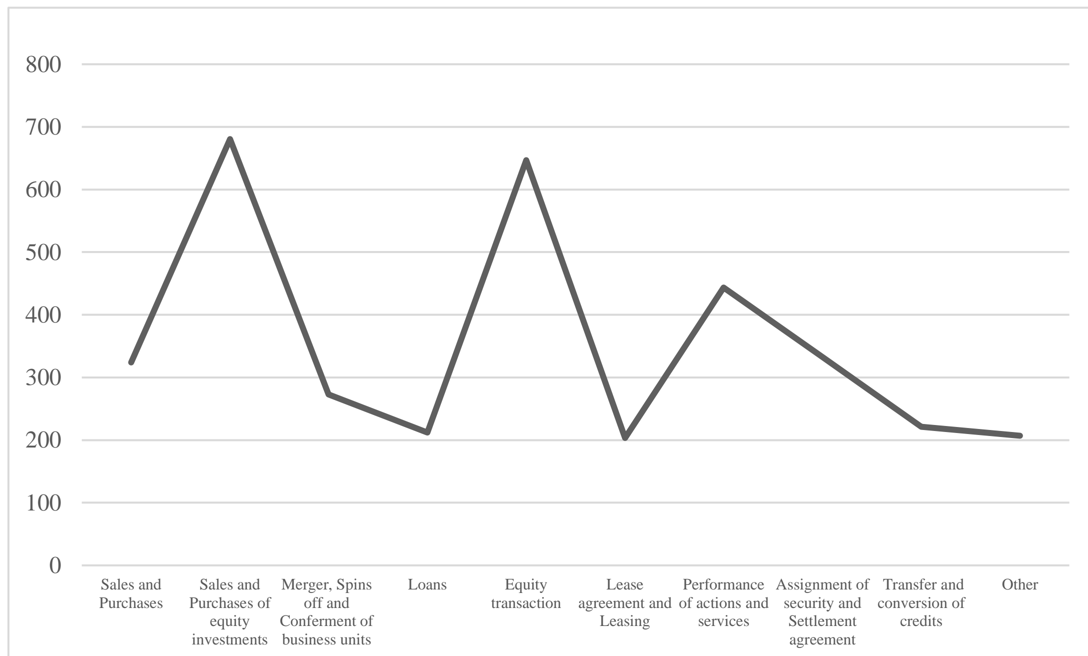
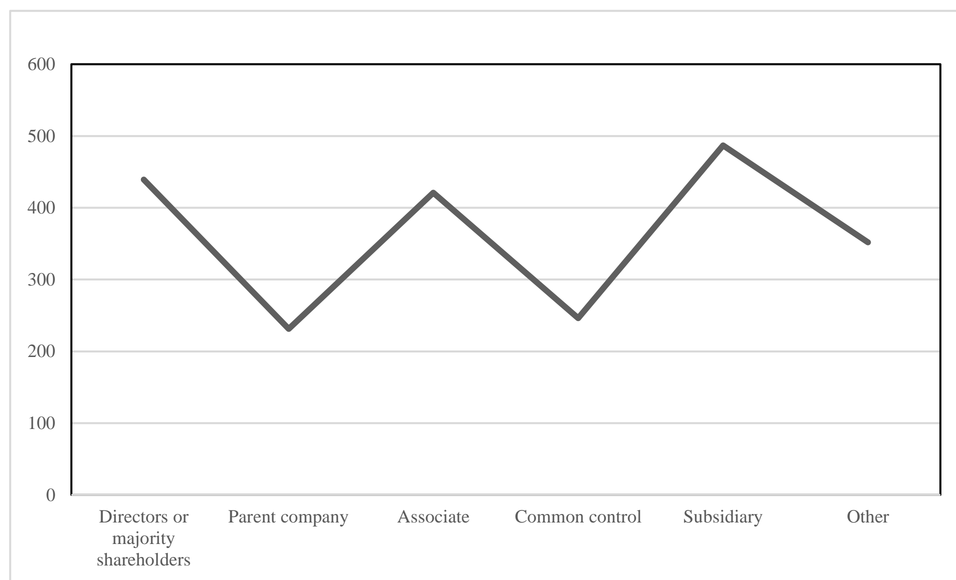


Figure 4.2 highlights the word count in sample risk paragraphs, clustering based on related party engaged. In this view, the RPTs involving the subsidiary company and the majority shareholders report respectively 486 and 439 items greater report a more extensive portion of the risk section than other information documents on highly material RPT engaging with different related parties. The length of the risk section reduces in documents on operations carried out with Parent companies (by -52% compared to *Related-party sales and purchases of equity investment*).

Figure 4.2- *Word count of risk section for the related party involved*



4.8.2 Risk sentiment

This section provides a descriptive analysis of the *risk sentiment*. The risk sentiment is calculated as the proportion of uncertainty and risk words in the risk section of the RPT document.

Table 4.7 shows that mean occurrence risk-related words (combining uncertain and risk keywords) are approximately 6% of the total number of items included in the risk section.

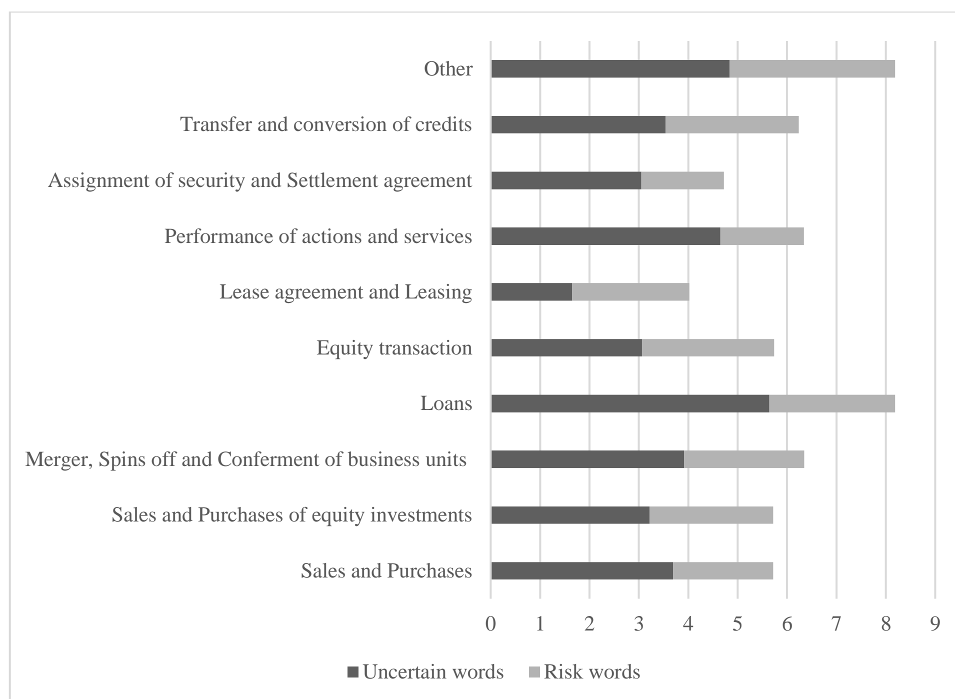
Table 4.7 – *Descriptive statistics of Risk sentiment (sum of risk and uncertain words)*

Min	Max	Mean	Median	Dev st
1%	23%	6%	5%	4%

As emerged from results, our sample RPT provides more uncertain words than risk words in the risk factor section. More specifically, the risk factor section contains, on average, a percentage of uncertain terms approximately equal to 4% and 2,44% risk ones. For comparison purposes, the Figure below provides evidence of the differences in the number of risk-related items on the basis of the type of RPT. In particular, preliminary findings emerges that the mean number of uncertain words varies from

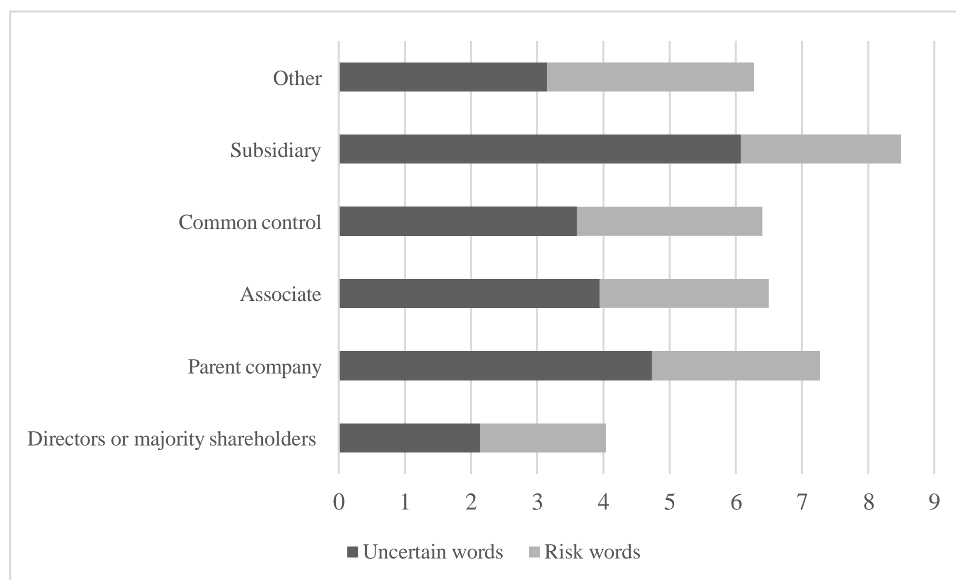
1,65% (*Lease agreement and Leasing*) to 5,64% (*Loans*). In contrast, on average, the mean number of risk words are very close to 2,44%, reaching the highest percentage (3,35%) in the residual category (*Others*) (Figure 4.3).

Figure 4.3- *Risk and uncertain words for types of RPT*



Regarding the variation of risk sentiment in documents considering related party involvement, the number of uncertain words is highest in information documents on RPT engaging with *Subsidiary companies*. The frequency of risk items remains approximately the same in every different RPT risk section. The figure below (4.4) shows that there is only a slight decrease in the number of risk words in documents concerning RPT carried out with *Directors or majority shareholders* (mean value 1,9%).

Figure 4.4- *Risk and uncertain words for the related party involved*



The second stage of analysis focuses on *what* is disclosed relating to risks. From the operational perspective, I examine the frequency of risk key words distinguishing the items based on Campbell's risk-type thematic categories (*Financial, Other-Idiosyncratic, Legal and Regulatory, Other-Systematic, Tax).* Most of these keywords relate to *legal and regulatory risk* (mean value 1,58%). In contrast, on average, a percentage lower than 1% of the key words covering other categories. I detect a low percentage of *other-idiosyncratic risks* (0,29%) *other-systematic* (0,33) *tax (*0,11) and *financial* (0,13). In these last cases, the median is always equal to 0.

Table 4.8 – *Descriptive statistics of risk keywords into Campbell's categories*

	Min	Max	Mean	Median	Dev st
Financial	0,00	2,41	0,13	0,00	0,35
Other- Idiosyncratic	0,00	3,60	0,29	0,00	0,56
Legal and Regulatory	0,00	4,78	1,59	1,39	1,22
Other-Systematic	0,00	3,61	0,33	0,00	0,59
Tax	0,00	1,69	0,11	0,00	0,27

4.8.3 Net tone of Risk section

Consistent, the measure of net Tone is based on a word frequency count approach. This measure is calculated as a count of positive words minus the count of negative words, divided by the total word counts. Therefore, a positive sentiment score indicates an overall positive tone in the RPT risk section, and a negative score means an overall negative tone.

Table 4.9 presents descriptive statistics for corporate disclosure tone.

It provides information about all RPT risk sections words with on average 2,89% positive words and almost 1,92 % of negative words. The overall net tone of RPT risk section is on average positive and equal to 0,97%. The maximum and minimum values of Tone are 7,18 and -9,09, respectively. As emerged from Table 4.9, 75% of the sample documents present in their section a positive tone.

Table- 4.9 *Descriptive statistics for corporate disclosure tone*

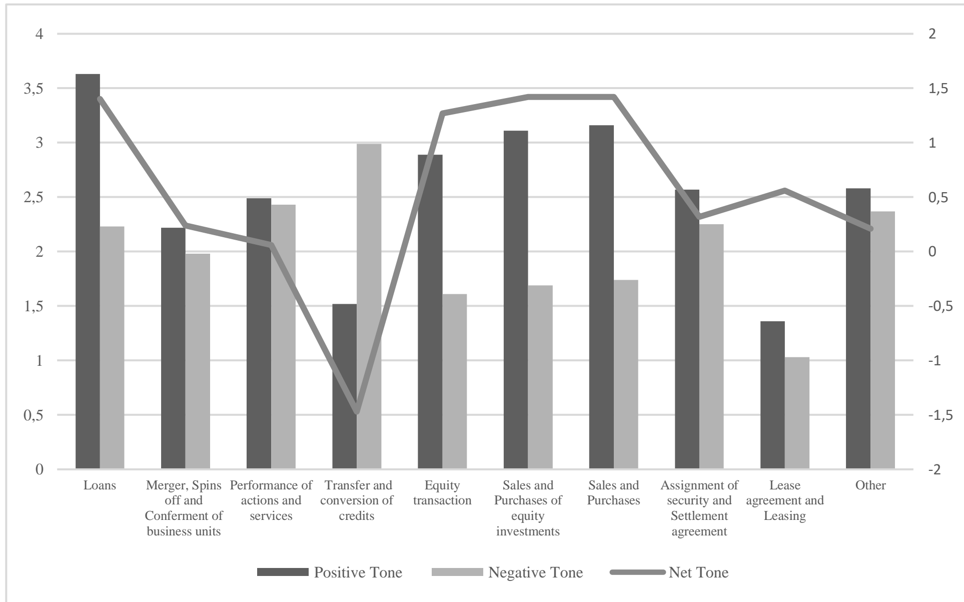
	Min	Max	Mean	Median	Dev st
%Positive words	0	7,75000	2,891446541	2,77	1,961256123
%Negative words	0	9,09000	1,920880503	1,58	1,34808664
Tone	-9,09	7,18000	0,970566038	1,27	2,343037926

Table- 4.10 *Tone of RPT risk section*

No Risk section Positive Tone	No Risk section Negative Tone
120	40
75%	25%

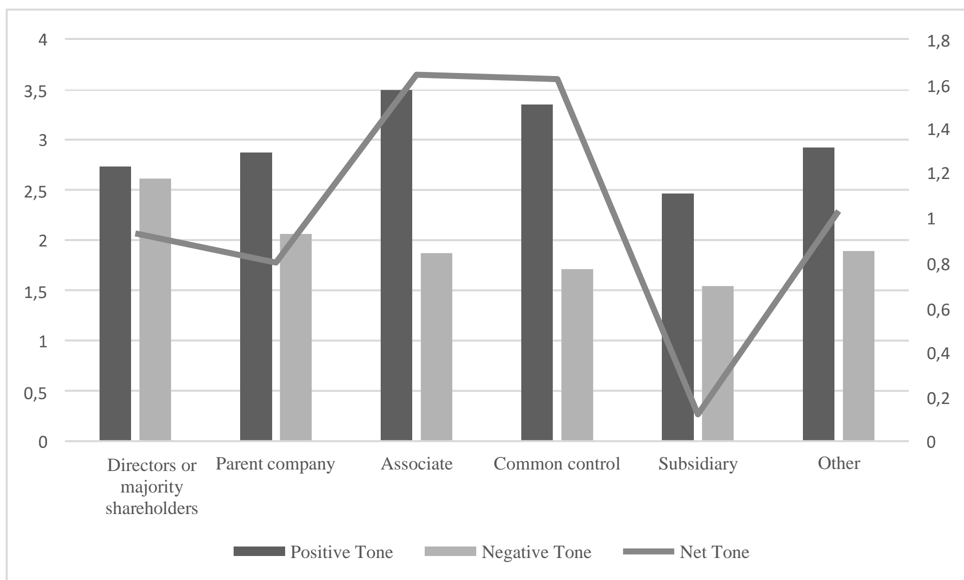
On average, the RPT risk sections related to *Loans* show a predominance of positive words (3,63% against almost 2,23 % negative); hence the overall net tone of this type of section is on average positive (1.4%). In contrast, documents on *Transfers and conversions of credits* contain a percentage of positive words equal to 1,42% and 2,99% of negative ones in the section, with a consequent net tone of -1,47%.

Figure 4.5 – *Net Tone for type of RPT*



Evidence suggests that, on average, the information documents that illustrate transactions engaged with an *Associate* company have - consistently with all other documents - a greater number of positive than negative words. Its net tone is the most positive of the six categories, as illustrated by the average value for the sentiment of 1,64%.

Figure 4.6 – *Net Tone for type of related party*



All mean scores for net optimism are different from zero, suggesting that the tone in the RPT risk section is not neutral. Thereby, readers are left with a positive impression of corporate risk management.

4.8.4 Argumentation Units

In this research stage, I carried out a preliminary and explorative analysis of the number of AGU report in the risk section. The number of Argumentation units is considered a proxy of the quality of argumentation**.** Every Argumentation Unit is introduced by Linguistic connective included in Lico List. The findings shed new light on this new aspect of corporate reporting, showing that the mean number of sample observations is 18 units.

The figure below shows the average number is deficient in the risk section of *Loans* (9), demonstrating that despite the number of words higher than other categories, the quality of argumentation appears reduced.

Figure 4.7 – *Argumentations units for type of RPT*

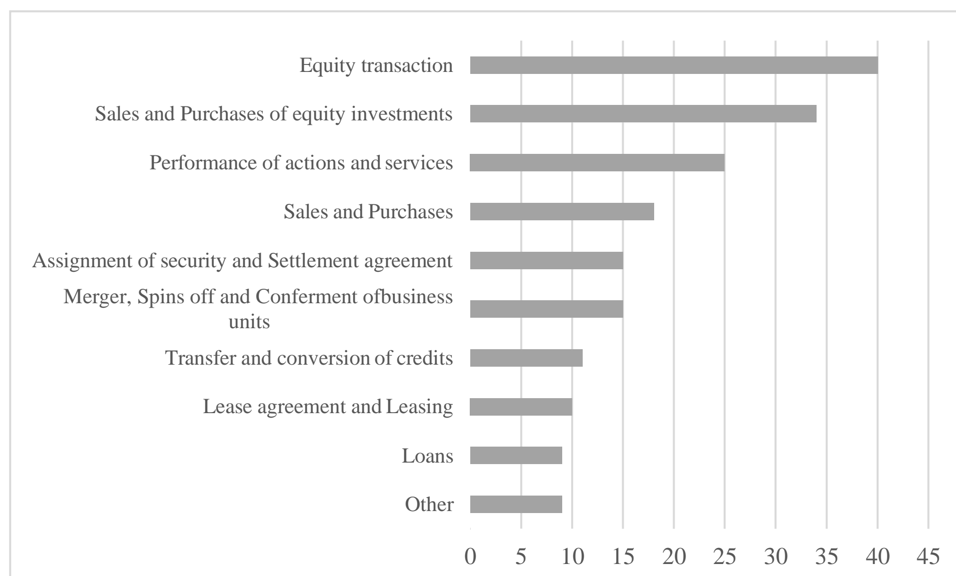
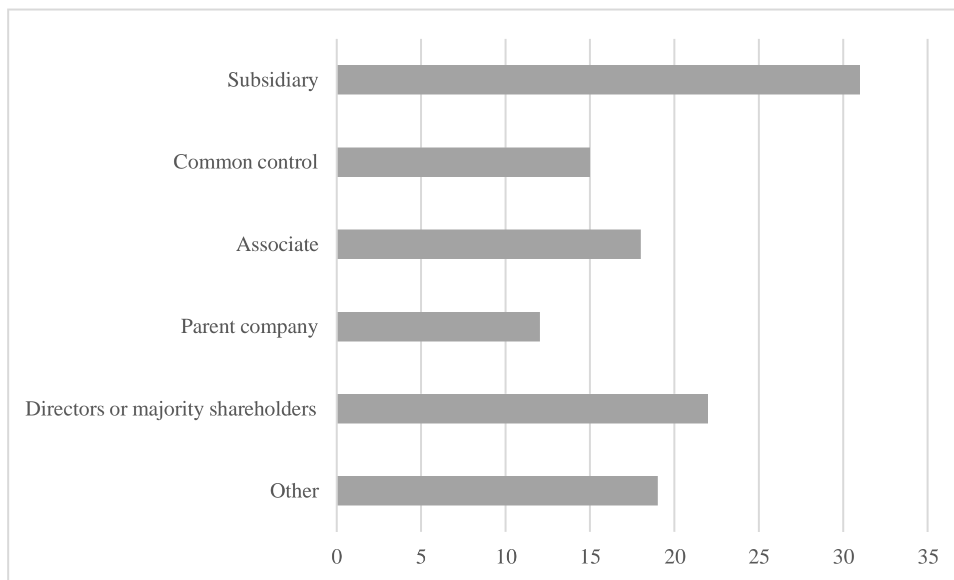


Figure below illustrate the sample results with regard to the type of related party.

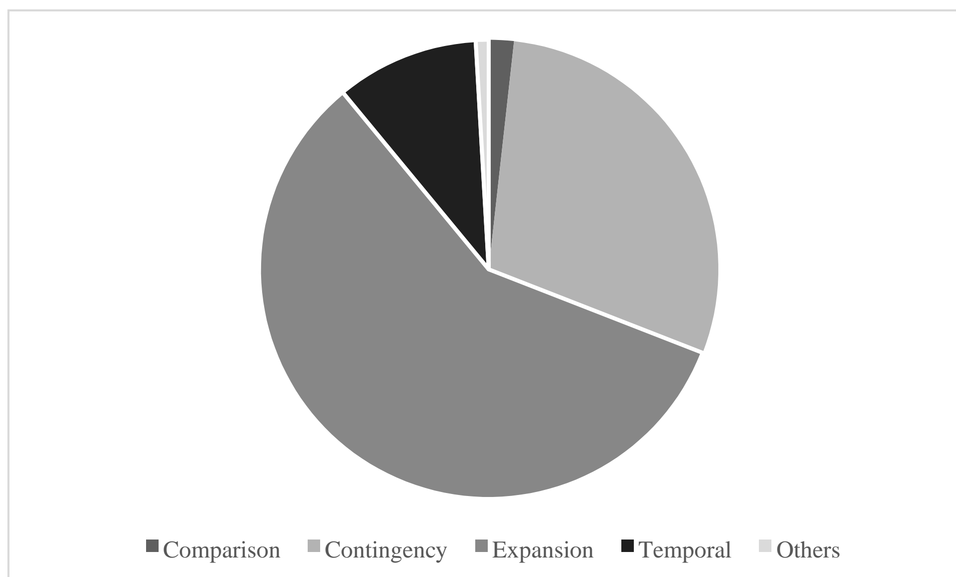
The risk sections of documents on RPT carried out with a *Subsidiary company* present a highest number of *Argumentations Units.*

Figure 4.8 – *Number of Argumentation Units for related party*



As emerged from LICO categories (*Comparison, Contingency, Temporal, Others*), the majority of detected connective linguistic are included in *Contingency* (28%) and *Expansion* (54%) clusters.

Figure 4.9 – *LICO categories*



Contingency indicators can introduce many types of argumentative relations:

- Causal (such as "*a causa di*", "*allora*", "*così*")
- Conditional (for example "*se*", "*a condizione che*", "*purché*")

- Negative conditional (as "*in caso contrario"*)
- Purposal (as "*a tal fine*", "*allo scopo di*", "*affinchè*").

In the same way, *Expansion indicators* can present several argumentative relations:

- Conjuctional ("*anche", "comunque"*)
- Disjuctional ("*o","oppure*")
- Equivalence ("*ossia", "in altre parole"*)
- Instantiation ("*ad esempio", "infatti"*)
- Level-of-detail ("*in realtà", "vale a dire"*)
- Substitutional ("*invece di", "al posto di"*)
- Exceptional ("*eccetto", "tranne"*)
- Manner

4.9 Variables Definition and Research Method

To examine the impact of the minority directors' representativeness on Related Party Transaction disclosure, I set up three Multivariate Robust regressions.

In particular to address the first research question:

Hypothesis 1 (a): *the appointment of at least one minority director has an impact on disclosure risk sentiment.*

I set up the following Robust regression.

$$
\begin{aligned}
Risk\ sentiment_{it} = {} & \beta_0 + \beta_1 BoD_Dummy_Minority_{it} + \beta_2 Perc_BoD_Indep_Mag_{it} \\
& + \beta_3 BoD_Size_{it} + \beta_4 CEO_Duality_{it} + \beta_5 AC_Dummy_Minority_{it} \\
& + \beta_6 Own_Conc_{it} + \beta_7 Strongly_Controlled_{it} + \beta_8 State_Own_{it} \\
& + \beta_9 Inst_Investors_{it} + \beta_{10} Revenue_ln + \beta_{11} ROA + \sum(Year_Effects)_{it} \\
& + \sum(Industry_Effects)_{it} + \sum(Market_Index_Effects)_{it} + \varepsilon_{it}
\end{aligned}
$$

Hypothesis 1 (b): *the appointment of at least one minority director has an impact on disclosure tone.*

I set up the following Robust regression

$$Pessimistic\ Tone_{it} = \beta_0 + \beta_1 BoD_Dummy_Minority_{it} + \beta_2 Perc_BoD_Indep_Mag_{it} + \beta_3 BoD_Size_{it} + \beta_4 CEO_Duality_{it} + \beta_5 AC_Dummy_Minority_{it} + \beta_6 Own_Conc_{it} + \beta_7 Strongly_Controlled_{it} + \beta_8 State_Own_{it} + \beta_9 Inst_Investors_{it} + \beta_{10} Revenue_ln + \beta_{11}\ ROA + \sum(Year_Effects)_{it} + \sum(Industry_Effects)_{it} + \sum(Market_Index_Effects)_{it} + \varepsilon_{it}$$

Hypothesis 1 (c): *the appointment of at least one minority director has an impact on disclosure argumentations.*

I set up the following Robust regression

$$Tot_Discourse\ Indicators_{it} = \beta_0 + \beta_1 BoD_Dummy_Minority_{it} + \beta_2 Perc_BoD_Indep_Mag_{it} + \beta_3 BoD_Size_{it} + \beta_4 CEO_Duality_{it} + \beta_5 AC_Dummy_Minority_{it} + \beta_6 Own_Conc_{it} + \beta_7 Strongly_Controlled_{it} + \beta_8 State_Own_{it} + \beta_9 Inst_Investors_{it} + \beta_{10} Revenue_ln + \beta_{11}\ ROA + \sum(Year_Effects)_{it} + \sum(Industry_Effects)_{it} + \sum(Market_Index_Effects)_{it} + \varepsilon_{it}$$

Where:

- *Risk sentiment:* sum of uncertain and risk word counts, divided by the total word count
- *BoD_Dummy_Minority:* dummy variable assuming value equal to 1 if at least one independent minority directors have been elected, 0 otherwise;
- *Perc_BoD_Indep_Mag:* percentage of independent directors appointed by majority shareholders;

- *BoD_Size:* number of the Board of Directors' constituents;
- *CEO_Duality:* dummy variable assuming value equal to 1 if the CEO is also the chairman of the Board, 0 otherwise
- *AC_Dummy_Minority:* dummy variable assuming value equal to 1 if at least one minority auditor has been elected, 0 otherwise;
- *Own_Conc:* percentage of the share capital owned by shareholders who possess more than 2 per cent of the share capital of the company;
- *Strongly_Controlled:* dummy variable assuming value equal to 1 if the controlling shareholder holds a stake higher than 50%, 0 otherwise;
- *State_Own:* dummy variable that equals 1 in case of a state-owned entity, 0 otherwise;
- *Inst_Investors:* dummy variable equal to 1 if an institutional investor with significant interests in the share capital is present, 0 otherwise;
- *Revenue_ln:* log function of the total annual sales;
- *ROA:* return on asset, defined as the ratio between operating income and total assets
- *Pessimistic Tone*: as the count of negative, uncertainty and risk words, divided by the total number of words
- *Tot_Discourse Indicators*= number of discourse indicators that introduce AGU

4.9.1 Control variables

I include a battery of control variables to account for the possible impact of factors other than minority directors on a firm's disclosures. Specifically, I identify two groups of the control variable that might affect the informativeness of documents.

Corporate governance variables

The number of the Board of Directors' constituents is included as a proxy of *Board size*. In this regard, John and Senbet (1998) provide evidence that while the board's monitoring capacities increase as the number of members on the board increases, this benefit may be offset by the incremental cost of poorer communication and decision-making efficiencies that are often associated with large groups. However, there is

evidence that oversized boards are less efficient in performing their duties because of the increasing communication and coordination problems as board size increases and their decreased ability to control management. Thus, with dispersed opinions and non-cohesiveness in viewpoints, a too-large board may have diminished monitoring capabilities (Lipton & Lorsch 1992; Jensen, 1993). According to another part of the literature, there is no association between board size and the level of voluntary disclosure (Cheng, 2006).

Thus, there is no preponderance of theory or empirical evidence to suggest a relation between board size and levels of disclosure, and it remains a practical issue that requires concern in this analysis.

I also include *CEO_Duality* in the models. Prior work by Mather and Ramsay (2007) shows that the concentration of CEO and chairman roles in the same person is associated with increased selectivity. Boards are expected to be more independent and efficient when the board's chairman is not an executive director.

As suggested (Andersen, Deli, & Gillan, 2003; Dechow, Sloan, & Sweeney, 1996; Goyal & Park, 2002; Jensen, 1993), boards with CEOs also the chairperson are generally expected to exhibit weaker monitoring capabilities. In the context of the disclosure, however, results have been mixed. While Forker (1992) found a negative association between duality and the quality of share-option disclosure, Ho and Wong (2001) show no association between duality and voluntary disclosure. On the other hand, Gul and Leung (2002) document a significant and negative relationship between duality and voluntary disclosure. The direction of the association between Ceo Duality and quality of disclosure is not predicted prior.

Furthermore, I control for the proportion of independent directors appointed by controlling shareholders (*Perc_BoD_Indep_Mag)*. Ignoring the election system in use, according to much of the literature, the presence of independent directors on the board, and in particular in certain key committees, can protect investors' interests, with a positive impact on firm's market value and stream the risk of accounting irregularities and corporate fraud (Bebchuk & Hamdani, 2009; Dahya et al.,2006; Black et al. ,2005; Smaili & Labelle, 2009; Klein,2006; Nguyen & Nielsen,2009). Consistent with these findings, other scholars support the idea that independent directors fulfil their

monitoring role, reducing fraudulent incidence (Beasley, 1996) and aggressive reporting (Peasnell et al., 2005).

This empirical evidence is consistent with Williamson (1984) theoretical framework, which shed new light on the relationship between the board's monitoring effectiveness and its composition and should be shown at the level of firm transparency. Indeed, many studies find a significant and positive association between board independence and voluntary segment disclosure and (Chen & Jaggi, 2000) or mandatory financial disclosures (Leung & Horwitz, 2004).

Ho and Wong (2001), using a direct measure of a voluntary disclosure based on analyst perception, cannot confirm a significant relationship between the level of voluntary disclosure and board independence. Also, Forker (1992) confirms no significant association between the fineness of mandatory disclosure of stock options and the proportion of non-executive directors.

In contrast, other studies interpret the presence of independent directors under a critical perspective, providing counterintuitive and unexpected results.

Eng & Mak's (2003) direct measure of nonmandatory disclosure is significantly and negatively associated with the percentage of independent directors. Gul and Leung (2002) document a significant negative association between a direct measure of voluntary disclosure and the percentage of "expert" non-executive directors (proxied by multiple board memberships).

These findings run counter to Williamson (1984) theory and the foresight that higher board independence is associated with more transparency and better monitoring. These unexpected results could be attributed to the inclusion of *grey* directors in the outside director variable. While the Gul and Leung (2002) study consider the effect of grey directors on board monitoring, their unexpected results may arise from using a noisy proxy for director expertise (multiple directorships). It is significantly and negatively associated with a firm value (Mak, Sequeira, & Yeo, 2003). While one could speculate that greater board independence obviates the need for higher levelsof disclosure, there is no theory of the firm to support this contention. These findings justify introducing a proxy for the proportion of independent majority directors

appointed by majority shareholders, which are more likely to be *grey*, stating the hypothesis in the alternative form.

I also control the level of ownership concentration (*Own_Conc*) because it impacts the extent and quality of disclosure. Yassel (2014) demonstrate that ownership concentration is negatively associated with financial reporting quality. An extended body of literature (Gelb, 2000, Arcay & Vasquez, 2005; Ali et al., 2007)

argue that higher concentrated ownership incentives the owner to intervene in the firm's management, not requiring these firms to grow financial disclosure. On the other hand, firms with diffused ownership are compelled to have a higher disclosure as a monitoring device. Hence, a higher disclosure might reduce the asymmetric information between managers and shareholders. In this perspective, under concentrated ownership controlling shareholders, the conflict of the first type become the conflict of the second type. In RPT disclosure, firms might not disclose RPTs transparently when they are wealth expropriation or private benefit-seeking activities by majority shareholders to the detriment of minority ones (Ali et al., 2007). To hide this entrenchment, firms might not transparently disclose RPTs. This evidence is based on the idea that increasing concentrated ownership discourages firms from being more transparent. This argument is also supported by the studies of Claessens et al. (2000), Fan and Wong (2002) that firms with a more considerable discrepancy between control and ownership tend to have a lower firm value and lower firm disclosure.

However, there are controversial findings on this topic.

Indeed, Wang (2006) states that concentrated ownership has a higher financial disclosure because the poor quality of financial disclosure might jeopardize a firm's reputation, wealth and long-term performance. Based on these explanations, we conclude that communication can be affected positively (negatively) if the concentrated ownership causes an alignment effect (entrenchment effect).

I also control for the type of ownership (including dummy variable assuming value equal to 1 if the controlling shareholder holds a stake higher than 50%, 0 otherwise) (*Strongly_Controlled*) expecting, in this case, a close alignment between corporate and controlling shareholder interests and thereby an improvement of disclosure

transparency. Moreover, I control for the presence of state with significant interests in the share capital (including a variable that equals 1 in case of a state-owned entity, 0 otherwise) (*State_Own*) (Moscariello et al., 2018; Bianchi et al.,2018)

I also include a dummy variable equal to 1 if an institutional investor with significant interests in the share capital is present, 0 otherwise as a proxy for monitoring the role of institutional directors on the board (*Inst_Investors*).

The large investors undertake the responsibility of monitoring managers (Shleifer & Vishny, 1986), reducing agency problems. Evidence in García Osma and Gill-de-Albornoz (2007) suggests that their presence on the board is associated with lower accrual manipulation. In general, the presence of institutional investors with significant shareholdings should improve governance. Institutional investors can get either "*vote with their feet*" (i.e., sell their shares) or take an active role in the governance and decision-making process.

Moreover, given that institutional investors' active ownership may play a significant role in explaining the quality of RPTs internal procedures (Bianchi,2011), I predict an impact on the quality of RPT disclosure too.

Firm-accounting attributes

Firm size and ROA are also used as control variables because they are firm-accounting factors that might influence disclosure quality.

Large firms are generally exposed to a more significant array of investors and are expected to disclose more information than smaller firms (Lang and Lundholm,1996). Many studies (Cooke, 1989; Botosan, 1997; Camfferman and Cooke, 2002; Premuroso & Bhattacharya;2008) show a positive relationship between the extent/length of disclosure and firm size.

Prior literature shows several reasons that can lead larger firms to convey more financial information: (1) better transparency and disclosure enable larger companies to get a lower future cost of capital through the capital market (Singvhi and Desai, 1971) (2) larger firms tend to be more monitored by investors than smaller firms, and thus they are enforced to disclose more financial information; (3) larger firms have

more capabilities including financial resources to reveal financial information (Botosan,1997).

Moreover, it is also demonstrated that the cost of obtaining and preparing financial information compress and (ii) competitive troubles reduce in larger companies (Ball & Foster, 1982; Arcay & Vasquez, 2005)

Thus, firm size raises the extent of disclosure, including RPT disclosure. Indeed, larger companies may have a higher incentive to disclose RPTs because they are subject to more scrutiny by financial analysts and investors (Hossain et al., 1995; Gul and Leung, 2004). For this reason, firm size (measured by *Revenue_ln*) is used as general control variables in many studies on the topic (Kohlbeck & Mayhew, 2004; Gordon et al.,2004). I take into account firm performance (computed as Return on Asset) (*ROA*) Because managers may delay disclosing bad performance news relative to good performance news (Kothari et al., 2008; Marchetti et al., 2018). Several studies have confirmed the use of earnings management by large numbers of listed companies to achieve particular levels of return (Chen & Yuan, 2004; Liu & Lu, 2007). The manipulation of the process of financial reporting to obtain private gain may beeasily placed through RPTs. The impact of ROA on the dependent variable seems unclear, so I do not make any prediction.

4.9.2 Proxy for independent minority directorship

Following the prior literature, I operationalize independent minority directors by a dummy variable that is equal to one if at least one minority director sits in the Board, 0 otherwise.

4.9.3 Proxies for disclosure quality

As far as quality of communication is concerned, two aspects have to be balanced. On the one hand, the absolute number of information disclosed has to be considered a proxy of the amount of disclosure provided by companies. The length of disclosure counts the total number of words that appear in the firm’s risk factor disclosure section. Overall, many studies rise to (non-directional) hypothesis that the length of the RPT

risk section could be considered a driver of quality of disclosure. Minority shareholders' representativeness in the board of directors potentially affects this proxy. On the other hand, a second perspective is offered that integrates the different dimensions of analysis to depict the communication profile adopted by a firm in risk disclosure instead of merely counting only the total number of disclosed items.

I measure the emphasis on risk in the RPT information document by counting the frequency of words related to risk or uncertainty (*"risk sentiment"*) (Li, 2006) in the risk section of the RPT information document.

I attempt to capture the *pessimistic tone* of the section measured as the sum of negative, uncertain and risk words on the total number of words. Prior research shows that managers tend to express their negative views using terms like "risk" and "uncertain" (Li, 2010). Therefore, many sentences with uncertain tone are also possibly of negative tone. For this reason, consistent with Holtgraves (2015), combine the uncertain tone group with the negative tone group in this empirical analysis.

In Model 3, the research investigates the *percentage of linguistic indicators* presented in the risk section to identify the number of Argumentation Units.

4.10 Descriptive statistics

Tables 4.11 and 4.12 present the descriptive statistics (except for the dummy variables) of 160 observations for the 9-year reference period from 2011 to 2019.

More in detail, Table 4.11 shows that the board of directors has an average size of 9, with a proportion of independent directors appointed by the controlling shareholders (*Perc_BoD_Indep_Mag*) of 0,37 (very close to the median value that is about 0,38). As to the ownership dispersion, the sample firms are characterized by an average *Own_Concentration* of 0,65 (its median stands at about 0,68). The mean size (proxied by Log-function of Sales) of firms included in the sample amounts to 19,10, with an average ROA of about 0,00.

Table 4.11 - *Descriptive statistics – Corporate Governance and Firm- accounting variables*

	Min	Max	Mean	Median	SD
BoD_Dummy_Minority	-	-	-	-	-
Perc_BoD_Indep_Mag	0,00	0,67	0,37	0,38	0,13
BoD_Size	5,00	20,00	8,99	8,00	3,08
CEO_Duality	-	-	-	-	-
AC_Dummy_Minority	-	-	-	-	-
Own_Conc	0,27	0,99	0,65	0,68	0,18
Strongly_Controlled	-	-	-	-	-
State_Own	-	-	-	-	-
Inst_Investors	-	-	-	-	-
Revenue_ln	13,28	25,57	19,10	18,95	2,29
ROA	-0,37	0,17	0,00	0,02	0,09

Table 4.12 provides descriptive evidence of disclosure proxies considered by the proposed framework. As emerged below, the average number of risk and uncertainty words on the total word count in the risk section (*Risk sentiment*) is very low, equal to 0,06. The mean length of the RPT risk section is 348 words. Regarding the *Pessimistic Tone*, on average, it is equal to 0,08 (very close to median value of 0,07).

Tabella 4.12 *Descriptive statistics – Disclosure quality variables*

	Min	Max	Mean	Median	Dev st
Pessimistic Tone	0,03	0,32	0,08	0,07	0,05
Risk sentiment	0,01	0,23	0,06	0,05	0,04
Tot_Discourse Indicators	0,00	0,12	0,05	0,05	0,02
WC	24,00	5487,00	348,69	212,00	597,10

4.11 Univariate and Pairwise correlation

Table 4.13 shows the Pairwise correlations matrix for all the defined variables. Firstly, it must be noted that the variables included in the model do not suffer from collinearity matters. None of the variables is '*paired*' to others with a coefficient greater than 0.8. Therefore, collinearity matters are not likely to threaten the accuracy of the relationships estimated in the model (Hair, Anderson, Tatham, & Black, 1998; Gujarati, 2004).

As to sign and the significance of the correlation coefficients, the results from the univariate analysis highlight that the number of uncertain and risk words included in the risk section (*Sum_U_R_WC*) significantly and negatively related to *ROA* and *Perc_BoD_Indep_Mag*.

In addition, the appointment of at least one minority director is also significantly and negatively correlated in the case of *strongly controlled firms.* Predictably, the table below provides evidence of a significant and negative correlation between *BoD_Minority* and *Perc_BoD_Indep_Mag*. On the other hand, the probability of finding at least one minority director is positively influenced by the presence of at least one auditor appointed by minority shareholders.

Besides, the appointment of at least one minority director is also significantly and positively correlated in the case of *state-owned entities*.

Table 4.13-*Correlation matrix*

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Sum_U_R_WC	1,0000						
BoD_Dummy_Minority	0,0454	1,0000					
Perc_BoD_Indep_Mag	-0,2161*	-0,3233*	1,0000				
BoD_Size	0,1287	0,0324	0,0750	1,0000			
CEO_Duality	0,0865	-0,0690	-0,0679	-0,1107	1,0000		
AC_Dummy_Minority	-0,0436	0,6923*	-0,3107*	0,0779	-0,2203*	1,0000	
Own_Conc	0,0479	-0,1114	-0,1395	-0,1784*	0,1419	-0,0172	1,0000
Strongly_Controlled	0,0528	-0,2250*	-0,0418	-0,1057	0,1683*	-0,0746	0,7034*
State_Own	-0,0663	0,1970*	0,0966	-0,0335	-0,1702*	0,1185	-0,2816*
Inst_Investors	0,1194	0,1429	-0,2315*	0,1705*	0,0617	0,1333	0,0075
Revenue_ln	-0,0181	0,1244	0,0997	0,4561*	-0,0841	0,1544	-0,2533*
ROA	-0,2092*	0,1074	-0,0019	0,1036	0,0074	0,1267	0,1562*

	(8)	(9)	(10)	(11)	(12)
Strongly_Controlled	1,0000				
State_Own	-0,1443	1,0000			
Inst_Investors	-0,0359	0,0875	1,0000		
Revenue_ln	-0,1497	0,3583*	0,3740*	1,0000	
ROA	0,1109	0,2218*	0,2577*	0,4685*	1,0000

**Significance at the 0.5*

4.12 Findings and Discussions

Table 4.14 the estimation results for the regression analysis (Model 1).

As emerged from findings, *risk sentiment* is significantly and negatively influenced by *ROA* (-0.165, with P > |z| = 0.00). At the same time, there is a significant and positive relation between *risk sentiment* and the presence of one shareholder that holds more than 50% of shares (0.018, with P > |z| = 0.01).

Also, the board composition impacts the number of risk information. In fact, as also predicted by the univariate analysis, the percentage of independent directors appointed by Majority shareholders significantly negatively influences the number of risk information (-0.05, with P > |z| = 0.03).

Overall, these results highlight a significant and positive relationship between the appointment of at least one minority director in the Board and the number of risk-related information (0.015, with P > |z| = 0.09) and the *Board size* (0.002, with P > |z| = 0.04).

Table 4.14 - Regression analysis – Model 1

Dependent Variable:Risk sentiment	Coefficients	t-stat	P > |t|
Intercept	-0,0006394	-0,01	0,98
BoD_Dummy_Minority	0,0157178*	1,69	0,09
Perc_BoD_Indep_Mag	-0,0524176*	-2,11	0,03
BoD_Size	0,0022568*	2,00	0,04
CEO_Duality	0,0064377	0,67	0,50
AC_Dummy_Minority	-0,0102311	-1,26	0,20
Own_Conc	6,77E-08	0,29	0,77
Strongly_Controlled	0,018889*	2,58	0,01
State_Own	0,0194945	1,51	0,13
Inst_Investors	0,0105709	1,25	0,21
Revenue_ln	0,0017017	0,79	0,43
ROA	-0,1656371*	-2,83	0,00
Year Effects	*Included*		
Industry Effects	*Included*		
Market Index Effects	*Included*		
R^2	0,3334		
F value	2,5		
Prob.> F/Chi^2	0,0003		
Root MSE	0,03661		
N. of Obs	160		
N. of Groups			

Bold values indicate Significance at 0.10

These findings are partially confirmed in Model 2. The proportion of independent directors elected by majority shareholders still exercises a negative impact on Pessimistic tone (0.061, with P > |z| = 0.05), while the coefficient of the variable *Bod_dummy_Minority* is not statistically significant. The number of Board member shows a negative and significant relationship with Pessimistic tone (0.002, with P > |z| = 0.09). There is also a significant and positive relationship between *Strongly_Controlled* and *Pessimistic Tone* variables (-0.024, with P > |z| = 0.00). The coefficient of ROA is however still negative (0.022, with P > |z| = 0.01).

Table 4.15 – *Regression analysis* -Model 2

Dependent Variable: Pessimistic Tone	Coefficients	t-stat	P > |t|
Intercept	-0,0085891	-0,15	0,87
BoD_Dummy_Minority	0,0186119	1,63	0,10
Perc_BoD_Indep_Mag	-0,0612133*	-1,90	0,05
BoD_Size	0,0024141*	1,71	0,09
CEO_Duality	0,0096243	0,79	0,42
AC_Dummy_Minority	-0,0130068	-1,30	0,19
Own_Conc	8,12E-08	0,28	0,77
Strongly_Controlled	0,0229942*	2,56	0,01
State_Own	0,0260369	1,56	0,12
Inst_Investors	0,0100295	0,89	0,37
Revenue_ln	0,002691	1,00	0,32
ROA	-0,218653*	-2,81	0,00
Year Effects	*Included*		
Industry Effects	*Included*		
Market Index Effects	*Included*		
R^2	0,3300		
F value	2,26		
Prob.> F/Chi^2	0,0013		
Root MSE	0,4643		
N. of Obs	160		

Table 4.16 presents the Results of Model 3.

Only the presence of an Institutional Investor that holds significant share of capital impacts on *Tot_Discourse Indicators.*

All other predictors of the model seem not to have an impact on the dependent variable, given the lack of statistical significance on their coefficients.

Table 4.16 – *Regression analysis* -Model 3

Dependent Variable: Tot_Discourse			
Indicators	Coefficients	t-stat	P > |t|
Intercept	0,0048392	0,15	0,87
BoD_Dummy_Minority	0,0005317	0,11	0,91
Perc_BoD_Indep_Mag	0,0163403	1,11	0,27
BoD_Size	0,000214	0,31	0,75
CEO_Duality	0,0012741	0,32	0,75
AC_Dummy_Minority	0,0071008	1,60	0,11
Own_Conc	8,08E-08	0,43	0,67
Strongly_Controlled	-0,0046961	-1,03	0,30
State_Own	0,0131338	1,64	0,10
Inst_Investors	-0,0111829*	-2,56	0,01
Revenue_ln	0,0020395	1,54	0,12
ROA	0,0060708	0,23	0,82
Year Effects	*Included*		
Industry Effects	*Included*		
Market Index Effects	*Included*		
R^2	0,3367		
F value	2,58		
Prob.> F/Chi^2	0,0002		
Root MSE	0,02005		
N. of Obs	160		

Conclusion and Remarks

This research contributes to the corporate governance literature by investigating the impact that the appointment of minority directors can have on the fairness of RPT procedure and transparency of RPT disclosure.

After a review of literature on RPT, the study analyses several *anti-tunneling* mechanisms to compress the risks of self-dealing RPTs. From limits of current legal tools arises the necessity minority shareholders' representativeness to guarantee the board independence and compress the risk of value-expropriation by majority shareholders to the detriment of minority ones.

Proposing a new framework for the analysis of risk disclosure the findings provide evidence of the impact that at least one minority director on the Board exercises on the company. This mechanism makes entity more sensitive to investors' interests insisting on stricter RPT procedures and more transparent corporate disclosure.

The actual independence of the Board of the director can play an essential role in monitoring potentially self-dealing transactions and reducing the chance that value will be expropriated from minority shareholders improving the transparency to the market.

Finally, it is interesting to note the role of majority shareholders-appointed independent directors on the informativeness of the risk section of RPT information documents. Consistently with previous studies on the effectiveness of board independence in concentrated ownership setting, this finding supports the thesis that the presence of controlling shareholders mitigates the role of dominant shareholders-appointed independent directors in monitoring self-dealing transactions and undermines their independence over time by making them affiliated or grey directors (Yeh & Woidtke, 2005; Dong-Song & Zootae, 2007; Pizzo, 2013). The regression analysis reveals that majority shareholders-appointed independent directors exercisea negative influence on risk sentiment and the pessimistic tone of the text. Thereby, the independent directors appointed by the majority of shareholders reduce the quality of disclosure. This empirical evidence supports that the power of independent directors' appointment conferred to controlling shareholders undermines these directors' status of independence.

In line with expectations, the number of board members improves disclosure transparency, increasing risk sentiment and pessimistic words.

Contrary to our expectations, there is no significant relationship between ownership concentration and disclosure variables. Still, if only one controlling shareholder holds more than 50% of share capital, his interests align with corporate ones, with a significant and positive impact on the section's risk sentiment and pessimist tone.

This analysis reveals that the introduction of minority directors serves intended purposes and influences other aspects of the shareholders' protection.

Besides the general descriptive aspects and statistics that allow the observation of the phenomena, qualitative and quantitative tools are cross-sectionally and sometimes jointly used to address research objectives.

The findings confirm that the introduction of minority directors can be an effective mechanism to alleviate principal-principal conflict via RPT and reduce information asymmetry. The slate-vote system enriches the transparency of RPT disclosure, increasing risk sentiment. Despite the contributions, this study is not without limitations. The cost associated with the appointment of minority directors requires an assessment of the trade-off between their effectiveness and the potential inefficiency related to the side effects of their discussed characteristics.

The study also ignores other adverse effects of the introduction of minority directors. It has to be considered that, as described above, the potential benefits associated with their appointment might be offset by their self-interest nature that could cause some possible distortion. Therefore, together with the expectations that look at minority directors as potentially able to improve RPT disclosure as a shareholders' protection tool, it is necessary to consider some issues related to the presence of minority directors that could mitigate or even overturn such expectations.

Moreover, this investigation examines the minority directors as an anti-tunnelling instrument in a single country. Although findings are likely generalizable to other institutional contexts, a cross-country analysis could help obtain a more comprehensive picture.

More in general, this study also contributes to the advancement of knowledge on the role of minority directors: this could be the basis for future suggestions related to the

legislative framework and both academics board practitioners. In addition, future insights will also be enabled relative to the relationship between the type of RPT or the type of related party involved and disclosure, hypothesizing its transparency can be a function of these features.

Further, since this study examines the determinants of the newly created risk factor section when all firms were mandated to provide this disclosure, we are uniquely able to address the debate on the usefulness of mandatory disclosure and the criticism currently facing the CONSOB. The findings of this study support the necessity for more scrutiny by regulators, policy makers and standard setters to monitor the conflict of interests in RPTs by introducing stricter regulations for RPTs and improving CG practices specially to monitor RPTs in order to limit the opportunistic behaviour of related parties. In general, the controversial role of majority shareholders' independent directors and the effectiveness of minority directors require further works to explore an issue that should represent a significant concern for academics and regulators.

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