**Corporate Governance Sound Practices:**

**A Case for Financial Markets Stability**

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**Corporate governance: challenges and opportunities**

1. **Introduction**

The term corporate governance derives from an “analogy between the government of cities, nations or states and the governance of corporations” [Becht, Bolton and Röell, 2005]. The early corporate finance textbooks saw “representative government” [Mead, 1928] as an important advantage of the corporation over partnerships but the issues of how representative corporate governance really is and whom it should represent are still contentious.

The need for corporate governance arise from two relevant market failures affecting corporate elections and the role and fiduciary duties of the board of directors. On the one side, shareholders bear high coordination costs to select and appoint corporate directors who are able to maximize firm value (so-called collective action problem). On the other side monitoring that managerial actions are in line with shareholders’ ex-ante indications is burdensome (so-called principal-agent problem).

Corporate governance and so-called intra-company mechanisms for the protection of shareholders can play a very significant role in the development of equity markets. The link of causality, documented by ample economic literature, is simple: if company law protects (minority) shareholders adequately, savings flow to businesses through the stock exchange, and share ownership broadens. On the contrary, undeveloped equity markets and high ownership concentrations can be symptoms of their insufficient protection.

1. **Comparative corporate governance through recent crises**

Agency problems are magnified when corporate ownership is dispersed, as it is in the US and in the UK, because the interests of management and shareholders are not aligned. The main aim of corporate governance in the US and in the UK is then to alleviate the conflict of interests between dispersed small shareowners and powerful controlling managers, given that listed companies controlled by large blockholders are relatively few.

On the contrary, the typical firm around the non-anglo-saxon world has a dominant shareholder, who controls the majority of votes, often through control enhancing mechanisms such as pyramids, cross-shareholdings, dual class shares and coalitions, and few listed companies are widely held. The appointment and monitoring of management is more efficient when a dominant shareholder controls the majority of votes because he has adequate incentives to perform the screening and monitoring functions as well as the power to discipline management. Here, conflicts of interest between majority and minority shareholders are the key issue to address.

While the US and the UK share many other common features, which distinguish them from most Continental European countries and Japan, there are also several differences. For example, British institutional investors tend to be more interventionist than their American peers, thus making boards of directors more accountable on issues such as the composition of the board, the appointment of new directors and executive pay.

During the 1990s, the US economy markedly out-performed that of most European countries and Japan. It was widely believed that this was due to the vitality of US financial markets, which ensured that badly managed firms were reorganized or taken-over and promising projects had easy access to capital. The focus on shareholder value as the principal measure of a company’s performance was seen to be a powerful force for inducing managers to pursue profits. Other countries then followed the US model, emphasizing the importance of shareholder value and enhancing the contestability of listed companies as an instrument of discipline. In Europe, and to a lesser extent in Japan, additional pressure to make these changes came from the growing influence of US and UK institutional investors as shareholders in European companies.

After the stock market crash of early 2000s, followed by Enron, WorldCom and other corporate scandals, the US model of corporate governance lost much of its appeal. However other scandals regarding European companies showed that corporate governance in Europe was far from perfect. Regulators consequently focused their attention on possible reforms, mainly by reshaping the systems of internal control. The key areas of intervention were the role of boards of directors as monitors of management and the independence and effectiveness of auditors.

In choosing between state intervention through “command and control” rules and self-regulation, the US opted for the first route, principally through the Sarbanes-Oxley Act provisions (which took several significant powers away from the states) and secondary rules imposed by the Securities and Exchange Commission. In addition, both the NYSE and the NASDAQ improved their listing standards. Differently, the UK went for the second route building on the principle of voluntary compliance and introducing the concept of “comply or explain” by which all listed companies are expected to adhere to the Code of Conduct, or otherwise explain why non-compliance is appropriate and justifiable.

Continental Europe reforms went in the same direction, promoting improvements to corporate governance codes of conduct at the national level (e.g. the Cromme Code for Germany, the Preda Code for Italy and the Viénot/Bouton Reports for France) and adopting two Commission recommendations under Article 211 of the EU Treaty. These involved, among others, the adoption of a “comply or explain” regime for listed companies, the inclusion of independent directors on boards and the establishment of remuneration, nominations and audit board committees. Later reforms at national level (e.g. the Italian “Law on Savings”) implemented these recommendations and often gold-plated their prescriptions adding further gatekeepers.

The market and macroeconomic environment before the 2008-2010 financial crisis put again the corporate governance systems under stress. As new and unusual profit and growth opportunities emerged (in particular in the financial sector), shareholders exercised stronger pressure for short-term results while they neglected their monitoring functions. At the same time boards failed to define and manage a “sustainable” strategy with regard to risk appetite and incentive/remuneration mechanisms.

As the emphasis shifted from value creation to financial stability, corporate governance issues were not necessarily a priority when, in late 2008, the international re-regulatory process started. In the particular case of non-anglosaxon countries, a system based on a stronger power of controlling shareholders, a less competitive market for corporate control and top managers and a (still) modest role of institutional investors did not seem necessarily detrimental as it was supposed to ensure stability. Similarly, issues arising from the role of the State both as owner and rule maker were less emphasized as many financial firms needed massive equity injections from taxpayers for their bailout.

However, the view that the financial crisis can be in part attributed to failures and weaknesses in corporate governance arrangements was shared by a number of key policy makers in the banking sector, such as the *UK Financial Services Authority*, the *Committee of European Banking Supervisors*, the *United States Department of the Treasury*, etc. To be sure, during the ‘acute phase’ of the financial crisis, ensuring sound systems of executive compensation was mainly considered an issue for financial institutions that were being rescued by government-sponsored bail-out plans. After the first G20 meeting in Washington D.C. on 15 November 2008, an Action Plan setting out ‘high priority actions to be completed prior to March 31, 2009’ and requesting Finance Ministers to formulate additional recommendations was published. It focused on identifying sources of systemic risk, integrating financial supervision, strengthening the capacity to react to crisis and “reviewing compensation practices as they relate to incentives for risk-taking and innovation”.

The Basel Committee worked extensively on this issue and set up specific (and more compelling) rules on compensation practices for financial firms. In November 2008 it started a consultation process to update the Basel II Framework which, under ‘sound compensation practices’ endorses the FSF’s ‘Principles for Sound Compensation Practices’. The Financial Stability Forum (FSF, meanwhile strengthened to implement G20 deliberations and renamed Financial Stability Board, FSB) later published “Principles for Sound Compensation Practices for financial institutions to prevent incentives towards excessive risk-taking that may arise from compensation schemes” (FSF, 2009b). These principles have been followed by a set of Implementation Standards which provide more specific guidance on compensation governance, structure and disclosure.

It soon became clear that ensuring better alignment of shareholders’ and corporate directors’ incentives through well-designed compensation packages was also a more general problem involving non-financial companies. Introducing a mandatory regime for board remuneration was then the key corporate governance reform introduced both in the EU and in the US for financial and non-financial firms. As for the US, a comprehensive financial regulatory reform, entitled “Dodd-Frank Wall Street Reform and Consumer Protection Act”, was enacted on 21 July 2010. It included not only executive compensation but also investor protection and hedge fund and credit rating provisions.

The Dodd–Frank Wall Street Reform and Consumer Protection Act envisaged rules applicable to all public companies, including the authorization of the SEC to grant shareholders access to companies’ proxy materials to nominate directors, the requirement for an annual ‘say on pay’ vote at listed companies’ annual general meetings (AGMs) and the introduction of stricter independence standards for directors serving on compensation committees. More stringent rules have been directed to certain bank and non-bank financial institutions, including the establishment of risk committees and provisions for ‘clawback’ of bonuses.

Similar provisions were also implemented in Europe. In late 2008 the CEBS formed a task force to develop principles for sound remuneration on behalf of all three European committees (CEBS, CEIOPS and CESR, later strengthened and transformed into EBA, EIOPA and ESMA). Following a consultation period, the final draft of these principles was released on 20 April 2009. It addressed both banks and regulating authorities within the EU, focusing on the alignment of company and individual objective, transparency towards internal and external stakeholders, governance with respect to oversight and decision-making, performance measurement and form, or structure, of remuneration.

On 29 April 2009 the European Commission announced that it would issue two recommendations on executive compensation for member states to incorporate into national laws: one related to financial institutions and the other to all listed companies. Rules relating to financial institutions were organized according to five themes: a) structure of remuneration policy; b) performance measurement; c) governance of the pay-setting process and internal oversight over pay awards; d) enhanced disclosures of the pay-setting process and remuneration policy, including details of performance criteria; and e) regulatory oversight, with the last three issues being applicable also to non-financial institutions.

To summarize, in the aftermath of the 2008-2010 financial crisis the international debate on corporate governance has been concentrated on executive compensations in financial and non financial institutions. However, once the exceptional circumstances of the last few years will be over, there will be a need to go back to the overall system of corporate governance as a booster of competition and value creation which are the essential drivers of economic growth. A system of institutional and market mechanisms that allow shareholders to minimize the risk of management inefficiency, shirking or fraud is a prerequisite of attracting investments and fostering growth through the stock exchange. The EU and Italy have already done some steps in this direction.

1. **Corporate governance and the equity market in Italy**

The equity market has always played a modest role in Italy, which is a bank-based economy. In the last decade stock markets undergone a further contraction, only partially explained by unfavorable macroeconomic conditions. In particular, between 2001 and 2012 the number of Italian listed companies remained less than 300 and the proportion of capitalization to GDP almost halved (from 47 to approximately 22 per cent); dividends (and repurchase of own shares) amounted to more than capital increases and every year resources of an average 15.8 per cent of capitalization were returned to shareholders. Despite the real economy is by and large sound, the potential of attraction of the Italian economic system is still too low compared with that of its peers.

On the supply side, the undersizing of the Italian stock exchange is rooted in the structural fragmentation of our productive system into a very high number of small and medium enterprises (SMEs).

Due to its high number of dynamic SMEs, Italy has one of the largest manufacturing industries in the Euro-area. With a 16% share, it is the third largest in real terms (just behind France with 17%). Most firms are export-oriented. Italian foodstuffs, clothing and furniture are known globally, but their engineering products, chemical and petrochemical industry, and motor vehicles are also top sellers. Top exports are represented by pharmaceuticals, basic metals, electronics and mechanical engineering products. Italy’s trade is highly diversified across partners and the trade balance is positive with respect to developed North America countries and Western Asia countries.

In spite of their vitality, few Italian SMEs are able to make the dimensional leap that would allow them to explore new markets and exploit new business opportunities. In fact, they are reluctant to go public, because they are too small to cope with the fixed costs associated with listing and are not willing to accept greater transparency and contestability. In addition, the development of trading platforms dedicated to medium-sized enterprises is unsatisfactory. Many dynamic and profitable medium enterprises can meet their financial needs only by resorting to bank finance, because of the obstacles they face to access to financial markets.

It is well known, however, that the current euro-area crisis and the new rules laid down by Basel III introducing more stringent capital requirements for credit risk inevitably entail a credit rationing, above all in relation to the most risky and innovative enterprises. Expanding the role of the equity market is therefore a priority. The role of institutional investors, still too weak, will be crucial. Only specialized investors, in particular those specialized in seed and venture capital, are able to adequately diversify and consequently absorb the physiological default rate that inevitably characterizes the most innovative projects.

On the demand side, a traditional weakness of the Italian market is rooted in the limited size of the asset management industry and other institutional investors in the equity market such as pension funds. The monitoring role these actors are able to exercise across the globe is consequently impaired and investor protection is essentially entrusted to regulation. In this framework, corporate governance rules can play a very significant (positive) role in fostering domestic and foreign equity investments, by reducing the risk of frauds and exploitation of minority shareholders. These latter, in turn, can boost the country's economy in terms of employment growth, formation of the human capital, technological and organizational innovation.

Consob is working for the development of the equity market by acting both on the supply side, by reducing the regulatory costs that may discourage firms from going public, and on the demand side, by stimulating the inflow of investments to the stock exchange through a sound system of safeguards for minorities. Consob’s efforts are aimed at seeking an effective balance between cutting the cost of red tape for supervised firms and granting protection to investors. However, not all Italian rules on corporate governance are designed at the domestic level as they increasingly descend from European directives.

**4. Corporate governance rules in Italy and in Europe**

At the EU level, since the advent of the Financial Services Action Plan, the rules laid down to protect minority shareholders have undergone significant innovations to make the market more attractive to investors. A number of regulations relating to protection of minorities have been adapted from the more advanced common law systems. For example, with the Shareholder Rights Directive, participation in corporate decisions has been made easier, making the convocation of shareholders' general meetings and exercising voting rights easier. Changes in the area of directors’ remuneration, which I mentioned before, constitute another piece of a regulatory mosaic which aims to increase the transparency of listed companies and to govern their conflicts of interest.

Shareholder communication with the board of directors is gaining vital importance in corporate governance practices across Europe as investors (and in particular institutional investors) demand an increasing say in firm decisions. The EU Green Paper recognize the important role of shareholders, focusing on possible measures to take in order to encourage active shareholders’ participation and to realize a more efficient corporate governance system.

The new EU rules on shareholder meetings, resulting from the implementation of the Shareholder Rights Directive pursue two aims: enhancing shareholders’ rights in listed companies and tackling hindrances to cross-border voting. In order to do this, different provisions are provided.

First of all, it enhanced investor engagement by ensuring that shareholders are able to cast informed votes at the general meeting, having the sufficient time to consider the relevant information and documents. Secondly, the directive introduces the right to pull items on the agenda and to table draft resolutions. These rights have traditionally been recognized across major European countries. However, the actual exercise of these rights has often been subject to limitations, reducing their impact on corporate practices. Third, it introduces the right to ask questions on agenda items for every shareholder and the duty of the firm to answer. Fourth, it make it easier proxy appointment, stating that a proxy may even be given to an individual who has a conflict of interest, including, for instance, members of management or control bodies of the company of companies, under certain disclosure obligations. Finally, shareholders are not any more forced to keep their shares in the last few days before the AGM.

To assess the effectiveness of current rules and the need for further improvement, two EU Green Papers on corporate governance (for financial and non-financial firms, respectively) have recently been published.

At the national level, recent reforms regarded the board structure, tackling in particular the traditional issues of interlocking directorships and gender quotas, while a specific novelty of Italy was the regulation on related party transactions.

**1.** Let me consider the first mechanism. The **board of directors** is the central body of corporate governance as it can challenge executive management. It has the primary responsibility for determining and pursuing the strategic objectives of the issuer and has a vital part to play in the development of responsible companies. Its effectiveness crucially depends on its composition. The recent EU Green Paper on Corporate Governance has emphasized the role of the board and in particular of its chairperson and non-executive members. Non-executives’ diversity of views, gender, skills and professional experiences (as well as time availability and - consequently - remuneration) is considered as the key to enhance their supervisory role.

1.1 Many regulatory efforts have concentrated on the issue of **independence** of the board. Many countries have introduced requirements that a minimum fraction of the board be composed by independent directors. The rationale behind these regulations is that if directors are not dependent on the main shareholder (in continental countries) or on the CEO (in the others), they are more likely to defend shareholders’ interests and to express independent judgments.

In Italy the role of the independent director has been introduced by the Corporate Governance Code in the 1999. In the 2005, following the famous Cirio and Parmalat scandals, also the law introduced a provision related to independent directors, requiring that at least one member of the board (or two, if board size is higher than seven) has to be “independent”, according to the law definition.

1.2 Another relevant provision related to board composition concerns the role of **directors appointed by minorities**. The process leading to board election is a key issue in corporate governance, and has come in the spotlight after the financial crisis. Italian regulation in this field is unique and has been mentioned by the EU commission in the Green Paper on corporate governance as a possible leading example. Since 2007 all listed companies are required to reserve at least one board seat to minority candidates. Hence, also shareholders with a small stake (i.e. minority shareholders) can present a slate and appoint a director. The rationale behind this provision is clear. A minority director can pursue the interests of all shareholders different from the controlling one better than any other director.

1.3 A widespread phenomenon which could undermine the effectiveness of board functioning is the **interlocking directorship**, defined as a situation in which a person affiliated with one organization sits on the board of directors of another organization. Two are the main negative consequences of this phenomenon. First, interlocking can reduce the monitoring effort exercised by the board because directors are busy; second, interlocking may foster collusion, either in the product market, to the detriment of competition and consumers, and in the takeover market, where interlocked firms help each other to prevent unwanted acquisitions. Despite criticisms interlocking directorates are diffused all around the world, as documented by a growing literature.

In order to limit the phenomenon, the government has recently introduced a provision expressly prohibiting interlocking directorship in the financial industry. The prohibition applies to holders of a seat in managerial, supervisory and control bodies as well as officers charged with managerial duties in companies or group of companies active in the banking, insurance and financial markets that hold, or exercise, similar offices in companies or group of companies active in the same products and geographic markets.

1.4 Least but not last, let me mention the provisions related to **gender quotas**. The importance of diversity in corporate boards has been extensively shown in the empirical literature, which has tried to measure the effects of female representation on the adoption of good governance practices. A wider representation has been found to be associated with stronger attention to the handling of conflict of interests, with a higher use of search consultants, higher board attendance, higher number of board meetings and a more frequent use of pay linked to performance.

The gender diversity issue is now also driving a policy debate which is leading a number of European countries to introduce some kind of compulsory quotas. After the leading example of Norway, gender quotas are currently on the agenda of rule makers around the world who aim at addressing the scant progress in increasing female representation.

**2.** Let me secondly focus on the issue of **related party transactions**.

Agency problems and tunneling are traditional features of corporate governance in Italy. In a system of concentrated ownership, majority shareholders have both the incentives and the means to monitor managers but they also face the temptation to extract private benefits of control to the detriment of minorities. Bilateral transactions between the company and its controlling agent, generally referred to as self-dealing, raise major concerns for minority protection in that the transfer price could favor the controlling or related party at the expense of outside investors. A new regulation on related party transactions has been in force in Italy since the beginning of 2011.

The new rules cover both RPTs disclosure and their approval, by defining the procedural steps that companies must take to ensure RPTs fairness. The disclosure and procedural requirements are differentiated depending on the transaction’s magnitude, i.e. its materiality. While a general procedure is envisaged for RPTs, stricter approval requirements are to be followed when the transaction is material. Both procedures rely on independent directors as the primary gatekeepers in charge of ensuring the RPTs’ fairness.

**5. Conclusion**

As I mentioned at the beginning, corporate governance can play a very significant role in the development of equity markets. If minority shareholders are adequately protected, savings flow to businesses through the stock exchange, and share ownership broadens. Consob aims at easing the development of the Italian equity market by enhancing investor protection and minority rights. At the same time, Consob is aware that reducing unnecessary regulatory burdens is vital. While increasing consumers’ confidence in the financial market is the key to foster their demand for equity, cutting the red tape is crucial if we want to provide companies with the appropriate incentives to go public.

Last year Consob faced these challenges through an ad hoc working group that I personally chaired. Open to all relevant stakeholders, it aimed at reducing to the minimum all the unnecessary burdens that were accumulated in past streams of regulation. As a result of this process, the Italian financial markets regulation is now perfectly in line with minimum EU standards (i.e. it refrains from gold-plating EU law) while it concentrates further efforts in few key areas where the Italian market characteristics require enhanced investor protection. I believe an appropriate balance of investor protection and essential regulation is the best way for welcoming and encourage Italian businesses and foreign investments.