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**DEVELOPMENTS AND CRITICAL ISSUES OF CORPORATE GOVERNANCE IN ITALY**

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**INTRODUCTION**

A summary of the most significant amendments to the Corporate Governance Code for Italian listed companies (the “Code”) approved on July 9, 2015 by the Corporate Governance Committee seated at the Italian Stock Exchange (the Committee)<sup>1</sup> is indicated herein. Main grey areas remained uncovered from such changes and certain critical issues are briefly illustrated as well.

The Code constitutes the main source of soft law in the area of corporate governance for Italian listed companies (and for unlisted companies as well) and has proven inspirational to several legislative reforms of the Italian corporate law.

Adherence to the Code (or any other corporate governance code) by Italian listed companies is voluntary and based on the so-called “comply or explain” principle<sup>2</sup>. For companies adhering to the Code, the changes (with the exclusion of changes regarding the statutory auditors, which listed companies are invited to apply since the first renewal of the Board of Statutory Auditors occurring after the fiscal year beginning in 2015) should be implemented by listed companies by the end of the fiscal year beginning in 2016, providing information about such implementation in the corporate governance report to be published in the following fiscal year.

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<sup>1</sup> The Committee, with seat at Borsa Italiana S.p.A., Milan, Piazza Affari 6 (the Italian Stock Exchange), was set up, in its current composition, in June 2011 on the initiative of the main Italian associations representing corporations and institutional investors (ABI, ANIA, Assonime, Confindustria, Assogestioni) and Borsa Italiana S.p.A. and it is composed of representatives of the promoters above and Italian listed companies.

The Committee is in charge of promoting good corporate governance of Italian listed companies, pursued by a constant alignment of the Code with best practices and through initiatives which would enhance the credibility of the Code.

<sup>2</sup> As provided pursuant to Directive 2013/34/EU and Article 123-bis of the Consolidated Law on Finance (*i.e.*, Legislative Decree No. 58 of 24 February 1998, as subsequently amended), each listed company is required to include a “corporate governance statement” in its annual management report, indicating “*the corporate governance code which the undertaking may have voluntarily decided to apply*”. In case a listed company decides to depart from any provision of the corporate governance code to which it voluntarily adhered, it should provide a clear and exhaustive explanation thereof. A listed company should also adequately explain its decision not to adhere to any corporate governance code (see Article 20 of EU Directive 2013/34/EU; see also the Commission Recommendation of April 9, 2014 “*on the quality of corporate governance reporting (“comply or explain”)*”).

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The aforementioned amendments assimilate the recommendations provided in the second annual report of the Committee on the application of the Code, published on December 11, 2014 (the 2014 Report)<sup>3</sup>, and introduce certain principles on corporate social responsibility and whistleblowing.

## AMENDMENTS

The main amendments of the Code concern the following matters:

- increased attention by the Board of Directors to the risks that may affect the company's business in the medium-long term perspective and to induction sessions;
- reiteration of the recommendation to independent directors to hold separate and periodic meetings;
- recommendation to draft minutes of each committee's meetings and focus on the corporate social responsibility;
- role of the nomination committee when the Board of Directors submits a slate for the renewal of the Board;
- strengthening of the internal control and risk management systems in line with the best practices and the most recent whistleblowing provisions set out by Regulation (EU) No. 596/2014 on market abuse (so-called MAR) and Directive No. 2013/36/EU on prudential supervision and capital requirements of banks and credit institutions (so-called CRD IV);
- disclosure of the results of the verification of the independence requirements and remuneration criteria of statutory auditors.

### 1. Role of the Board of Directors

The Committee extends the role of the Board of Directors in relation to the sustainability of the business. In particular, the Board of Directors has to define the risk profile of the company consistently with the company's strategic objectives, considering the risks that may be relevant for the sustainability of the company's business activities in the medium-long term<sup>4</sup>.

The new provision expands the principle set out in Article 1 of the Code, whereby the Board of Directors has to pursue the overarching goal of *"creating value for the shareholders over a medium-long term period"*<sup>5</sup>.

On the other hand, the new provision includes, among the interests that the Board should take care of, the principle of sustainability, in compliance with the most recent European legislation<sup>6</sup>. This new provision also seems to suggest that sustainability matters (such as environmental matters, social and

<sup>3</sup> The 2014 Report is available on the Italian Stock Exchange's website: <http://www.borsaitaliana.it/comitato-corporate-governance/comitato/annualr2014.en.pdf>

<sup>4</sup> Criterion 1.C.1, letter b), of the Code.

<sup>5</sup> Principle 1.P.2 of the Code.

<sup>6</sup> Reference is especially made to Directive 2014/95/EU of 22 October 2014, providing new disclosure obligations for larger undertakings on *"non-financial information"* - and in particular on environmental, social and employee matters, respect of human rights, anti-corruption and bribery matters - and information on diversity policies.

employee-related matters, human rights concerns, anticorruption and bribery matters)<sup>7</sup> may have a relevant impact on the business and should be considered in the definition of the risk profile and strategic objectives of a company.

The Comment to Article 1 of the Code (contained in the Code) further develops this concept, highlighting “*the essential role of the Board of Directors in evaluating the actual functioning of the internal control system and the management of any risk that may affect the sustainability of the issuer’s business in a medium-long term perspective*”.

## **2. Composition of the Board of Directors**

The Committee recommends that the corporate governance report (to be prepared by listed companies’ directors jointly with the management report and the financial statement) should state the type and the organizational methods of any initiatives which occurred during the relevant fiscal year with regard to the induction sessions dedicated to directors and statutory auditors, which should be periodically organized by the chairman.

Such initiatives, in addition to providing the directors and the statutory auditors with an appropriate knowledge of the company’s business sector, corporate dynamics, development, and the relevant regulatory and self-regulatory frameworks, should also address appropriate risk management principles (Criterion 2.C.2).

## **3. Independent Directors**

The Committee expands and clarifies the recommendation according to which the independent directors meet at least once a year separately from the other directors (Criterion 3.C.6).

## **4. Establishment and Functioning of the Internal Committees of the Board of Directors**

The Committee also adds two new recommendations within the general recommendations on the establishment, composition and functioning of the internal committees of the Board of Directors.

First, the recommendation that meetings of committees be recorded with specific minutes has been integrated with the recommendation that the chairman should provide information to the board of directors regarding aforementioned recording at the first available meeting (see Criterion 4.C.1).

The second and more relevant amendment concerns the recommendation that the Boards of Directors of companies listed on the FTSE MIB index<sup>8</sup> evaluate the opportunity to establish a committee in charge of matters regarding the corporate social responsibility (see the Comment section of Article 4). The sustainability issues related to the business activities of the company and its interaction dynamics with all its stakeholders would be supervised by this committee. As an alternative to the creation of a dedicated

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<sup>7</sup> See Whereas 6 of Directive 2014/95/EU of 22 October 2014.

<sup>8</sup> The FTSE-MIB is the primary benchmark index for the Italian equity markets, comprising 40 shares listed on the Italian Stock Exchange and capturing approximately 80% of the domestic market capitalization. The Index is comprised of highly liquid, leading companies in Italy.

committee, the Board of Directors may choose whether to group or to assign the tasks above to the other established committees, most significantly the Internal Control and Risk Committee<sup>9</sup>.

This second recommendation is not subject to the “comply or explain” principle, as it is included in the Comment section of the Code<sup>10</sup>.

## 5. Appointment of Directors

Under Italian law the Board of Directors of Italian listed companies governed by the so-called “traditional” governance mechanism is appointed by the shareholders, pursuant to a voting-list mechanism, which is intended to grant to the minority shareholders at least a representative on the Board. The voting-list mechanism, including the right to present a list of candidates, is regulated by each company’s by-laws.

Normally, the lists of candidates are presented by the shareholders. However, according to some scholars, the Board of Directors in office may decide to present a list of candidates to be voted by the shareholders<sup>11</sup>. Indeed, the aforementioned right of the Board may help to simplify the coordination problems of minority shareholders in companies with a dispersed ownership.

This interpretative position is not clearly supported by the Code. However, in the Comment to Article 5, we read that the Committee highlights the importance of an engagement of the nomination committee *“in case the Board itself, as far as it is consistent with applicable law, submits a slate for the renewal of the Board”*.

Furthermore, the Committee also recommends that, if the listed company has adopted a plan for the executive directors’ succession, the plan’s procedure should clearly outline the plan’s scope, instruments and timeline.

## 7. Internal Control and Risk Management System

The Committee also passed changes regarding the system of internal control and risk management, which significantly strengthen the effectiveness of internal controls.

In particular, the revised Article 7 of the Code now explains that an effective system of internal controls and risk management contributes to the reliability of the information provided to the corporate bodies and not only of the publicly disclosed financial information<sup>12</sup>. Particularly, this provision includes the

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<sup>9</sup> For an analysis of the application of the corporate social responsibility principle by Italian listed companies, please see the research *“C.d.A. e politiche di sostenibilità. Come sostenibilità e CSR entrano nell’agenda dei consigli di amministrazione delle imprese quotate italiane”*, promoted by CSR Manager Network, in collaboration with Assonime and Nedcommunity, conducted between May 2013 and May 2014 with the research team of Alta Scuola Impresa and Società (ALTIS) of the Università Cattolica del Sacro Cuore.

<sup>10</sup> However, since the sustainability matters should be included in the definition of the risk profile of each company pursuant to the new Criterion 1.C.1, letter b), of the Code, the Board of each company should reasonably supervise such sustainability matters (if appropriate, with the support of the Control and Risk Committee).

<sup>11</sup> See for instance Stella-Richter, *Gli adeguamenti degli statuti delle società con azioni quotate dopo il D.Lgs. 303/2006*, in *Consiglio Nazionale del Notariato*, Studio n. 19-2007/I. However, this opinion is not shared by the Assonime, Circular no. 12 of 12 April 2006. On the pitfalls of Italian law on the voting-list mechanism and possible prospective reforms see also Enriques-Zingales, *Il voto di lista non basta nei big a capitale diffuso*, *Il Sole 24 Ore*, 21 Maggio 2015 and Marchetti-Ventoruzzo, *Ecco come si può rafforzare il voto di lista*, *Il Sole 24 Ore*, 2 giugno 2015.

<sup>12</sup> Principle 7.P.2 of the Code.

reliability of the internal flow of information among the core tasks of an effective system of internal control and risk management. Consequently, the Board should ensure the reliability and effectiveness of the internal flow of information and take prompt actions in the event of any circumstances that may prevent or question the reliability of the internal flow of information.

In critical situations, the reliability of the internal information channels and of the information provided to the Board of Directors is vital. In this regard, in the Comment to Article 1, the Code provides the following: *“under relevant circumstances, the Board of Directors acquires any necessary information and adopt any suitable measure to protect the company and the information to the market”*.

The new wording in the Code confirms that it is the directors’ duty to act in an informed manner (*i.e.*, to satisfy themselves that they have all the information that is necessary to take action) and to adopt appropriate remedial actions to protect the company and ensure that the markets are adequately informed.

The Control and Risk Committee<sup>13</sup> appointed within the Board may assist the Board in this respect. In fact, the Control and Risk Committee *“supports, with adequate preliminary activities, the Board of Directors’ assessments and resolutions on the management of risks arising from detrimental facts that the Board may have become aware of”*<sup>14</sup>.

The aforementioned amendment represents an important development as, pursuant to the Code, the Control and Risk Committee is composed by a majority, or exclusively, of independent directors<sup>15</sup>. Basically, such provision means that, in some circumstances that may potentially impact the company (the so-called “detrimental facts”) in a negatively way, the Board of Directors may benefit from the support of a committee that can assess the circumstances and the potential remedial actions with the highest degree of independence.

According to the provisions of the Code, each company should provide for the coordination of the corporate bodies and functions with specific tasks in the context of the system of internal control and risk management *“in order to enhance the efficiency of the internal control and risk management system and reduce activities overlapping”*. In order to reinforce this provision, the Code now requires each company to describe in its annual Corporate Governance Report the instruments adopted to ensure the coordination among the corporate bodies and functions responsible for the system of internal control and risk management<sup>16</sup>. Among these corporate functions, Comment to Article 7 of the Code now mentions the legal and compliance functions, *“with particular regard to the management of legal and non-compliance risks, including the risk that crimes are committed against, or in the interest of, the company”*.

This provision is worth mentioning also because, by referring to crimes potentially committed against (as opposed in) the interest of the company, it clearly signals that legal and non-compliance risks go beyond

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<sup>13</sup> According to Principle 7.P.3. letter (ii) of the Code, the Board of Directors shall identify within the Board *“a control and risk committee [...] to be charged with the task of supporting, on the basis of an adequate control process, the evaluations and decisions to be made by the Board of Directors in relation to the internal control and risk management system, as well as to the approval of the periodical financial reports”*.

<sup>14</sup> Criterion 1.C.2, letter g) of the Code.

<sup>15</sup> Pursuant to principle 7.P.4 of the Code, *“The Control and Risk Committee is made up of independent directors. Alternatively, the committee can be composed of non-executive directors, the majority of which being independent; in this latter case, the chairman of the committee is selected among the independent directors. If an issuer is controlled by another listed company or is subject to the direction and coordination activity of another company, the committee shall be made up exclusively of independent directors”*.

<sup>16</sup> Criterion 7.C.1, letter d) of the Code.

the crimes for which the company can be held liable under Legislative Decree No.231 of 2001 on the *quasi-criminal* liability of corporations<sup>17</sup>.

In the Comment to Article 7, the Code provides that an adequate internal control and risk management system - at least in the most significant companies (*i.e.*, companies included in the FTSE-MIB index) - should include a so-called “whistleblowing” system, consistently with domestic and international best practices and ensuring “*a specific and confidential communication channel as well as the anonymity of the reporting person*”. Since this provision is included in the Comment of the Code, it is presented as a reasonable interpretation of the flexible concept of “adequate” system of internal control and risk management, which may influence the interpretation of Italian courts on this regard. In fact, according to Italian law, the executive directors have a duty to assess the adequacy of the organizational, administrative and audit system of the company, which also include the system of internal control and risk management.

## 8. Statutory Auditors

The last amendments to the Code approved by the Committee concern the recommendations applicable to statutory auditors.

Pursuant to the “traditional” governance structure of Italian joint stock corporations, the shareholders appoint a Board of Statutory Auditors, vested with wide monitoring responsibilities within the supervisory system of a company.

According to the amendments passed by the Committee, the results of the verification of the independence requirements of the statutory auditors, to be performed after their appointment and subsequently on an annual basis, shall be submitted to the Board of Directors. The Board will then disclose such results through a press release to the market relating to the first verification conducted after the first appointment and in the relevant corporate governance report with reference to the annual verification (Criterion 8.C.1.).

Moreover, the Code now provides a new remuneration criteria, since the compensation of the member of the Board of Statutory Auditors was not proportionate to their wide spectrum of responsibilities and potential liabilities. In consideration of this, in line with the recommendations already set forth for directors’ remuneration, the Code now states that the remuneration of statutory auditors should be proportionate to the commitment required from each of them, to the importance of their office and to the size and business sector of the company (Criterion 8.C.3.).

### CRITICAL ISSUES

The recent amendments to the Code mainly focus on the area of risks, with an emphasis on the risks that can affect the sustainability of a company. However, some questions remain still open.

**(i)** Italian companies, both listed and unlisted ones, have not had the possibility to choose among alternative governance systems (one-tier “monistico” and two-tier board “dualistico”), mainly due to the lack of an adequate regulatory framework, which could provide both autonomous and clear rules for such alternative systems.

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<sup>17</sup> Legislative Decree No.231 of 2001, as subsequently amended, provides for the responsibility of the company for crimes committed by its directors and employees in the interest of the company.

As a result, almost all listed companies resort to adopting the “traditional” system (based on the supervision by the Board of Statutory Auditors), a rare one, largely unknown to most institutional investors. Moreover, after the 2003 reform on internal corporate controls, a flow of chaotic laws created an excess of bodies all responsible for the implementation of internal controls (*i.e.* risk management committee, compliance function, internal audit committee).

This implied duplications of tasks as well as potential inefficiencies, also producing huge and unnecessary compliance costs for the listed companies. Therefore, the adoption of an organic reform for the simplification of the internal control systems would be opportune.

**(ii)** A second issue of the Italian corporate governance system relates to slate voting.

As mentioned above, with reference to the amendments to Article 5 of the Code, in the Italian system, minority shareholders are allowed to nominate directors in the Board of Directors. This is a standard mechanism made mandatory in order to ensure both Board monitoring and the protection of shareholders against expropriation.

This system seems to have one big advantage: its great simplicity and straightforwardness, which make its possible outcomes reasonably predictable.

However, list voting is in no way a guarantee of perfect governance. In particular, it seems that one or two minority directors are not sufficient, at least when the board counts 12 or more members. A more substantial representation of minority investors might be preferable.

Moreover, compensation packages of independent and minority directors, in certain corporations, are not sufficient. The sheer amount might appear significant, even generous, but if we make a serious calculation just in terms of hours that a dedicated board member devotes to the job, the amount per hour becomes quite low, especially if we factor in the responsibilities and the undeniable reputational and economic risks associated with these positions. I believe that, in order to cut costs, smaller boards with more motivated and invested directors not serving on multiple boards would be more efficient.

**(iii)** A third critical issue in Italian corporate governance relates to the issuance of multiple voting shares (“true” multiple voting shares<sup>18</sup> and loyalty shares<sup>19</sup>). The Italian Government has rightly introduced this big change in our corporate law, following suggestions made by Consob<sup>20</sup> along with other proposals, fostering the development of our stock exchange<sup>21</sup>.

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<sup>18</sup> According to Article 2351 of the Italian Civil Code, both listed and unlisted companies have the possibility to issue shares carrying more than one vote, up to a maximum of three votes. Nevertheless, some restrictions on issuing such shares in listed companies are provided for by the Consolidated Law on Finance (on this issue, see footnote 21).

<sup>19</sup> According to Article 127-quinquies, paragraph 1 of the Consolidated Law on Finance “*the Articles of association may specify that increased voting rights may be attributed, up to a maximum of two votes, for each share belonging to the same subject for an uninterrupted period of no less than twenty-four months starting from the date of registration contemplated by subsection 2. In such a case, the Articles of association may also contemplate that the subject holding the voting right may irrevocably renounce, all or part, the increased votes*”.

<sup>20</sup> The Commissione Nazionale per le Società e la Borsa (CONSOB) is the public authority responsible for regulating the Italian financial markets. Its activity is aimed at the protection of the investing public and consists in conducting investigations with respect to potential infringements of insider dealing and market manipulation law.

<sup>21</sup> Article 127-sexies, paragraph 1 of the Consolidated Law on Finance applying to listed companies provides for as follows: “*1. In derogation from Article 2351, section four, of the Italian Civil Code, the Articles of association cannot contemplate the issue of multiple-voting shares.*

*2. Multiple-voting shares issued before the start of trading on a regulated market maintain their features and rights. Unless specified otherwise by the Articles of association, in order to maintain unaltered the ratio between the various share categories, companies which have issued multiple-voting*

The possibility of issuing multiple-voting shares will effectively encourage initial public offering, as it gives greater freedom to entrepreneurs to decide for the optimal ownership structure, balancing the trade-off between control and capital raised on the market.

Loyalty shares are a very positive innovation as well: they are a tool to encourage long-term investment and, consequently, the presence of stable investors with greater monitoring power and less propensity towards short-termism. This would reduce share price volatility and consequently increase market efficiency. So far, loyalty shares have been more successful than multiple voting shares.

**(iv)** Another significant issue to be observed (not regulated so far under Italian law) relates to the possibility to set up hold harmless (or indemnity) covenants to protect directors (and Statutory Auditors) against actions initiated by the company managed (or controlled) by them, company's shareholders or any third party, in relation to the activities carried out by directors (or Statutory Auditors) in their office.

Under Italian law such covenants are not specifically envisaged in the Civil Code, nor in any other law or regulation, whilst they are qualified atypical guarantees to be considered valid in case interests worthy of protection are pursued under Articles 1322 (Freedom of contract), 1343 (Unlawful consideration) and 1418 (Causes of nullity of the contract) of the Italian Civil Code.

Therefore, in the Italian system, it is firstly necessary to ascertain if limits of public policy exist to the eligibility of atypical guarantees (or atypical contracts / hold harmless covenants). To this regards, it is commonly accepted that it is contrary to the public policy only the covenant to indemnify a party from damages deriving from its willful misconduct (or damages related to intentional abuse). As a consequence, a valid hold harmless covenant may be entered into in all cases in which a guarantor assumes damages or liabilities arising from negligent or grossly negligent actions of the guaranteed towards third parties.

With respect, however, to the breach of administrative provisions of law, it has to be noted that, in application of secondary legislation that regulates the insurance sector, it is not valid any form of indemnity to cover risks relating to the imposition of administrative fines. This is because such an indemnity agreement would deprive the power of reaction of the State towards the administrative offenses provided for by provisions for the protection of the public interest. Nevertheless, an exception to this principle is made by fiscal rules, by which for cases of infringement carried out without fraud or gross negligence, the individual, the company, the association or the entity may assume the debt of the person (director) responsible of the infringement (usually, the CEO or the director charged with the responsibility of Tax compliance)<sup>22</sup>.

An important aspect for the purposes of setting up a valid hold harmless covenant is represented by providing for a determined or determinable object. In fact, it could be argued that a wide hold harmless covenant - with no indication of a specific event or behavior from which future liability might arise - may

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*shares or companies resulting from the merger or spin-off of such companies may issue multiple-voting shares with the same features and rights of those already issued only in the following cases:*

*a) a share capital increase pursuant to Article 2442 of the Italian Civil Code or by new conferments without excluding or limiting option rights;*

*b) merger or spin-off.*

*3. In the case contemplated by section 2, the Articles of association may not contemplate further increases in voting rights in favour of single share categories nor pursuant to Article 127-quinquies.*

*4. If the company does not take avail of the faculty of issuing new multiple-voting shares pursuant to the second sentence of section 2, there is no need for approval of the resolutions, pursuant to Article 2376 of the Italian Civil Code, on the part of the Special Meeting of the holders of the multiple-voting shares<sup>22</sup>.*

<sup>22</sup> See Article 11, section 6 of the Legislative Decree December 18, 1997, no. 472, as subsequently amended.

