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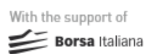

In cooperation with

The role of Italian companies' boards in the age of disruptive innovation

(Remarks by Luca Enriques at the Italian Corporate Governance Conference 2016, Milan, 2 December 2016)

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1. Introduction

A cynic will tell you that the two main functions of boards are, first, to act as a marketing tool to sell the company and its management team to outside investors; and, second, to engage in periodic self-evaluation.

You don't have to be that much of a cynic to agree that this conference serves the same two functions at a country level. It is a way to showcase the state of corporate governance in Italy. And it is a way to reflect upon its performance and to see whether it can do even better.

My introduction to the discussion will lean more on the side of self-evaluation. I will give you a few thoughts on what functions boards perform, what forms the dialogue with shareholders takes, how boards are composed and whether there is room for improvement.

To start with, what is corporate governance about?

Nowadays, the essential function of corporate governance is to ensure fruitful cooperation and mutual trust between outside investors and insiders. Outside investors have a necessarily standardized view of portfolio companies, based as it is on (a) publicly available information, (b) the signals that come from stock market prices and (c) analysts' reports building upon comparisons with similar companies. Insiders, in turn, which means top managers and often, in Italy, dominant shareholders, have their own idiosyncratic and entrepreneurial vision about the company and its future, which may well be swayed by cognitive biases and conflicts of interest, but still is absolutely essential for the company to thrive.

Arguably, in a business world ever more dominated by disruptive innovation in all possible industries, the knowledge gap between insiders and outsiders is widening across the board. In today's economy, you can't succeed if you're not innovative. You are not innovative if you're not unique. You don't stay innovative if, to retain your competitive advantage, you are not somewhat secretive about your plans and strategies. Very often, to stay competitive, you have to purchase ready-made innovation by acquiring rapidly growing and potentially disruptive businesses.

The takeaway is that share prices are becoming both a rougher measure of a company's prospects, because of the difficulty of valuing pervasively disruptive innovation, and also more relevant for dominant shareholders, as important external growth opportunities may only be available via stock-for-stock acquisitions. Thanks to new opportunities to deviate from one share one vote, the curb on external growth via stock-for-stock acquisitions which comes

from dominant shareholders' desire not to lose control may today be less significant in Italy than in the past.

In such a context, the need for smooth and ongoing communication channels between outside shareholders and companies is ever greater.

2. The roles of the board

Cynicism aside, what roles do boards perform today?

Looking at international best practices, boards perform three main functions: first of all, boards manage. More precisely, as the UK corporate governance code puts it, boards are engaged in high-level management: they set strategy, they ensure leadership, and they define a company's values.

Secondly, boards monitor: as one would put it by looking at US practices, the board hires, monitors, and, as the case may be, fires the CEO. In addition, a board, or a committee thereof, is in charge where a conflict of interests arises, be it about compensation setting or conflicted transactions.

Third, according to the literature, boards mediate between shareholders and other constituencies. In the real world, however, boards are much more in the business of mediating between enterpreneurial controllers and outside share-holders. According to the UK Corporate Governance Code, engaging in a dialogue with shareholders is one of the main functions of boards.

What about Italian companies' boards functions? First of all, boards do manage, although delegation to executives is ingrained in the Civil code itself and even in the wording of the Corporate Governance code, where the board's high-level management role, unlike in the UK, is depicted rather in terms of "approving" (management) plans than as a primarily board-level function (Principle 1.C.1). Perhaps, the Italian description is more realistic, but it is definitely less expressive of authority and power as residing with the board rather than with the management.

Then, of course Italian boards also monitor: under both hard and soft law, the board has to monitor management. In addition, as a matter of Civil Code provisions, Consob regulations, and Corporate Governance recommendations, the board is the controller-in-chief of conflict of interest situations, be they, again, about conflicts of interest or compensation.

What about the board as a mediator between the insiders and the outside investors? Not only is there nothing in the law about it, but there is very little in the Corporate Governance Code.

3. The mediating role: boards' engagement with shareholders

The current international trend is one of involving boards in handling relations with shareholders on an ongoing basis. This is well reflected in the UK Corporate Governance Code. Let me quote from its Section E:

"The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place."

"[T]he chairman [who is to be independent on appointment, according to the Code: Principle A.3.1] should ensure that all directors are made aware of their major shareholders' issues and concerns." Further, "[T]he board should keep in touch with shareholder opinion in whatever ways are most practical and efficient" and "[t]he chairman should discuss governance and strategy with major shareholders." What about non-executive directors? They "should be offered the opportunity to attend scheduled meetings with major shareholders and should expect to attend meetings if requested by major shareholders." Finally, "the board should … ensure that … the non-executive directors develop an understanding of the views of major shareholders about the company, for example through direct face-to-face contact," and so on.

In Italy, the Corporate Governance Code provisions are quite different. Sure enough, the principle is there ("The Board of Directors shall endeavour to develop a continuing dialogue with the shareholders based on the understanding of their reciprocal roles"), but the implementing recommendations are quite disappointing: when it comes to them, there is a suggestion that companies appoint an investor relator (hence, by default, someone who reports to the CEO).

And then, there's a number of detailed provisions about shareholder meetings and how the dialogue should take place during them. There is nothing on the relationship between boards and shareholders outside of meetings. This is quite bizarre, because whoever has attended a shareholder meeting of an Italian company will have noticed that attendance comprises plenty of retail investors who appear to hold shares as a ticket to the buffet, a bunch of lawyers, a few consultants, and then one guy (always the same for all Italian companies) with proxies from basically all institutional investors. This guy is smart, likeable and everything, but is he really the person boards should aim to engage with?

4. Board composition

On board composition, we have witnessed three trends, one older and two newer, which have led to boards that are, first, more independent, second, more diverse, and, third, more expert.

On independence, Italy has the comparative advantage of the legal provisions mandating minority shareholder appointed directors, which allow for a counterweight to the more suspicious independence of controlling shareholder-elected independent directors.

In fact, there is plenty of anecdotal evidence, recent and less recent, of boards that are quite too ready to rubberstamp vows of independence by members nominated by dominant shareholders.

There are two good rules of thumb for predicting independence in fact, as a senior independent director of a Spanish bank noticed during an ICGN conference:

"Rule number one is that he or she must be able to maintain the same standard of living if she or he resigns from the board. The second rule is that the board member must not have a personal problem in arguing or voting against the chairman's proposals. He or she should not be a personal friend or owe any favours to the chairman."

An independence check based on these two criteria would go a long way towards ensuring effective independence. But still, it will remain true that the proof of independence is in the pudding.

Finally, even conventionally defined, the number of independent directors at Italian companies is still lower than in the jurisdictions where most institutional investors are based. It is, for sure, going up, but it is still below the 50 percent threshold as an average even for the largerst companies.

Italy fares well when it comes to gender diversity, thanks to legally mandated gender quota, but not as well on other dimensions of diversity, that may be equally important to reduce the risk of groupthink. Because they are not ready to hold board meetings in English, most Italian companies will have a hard time finding foreign candidates, which dramatically reduces the candidates' pool and boards' diversity.

Last but not least, expertise was for long neglected, but its relevance has become self-evident with the experience of banks' boards before and during the crisis.

A few months ago, I had a conversation with an English corporate goverance guru with a past as a lobbyist and as a journalist. I naively asked him whether he

held many independent directorships and his answer was, to an Italian, quite unexpected: he told me that having no prior business experience, he could not even be considered for a board position in the UK.

If that criterion had been applicable in Italy in the last twenty years, quite a few of my colleagues in academia would have never started a career as independent directors. Incidentally, we would have never had the contribution of some of the best minority directors appointed at Italian companies, so perhaps one should not be too strict, but still no prior business experience would seem to be a good predictor of a director's ineffectiveness.

And here's a problem: due to the limited pool of candidates, it may prove practically impossible to achieve at all Italian companies, a board mix that jointly ensures independence, diversity, and experience. That's a challenge that has to be taken on. To help solve it and have better composed boards, one may start by thinking of ways of increasing the role of the board in the process that leads to board elections. The current, heavily decentralized system, which relies almost exclusively on shareholders' initiative, doesn't make things easier if boards have to comprise adequate numbers of indepedents, be sufficiently diverse *and* ensure expertise.

5. Final remarks

To conclude, it appears that there is ample scope for moving forward in the direction of corporate governance practices that are more in line with the expectations of international institutional investors, especially when it comes to engagement with shareholders. This is an area where the Corporate Governance Code, which, incidentally, would greatly profit from a redraft that made it more readable, has to catch up with Italian companies' best practices; and Italian companies' best practices have themselves to catch up with international best practices.

That needs to be done both, cynically, to better sell the company and its management team to investors and as a necessary step to reduce the knowledge gap between insiders and outside investors in this age of pervasive disruptive innovation.