Corporate Governance and Value Creation: Institutionalisation of Growth Companies and SMEs

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G20 OECD Corporate Governance Forum

Introduction

Ladies and Gentlemen,

First of all, I would like to thank the organizers for inviting me to speak at the **G20 OECD Corporate Governance Forum** as Chairman of the Italian Corporate Governance Committee.

Our meeting happens at a critical time for the OECD and G20 countries: we are hopefully at the end of a financial crisis but economies in many countries are still stagnant unemployment reached unacceptable levels and people are still doubtful for the future. Companies, on their side, particularly SME face stiff financing constraints in the financial markets.

In order to invert such trends we need first to improve the institutional design towards a modern economic environment. Second we need innovation which is the engine for value creation and growth. And third to stimulate innovation we need an efficient and liquid capital market: in this sense corporate governance is a true bridge between companies, investors and the market at large.

Growth is the name of the game

Growth, as I have said, and jobs should be our priorities and our challenge. There is a need to unlock investments in European companies and infrastructures. <u>This is particularly true for SMEs, that are the backbone of the European economy</u>. So, correctly, the recent Green Paper of the European Commission on the Capital Market Union stresses the need to improve access to financing for all business but especially for SMEs, trying to increase and diversify sources of funding from investors as well as to make market more effective and efficient, linking investors to those who need funding at lower cost. This aim encompass both European and international investors all over the world.

All over the world but especially in Europe, growth is the real name of the game. And one of the countries that will particularly face this challenge is certainly Italy.

The Italian situation

In our country the medium-size enterprise sector, is increasing its global competitiveness, as indicated by many recent analyses. These firms are pursuing new business and organizational models, investing in skill and competence of their employees, increasing productivity, grasping the key value of innovation and leveraging it to compete on the world markets.

In is not a surprise therefore if in the last three years almost two thirds of the Italian industrial companies have increased their export sales, notwithstanding the strength of the Euro. Obviously if the actual weakening of the currency will persist there could be further interesting opportunities.

But we need a wider, and stronger support to our enterprises, particularly SMF from the financial and capital markets and in my opinion with the present situation of the monetary policies and of the program of the major Central Banks the question is not that much the attitude of the Bankers but rather the capacity of companies, particularly SME to present themselves with transparent and clear economic and financial statements and overall with a well built corporate governance system. I am very encouraged in that sense, because apart from my role of Chairman of Assicurazioni Generali, I am sitting on some Board of medium size companies, listed and not-listed, and I can tell that there is a very positive trend towards adopting in their governance the best internationally accepted principles.

The contribution of Corporate Governance for SMEs and growth

So let me turn now to the central theme of my analysis: the Italian situation of corporate governance, especially for SMEs and the dynamics in its recent reforms.

Corporate governance provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.

Good governance is an essential instrument for companies seeking access to capital markets and for countries that want to attract private investors. When companies are transparently governed, they will find it easier to tap capital markets and find stable investors willing to support their growth strategies.

Poor corporate governance, on the other hand, detracts from the company’s potential and can pave the way to decline. While there is not crystal-clear empirical evidence that companies performing well have an outstanding corporate governance (at least according to what is measurable), it is probably fair to say that companies performing very badly in the past had in general a poor corporate governance system.

Corporate governance plays an important role in the evolution and culture improvement of our companies. A high level of transparency and compliance with Corporate Governance Codes brings some additional expenses for our companies, it may be burdensome especially for smaller firms, but it should not be regarded as a cost but rather as an investment for the future and the long-term growth of the company.

Any corporate governance system results from a mix of mandatory rules and best practices included in Corporate Governance codes, often inspired by the OECD principles, which are different across countries.

In this respect, the Italian legal framework has been strengthened over the past years in order to ensure a high transparency level as well as a high degree of investors’ protection.

Mandatory rules applicable to listed companies are totally aligned to European Regulation and, in several cases, are more stringent than the ones in force in other European Member States. Italian laws, in fact, cover a number of issues that in other jurisdictions are only addressed by way of best practices.

In 1999, after the de-mutualisation of the Italian Stock Exchange, a Committee promoted by the main business associations and coordinated by Borsa Italiana, published the first Italian Corporate Governance Code, identifying the best practices to be followed by Italian listed companies.

The Italian Code, as many others, is based on the comply or explain principle which allows a flexible approach by issuers that can choose not to comply, in whole or in part, with some of its recommendations. This approach has been definitely implemented by the Committee during the 2014 revision of the Code: in fact, guiding principles of the Code clearly set that the decision of a company not to comply with some Code recommendations does not involve a negative evaluation, being aware that the decision not to comply may be contingent on several factors – e.g. IPO, small size of the company etc. Proportionality is embedded into the nature of the Corporate Governance Code and of the comply or explain principle. Indeed, on one hand, the comply or explain principle encourages a mature and transparent approach to individual Code's recommendations, giving company the chance not to comply with some/some part of recommendations; in this case, companies should provide an exhaustive explanation of their choice. On the other hand, some Code's recommendations are explicitly fine-tuned for SMEs in order not to discourage them to comply with some recommendations: i.e. the Code envisages the possibility to choose a simplified composition requirements in terms of independent directors, set different conditions for the appointment of a Lead Independent Director or for the institution of board committees. In this way, the Committee tries to encourage them to a progressive compliance.

Secondly, even if the Code is generally referred to listed companies, it represents a collection of national and international best practices which may be implemented by all companies, irrespective of whether they are listed of not. Starting from this assumption, we may say that the Corporate Governance Codes is already a valuable reference point for unlisted companies. Actually, a good corporate governance structure is of crucial importance for SMEs and unlisted companies, in order to increase their access to different financing channels, gain credibility with investors, and, therefore, to grow and evolve. In Italy, we have some relevant examples of high corporate governance practices in unlisted firms (e.g. establishment of board committees in Lavazza).

As to the structure of the Italian Corporate Governance Code, it is built basically on three pillars.

The ***first one is effectiveness*** of the BoD which must always be the central body of the company, in charge of the company strategy, the level of risk appetite, management control and the approval of every important operation.

The ***second pillar is independence***: the Code provides for a very detailed list of cases whereby a director (or a statutory auditor) should not be considered independent. Such cases are focused on the relationship in place not only with relevant managers of the company, but also with major shareholders, taking into account the peculiar ownership structure of most Italian companies.

The ***third pillar is accountability***: the BoD is requested to disclose to the market detailed information regarding the CG model adopted by the company and the remuneration policy applicable to executives. Internal control systems and risk management should be designed so as to ensure that management choices are consistent with the business plan and the risk profile defined by the BoD.

As to the activity of our Corporate Governance Committee, it has the crucial duty to monitor the implementation of the CG Code. Accordingly, the Committee decided to publish, starting from 2013, an Annual Report on the implementation of the Code by listed companies with reference to the previous year, following the UK Financial Reporting Council example.

Overall, I think we can be reasonably satisfied with the results obtained so far and, for my personal experience with companies operating in different markets, Italy today is in line with world best practice in terms of corporate governance rules.

But as I said my greatest satisfaction comes from the spreading of the Code's principle also to unlisted and medium size companies showing that with some flexibility the Code rules make a lot of sense for every company, that really care for sustainable, long term performance .

2) Education, culture

One of the key points of a good corporate governance is culture. Companies and boards have the duty to shape their culture, which means both paying attention to board members educations and the improvement of the culture overall the company.

In particular, European SMEs are facing ongoing challenges in terms of access to long term financing opportunities and some cultural barriers are preventing them from competing and growing more rapidly. These barriers are, for example: lack of information or skills, insufficient networks and difficulties in reaching international pools of liquidity.

Culture and education would improve also the governance organisation of SMEs – it is an effort for small companies, but, as I said it before, it is not a cost but rather an investment for the future.

In Italy we have an interesting and growing educational project that helps SMEs to address these challenges. The Italian Stock Exchange launched a new project, called ELITE, which is a single international platform of integrated services designed to help companies achieve their goals – a platform that provides the industrial, financial and organisational skills needed to deal with the challenges of international markets. The program, previously limited to Italian leading companies, is now aimed at European SMEs, offering them a three-phase programme to help them map out their route to success. This platform is realising a community of excellence: companies, advisers, investors and stakeholders with an interest in supporting SMEs.

Talking about technology, I would also add that despite the modest trend record for the investments in the area of R&D, being half of the OECD average in terms of percentage of GDP, Italy is eight in the world for the scientific production quantity and seventh for quality. There are also <u>several promising developments in terms of innovation and technology transfer</u>, like the achievements of the Italian Institute of Technology, of which I am the President. And by the way, again the part of education is essential for start ups and spin-offs. At IIT we have started courses of management led by a Nobel Prize, to give our top scientists willing to become entrepreneurs the capabilities to develop new companies and confront the necessary future financial stakeholders.

3) Access to finance

I have already mentioned the need to improve access to financing for all business but especially for SMEs, trying to increase and diversify sources of funding as well as to make market more effective and efficient, linking investors to those who need funding at lower cost. This aim encompasses both European and international investors all over the world.

In order to ease the access of SMEs to finance, we should firstly think about the different opportunities provided by equity and non-equity funding. There is a great need for flexibility also in this field: companies should have the possibility to issue and shape different financial instrument in relation to their concrete needs and opportunities. In case of SMEs, it should be considered the opportunity to raise funds issuing bonds or other debt instruments (e.g. the so-called “mini-bonds”).

In Italy, the legal framework already provides companies with the possibility of issuing different categories of shares, whit specific features. A recent example of such tailor made shares are the so-called “azioni sviluppo”, which have been introduced in order to enhance the growth and favour the stability of the company. This “development shares” provide a preferential right in the profit sharing (i.e. a higher dividend than ordinary shares), while the voting rights are limited to the cases of a takeover bid and a liability action against company directors.

In the last years, the Italian legislator introduced also some other provisions that are going in the same direction: the “dividend increase” (maggiorazione del dividendo), the “loyalty shares” (maggiorazione del voto) and “shares with multiple voting rights” (azioni a voto plurimo). In particular, the new law introduced the possibility for listed companies to introduce in their articles of association a specific provision of an increase of voting rights (up to a maximum of two votes) to be assigned to shareholders who are holding their shares for at least 24 months (loyalty shares) as well as the possibility for unlisted companies to issue shares providing more than one voting right (up to a maximum of three voting rights per share).

Fundamentally I think that not one size fits all in the sense that I am not impressed by the fact that technological development of the main stock exchanges or the expansion of the big institutional investors can’t support the growth of SME as long as like in Italy, the same official stock exchange provides other instruments like the

Star segment or the AIM to arrange the meeting between smaller companies and the right kind of investors (segmentation).

4) Flexibility

Some say that "self-regulatory" frameworks and the flexible approach of corporate governance codes revealed their uselessness in some cases, as Enron or Parmalat, where corporate governance recommendations have not prevented certain degenerative behaviors of company directors. In my opinion, this is an erroneous interpretation of the evidences: these cases should be rather understood looking at the whole system of corporate controls: control bodies, auditors, supervisory authorities. Moreover, this interpretation seems to ignore the positive outcomes of the self-regulatory framework as well as the existence of many listed companies that are outstandingly managed.

The choice between self-regulation and legislative interventions continues to be under discussion in many countries. Due to the crisis, some are evoking more prescriptive provisions and criminal sanctions also in the field of corporate governance, perhaps forgetting that the most critical situations have been actually generated by systems characterized by prescriptive legal provisions (e.g. in the US, especially after the Sarbanes-Oxley Act).

When talking about sanctions, we should firstly refer to market sanctions, which have been considered for a long time as too weak. But today, the market seems to be more mature and to know how to read corporate governance issues, to evaluate the substance of corporate governance information.

As Chairman of the Italian Corporate Governance Committee, I noticed, day by day, the importance of a flexible approach in the field of corporate governance, which led Italian companies to important results in term of qualitative governance. Flexibility, rather than stringent regulatory approaches, is the right way to contribute to the evolution of best practices. National Corporate Governance Codes reached a high level, evolving over time, looking both to empirical evidences as well as to the evolution of international best practices. A fundamental tool for the evolution and improvement of national corporate governance principles are the OECD Corporate Governance Principles, which represent the ideal over-arching principles of our Codes.

If there is one area where I would not scale down the corporate governance requirements this in the separation of ownership and management – not in the sense that they have to be two different categories of person, but in the sense that, if that is not the case, there have to be appropriate elements of control to avoid conflicts of interest with the other stakeholders.

This is pivotal to ensure all stakeholders, and particularly creditors and minorities that management is operating in a credible and sustainable way.

Thank you for your attention.