ICGN Viewpoint
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Promoting the 'voto-di-lista' system in Italy to support stewardship and board effectiveness

As the visibility of investor stewardship continues to build in Italy and in other markets globally, Italy's *voto di lista* system stands as a distinctive mechanism to facilitate investor involvement in the board nomination process, leading to the election of investor-nominated directors. Given the concentrated ownership blocks of many Italian companies *voto di lista* provides a counterweight to ensure independent board composition that is sensitive to the needs of all shareholders, including minority institutional investors.

The effectiveness of the *voto di lista* system may vary from company to company, and may need improvements to ensure that it works as intended. It requires proper commitment by shareholder-nominated directors to promote the company and its long-term success. It also requires both understanding and receptivity by company boards to make this role successful.

Shareholder elected independent directors have a fiduciary duty to promote the long-term success of the company, taking all shareholders into consideration—but are not beholden to any single shareholder or class of shareholder, nor to company management.

In turn, it is critical for company boards in Italy, and all markets, both to appreciate the importance of this role from a governance perspective and to demonstrate appropriate respect for shareholder-elected directors and the role they serve.

The ICGN believes that shareholder-elected directors can contribute positively to the governance of companies in Italy. We encourage both Italian companies and institutional investors to embrace the *voto di lista* system in both form and substance, and to contribute to improvements that might enhance its utility and integrity. It is our view that this can contribute to the practice of good stewardship as outlined in ICGN's own *Global Stewardship Principles* -- to promote mutual goals between investors and companies for long-term corporate success and value creation. Company monitoring is a critical component of these *Principles*, and this includes monitoring board effectiveness.

For those companies with shareholder-nominated directors on board, investors are positioned—and should be encouraged as good stewards-- to use company engagement to better gauge and advocate the effectiveness and integration of these shareholder-nominated directors in practice. In the spirit of good stewardship, this form of monitoring and engagement can serve to both build understanding and to promote the company's sustainable value creation.

ICGN presents below the speech of Stephen Davis-- ICGN co-founder and past winner of the ICGN Award—at the recent Italian Corporate Governance Conference in Milan. Dr. Davis is currently Associate Director and Senior Fellow of the Harvard Law School Programs on Corporate Governance and Institutional Investors, and a member of ICGN's Shareholder Responsibilities Committee. While Dr. Davis' remarks were delivered in a personal capacity, the main themes of this speech are both timely and in clear harmony with ICGN's own policy positions relating to stewardship, shareholder rights and promoting board effectiveness through strong and independent directors.

Stephen Davis speech
'Stewardship in Principle & Practice' panel

ITALY CORPORATE GOVERNANCE CONFERENCE
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Thank you for the honor of being with you today, and thanks especially to the team at Assogestioni, and support of Assonime, Borsa Italia, and the OECD, for convening this timely conference.

Our topic today is "stewardship", the term we use to describe how investors act as owners of assets. I will focus on Italy, but I want to begin with a few words on the US, since there may be lessons that could apply to Italy in light of the 4 December referendum. The upset election of Donald Trump has prompted urgent questions about the future of investor stewardship, especially since he campaigned to repeal the Dodd-Frank Act, which contains important measures empowering shareholders. Now, had this election occurred several years ago, a rollback of such law and regulation might indeed have put a hard brake on stewardship.

But here is what has changed. Increasingly, institutional investors today consider stewardship one of the tools they use to seek value and manage risk at portfolio companies. Many no longer engage in it because lawmakers and regulators tell them to. They do it because it helps protect returns. Take the latest example. In the US, just last year, we saw a sudden and astonishing spread of bylaws akin to Italy's *voto di lista* system that allow minority investors to nominate candidates in director elections. None of that occurred because of an obligation in law or regulation. Instead, reforms came about solely due to pressure on companies from investors at home and abroad.

So in my view, even if Congress scraps Dodd-Frank, stewardship in the US will stay for a simple reason: it is now rooted in investment strategy. Big international institutional shareholders simply do not wait around for the law to force them to do what they now recognize is in their financial interest. I'm guessing that will be the case in Italy, regardless of whether Prime Minister Renzi's government remains in charge or whether a referendum result this Sunday prompts a change of occupant at the Palazzo Chigi.

Indeed, I would contend that we have entered a transformational moment. In the last two decades we have seen worldwide a radical overhaul in the way corporate boards look and work, largely thanks to pressure for greater accountability from investors. This, as you all know, has been echoed in Italy, where the *voto di lista* system has wrought remarkable changes to board composition. But now comes a natural question: what about the shareholders themselves? How well do they live up to the standards they expect of corporate boards? How transparent are investing houses? How accountable are their governing bodies? And most importantly for this panel, how willing and able are they to exercise "stewardship"?

In my view, stewardship is the next big wave of change in governance in global capital markets—and we are only at the very beginning. Before this moment, many asset owners and asset managers treated voting and engagement purely as compliance exercises to keep regulators happy. Quite naturally, funds devoted scant attention to such duties. Why should they have done otherwise?

In the US, believe it or not, there used to be no way to vote 'no' in director elections. In the UK, proxy votes often were not counted. Elsewhere, director slates were not even announced until the last minute, making informed investor consideration all but impossible. So given that their voting had limited impact, there was little incentive for investors to devote serious attention and resources to it. They were rationally indifferent.

Today, however, these same institutions are equipped with markedly more rights. As a result, more of them treat stewardship as a tool to enhance value and protect against risk at portfolio companies. This change represents nothing less than a strategic revolution in the architecture of investment, with sweeping implications for institutional investors and companies. Vanguard founder Jack Bogle calls it 'The Great Awakening". But the truth is that many have missed its importance.

So let's today shine a spotlight on it. Stewardship is emerging as a new and distinct discipline. The trend is supported, first, by empirical evidence that investors can advance asset value by exercising scrutiny, engagement and voting at portfolio companies. Second, the discipline is propelled by market codes such as the International Corporate Governance Network's groundbreaking Global Stewardship Principles, and national stewardship guidelines. Third, more asset owners are requiring their fund managers to demonstrate a track record of stewardship. Fourth, NGOs and social media networks such as Twitter are opening powerful new ways for beneficiaries or citizen savers to apply pressure on financial agents to be responsible owners. Finally, in some cases, the hand of government is involved. The UK's Financial

Reporting Council just announced it will penalize funds that fail to demonstrate that they take stewardship seriously. And the European Commission's Shareholder Rights Directive is expected to enshrine shareholder engagement in a new 'comply-or-explain' provision.

So for all these reasons, institutional investors are moving into a fresh epoch. How can we tell? Well, there is now hard evidence of this transformation that few people know about. Let's bring it to light this afternoon. Investors have begun a material expansion of internal budget, personnel, and professional resources in stewardship while raising the status of stewardship professionals in relation to portfolio managers. Blackrock alone is growing its voting and engagement staff this year by 35%. Other big institutions are doubling personnel involved in the discipline. This is what happens when investors move stewardship from a compliance exercise to one bound to value. But you will find little in the media about this profound revolution in strategy. In fact, it is happening with few companies anywhere aware of, or ready for, the more intense era of engagement that lies ahead.

The good news is that in its *voto di lista* system, Italy has developed built-in, market-wide channels for investors to exercise stewardship. Funds don't have to invent such channels here as they have to do elsewhere. Shareholders can help name corporate directors who, in turn, can provide confidence that boards will be prompted to align with investor interests.

This state-of-the-art governance innovation can offer Italy a formidable comparative advantage over other markets, and thus accelerate foreign investment. The *voto di lista* framework especially offers rewards to individual companies. If handled well by all parties, enabling investors meaningfully to manage governance risk, *voto di lista* has the potential to significantly reduce the cost of capital, a crucial benefit to Italian companies in today's competitive market.

What Italy started in *voto di lista,* other markets are now following—namely in asserting two principles. First, *voto di lista* was founded on the belief that the controlling bloc in a listed company should not have monopoly authority to name board members. Second, it was based on the assertion that minority investors have a fiduciary responsibility to be conscious contributors to board composition.

We can see the first principle, that multiple voices need to be involved in the board, now echoing in the US. As I mentioned, last year saw a rapid proliferation of 'proxy access' bylaws, which offer opportunities for minority investors to propose director candidates. We can see it echoing in the UK, where Tuesday's Green Paper from the Department of Business, Energy and Industrial Strategy floats options for how stakeholder interests can be reflected on corporate boards. And of course the principle is already well installed in markets such as the Netherlands, Germany, and France, where employees typically have a statutory say in nominating members to top boards. So let's recognize what has changed. Companies around the world are today on notice that one way they earn trust, or what we call a 'social license to operate,' is by demonstrating that their boards are drawn from diverse sources.

Voto di lista's second founding principle, that shareholders should protect their interests by having a say in board nominations, can be seen in the spread of stewardship codes, such as Italy's own, that encourage investor engagement on board composition. Investors around the world are coming to a critical realization: the biggest governance risk is when boards atop companies are effectively what I would call a monoculture, one far less diverse than the business environments firms face. To give one example, companies that operate worldwide too often feature a board without a strong international component. This is as common a flaw in US corporate boards as it is elsewhere. It should be no surprise, then, that investors have begun to speak out when they see boards that lack diversity, or when they feel boards fall short of being responsive to shareholder interests. So let's recognize what's changed here, too. Institutional investors survive on trust just as much as companies. And today funds around the world are on notice that one way they earn their own 'social license to operate' is by showing that they exercise stewardship in meaningful ways.

The bottom line: Boards can no longer be clubs. And investors can no longer be passive observers in board nominations. Both trends are a signature achievement of Italy's *voto di lista*. And they are part of "the Great Awakening".

But going forward, the success of *voto di lista* depends on safeguards that protect the utility of the system and the integrity of the Italian capital market. That's what I meant when I said that the system, to function optimally, must be handled well by all parties. *Voto di lista* may be strengthened, for instance, with the following four measures, which I offer with some humility as an enthusiast looking from the outside:

> First, developing templates to encourage board-investor engagement so that both corporate directors and shareholder representatives feel informed, protected, and constructive. One such is the Shareholder-Director Exchange Protocol, which may be found at www.sdxprotocol.com.
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> Second, raising the profile of Assogestioni's stewardship code, including regular review of its provisions and encouraging its use by domestic and non-resident investors.
>
> Third, ensuring protection of independent corporate directors, for instance with secure D&O insurance coverage, so that they feel able to raise concerns, and so that boards can attract highest quality candidates.
>
> And fourth, adopting market-wide and company-specific principles for board candidate selection so that nominees of the state, block holder, or minority investors best suit the needs of the company, especially in their ability to engage with investors as well as contribute to the skill sets required for success.

Let me conclude with this observation. Stewardship in Italy has two secret weapons: Assogestioni itself, for one, and the Investment Managers Committee, which has responsibility for making minority director nominations for corporate boards, for another. These represent a comparative advantage for Italy. Assogestioni, for instance, is one of the best resourced, best supported, most sophisticated, and most internationally connected domestic investment associations anywhere. It can and does create infrastructure for engagement. Investors know very well that markets that lack such a homegrown body pose a far higher risk.

So Italy has, in its stewardship code, *voto di lista* system, and Assogestioni and the Investment Managers Committee, a constellation of factors that make stewardship a uniquely powerful market asset, especially as they all happen to be in place at just the moment investors at home and abroad are ready to use them. Vital next steps involve keeping them best fit for purpose so that they are active drivers of Italy's economic progress over the long term. That is the real payoff when corporate governance works.

Thank you for your kind attention, and I look forward to the panel's discussion.

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