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19 December 2019, Milan

To the Chairs of the Board of Directors of Italian listed companies

Cc: to the Managing Directors of Italian listed companies

Cc: to the Chairmen of the Board of Auditors of Italian listed companies

Dear Chair,

I am writing to you in my capacity as Chair of the Italian Corporate Governance Committee (hereinafter “the Committee”), supported by Abi, Ania, Assogestioni, Assonime, Confindustria and the Italian Stock Exchange. The Committee’s objective is to promote good corporate governance in the financial community by issuing and updating the Corporate Governance Code (hereinafter the “Code”) and other institutional, scientific, informative and promotional activities that can strengthen its credibility.

In particular, the Code’s *guiding principle* VII assigns the Committee the task of monitoring the way it is applied by companies that are listed on the Italian regulated market (hereinafter “issuers”) and that declare to have adhered to it. In accordance with the *guiding principle*, the Committee approves an Annual Report on the application of the Code (hereinafter the “Report”), which this year is in its seventh edition.

Ever since the publication of its first Report in 2013 the Committee has been aware of the importance of an appropriate monitoring activity for ensuring the effectiveness and credibility of the best practices set by the Code. To strengthen this awareness, since December 2015 the Committee sends to all issuers a letter highlighting the monitoring activity conducted and emphasising the main problems encountered.

With the present letter, and the enclosed Report, we intend to provide a follow-up to these practices in order to encourage a more attentive application of the Code by the issuers that adhere to it and, more generally, in order to promote the evolution of corporate governance in all Italian listed companies in accordance with the Code’s principles, regardless of whether or not the companies formally adhere to it.

This letter and the Report provide a comprehensive framework of the current application of the Code and therefore serve as an important parameter for evaluating the relative degree of compliance obtained by the company whose board you chair.

For issuers, the decision to adhere to the Code means a commitment to the market to ensure the proper quality and transparency of its governance practices. Such a commitment is recognised by the Consolidated Law on Finance, which sets precise disclosure requirements for issuers and entrusts the controlling body with the specific duty of monitoring the governance measures adopted for implementing the recommendations of the codes of conduct to which the company declares to adhere¹.

In this light, issuers are clearly expected to commit themselves to giving credibility to their application of the Code in a dynamic and evolutionary vision characterising the relationship between companies and the market.

It is precisely the need to ensure a continual consistency between the Code's recommendations and the evolution of markets and investors' expectations that led the Committee to begin a revision of the Code, which, safeguarding the fundamental principles that have inspired it since its first edition in 1999, has the primary objective of enhancing the role of self-regulation in guiding the governance choices of listed companies and above all in encouraging them to pursue the long-term value for shareholders with due consideration of the interests of the other relevant stakeholders.

The Code's new edition, examined by the Committee during its last meeting held in December 2019 and to be shortly approved, will introduce a number of significant changes such as:

- a rationalised and simplified structure, also through a rearrangement of existing principles and recommendations;
- a greater and more integrated approach to sustainability which shall encompass the business strategy, integrated into its strategic perspectives;
- the strengthening of some existing best practices and the implementation of those in progress;
- a greater proportionality of the Code's recommendations based on the companies' size and ownership structure, so that the needs and peculiarities of companies with a strong controlling shareholder (many of which are family businesses) and smaller companies are adequately considered.

The Committee, while deeming that companies should have an adequate period to adapt to the new edition of the Code and therefore providing for its application to start in 2021, with information to be

¹ Article 149, 1, c-bis) of the Consolidated Law on Finance.

reported in the corporate governance reports to be published in 2022, believes that company practices should provide for prompt adaptation to its inspiring principles, especially in terms of sustainability, thus consolidating and strengthening the evolution that is already underway. For this reason, in addition to the usual recommendations aimed at overcoming some critical issues that still exist in the application of the current Code, the Committee's letter suggests some evolutionary lines of governance, especially in order to ensure the priority of companies' sustainable success vision in the definition of their governance structures and strategies.

I invite you to submit the **Recommendations of the Committee for 2020**, provided below, to the board and the competent committees for examination, hoping that these recommendations will be the subject of a special board debate and careful assessment during the board review with the purpose of identifying the possible evolution of governance or of remedying any shortcomings in the application or the explanations provided. I also invite you to submit these recommendations to the controlling body, which is responsible for overseeing the implementation of the Code's recommendations.

I would like to reiterate the hope, as expressed in the last two years, that the considerations of the company whose board you chair concerning the Committee's recommendations and the possible planned or undertaken initiatives are clearly reported in the next corporate governance report in order to emphasise the issuer's unflagging attention to the quality of its governance. To this end, the Committee has entrusted its Technical Secretariat, which is available for any clarification (segretario@comitato-cg.org), to examine the issuers' considerations with the purpose of ensuring the timely and comprehensive monitoring of the evolution of the Code's application practices, with particular regard to the issues covered by the specific recommendations.

Sincerely yours,

Patrizia Grieco

THE RECOMMENDATIONS OF THE COMMITTEE FOR 2020

The 2019 Report on the application of the Code

The Committee Report provides an overview of the application of the Code's main recommendations, paying particular attention to the most relevant ones for the correct and effective functioning of the board of directors.

By the end of 2018, 94% of Italian companies listed on the Italian regulated market (MTA) formally declared to have adhered to the latest version of the Code.² The choice not to apply the Code is limited to a few cases and is generally due to the reduced size of the company.

The analysis contained in the Report shows a good level of information offered by the corporate governance reports. Issuers generally describe in a clear and analytical manner their governance model, both in the case of the application of the Code's recommendations and in the case of their complete or partial non-application.

For a large part of the Code's recommendations the degree of application is high. There remain, however, some areas where, despite the repeated reminders made in the previous Reports, the level of implementation of the recommendations is still low and the quality of the information provided concerning the relevant deviation is unsatisfactory. These areas are clearly identified in the Report and the Committee has formulated specific recommendations in their regard, recommendations that are graphically emphasised in the text, encouraging issuers to apply the Code in a more substantial and transparent manner.

The effects of the recommendations submitted in 2018

In the Report published in December 2018, the Committee recommended the issuers to assess, and if necessary to improve, the practical and substantial application of some best practices contained in the Code, and to consider the possibility of a broader qualitative improvement, regardless of the Code's recommendations, in some governance areas. The Report was sent to the top representatives of all the issuers together with a formal letter in which the Committee's Chair invited the corporate bodies of these issuers to examine, also during their board review, the main areas for improvement that emerged

² This is the 2015 edition of the Corporate Governance Code; among these, many have declared in their reports also the intention to adopt the recommendations contained in the 2018 edition of the Code.

from the Report and were the subject of specific recommendations in the accompanying letter ("Committee Recommendations for 2019") in order to identify the possible evolution of their governance and to remedy any shortcomings in the application or in the explanations provided, with adequate disclosure on the initiatives undertaken in the next corporate governance report. An invitation was also made to submit the same recommendations, as far as their authority permits, also to the issuer's controlling body.

In over 75% of the cases (a marked increase compared to the 50% in 2018) the issuers provided a timely reply to the indications of the letter, declaring that they had used the Committee's indications for the evaluation of their degree of adherence to the Code: more than half of these issuers state that they are already in line with all or part of the Code's recommendations, while about a quarter of the companies have identified one or more areas of possible improvement in their governance among the issues highlighted by the Committee, indicating the initiatives they undertook or intend to undertake for this purpose. In the remaining cases, the issuers limited themselves to mentioning that the board had examined the contents of the letter without expressing any evaluation (about 14%) or postponing the examination of this letter to a board meeting during the 2019 financial year (6%).

It is interesting to note that a significant number of issuers that do not adhere to the Code (5 out of 11 of the surveyed companies) state that their board of directors has considered the letter's abovementioned indications, confirming the indicative value of the Committee's monitoring activities for all listed companies.

Based on the analysis of the corporate governance reports published in 2018, four main areas for improvement were identified in the Committee's Recommendations for 2019. They concerned:

- the adequacy of the pre-meeting information to the board;
- the application of the independence criteria recommended by the Code;
- the transparency and governance of the board review;
- the transparency and adequacy of policies for the remuneration of executive directors.

The analysis of the information provided in the corporate governance reports published in 2019 shows some signs of improvement in these areas, although it is accompanied by the persistence of common application weaknesses. The Committee therefore reiterates how important it is that issuers further undertake to align their practices with the relevant recommendations. The Committee has also included these areas among those on which to elaborate more stringent indications in the Code's new edition.

The adequacy of the board ***flow of information*** to board members is still unsatisfactory in over half of the listed companies (see below). In particular, the number of issuers (about one third of those adhering to the Code) making generic reference to reasons of confidentiality, such as exemptions from compliance with the adequate deadline, is stable over time. At the same time, also the indication regarding the effective compliance with the deadline previously set as adequate has not improved and appears stable over time (see below).

With regard to the application of the ***independence criteria*** indicated in the Code, the 2019 data show a situation that has gradually improved. While the decisions of the companies to deviate from one or more independence criteria recommended by the Code appear to be substantially crystallized, cases in which directors whose independence is considered "at risk" are constantly decreasing (especially those exceeding the nine-year mandate limit and in which directors receive additional remuneration of a significant amount compared to the standard remuneration for the position of director and participation in the committees). At the same time, the number of cases in which the explanations justifying the qualification of a non-executive director in terms of independence are absent or generic remains high, although it is gradually decreasing. Finally, the choice of the companies to provide in the corporate governance reports information on the quantitative and/or qualitative criteria used for the assessment of relationships that could be relevant for the correct application of the independence criteria is very rare.

As for the ***board review***, although frequent among the companies applying the Code (approximately 90%), there still appears room for improvement in terms of transparency of the procedures (in one third of the cases, which are stable over time, only summary information is provided) and the assignment of a supervisory and coordination function to an internal member of the board, at least as regards the definition of the scope and the methods of carrying it out.

Finally, with regard to the ***remuneration policies*** concerning executive directors, it should be noted that approximately one fifth of the companies that provide for the payment of a variable component do not link the relative remuneration, even in part, to long-term objectives; furthermore, in line with the surveys carried out in 2018, one third of the issuers adhering to the Code envisage the possibility of providing "ad hoc" bonuses that are not subject to clear regulation within the remuneration policy and for which it therefore does not appear possible to assess ex ante their consistency with the achievement of the long-term objectives, in accordance with the criteria of predictability and verifiability.

In relation to the issues highlighted above, the monitoring carried out in 2019 therefore shows a significant improvement only with reference to the progressive decrease in the number of independent directors "at risk". Concerning remuneration, however, it must be considered that the related policies

normally have a multi-year time horizon and, therefore, their revision to accommodate the Committee's recommendations can only be gradual.

The main areas for improvement identified in 2019

In light of the results of the Report for 2019 and the analysis of the issuers' behaviour towards the issues highlighted in the accompanying letter, as well as the reflections and in-depth analyses carried out for the revision of the Code, this year the Committee has identified four main areas that need improvement in the issuers' governance practices, addressing not only the board of directors, but also, as far as its authority permits, the controlling body. The areas identified by the Committee concern, in particular: 1) sustainability, understood as a general and strategic profile for the business activity; 2) the quality of the flow of information to board members; 3) the quality of independence assessments, understood as a fundamental element for an effective functioning of the corporate governance system outlined by the Code; 4) the adequacy of the remuneration of non-executive directors and members of the controlling body, also in the light of a comparative analysis.

- The first area of improvement therefore concerns the management of the business activity's **sustainability** issues and its ability to pursue the creation of long-term value for the benefit of the shareholders, also taking into account the interests of the various other stakeholders relevant to the company.

The current Code already provides some indications on the importance of a sustainable vision of the business activity, recommending that the risk management policy should assess the elements "*that can take on importance from the viewpoint of the medium-long term sustainability of the issuer's activity*" (Art. 1, para. 1b). The Code also, in the *comment* to Article 4, provides some organisational indications for companies belonging to the FTSE MIB index that are aimed at assigning to an inner-board committee some specific functions for supporting the board in terms of sustainability.

The Committee observes that, even if there are a good degree of application of these indications, in many cases the board of directors is clearly not attributed with the responsibility of considering the issue of sustainability as an integral and fundamental part in the definition of business strategies.

The attribution to an inner-board committee of inquiry and support functions for what concerns sustainability is sometimes formulated in general terms, highlighting the risk of sustainability management assuming mostly communicative functions, in particular to meet the obligations regarding non-financial information.

From an analysis conducted by Consob of the documents published in the first year of application of the legislation that introduced these obligations, it appears that "*most companies have operated from a compliance perspective, while few issuers, mainly larger ones, have seized the opportunity offered by the directive to start a transformation process capable of involving business, governance and strategy models*"³.

Recommendation 1:

The Committee invites the boards of directors to integrate the sustainability of the business activity into the definition of strategies and remuneration policies, also on the basis of an analysis of the relevance of the factors that may affect long-term value generation.

- The second area of improvement still relates to the **quality of the information flow to the board of directors**. As noted in the examination of the effects of the letter sent in 2018, the adequacy of the board information flows, even after an ever more thorough examination of the practices applied and reported in the corporate governance reports, remains unsatisfactory in more than half of listed companies. In particular, 75% of the companies that adhere to the Code quantified in a precise way the deadline that is normally considered appropriate: a quarter of these companies, however, do not provide any information on the actual compliance with the deadline previously indicated as adequate. The *ex-ante* and *ex-post* identification of the quality and timeliness of the disclosure to the board is therefore still problematic in half of the listed companies, despite a slight increase over time.

A more detailed analysis of the practices described in the corporate governance reports also highlights that a third of the companies adhering to the Code makes generic references to reasons of confidentiality, such as exemptions from compliance with the appropriate deadline. This is a critical data that has been the subject of further investigations and which led the Committee to strengthen its recommendations in this regard.

Recommendation 2:

The Committee recommends that the companies, also in the eventual regulation of the board's work session, adequately manage the information flows to the board of directors,

³ Consob, [Non-financial information as a driver of transformation Evidence from Italy](#), p. 3.

ensuring that the confidentiality requirements are protected without compromising the completeness, usability and timeliness of the information.

- The third area of improvement also concerns an issue already subject to past Committee recommendations concerning the practical and complete application of the **independence** criteria recommended by the Code.

The data collected in 2019 highlight the persistence of a significant number of critical issues in the qualification of the independent directors and the poor quality of the information provided by the issuers, both with reference to the choice to deviate from the criteria indicated by the Code and with reference to the overall quality of the adoption of the independence model outlined by the Code itself.

In particular, despite a significant reduction in cases of independent directors "at risk",⁴ who appear to have declined sharply at the end of 2019 compared to previous years (almost a fifth less than in 2018), the monitoring highlights, on the one hand, the persistence of a significant number of such "at risk" situations and on the other hand, it brings out a substantially crystallized picture of the issuers' choice not to apply *tout court*, or to apply with the "substance over the form" criterion, one or more non-independence criteria set by the Code, which affect or may affect the independence of the director (this phenomenon is recorded, respectively, in 8% and in 17% of cases).

The 2019 analysis also confirms the lack of information regarding the assessment of the relationships that could be relevant for the purpose of a correct application of the independence criteria (this assessment is communicated by just 7% of the issuers that apply the Code).

Given the importance attributed by the Code and the regulatory framework to independent directors in the decision-making process of the board in relation to matters of particular relevance and delicacy, the Committee observes how a rigorous application of the criteria indicated by the Code can significantly affect the effectiveness and adequacy of governance systems.

⁴ Understood as directors qualified as independent who nevertheless find themselves in specific, objectively measurable situations of non-independence, pursuant to the Code (with more than a nine-year term, with particularly high remuneration, holding other positions in the company).

Recommendation 3:

The Committee invites the board of directors to apply with greater rigor the independence criteria defined by the Code and the controlling body to monitor the correct application of these criteria. The Committee, in addition to reaffirming the exceptionality and the necessary individual motivation - linked therefore to the concrete case of the individual director – regarding the decision not to apply every criterion of independence recommended by the Code, invites the issuers to pay more attention to the assessment of the significance of the relations subject to evaluation. To this end, the Committee invites the boards of director to define ex-ante the quantitative and/or qualitative criteria to be used for the evaluation of the significance of the relations under examination. These criteria should relate to the overall position, not limited to the merely economic benefit, of the director whose independence is being assessed, and to find adequate and transparent disclosure to the market in the corporate governance report.

- The fourth area of improvement concerns the **remuneration** of **non-executive directors** and **members of the controlling body**, especially in medium-small companies.

Here the analysis of the Committee focused on the empirical data on the remuneration given to these subjects, which were examined not so much in terms of consistency with the overall policies defined for the remuneration of the corporate bodies (which are reasonably concentrated on the more comprehensive definition of variable compensation for executive directors, managing directors and directors with strategic responsibilities), but rather in light of the commitment expected of these subjects in fulfilling their tasks and of the consequent responsibility profiles.

In this context, the remunerations actually recognised often appear, especially in smaller companies, inadequate given the professionalism, competence and commitment required both of the non-executive and independent board members (especially when participating in the inner-committees work, to which increasing investigative, propositional and consultative functions are attributed) and of the controlling bodies members, who are called upon to increase their commitments and responsibilities that also derive from the tasks assigned to them in their relations with the Supervisory Authorities.

The phenomenon has already been observed in past monitoring activities on the application of the Code and was the subject of some Committee observations⁵ carried out also in light of the Code's current recommendations regarding the adequacy of the related compensation. It appears even more evident when compared on an international level. In particular, when comparing companies of similar size, non-executive directors of Italian companies have substantially lower median remuneration than their British counterparts, especially in smaller companies: the difference is approximately 15% in very large companies (with a capitalisation of more than 10 billion euro), increasing to 30% in medium-large companies (with a capitalisation of between 1 and 10 billion euro) and then even 50% in medium-sized companies (with capitalisation between 500 million and one billion euro).

The difference persists, albeit in a less accentuated manner, also in the comparison of the remuneration of the members of the controlling body in Italian companies with respect to the members of the audit committee of British companies: the median remuneration of these bodies' chairmen is about 20% higher in the United Kingdom in larger companies and about 12% in medium-large and medium-sized companies. The "pay gap" is particularly relevant for the "simple" members of these bodies: the median remuneration of the members of the audit committee of British companies is 30% higher than that of the members of the controlling body of Italian companies in all size categories.

Recommendation 4:

In light of the comparative analysis, the Committee recommends that the boards of directors - and the relevant committees responsible for remuneration - verify that the amount of compensation paid to non-executive directors and members of the controlling bodies corresponds to the competence, professionalism and commitment required of their position. For this purpose, a valid source of assistance could be a comparison with the remuneration practices in companies of similar size or sector, possibly considering relevant foreign experiences.

⁵ Corporate Governance Committee, 2017 Annual Report, p. 70, with particular focus on the average remuneration of independent directors in listed companies distinguished by size (large, medium, small).

See enclosed: SEVENTH ANNUAL REPORT ON THE APPLICATION OF THE CORPORATE GOVERNANCE CODE (in Italian version only)