Corporate Governance in Italy and the role of non-executive directors in investee companies of private equity funds

By Fabio Sattin, with assistance by Martin Miszerak

I would like to focus my comments on how in practice Italian private equity funds perceive the role of independent directors. I will try to make some general observations, but let me say at the outset that I will inevitably be influenced by specific experience of Private Equity Partners, a private equity fund of which I am Chairman and founding partner, and which has successfully operated as a private equity investor for almost twenty years.

Like many private equity funds of Anglo-Saxon origin (even though we operate through a local Italian fund management company, our investor base is exclusively international, mainly from the US), we have an approach to corporate governance, and in particular the role of non-executive directors, that in some ways reconciles the Continental European-Italian approach (we invest mainly in Italian companies) with the the Anglo-Saxon approach, which our investors usually identify with.

Anglo-Saxon governance

Let's review briefly see the key aspects of the American scenario.

Before the 1970's, a typical board of directors in the United States had primarily an advisory function, while its members were in reality selected by the CEO (who almost always was also Chairman) from among persons whom he considered trustworthy. After a number of scandals in the late 1970's, the board was assigned the responsibility of „monitoring" management behaviour and within this function, a key role was identified for the „audit committee", responsible for the supervision of financial information and internal controls. Thus, a structure was adopted made up of committees consisting of independent directors, empowered to interact directly with management.

In this period, the ratio between non-executive or „outside directors" and „inside directors" turned quickly upside down, from 15/85 to 80/20, according to some statistics (Gordon 2005). As a consequence, the profile and background of non-executive directors changed also, requiring them to possess broader and at the same time, more specific competencies. From a „monitoring" function, the responsibilities of board committees extended to other areas, including the evaluation of management performance (*Remuneration Committee*), defining company strategy (*Strategic Committee*), and the very important function of „hiring and firing" (typical of widely-held listed companies), in which non-executive directors are given the power to decide on the change of the CEO.

More recently, we have even witnessed in the United States the emergence of „independent committees", completely made up of „outside" directors, in order to deal with situations of evident conflict with management, such as a management buy-out (MBO) typical of private equity transactions, which requires a negotiation between the company and management. In such cases, the company becomes „represented" by such independent committees,

which are often advised by merchant banks and lawyers.

Let's see what, according to the US system, should be the main function of non-executive directors. In that system, the primary responsibility of such directors is the maximisation of shareholder value. Even if the Sarbanes Oxley Act (SOX) tried to restore trust following the recent financial scandals by emphasizing the monitoring and controlling role of the boards (audit committee *in primis*), maximising share value remains the non-executive directors' most important objective.

Italian governance

Let's review now the situation in Italy and Continental Europe in general.

First of all, the Italian Law on Financial System (*Testo Unico Sulla Finanza, the main law governing corporate governance in Italy*) underscores the central role of Board of Statutory Auditors (*Collegio Sindacale*), a corporate body which does not exist in the Anglo-Saxon system. As a result of a different legal framework, the Italian system does not focus on the distinction between executive and non-executive directors, but rather emphasizes the role of the Board of Statutory Auditors, which is not an advisory body and which possesses practically the same characteristics as the audit committee.

According to art. art 2400 of the Italian civil code, the key task of the Board of Statutory Auditors (*Collegio Sindacale*) is to make sure that the company observes the laws and statutory objectives, following the best practices for a correct administration, assuring the adoption of internal control systems and the use of correct methodologies with regard to accounting principles and valuation.

As far as listed companies are concerned, the so-called „Self-Discipline Code" promoted by the Milan Stock Exchange, has copied practically the Anglo-Saxon approach. Thus, listed companies are required to follow what could be defined as a „hybrid" system, from certain points of view even more complicated than the Anglo-Saxon system, resulting from the presence of two controlling bodies: one within the board (represented by non-executive directors and committees), and one outside of the board, in the form of the Board of Statutory Auditors. (In the Italian system, like in Poland, the Stock Exchange requires additionally all listed companies to designate certain directors as „independent non-executive directors", as certain non-executive directors may be closely associated with certain important shareholders.) This situation may be subject to even more complex variations given the different options available today with respect to formal structuring of company management (possibility of introducing the „dual board system" characteristic of the German governance).

However, the problem regarding Italy, and not only Italy, is not so much about the legal structure, but rather related to the fact that very often companies, whether listed or not, have a ownership structure centred in one shareholder, who often controls the majority of shares. In such cases, the key question becomes as follows: Does it make sense to have independent non-executive directors in companies controlled by a single shareholder? More specifically, without having at their disposal the „hiring and firing" function (which is the most important function of non-executive directors in widely-held companies), do independent non-executive directors still have a role?

We could discuss this point for hours. My personal opinion is that even in these cases, independent directors's role is likewise useful and important as a guarantee of a suitable governance.

If they are authoritative and professional, non-executive directors will not make decisions without a proper informed discussion regarding the risks and benefits for the company and all shareholders. Furthermore, the contribution that these directors can give in matters of strategy, growth, and professionalism is also of utmost importance for a proper board discussion. Personally, I believe that this role is of utmost importance even in situations in which a controlling shareholeder owns most of the shares, whether a company is listed or not. Likewise, I also believe the main responsibility of non-executive directors is that of increasing shareholder value, hence company's future prospects.

Private equity governance

Let's now discuss the role of independent non-executive directors specifically in private equity transactions.

If we agree that the duty of non-executive directors is ultimately to maximise shareholder value (Anglo-Saxon approach) and simultaneously to monitor management, it becomes evident that such objectives are exactly the same as those of a private equity investor whose only goal is to increase the value of his investment in order to realise a capital gain.

Therefore, it is evident that a private equity investor looks highly favorably upon the inflow of independent professionalism into investee companies, while the tasks such investor would like the non-executive directors to achieve coincide with the objective of shareholder value maximisation.

I also believe that, for private equity investors, it makes little difference if a company is listed or not. As in either case the governance objectives are the same, the investor will implement as soon as possible effective operational and control mechanisms, including the use of professional independent directors.

In brief, the view of private equity investors is that the independent directors must always and unconditionally carry out the crucial responsibilities associated with their role, being foremost share value maximization within total respect for rules of governance, and strict and efficient monitoring of management.

In a well-known article published in 1989, Michael Jensen, Professor of Business Administration at Harvard and founder of „Managerial Economics Research Centre" and „Journal of Financial Economics", argued that the „active investor" role played by private equity investors in the companies they acquire, encouraged the phenomenon which he defined as „Reemergence of Institutional Monitoring of Management". In the context the US market, where private equity transactions involve primarily listed companies, widely-held share ownership and tight restrictions on the use of confidential information have left managements with almost complete and uncontrolled power. The return of investors that make their presence felt in a forceful and incisive way in order to control and monitor management, including the possibility of changing it if necessary, was viewed by Jensen as an effective answer to many problems brought about by the overwhelming power of management and the CEO in particular. And this outcome is achieved primarily by non-executive directors.

However, the form of governance (and the reliance on non-executive directors), may differ according to the preferences of private equity investors.

In most cases, a private equity investor appoints to the board, in addition to the independent directors, its own representatives, who are usually partners in the fund management company. This is unquestionably the custom; however, it is not always the case. In fact, there

are private equity investors who, regardless of whether they are in a majority or minority position, choose not to appoint their „employees" (partners) to boards, but rely exclusively on independent non-executive directors.

My company, Private Equity Partners SGR, works almost always in this way and I can assure you that our track record (we have raised the fourth fund and we have brought more companies to the Stock Exchange than any other Italian private equity fund) has widely proven that our approach works, although we are aware that it is unusual among private equity funds. We believe in fact, that it is better to appoint to the board the most highly qualified professionals who are able to provide the highest value added to investee companies, while at the same time ensuring a high (I would say higher than average) level of independent and professional governance. At any rate, we think this way, but it is not our intention to argue that our approach is superior. There are simply different ways of approaching the issue.

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