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Making the grade

Is Italy keeping pace with its European counterparts when it comes to Say on Pay? Andrea Di Segni reflects on a year of progress.

This has been the most confrontational year ever for shareholders, according to a study released by Institutional Shareholder Services (ISS) on the 2012 institutional voting results in Europe, with remuneration proposals receiving the highest levels of dissent.

This controversy is reflected in the huge debate as to whether remuneration proposals should be presented to the shareholder as a consultative or binding vote. The differences of opinions are vast and agreement at seems some way off. However, at some point a redde rationem is bound to be demanded, and perhaps then a consensus will be dragged into existence and implemented.

While controversy still reigns, what is generally agreed upon is that shareholders can help companies in helping set remuneration in alignment with a long-term perspective without getting into the micro-management of the company. But in order for this to succeed, engagement between companies and shareholders must be recognised as a critical point – only through dialogue can corporations help shareholders understand the rationale behind their remuneration plans.

Before getting into a practical demonstration on how an engagement plan over the years can pay, it is necessary go over a brief overview of the 'say on pay' debate in Europe, what has been done in the Italian market, and finally the investors' view point via a survey conducted by Sodali during the summer.

The European context

This is the fundamental question and, as mentioned above, opinions vary considerably among the decision makers involved in the debate, and there are a great many with a stake – the EU Commission, individual member-state regulators, politicians, corporations, the media and institutional investors and the associations that represent their interests all have their own corners to fight.

In 2002, the UK advocated an advisory shareholder vote on the annual executive and non-executive director compensation practices of UK listed companies. This has now been taken one step further with new proposals to reform the approval process for director remuneration, including the introduction of a binding vote on remuneration policies. Switzerland is also considering whether to introduce a binding say-on-pay vote, with a referendum to be held pending the executive salary review initiative which was launched in 2006. The Netherlands, on the other hand, has had a binding vote in place since 2004, though there have been few cases in which a negative vote has actually been cast.

Sweden adopted requirements for non-binding shareholder votes on remuneration reports in 2005. Norway, Spain, Portugal, Denmark and, most recently, France, have followed suit and Germany is now among a number of countries currently considering introducing legislation.

On top of this, the EU Commissioner, Michel Barnier, is pushing to introduce a binding vote on say on pay as a practice in Europe, but this plan has encountered a lot of resistance at state level, who argue that the existing cultural diversity that helps differentiates the various financial marketplaces would make such an introduction difficult. At present there is no empirical evidence to suggest whether a binding or advisory vote, when it comes to say on pay, is better for financial markets. Variables such as market requirements, company circumstances and the shareholders'

will to commit resources to such an undertaking make it a complex matter. Furthermore, the import of cultural attitudes to compensation must not be underestimated, not to mention the uncertainty of finding one's bearing at a regulatory level, and the still-controversial role of proxy advisory firms.

With this in mind, Sodali recently performed a survey of the major institutional investors to figure out what they really think about say on pay. Results are in many cases straightforward and give guidelines for future discussions:

- More than 50% of the respondents acknowledge that a say on pay vote strongly increases board accountability and protects shareholder rights.
- Two-thirds prefer the advisory vote approach, and slightly less than 80% want an annual vote.
- More than 50% want the vote on remuneration policy to encompass a company's approach and objectives

There was a clear indication that say on pay should reflect the efficiency of the board. However, this clear message should not decide the action of the board – there was strong preference for having an advisory vote so as to allow the board full responsibility to align remuneration to long-term sustainability and performance. This also removes the temptation for corporations to be micro-managed by shareholders.

The Italian situation

In response to the many differing views on the subject, the Italian regulators recently opted for a compromise option whereby remuneration policies of financial institutions and insurance companies receive a binding vote from shareholders, while for all other companies a consultative 'say on pay' mechanism is in effect.

In 2008, the Bank of Italy dictated that ordinary shareholder meetings need to approve (in a binding vote) and be involved in the setting up of remuneration policies and in establishing equity-based compensation plans. In addition, in March 2011, the Bank published a set of supervisory provisions to implement the third Capital Requirements Directive. These provisions meant that the remuneration of members of the board and committees having supervisory, management and control functions (including any share-based incentive plans) should be approved at the shareholders' meeting with a binding vote.

On 23 December 2011, the Commissione Nazionale per le Società e la Borsa (CONSOB) adopted new regulations over the content and timing of the mandatory public remuneration report on directors, general managers and managers with strategic responsibilities of Italian listed companies, as well as the relative resolution to be approved at the general meeting. In relation to the role of the shareholders at the general meeting, in applying the say on pay principle, the regulation stipulates that the shareholders' meeting provides an advisory vote on the first section of the remuneration report. The shareholders' resolution is not binding, but the results of the vote must be publicly available on the website of the issuer.

Italian proxy season

The 2012 Italian proxy season has seen an increase in the number of companies with dissenting shareholder votes. Some commentators attribute these failures to an increasing disconnect between pay and performance, fueled by negative recommendations from proxy advisory firms like ISS. Others note that the failures correlate more closely to shareholder dissatisfaction with corporate performance (an issue wholly aside from whether pay levels were appropriate for the performance actually achieved), or are attributable to high absolute or relative pay levels, above-median benchmarking or use of inappropriate types of compensation.

According to a report released by ISS on the Italian market, dissent increased significantly – up from 3.2% in 2011 to 4.6% this year, mainly due to the introduction of 'say on pay' resolutions. Out of the 128 say-on-pay resolutions proposed, only in one company, Impregilo, was the motion rejected.

While the results of the 2012 proxy season say-on-pay votes have been very encouraging, it remains clear that the ownership structure of Italian companies has a significant effect in reducing the practical impact of the dissent level to such resolutions. Furthermore, the against votes expressed by several international investors, together with many negative recommendations issued by the main proxy advisory firms, has sent a signal that Italian companies need to consider how their compensation policies are defined.

We, as Sodali, have been through this matter with many Italian listed companies. They are starting to

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appreciate that in future, say on pay resolutions need to be addressed in advance and that a different, to some extent more holistic, approach needs to be defined so as to better anticipate and address the critical arguments about how the remuneration policies are structured.

The survey Sodali conducted reinforces the idea that outreach and dialogue with shareholders is the best course of action following a negative vote on say on pay. This, together with more openness by corporations, seems to reflect a new unity in governance thinking where constructive dialogue is the best path to aligning interests.

Expectations

Engagement with investors. It is through this principle that, from a corporation's perspective, the greatest benefit will be achieved. It will not be the 'panacea' for moderating shareholders expectations, nor will it repair the broken linkage between pay and sustainability – but it will help corporations understand which road to follow in order to regain shareholder confidence. Engagement creates long term share value and improves governance practices by building trust in the decisions taken by management. Furthermore, constructive engagement with investors will improve the approach of the company toward its governance and risk management policies, while making it more competitive.

However, engagement does not mean that corporations should blindly follow the guidance that results from these discussions – corporations and shareholders have different interests, perspectives and objectives. It should be viewed as a tool for both parties to hold meaningful discussions and to renew the 'contract' which is the base of the relationship.

Case study: Unicredit Group

What has been said until now can be seen as a sort of 'idealism, a decription how things should be done in the financial world. Often this is kind of argument is viewed as simply 'words in the air' – a discussion that will never be applied to what is happening 'on the ground'.

To counter this view Sodali, together with Unicredit Group, one of the leading European financial institutions, embarked on a 24-month remuneration engagement program. It's aim was to better understand what shareholders wanted in order to align their interests with that of the Board. Through its Human Resources & Compensation, Investor Relations and Corporate Law teams, Unicredit developed a plan for dialogue between international investors and proxy advisory firms in order to gain positive endorsements for the company's remuneration policy and compensation plans.

In 2011, an outreach program was launched to contact international investors and proxy advisory firms and to gather data on voting expectations and concerns over remuneration. Initial feedback showed slightly less than 50% of the target had constructive feedback to offer. In 2012, a second outreach program was undertaken, this time with a more customized approach, taking into consideration the previous year's response. Almost 75% of the those contacted responded with constructive suggestions in regard to the proposed compensation schemes. Encouragingly, many of the investors welcomed the active approach to engagement that Unicredit displayed in relation to its remuneration policies.

As a result of the outreach programs, the workingw group identified a number of very specific suggestions for the management and board to consider when developing its future compensation plans, remuneration reports and other materials for the 2012 general meeting. Thanks to the willingness of both Unicredit and its shareholders to engage in dialogue, the company's 2012 general meeting was a success. Better still, UniCredit is now perceived as one of the leading financial institutions when it comes to remuneration practices.

In the period since the program started, international investor support for the remuneration schemes increased from an average of 63% to an impressive 96% – highlighting how a strong commitment from the board and management to listen and factor in other points of view, along with a tailored communication plan, can produce extraordinary results. Even though it is often difficult to find empirical evidence, this results achieved by this exercise should encourage other corporations, both in Italy and abroad, to seek constructive dialogue with their shareholders and regain the lost alignment between ownership and management.

ABOUT THE AUTHOR

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