

Client Alert

Latham & Watkins
Corporate Department

New Rules on Transparency of Executive Compensation of Italian Listed Companies

On December 23, 2011, the Italian Financial Authority – Consob (*Commissione Nazionale per le Società e la Borsa*) adopted resolution no. 18049 (the “**Resolution**”) that amends Consob Regulation no. 11971 of May 14, 1999 (the “**Issuers Regulation**”) in order to implement at the regulatory level the more general law on executive compensation of Italian listed companies (“**Issuers**”) set out in Article 123-ter of Legislative Decree no. 58 of February 24, 1998 (the “**Single Financial Act**”). Such provision regulates the level and content of disclosure to be provided by Issuers regarding executive compensation and the mechanism for a non-binding shareholder vote to approve of an executive compensation policy for the relevant Issuer.

This client alert describes the main innovations introduced by the Resolution and discusses the new regime on Issuer transparency of executive compensation.

1. The purposes of the new regime on transparency of executive compensation

Article 123-ter was introduced in the Single Financial Act in 2010² to implement in Italy the Recommendations of the European Commission on director compensation of listed companies adopted in 2004 and 2009³.

Until the adoption of Article 123-ter of the Single Financial Act, Issuers had no generalized obligation to articulate or disclose to the market any policy on executive or director compensation. There were, however, specific obligations with respect to disclosure for amounts paid to members of management and control bodies, general managers and managers holding strategic responsibilities⁴ within the Issuer as well as disclosure requirements with reference to incentive plans based on securities⁵.

As discussed in this Alert, Article 123-ter of the Single Financial Act and the relevant implementation provisions introduced by the Resolution pursuant to the Issuers Regulation pursue the aim of increasing transparency regarding compensation matters. The Resolution, therefore, responds to a shareholder and stakeholder demand for greater transparency which has gathered strength during the recent global financial crisis. The Resolution embodies the ideal that transparency represents a fundamental means of ensuring integrity and the effectiveness of corporate governance systems. Disclosure of compensation matters allows investors to understand and analyze the incentive structure to reward members of management and control bodies, general managers and managers holding strategic responsibilities, fostering a more accurate evaluation

“The new Italian rules require greater disclosure and accountability on executive compensation and entitle the shareholders to have more say over corporate pay packages.”

of the Issuer and an informed exercise of shareholders' rights. In addition, disclosure of executive compensation can stimulate and shape market participants and industry bodies to structure compensation in a manner that will align management self-interest with the maximization of shareholder value or other enterprise goals. Finally, increased transparency will foster best practices and the risk of negative publicity or market reaction will encourage more effective compensation structures. Moreover, in a context wherein Issuers are frequently controlled by majority shareholders, transparency may represent an effective protection for minority shareholders⁶.

2. The regulations contained in Article 123-ter of the Single Financial Act on the report on compensation

Article 123-ter of the Single Financial Act requires Issuers to make available to the public a report on executive compensation (hereinafter, the "**Report**") at least 21 days before the annual shareholders' meeting called to approve the yearly financial statements pursuant to Article 2364, paragraph 2 or Article 2364-bis, paragraph 2, of the Italian Civil Code⁷.

The Report must be approved by the Board of Directors of the relevant Issuer and is divided into two sections⁸:

- The first section describes: (a) the policy adopted by the Issuer for the compensation of directors, general managers and other managers holding strategic responsibilities, in all cases for at least the following fiscal year; and (b) the procedures for the adoption and the implementation of such compensation policy
- The second section of the Report: (a) provides an appropriate disclosure of all the components of the compensation and their compliance with the compensation policy approved in the previous fiscal year, including any indemnity in the event of early termination and; (b) describes in detail any compensation paid during the relevant fiscal year, regardless of source, and in any form by the Issuer and its controlling or affiliate companies, also indicating the possible components of such compensation that are attributable to activities performed during the fiscal years preceding the relevant one, highlighting deferred compensation for the activity performed during the relevant fiscal year, and it is recommended, possibly indicating an estimated value for the components of the compensation which are not objectively quantifiable during the relevant fiscal year. Such information must be provided on a name basis for the directors and the statutory auditors and, on a generalized aggregate basis for managers holding strategic responsibilities save for certain exceptions as set out in the Resolution.

According to the principle of "say on pay" as implemented in the United Kingdom and the United States, among other jurisdictions, Article 123-ter requires the shareholders' meeting called to approve the yearly financial statements to approve or reject the first section of the Report on the compensation policy. Such resolution is not binding but the voting results must be made available to the public on the website of the Issuer.

Article 123-bis, paragraph 7 of the Single Financial Act, delegates rulemaking authority to Consob to determine the level and type of information which should be included in the first section of the Report. Consob is required to first consult with the Bank of Italy and Isvap (the Italian insurance regulator) with respect to their respective regulatory mandates and Consob should also consider any relevant EU provisions⁹. Consob will then establish disclosure requirements regarding the coherence of the Issuer's compensation policy with the Issuer's long-term interests and its compliance with the Issuer's risk management policy¹⁰ as well as set guidelines regarding the content of the second section of the Report which, among other things, lists specific compensation paid in the relevant fiscal year. In addition, Consob has been empowered to identify managers holding strategic responsibilities and determine the level of information to be provided regarding such managers'

compensation on an individualized basis. Consob can also establish varying levels of granularity of information based on the market capitalisation of the Issuer¹¹.

3. The new discipline introduced in the Issuers Regulation by the Resolution

In order to fully enact the provisions contained in Article 123-ter, the Resolution has introduced in the Issuers Regulation a new Article 84-quater which details the content of the Report that must be prepared in compliance with a new form attached under Scheme 7-bis of Annex 3A to the Issuers Regulation (the "**Form 7-bis**").

According to Form 7-bis, the Report must be divided into two sections: the first section provides, with reference to an Issuer's directors, general managers and managers holding strategic responsibilities¹², information regarding the Issuer's compensation policy, and the procedures to adopt and implement such policy. In particular, the first section of the Report must indicate, *inter alia*: (a) the corporate bodies, committees and persons tasked with preparing and implementing the Issuer's compensation policy; (b) the role, if any, of the compensation committee or any other competent committee, including a description of its duties and composition (distinguishing the non-executive and the independent members thereof); (c) the name of any independent expert engaged to advise on compensation matters; (d) the goals advanced by the Issuer's compensation policy and any change to the policy adopted in the previous fiscal year; (e) detailed information concerning the policies adopted on fixed and variable compensation with a description of the performance goals adopted when assigning the latter; (f) information concerning the criteria adopted to evaluate the performance goals used when granting stock option or other incentive plans; (g) information on any golden parachute and indemnity in event of dismissal or resignation from office as well as a description of the circumstances in which such provisions are activated as well as the indication of any link with the performance of such director or manager; (h) information concerning any insurance or pension fund coverage; (i) information concerning any compensation policy adopted for independent directors, committees and other offices such as the Chairman and the Vice-Chairman of the management body.

The second section of the Report is in turn divided into two sections and must describe on an individualized basis: (a) the compensation of directors, statutory auditors and general managers; and (b) the compensation of managers holding strategic responsibilities received in the course of the fiscal year at issue if such compensation (determined adding and monetary and securities based compensation) is higher than the highest total compensation paid to the persons corresponding to clause (a) above. With respect to any other manager holding strategic responsibilities other than those under clause (b) above, the information concerning their compensation is to be provided on an aggregate basis. The same aggregate information with respect to the managers under clause (b) above can be provided by the small capitalization Issuers as defined in the Related Parties' Regulation (hereinafter, "**Small Cap Issuers**")¹³.

The second section of the Report provides for a detailed description of each item that composes executive compensation, including the indemnities paid in case of early termination of the office or the employment contract, and a discussion of such compensation's compliance with each provision of the general compensation policy adopted by the Issuer.

With reference to the incentive plans based on securities, there may be a cross reference to the information included in such incentive plans disclosed to the market through a separate document pursuant to Article 114-bis of the Single Financial Act.

The Regulation grants Small Cap Issuers the ability to limit the information concerning the agreements that provide indemnities in case of early termination to relevant executive directors and the Chairman of the Board of Directors.

The second section of the Report also requires mandates disclosure, for each relevant person, of any compensation paid by the Issuer and its subsidiaries and affiliates. This requires various tables which list all the persons who served as directors, statutory auditors, general managers or managers holding strategic responsibilities during the fiscal year concerned.

In addition to the above, new Article 84-*quater* requires the Issuers to disclose in the Report, in accordance with a new form attached under Scheme 7-*ter* of Annex 3A to the Issuers Regulation, all the shareholdings owned by the directors, statutory auditors, general managers and managers holding strategic responsibilities, including those held by their respective spouses as the case may be (if not legally separated), minor children under 18 years of age, in both instances, either directly or indirectly through controlled companies, trusts and nominees, as evidenced by the Issuer's ledger or from any other information and notice gathered by directors, statutory auditors, general managers and managers holding strategic responsibilities. It should be mentioned that the form under Scheme 7-*ter* of Annex 3A does not require disclosure of shareholdings held in the companies which control the Issuer.

4. Disclosure of the Report

Pursuant to Article 84-*quater* of the Issuers Regulation as introduced by the Resolution, the Report must be made available to the public at the registered office of the Issuer, on its website, and further available pursuant to the officially appointed mechanism for the central storage of regulated information. Article 84-*quater* also specifies that the Report must remain published on the Issuer's website for at least the entirety of the fiscal year during which such compensation is granted, vested or paid.

The Issuer can apply for an exemption to such disclosure of the Report if the contents regarding compensation would cause serious damages to the relevant Issuer¹⁴. Within a period of seven days, Consob may decide whether to exempt, fully or in part, and for a limited period of time, the disclosure of the Report or certain information therein insofar as such exemption does not mislead investors regarding essential facts and circumstances. Such provisions are in line with the Recommendation of the European Commission no. 2004/913/EC that states that the disclosure of compensation matters should not include any business-sensitive information¹⁵.

5. Further amendments to the rules on executive compensation

In light of the new disclosure regime on compensation established by Article 123-*ter* of the Single Financial Act and new Article 84-*quater* of the Issuers Regulation, the Resolution simplifies and structures in a more consistent manner other relevant provisions on compensation contained in the Issuers Regulation. Thus, in order to centralize all the relevant information on compensation, the Resolution abolished the provision requiring disclosure and discussion of compensation of the Issuer's directors in the notes to the Issuer's financial statements (Article 78 of the Issuers Regulation).

Furthermore, in order to avoid duplication of the disclosure duties, the Resolution has simplified the information to be provided on the incentive plans based on securities and other financial instruments in the information document to be published according to Article 114-*bis* of the Single Financial Act and Article 84-*bis* of the Issuers Regulation. Such plans must be attached to the Report pursuant to Article 123-*ter*, paragraph 5 and Article 84-*quater* paragraph 2 of the Issuers Regulation, or a cross reference in the Report must indicate where such plans are available on the website of the Issuer.

6. Entry into force of the new rules

The Resolution entered into force on December 31, 2011. Therefore, Issuers will have to publish the Report relating to the 2011 fiscal year, to be examined by the shareholders' meeting called in 2012 for the approval of the financial statements relating to the 2011 fiscal year pursuant to Article 2364, paragraph 2 or Article 2364-bis, paragraph 2 of the Italian Civil Code.

Endnotes

- ¹ The Resolution is the result of a large public consultation with the market participants that was launched by Consob through the consultation paper "*Implementation of Article 123-ter of Legislative Decree no. 58/1998 on transparency of compensation of directors of listed companies*" (the "**Consultation Paper**") published on October 10, 2011.
- ² Article 123-ter was introduced by Legislative Decree no. 259 of December 30, 2010 (published in the Official Gazette no. 30 of February 7, 2011) which implemented the delegation set forth by Article 24 of Law no. 96 of June 4, 2010.
- ³ See Recommendation of the European Commission no. 2004/913/EC of December 14, 2004 relating to the promotion of an adequate regime on compensation of directors of listed companies and Recommendation of the European Commission no. 2009/385/EC of April 30, 2009 which supplements Recommendation of the European Commission no. 2004/913/EC and Recommendation of the European Commission no. 2005/162/EC on the role of non-executive directors or of members of the supervisory board of listed companies and on the internal committees of the board of directors or of the supervisory board.
- ⁴ Article 78, paragraph 1 of the Issuers Regulation, repealed by the Resolution, provided that "*the issuers of securities should describe in the explanatory notes to the financial statements, on a name basis and pursuant to certain criteria established in Annex 3C to the Issuers Regulation, the compensation paid regardless of provenance and in any form, also by subsidiaries, to the members of the management and control bodies and to general directors. The compensation paid to managers holding strategic responsibilities regardless of provenance and in any form, also by subsidiaries, are disclosed on an aggregate basis.*"
- ⁵ Article 84-bis of the Issuers Regulation, as amended by the Resolution, provides for an obligation for Issuers to make available to the public a document drafted pursuant to scheme 7 of Annex 3A to the Issuers Regulation, as amended by the Resolution, on the compensation plans based on securities pursuant to Article 114-bis of the Single Financial Act within the deadline for publication of the notice of call for the shareholders' meeting called to resolve on such plans.
- ⁶ See pages 6 and 7 of the Consultation Paper.
- ⁷ See page 13 of the Consultation Paper.
- ⁸ See Article 123-ter, paragraphs 2 and 3 of the Single Financial Act.
- ⁹ The Resolution, by which Consob has enacted the legislative delegation, has taken into account the recent provisions on compensation adopted by the Bank of Italy for banks and banking groups (see the Bank of Italy provision of March 30, 2011 entitled "*Provisions on policies and practices of compensation and incentive, in banks and banking groups*") and by Isvap for insurance companies (see Isvap regulation no. 39 of June 9, 2011 on the compensation policies of insurance companies). The Resolution has also taken into account the amendments of March 2010 to Article 7 of the New Corporate Governance Code for Issuers promoted by Consob's Corporate Governance Committee, relating to compensation of directors and managers holding strategic responsibilities, in order to implement, by way of self-regulation, European Commission recommendations mentioned *infra* in Note 10.
- ¹⁰ The guidelines will be consistent with Recommendation of the European Commission no. 2004/913/EC and Recommendation of the European Commission no. 2009/385/EC.
- ¹¹ On February 24, 2011 Consob, awaiting the final implementation of Article 123-ter of the Single Financial Act, issued a general communication (no. DEM/11012984) containing requests and recommendations to Issuers in order to increase transparency on compensation, with reference only to the fiscal year 2010.
- ¹² According to new Article 65, paragraph 1-*quater* of the Issuers Regulation as introduced by the Resolution, "*managers holding strategic responsibilities*" are those defined as such by Annex 1 to Consob's regulation on related parties' transactions adopted with resolution n. 17221 of March 12, 2010 (the "Related Parties' Regulation"): "*people who hold, directly or indirectly, the power and responsibility*

of planning, direction and control of the business of the company, including the directors (executive or not) of the company.”

¹³ According to Article 3(f) of the Related Parties' Regulation “*small cap issuers are those issuers whose assets in the balance sheet or whose revenues, as resulting from the last approved consolidated financial statements, are less than Euro 500 million. Small cap issuers lose such qualification if for two consecutive fiscal years do not meet both the requirements above*”.

¹⁴ See Article 114, paragraph 6 of the Single Financial Act.

¹⁵ See Article 3.3 of Recommendation of the European Commission no. 2004/913/EC.

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