CORPORATE GOVERNANCE

FINANCIAL TIMES **SPECIAL REPORT** | Thursday October 7 2010

www.ft.com/corporate-governance-2010 | twitter.com/ftreports

Responsibility debate comes to the fore

After the financial crisis, the relationship between companies and their investors is under growing scrutiny, reports **Miles Johnson**

It took the near collapse of some of the world's largest banks finally to bring long-bubbling debates over shareholder responsibility to the front burner.

While the list of culprits drawn up by politicians, regulators and the media was long – with both investment and central bankers bearing the brunt of the blame – the nature of the relationships between investors and companies is coming under greater scrutiny.

In the eyes of the most critical observers, the lack of oversight exhibited by investors in banks in the run-up to the financial crisis was evidence that they had been co-opted into a cosy coterie of "absentee landlords" and had forgotten the interest of the pensioners and savers for whom they work.

Some have even argued that the fact that certain banks galloped towards the brink of disaster, being pulled back only by the heavy hand of government, has shattered the illusion that management teams will always act in the best interests of their ultimate bosses – the investors.

Alan Greenspan, the US central banker once celebrated as "the maestro" conducting the direction of the global economy, lamented the situation thus: "I made a mistake in presuming that the self-interests of organisations, specifically banks and others, were such that they were best capable of protecting their own shareholders and their equity in the firms."

It is these debates that have thrust corporate governance into the centre of wider discussions about if, and how, the financial system should be radically reshaped to ensure systemically important companies can never again threaten the stability of the global economy.

The sometimes maligned institutional investors themselves are also looking for reassurances.

Shareholders, who governments in the US and Europe will eventually rely upon to take bailed-out banks back into private ownership, will be reluctant to supply funds, unless they can be confident that boards will act in their long-term interests.

For Colin Melvin, chief executive of Hermes Equity Ownership Services, a crucial battle is to convince all shareholders that good corporate governance goes hand in hand with maximising investment returns.

Inside this issue

US Legislation is likely to encourage investors to try to bend companies to their will, writes **Justin Baer Page 2**

China **Jamil Anderlini** says the state is still jealously guarding the levers of power **Page 2**

Russia Laws do exist but enforcement is patchy. **Charles Clover** reports **Page 3**

EU The UK worries about a one-size-fits-all approach to regulation, says **Miles Johnson Page 4**

"In the short term, you can make money by doing the wrong thing, but in the long term making money and doing the right thing converge," he says.

However, due to the costs and time needed for engagement, which can lower the returns for an asset manager's ultimate beneficiaries, some worry that an overly regulation-based approach to governance will be counterproductive.

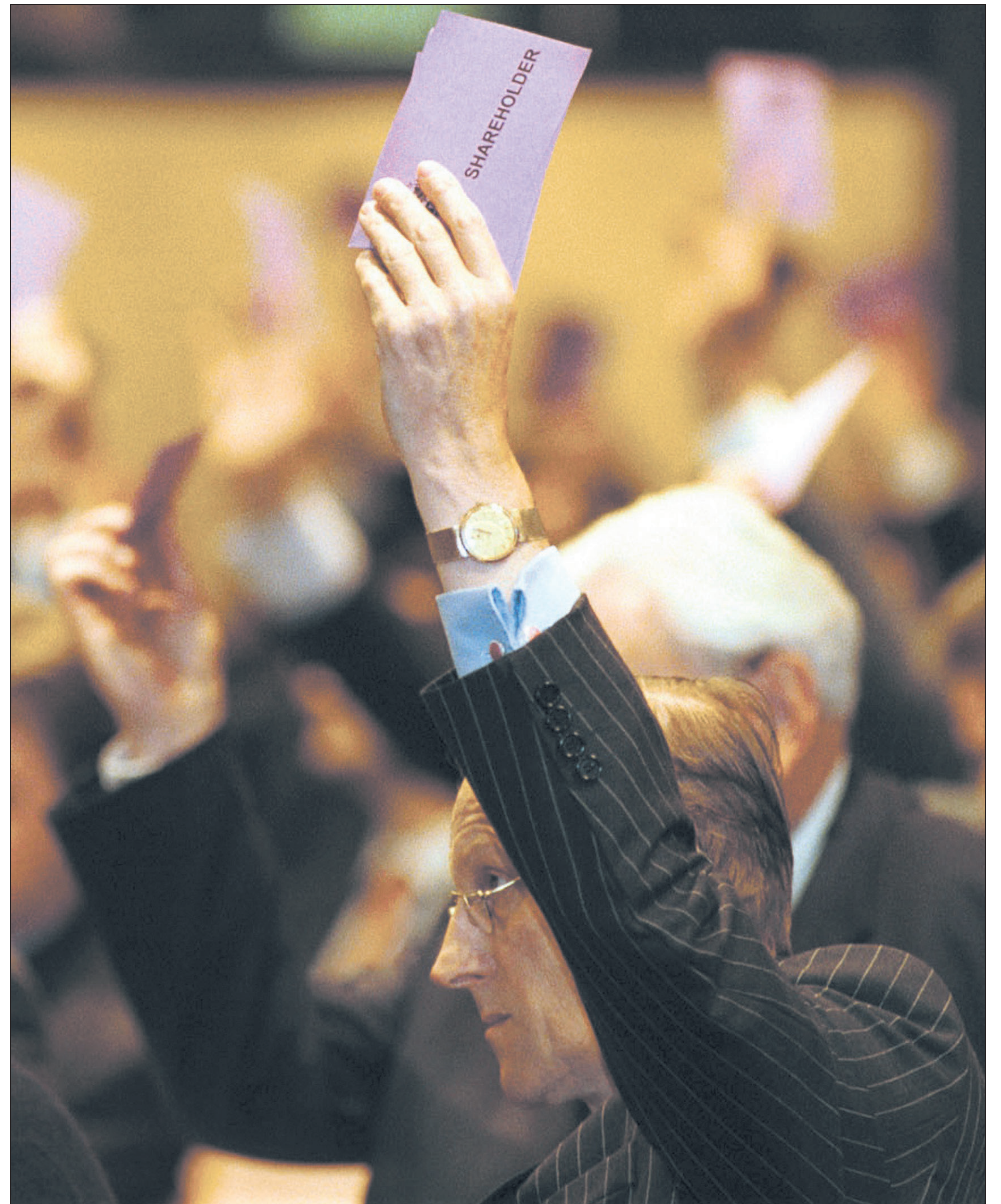
Others have pointed out the difficulties of the so-called "free rider" effect. Those investors who do engage pass on the benefits to others, who are sometimes competitors for business, who do not themselves bother to get involved.

"The free rider effect is always there but we engage because we believe that is what good fund managers do," says Anita Skipper, Global Head of Corporate Governance at Aviva Investors.

"The fact that other people own the company is neither here nor there, and that is why stewardship and investment need to go hand in hand."

Ms Skipper also argues that the people making investment decisions, the fund managers, are often judged on their short term performance and ability to

Continued on Page 2



A motion for change: there is a lack of global consensus on the role of shareholders in governance Corbis

Market incentives shrink grey economy

Brazil

Vincent Bevins explains how listing rules have encouraged transparency

OSX Brasil joins the *Novo Mercado*, which demands higher standards of governance than required by law Bloomberg

Not long ago, it would have been difficult to find many advocating Brazil, long characterised by financial crisis and family-style management, as a role model for corporate transparency or shareholder rights.

Now, however, the country is often held up as a bright light in the relatively murky world of emerging markets.

Over the past decade, the development of Brazil's capital markets has been helped along by developments in corporate governance standards on the BM&FBovespa multi-asset exchange, and many companies' emergence from the grey market into the formal economy.

Although the state has played its role, most analysts point to clever innovations that harness market incentives to encourage companies to undertake reforms voluntarily.

Perhaps the most celebrated is the introduction of the *novo mercado*, or new market, a listing segment on the BM&FBovespa.

To join the *novo mercado*, companies must issue only voting shares, offer 100 per cent tag-along rights – which protect minority shareholders by giving them the right to sell shares at the same rate if a majority shareholder sells its stake – and maintain a free float of at least 25 per cent of shares, among other rules.

This contrasts with an historical governance structure and legislation, in which small groups can maintain control with less than 20 per cent of total shares.

The new regulations were designed by the exchange, and choosing to list is voluntary but most companies that have held initial public offerings in the reinvigorated market of the past 10 years have chosen to do so.

"In 2000, the scenario was bleak. There were no new listings, and no IPOs," says José Luiz Osorio, partner at Jardim Botânico Investments, and formerly of the CVM, Brazil's securities and exchange commission. "We needed reform to send a big signal."

"After the introduction of the rules, the Brazilian market changed completely," says Cristiana Pereira, issuer development officer at the BM&FBovespa. "The IPO market flourished, we had a boom in 2006 and 2007 and even during the financial crisis we had IPOs."

Submitting to *novo mercado* strictures, or to those of level one or level two – two other voluntary governance categories that go beyond legal requirements – is "not just about price", says Ms Pereira. "It's about viability. It's not possible to do it outside *novo mercado*, except for very large companies."

The most notable recent listing that does not conform to *novo mercado* rules was last month's world record $67bn share offering

> Countries have been asking Brazil for advice on how it undertook its reforms

from Petrobras, the state-owned oil company.

The BM&FBovespa has done very well, as the crisis sent money scurrying from developed to emerging markets.

It is now the world's third-largest exchange by market value, and companies participating in special corporate governance levels represent 68.7 per cent of market capitalisation, 77.5 per cent of financial volume and 80 per cent of trades in the spot market.

Market forces have also been effective in forcing the formalisation of Brazil's companies, who these days are more likely to have a single set of accounts and behave properly, especially if they want to be taken seriously or participate in a merger or acquisition.

"Companies who are going formal need a set of accounting principles to show the market that they are serious and have a set of controls over the operations," says Ricardo Balkins, partner at Deloitte in Brazil.

Though the government has increased surveillance of companies, the move from the grey market to the formal economy "is mostly market-based", says Mr Balkins.

"One of the beauties of the development of capital markets here is that sectors such as real estate, meat producers, and so on, have been getting valuations that are much better than when they were on the grey markets," Mr Osorio says.

Other countries have been asking Brazil for advice on how it undertook its reforms, and the country now gets good reviews at international corporate governance events.

"Within a Latin American context, Brazil gets that attention because of its size," says Dwight Clancy, Latin America corporate governance analyst at Glass Lewis, a shareholder advisory firm in San Francisco.

"Countries such as Chile have done a better job of enshrining shareholder rights in national regulation but Brazil did a good job earlier this decade of using market forces."

However, recent developments have not been as inspiring for corporate governance advocates in the country, says Mr Clancy.

A new round of reforms for the *novo mercado* was delayed by companies who vetoed some of the more stringent regulations.

"That looked a little like the old Brazil," Mr Clancy says.

Mr Osorio adds: "I still think we are ahead but corporate governance is something on which we need constant improvement, it can't be something that is static."

Managing risk is an art in itself.

DAVID HARDING
Managing Director,
Winton Capital Management

David Harding has a perfectly clear picture of risk. As managing director and a founder of one of London's most prominent commodity trading advisors, with $13 billion under management, David relies on CME Group to manage a complex portfolio that includes everything from cattle futures to Eurodollars. With unparalleled liquidity, transparency and speed, and the security of central counterparty clearing, CME Group guarantees the soundness of every trade. That's why CME Group is where the world comes to manage risk. Learn more at **cmegroup.com**.

CME Group

CME Group is a trademark of CME Group Inc. The Globe logo, CME, Chicago Mercantile Exchange, E-mini and Globex are trademarks of Chicago Mercantile Exchange Inc. CBOT and Chicago Board of Trade are trademarks of the Board of Trade of the City of Chicago. NYMEX, New York Mercantile Exchange and ClearPort are trademarks of New York Mercantile Exchange Inc. COMEX is a trademark of Commodity Exchange Inc. All other trademarks are the property of their respective owners. Copyright © 2010 CME Group. All rights reserved.

Corporate Governance

Pay and benefits are still activists' biggest beef

US

Financial legislation is likely to encourage more investors to try to bend companies to their will, says **Justin Baer**

Occidental Petroleum, KeyCorp and Motorola are three US companies with little in common. They operate in vastly different industries, in diverse markets with dissimilar customers and competitors.

Yet in the minds of many corporate directors, institutional investors and their advisers, Occidental, an oil and gas company, KeyCorp, a regional bank, and mobile-phone maker Motorola may be linked inextricably by a shared setback.

All three failed to persuade a majority of their shareholders that their executive-compensation policies were appropriate this year in management-sponsored "say-on-pay" votes.

These non-binding polls, and the embarrassment the dissent left behind, offered a glimpse of the power shareholders could wield in the coming years now that "say-on-pay" votes and other corporate governance reforms are becoming mandatory.

"Many things investors have been clamouring for for many years have come to fruition," says David Lynn, a former chief counsel for the US Securities and Exchange Commission who now co-chairs the public companies and corporate governance group at law firm Morrison Foerster.

"What people have been convinced of is that governance matters should be part of their overall investment decision-making."

Landmark US financial services reform legislation The Dodd-Frank Act – aimed at pushing banks and securities companies into a new era – will also bring change beyond Wall Street.

Several governance initiatives, including those that enable all shareholders to vote on executive pay and golden parachutes for outgoing managers and pave the way for larger investors to put forward their own directors, were included in the legislation.

The bill granted investors who have held at least a 3 per cent stake in the company for a minimum of three years the right to replace 25 per cent of the board with directors of their choosing. The SEC approved the rules on so-called proxy access in August.

Other provisions, including those that decide directors' elections by a majority vote and campaigns to withhold votes on objectionable board members, have also been gaining in popularity.

Executive compensation has remained the activist investor's cause of choice, with non-binding "advisory proposals" – such as say-on-pay – becoming more common even before the financial regulatory legislation.

Unjustified pay increases, lucrative pensions and retirement funds, and excessive perks have all come under greater scrutiny, says David Drake, president of Georgeson, the proxy solicitor – proxy advisers provide advice on corporate governance to institutional shareholders.

Almost 70 companies had voluntarily adopted say-on-pay resolutions this year, and another 280-plus were required to grant investors a vote on pay as a condition of receiving bail-out funds through the government's troubled asset relief programme, according to Georgeson.

As the list of decisions facing shareholders grows, many institutional investors have sought the counsel of proxy advisers.

'From a board perspective, it's a much more activist environment and with each year it gets progressively more so'

The new rules are likely to encourage more investors to try to bend companies to their will. They come at a time when the term "shareholder activism" is no longer reserved for aggressive hedge funds or special-interest groups.

"Activism has become less pejorative," Mr Lynn says. "Investors are writing letters to companies they don't even know, saying this is our position.

"From a board perspective, it's a much more activist environment, and it gets progressively more so with each proxy season [when companies file proxy statements disclosing material facts to the SEC ahead of the annual meeting]."

Even some mutual fund managers, themselves under more pressure as investors hold them accountable for their votes on shareholder proposals, have been drawn into governance battles with companies in which they invest.

"Some institutional investors on the actively managed side are more concerned about governance," Mr Drake says. "There have been some criticisms levelled at the leading mutual fund companies for voting too often with management."

There is little doubt the activism movement will also continue to spark tension between executives and their directors, who have grown more independent and more mindful of the risks they face if they rubber-stamp management policies.

But while the new proxy season is sure to bring forth a fresh wave of Occidentals, Motorolas and KeyCorps, many more companies will head off similar rebukes by engaging with investors and addressing their concerns.

These dialogues should increase, as shareholders and companies adapt to new governance rules.

Open activism: non-binding "advisory proposals" – such as say-on-pay – are becoming more common Getty

Banks look for new ways to reward their stars

Remuneration

Senior figures insist they are sensitive to the post-crisis climate, says **Megan Murphy**

Politicians and regulators are squaring up for another fight over the size of bonuses awarded across Wall Street and the City of London, amid fears that banks have returned to "business as usual" two years after the near-collapse of the global financial system.

Cracking down on perceived excess in an industry widely blamed for the crisis remains a top priority for officials who believe that lavish bonus pay-outs fuelled excessive risk-taking and encouraged bankers to exploit a "light touch" regulatory framework on both sides of the Atlantic.

In the UK, workers in the financial services sector are now subject to the strictest remuneration regime in the world, including caps on the proportion of bonuses that can be paid in cash and a requirement that as much as 60 per cent of bonus payments are deferred over several years.

In the US, government-appointed "pay tsar" Kenneth Feinberg has publicly named and shamed 17 banks that overpaid their executives at the height of the crisis. He has subjected those lenders that have yet to repay taxpayer bail-out money to tough restrictions on how they can reward their top 25 people.

Senior bankers insist they are sensitive to the post-crisis climate and claim to have rethought their remuneration structures to account for new pay rules.

Last year, at the height of the public furore over pay, banks such as Goldman Sachs, Credit Suisse and Barclays Capital slashed the percentage of net revenues paid to employees, moving from a historical industry average of between 45 and 65 per cent to as low as 30 per cent at some banks.

A recent survey by the Institute of International Finance, the industry lobby group, also revealed that investment banks are using far fewer "guaranteed" pay packages to attract recruits, and have all but abolished controversial "multiyear" guarantees, where employees are promised a fixed incentive payment regardless of their performance or their business's profitability.

But concerns are growing that the absence of an international regulatory consensus on pay is making some banks increasingly wary of further restricting bonuses, amid fears of ceding ground to less regulated rivals.

In London, in particular, senior bankers complain the Financial Services Authority's intrusive approach has created an uneven playing field in relation to New York, Geneva and Asian centres, where officials have not taken as hard a line.

While the coalition government of David Cameron, the prime minister, has repeatedly indicated that it will not introduce last year's one-off 50 per cent "supertax" on bonuses higher than £25,000, there is concern that come the first reports of multibillion pound bonus pools, bankers will be seen as easy targets for boosting the UK Treasury's depleted coffers.

Senior bankers privately admit that they are actively looking at new ways to reward their top performers that remain within the letter and the spirit of the new guidelines.

Credit Suisse, for example, recently awarded about 400 senior employees in London a one-off, midyear bonus after bankers complained that they had been disproportionately affected by the supertax.

Unlike most rivals, which chose to shoulder the tax institutionally, Credit Suisse cut its global reward pool by 5 per cent and reduced UK managing directors' bonus awards by a further 30 per cent.

Many other banks have sharply increased salaries, reducing their employees' reliance on big, one-off bonus payments but also reducing their flexibility on costs in the event of another downturn.

Perhaps more significantly, in spite of all the talk of bank "fat cats", it has actually been a very difficult two quarters for financial institutions' investment banking and sales and trading businesses.

Several analysts are predicting banks will have to slash their bonus pots and shed thousands of staff

Several analysts are predicting banks will have to slash their bonus pots and shed thousands of staff unless activity picks up strongly in the fourth quarter.

Already, groups including Barclays Capital, Credit Suisse and Bank of America Merrill Lynch have announced job cuts, and many more are expected.

Of course, that does not mean that banks will not be paying out billions in bonuses but the levels are forecast to be significantly lower at many institutions than in 2009.

That may deflect some of the political heat come next year's bonus season but politicians and regulators are still likely to question how much things have really changed.

Star performers are still commanding top packages, as shown most recently by reports that Stephen Trauber, a prized energy banker poached by Citigroup from UBS, has signed a deal that could earn him as much as $30m over the next three years.

But bankers hoping for a respite from last year's unprecedented political and public outrage over pay are in for a long wait.

Party shows penchant for cosmetic reform

China

Jamil Anderlini finds Beijing still jealously guarding the levers of power

In late 2008, international investors were greeted with news that the top managers of China's three largest state-controlled airlines had been reshuffled without warning or explanation.

China Eastern Airlines replaced its chairman with the chairman of China Southern Airlines and also appointed a senior official from Air China as its president and executive director, while the man he replaced went to work for Air China in what appeared to be a straight swap.

All three airlines are listed on the Hong Kong stock exchange and have boards of directors and other trappings of modern corporate governance structures.

But this game of musical chairs had nothing to do with that.

The decision to rotate the top executives of the airlines was made by the highly secretive and largely unaccountable Organisation Department of the Communist Party of China Central Committee.

"We are all under the leadership of the party and it is up to the Organisation Department to make these decisions," one official from China Southern told the Financial Times at the time.

For international investors who have been around China for a while, this kind of shake-up is familiar and recognised as a sign that Beijing is planning a wave of reforms and consolidation in a particular sector.

Similar reshuffles of executives at state-owned companies that are supposedly keen competitors have occurred in numerous industries in recent years, most prominently in the telecommunications and banking sectors.

This type of exercise largely makes a mockery of the modern, western-style governance structures that have gradually been put in place at many state-owned enterprises over the past 15 years.

While it has receded into the shadows and built up the façade of modern corporate governance, the Communist party retains the final say in all big strategic decisions of these companies.

The chief executives and chairmen of most leading enterprises often consider themselves career politicians as well as captains of industry, and the party is just as likely to send them to be governor of a far-flung province as shift them to head a rival company.

In fact, the top officials at the largest state-owned enterprises are granted minister-level status in the Communist party while the heads of other important companies, including the largest state banks, hold vice-minister rank.

Which company chiefs hold minister status is a secret but according to people with knowledge of the matter, there are five of them and they include energy giants Sinopec, PetroChina and China National Nuclear Corporation.

The level of secrecy surrounding something as trivial as this provides a clear example of how far behind China is when it comes to creating a transparent and open governance environment.

A recent report co-written by CLSA, the Hong Kong-based brokerage, and the Asian Corporate Governance Association ranks China second to last in Asia in terms of "corporate governance culture", ahead of only the Philippines.

The report notes that the country's governance culture and enforcement of laws and regulations significantly lag behind regional neighbours, in a region that considerably lags behind the rest of the world.

"Corporate governance standards have improved in Asia over the past decade but even the best markets remain far from international best practice," the report concluded.

China is not ranked as one of the best markets.

Even the Chinese translation for corporate governance – *gongsi zhili* – implies official government control and regulation of companies rather than a system of transparent and independent checks and balances that protect the interests of all stakeholders.

Many experts who have studied Chinese corporate governance structures conclude the reforms implemented in recent years to introduce international standards have often been largely window dressing – a necessary precondition to listing on offshore stock exchanges and attracting foreign capital.

According to Amar Gill, CLSA's head of thematic research, the global financial crisis of 2008 was a wasted opportunity for Beijing and other governments in the region.

Air China had a board shake-up in 2008, at the behest of the party

"Rather than use it to push reform forward, most governments have taken a complacent view, happy that the crisis this time did not start in Asia," Mr Gill says.

"Not enough has been invested to make best practices work and the negative trends we see may lead to a build-up of governance risk for the coming years."

The penchant for cosmetic rather than substantive governance reform in China appears to be behind the recent rush by many large companies to produce glossy documents outlining their contributions and achievements in the field of Corporate Social Responsibility.

According to CLSA's report: "Even Chinese companies are encouraged to publish CSR reports to improve the country's branding and competitiveness."

Although the Communist party is encouraging its companies to introduce the trappings of modern governance structures, it continues jealously to guard the main levers of power and shows little sign of giving them up in the future.

Responsibility debate comes to the fore

Continued from Page 1

make snap judgments, meaning longer term governance issues can be of less concern.

"People can talk about corporate governance like it is something alien, when in fact it is integral to the future of companies," she says.

While the crisis has resulted in renewed focus on issues such as controls on corporate pay, risk management and board transparency, there remains a lack of global consensus on the roles and responsibilities of shareholders and what makes for good governance.

The increasing internationalisation of investors, with entities such as sovereign wealth funds and global asset managers owning greater numbers of shares outside their home markets, has led to more focus on harmonising governance standards across jurisdictions.

In the UK, the introduction of a code of governance conduct that all investors will have to sign up to, or explain why they have not, is seen by advocates as an important step towards strengthening engagement between companies and their investors.

Other developments in the UK, such as the annual re-election of board members by their shareholder base, have proved more controversial.

While some argue this provides an effective way for investors to hold management to account, other institutional shareholders

'As companies, we must do better. We need better, more diverse, boards'

have urged companies to ignore the measure, arguing that it encourages the short-termism that leads to strategic mistakes.

Meanwhile, in the US, investors are moving slowly towards gaining the rights that their peers in Europe take for granted, such as having a say on executive pay, and the right to vote on the election of directors.

Other contributions to this debate, however, have asked broader, and possibly more radical, questions about the duties of investors – some even reassessing the fundamental tenets of whether the shareholder-based concept of governance can work at all.

An early stage, consultation issued by the European Commission this year examining governance at financial institutions asked whether the "presumption of effective control by shareholders" could be still be relied on.

This has, in turn, prompted concern among some investors in the UK that the country's system of "comply or explain" governance, which relies on investor participation rather than coercion, could be eroded by blunter, catch-all regulations.

"There will be an awful lot of people trying to find out what went wrong in the banking sector and when they look at the reasons, they will look at the controls in place to stop a repeat," says Marc Jobling, assistant director at the Association of British Insurers.

"But we should be a little bit careful of mixing up good corporate governance and regulation. They are not the same thing."

While approaches to governance have differed internationally, few remain unconvinced that, at the very least, there needs to be greater clarity on how governance is approached across jurisdictions, a development that will benefit both companies and their shareholders.

"We have to find ways in our system of public equity markets of getting investors to collaborate," says Roger Barker, head of corporate governance at the UK's Institute of Directors.

"As companies, we have to do better. We need better and more diverse boards, and better transparency."

Contributors

Miles Johnson
Investment Correspondent

Jamil Anderlini
Beijing Correspondent

Justin Baer
Wall Street Correspondent

Vincent Bevins
FT Reporter

Charles Clover
Moscow Bureau Chief

Adam Jones
Accountancy Correspondent

Megan Murphy
Investment Banking Correspondent

Sarah O'Connor
Lex Writer

Ursula Milton
Commissioning Editor

Steven Bird
Designer

Andy Mears
Picture Editor

For advertising details, contact:
Hope Kaye
+1 212 641 6548
e-mail: hope.kaye@ft.com

All FT Reports are available on FT.com. Go to FT.com/reports

Follow us on twitter at twitter.com/ft.reports

All editorial content in this supplement is produced by the FT. Our advertisers have no influence over, or prior sight of, the articles or online material.

Laws do exist but enforcement is patchy

Russia

Charles Clover says shareholders can pursue bad managers but few trust the country's legal system

Valued almost any way, Russian companies are cheap – their shares, on average, trade at about seven times earnings, compared with 13 for Brazil, 15 for China, and 20 for India.

But before running out to load up on Russian shares, one should ask why.

Brokers and analysts almost in unison say the country's notoriously politicised and malfunctioning legal system, along with the perception that investors are vulnerable to powerful local interests are, in a sense, priced into the stock market.

"What holds investors back is concern about enforcement of contracts and corporate governance" says Peter Ghavami, head of global markets for Troika Dialog, the Moscow investment bank.

The government, meanwhile, is making a concerted effort to do something about the bad reputation Russia has in the business world. Legislation is planned and there has already been some progress.

Changes to the insolvency laws last year gave shareholders the ability to pursue managers and other shareholders who strip assets, although no big cases have yet tested this, lawyers say.

But the laws are not the main problem, say most experienced investors.

"The biggest problem is not the law itself, it is the implementation of the law," says the president of a big investment bank in Moscow. Most serious legal wrangling is done in London courts, as few trust Russia's legal system to deliver an impartial verdict.

President Dmitry Medvedev has made curing "legal nihilism" the priority of his presidency.

The government is seeking to court more international investors, as part of a post financial crisis plan to boost investment levels.

To help raise money, a privatisation plan worth $50bn over the next five years was announced by finance minister Aleksei Kudrin in September, and this will include significant stakes in Sberbank and VTB, the two largest state-owned banks.

The success of these efforts depends to a large extent on doing something about Russia's reputation for mistreating minority shareholders and other investors, not to mention corruption, excess bureaucracy, and other worries.

A number of well-publicised scandals involving foreign investors BP, Shell, Hermitage Capital, the investment fund, and Telenor, a Norwegian telecoms company, over the past few years have underlined that protection for foreign shareholders is slight at best and all are beholden to the Kremlin and powerful local interests.

One of the reasons corporate governance can be such a problem is that companies tend to have highly

> 'The biggest problem is not the law itself, it is its implementation'

concentrated ownership – a legacy of high cash flows and low share prices when most were born.

A dominant shareholder or group of shareholders tend to see the company as their personal property, even after it goes public, says a lawyer.

Even a London listing does not make companies immune to these large shareholders' whims.

In December 2008, Sibir Energy, the London-listed Russian oil company, shocked the market by agreeing to buy a property portfolio from one of its largest shareholders for $340m to help relieve his financial difficulties.

A former chief executive of Sibir was fined £350,000 by the FSA, the London city financial watchdog, in July, for his role in the case.

Experts say the cure for the problem of corporate governance lies not just in political will to enact reforms but a culture of legality and transparency – and that this requires Russian corporations having a stake in the process.

One western lawyer in Moscow pointed out that the trailblazer of governance in the 1990s was none other than Yukos, at the time the largest Russian oil company, which had a reputation for mistreating minority shareholders.

But when shareholders discovered they could vastly increase their wealth by increasing Yukos' share price, they embraced corporate governance, appointed several foreigners to management posts and saw the share price shoot up.

"They used to be real raiders," says the lawyer "but realised they could make more money playing by the rules. It was a simple business calculation."

However, that experiment failed with the dismantling of Yukos by the Kremlin after the arrest of its chairman, Mikhail Khodorkovsky, in 2004, in what investors say is the most flagrant example of politicised justice in Russia to date.

It may take Russia some time to rid itself of the stigma of the Yukos affair and other scandals that have hurt investor confidence.

But no matter how many scandals there are, there always seem to be people who will try their luck.

Silent giants start to show more interest

Sovereign funds

The crisis showed the importance of engaged investors, says **Miles Johnson**

It takes little more than a casual glance at the share registers of the FTSE 100 members to see that the notion of companies "belonging" to one specific country is becoming increasingly quaint.

Many constituents of the UK's blue-chip index not only conduct their principal business far away from the City of London but are also increasingly in the control of overseas owners – rather than the institutional investors who once controlled the majority of the City's equity capital.

According to data from the UK government's Office for National Statistics, foreign share ownership of UK listed companies at the start of 2009 hit 41.5 per cent, against a combined 26.2 per cent held by insurance companies and pension funds.

Flash back to 1990 and overseas investors held just 12 per cent of the market, with traditional institutional investors owning more than half.

The overseas investors that have attracted the most attention are sovereign wealth funds (SWFs), the vast state-controlled investment vehicles, typically from countries rich in natural resources and eager to diversify assets.

This increasing diversity of share registers, however, has presented advocates of shareholder engagement with new challenges: state-controlled international investors have developed a reputation for passivity on corporate governance.

"If you are a Middle Eastern investor with hundreds of billions in funds freely available, you may see issues such as executive pay in a different light from traditional investors," says Marc Jobling, assistant director at the Association of British Insurers.

With large stakes in companies such as BP, Credit Suisse, Total and Barclays, now held by SWFs, it is no longer possible to overlook them in debates on the development of shareholder engagement after the financial crisis.

"To date, SWFs have been a relatively unknown quantity but you can't lump them all together and say they will all behave the same," says Vanessa Knapp, principal consultant at law firm Freshfields.

Norges Bank Investment Management, which manages the assets in the Norwegian state pension fund, a huge SWF, is estimated to own about 2 per cent of European listed companies, up from 0.7 per cent before the financial crisis.

Other high-profile SWFs active in the European markets include China's State Administration of Foreign Exchange (Safe), China Investment Corp and the national funds of Qatar, Libya and Singapore.

Many SWFs have developed a reputation for secrecy, with Safe refusing, until recently, to admit its existence, a feature that has worried those suspicious of investments by external states in strategically important national companies and industries.

Most do not disclose their investments and some say that those that do – Norges Bank for instance – can be at a disadvantage to more secretive peers because they show their hand to the market.

Recently, however, there are signs that state-backed funds are becoming more interested in governance.

In 2008, many of the world's largest SWFs signed up to a set of voluntary guidelines, known as the Santiago Principles, which aim to increase transparency and governance standards.

"We talk to some SWFs, and some have views on governance," says Anita Skipper, global head of corporate governance at Aviva Investors.

"The influence of long-term shareholders has diminished over the past 20 years but the industry has adapted. We are now engaging with global shareholders on a regular basis. We talk to each other, just as we used to talk with investors down the road."

Norges Bank Investment Management, a leading investor in some of the UK's largest companies, has a governance unit and states the need to "safeguard long-term financial interests through active ownership" as one of its five main tasks.

> 'Many sovereign wealth funds lost a lot of money by investing in companies that were poorly run'

However, the passivity of many others can present problems for concepts of corporate governance that assume institutions are engaged.

"The challenge that SWFs pose for corporate governance is that in the UK [corporate governance] is based on a comply or explain mechanism, and that only works if there is somebody listening," says Vanessa Jones, head of governance at the Institute of Chartered Accountants in England and Wales.

"In the UK, institutional shareholders are, by and large, engaged and intervene when they need to but when the pattern of ownership changes to where you have more external owners . . . that could call into question the existing model."

Many governance advocates hope SWFs will recognise that increased engagement with companies will result in a better long-term performance of their investments. All investors, including SWFs, suffered as asset prices tumbled during the crisis.

"Many SWFs lost a lot of money by investing in companies that were poorly run, so they will now be much more focused on due diligence," says Mr Jobling.

"Once people get involved in the market they do tend, after time, to be drawn to issues of mutual interests for all shareholders."

Stewardship code aims to encourage collaboration

UK

Seven principles call on institutional investors to disclose how they will enact corporate change. **Miles Johnson** reports

Investment bankers might have shouldered the bulk of the blame for the banking crisis but the City of London's institutional investors have also been lambasted by politicians and regulators for failing to prevent it.

In his time as the UK's City Minister, Lord Myners issued a stinging rebuke to what he saw as "absentee landlords"; those investors who were happy to exact "economic rent" from their shares but neglected their responsibility to hold reckless boards to account – thus allowing banks to race towards the brink of collapse.

More recently, Vince Cable, the UK coalition government's business secretary, has renewed the political attack on City institutions, complaining about short-term investors and arguing: "We need shareholders to act like long-term owners."

These criticisms have triggered a series of reports on UK corporate governance in an effort to ensure investors are both encouraged and equipped to hold boards to account.

Last autumn, Sir David Walker's review of financial institutions proposed that shareholders should sign up to a code of conduct to formalise the rules of engagement between investors and companies.

This summer the Financial Reporting Council, the UK's corporate governance regulator, announced the launch of the Stewardship Code, seven principles that call on institutional investors to disclose how they will go about enacting corporate change, how they vote, and how they scrutinise company conduct.

As the first code of its kind in the world, corporate governance experts hope the guidelines will be an important step in developing a more robust corporate governance culture.

With the FRC planning to list on its website all the investors that have either signed up to the code or explained why they have not, the regulator hopes institutions will feel public pressure to adhere to the principles.

A key aspect of the code will be to enhance the ability of institutional investors to collaborate on governance issues.

Some of the UK's most prominent investors have complained that company management teams can use a tactic of "divide and rule" to deflect pressure from shareholders.

Neil Woodford, head of UK investments at Invesco Perpetual, argues that management teams tend to ignore the complaints of individual investors.

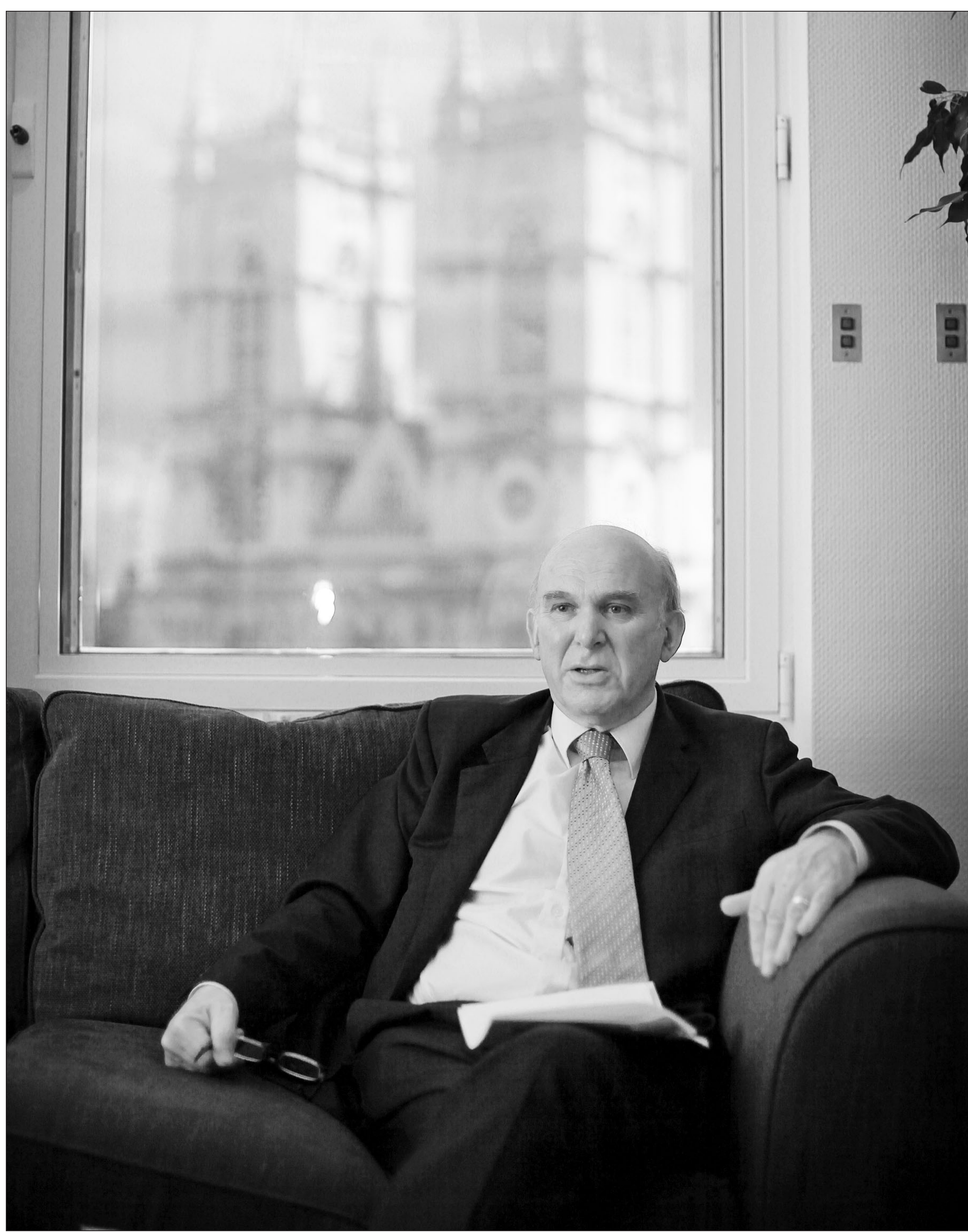
"The response we typically get [from companies] is, 'you are an important shareholder, we obviously are very interested in your views but we have all these other shareholders and they're not saying the same thing', so, it is very difficult to get your voice heard," Mr Woodford says.

However, when investors have attempted to form a collective, louder voice, it has proved difficult to co-ordinate the various interests of the diverse group of shareholders active in the UK market.

A recent example of collective shareholder anger fizzling out has been at Prudential, the UK insurer.

Prudential launched a takeover attempt for AIA, the Asian unit of the government controlled US insurer AIG, which ultimately failed and left the company with £377m of wasted advisory fees.

A group of City institutions, outraged by what they saw as squandering irresponsible management, began to consult each other about how changes could be effected.



Vince Cable, UK business secretary: 'We need shareholders to act like long-term owners' Charlie Bibby

However, after a high-profile campaign the group found it was unable to persuade the company's biggest investors to join the action.

> 'It is difficult to get institutions to agree on anything, frankly. It is a bit like herding cats'

Mr Woodford argues that UK institutions are not culturally accustomed to working together to bring about change.

"Its hard to get institutions to agree on anything, frankly. It's a bit like herding cats," he says. "When shareholders do come together – and it is very unusual for them to come together – you carry more weight."

With the Stewardship Code, the FRC hopes to change this.

While investors have previously had to be cautious not to fall foul of so-called "concert party" rules – which are aimed at preventing shareholders acting in concert to bring about a change of management control by a group of investors – the code proposes that investors should act collectively where it is appropriate.

But for some the Stewardship Code is not specific enough about where responsibility for engagement lies; whether investment managers should take responsibility for good governance or if the onus should be on trustees who grant them their mandate.

Lord Myners, for one, has argued that while the new code is an improvement, it fails to clarify the issue of responsibility.

For Roger Barker, head of corporate governance at the UK's Institute of Directors, the Stewardship Code is a first step in reforming attitudes to governance.

"As a statement of societal expectations on how institutional investors should act, the Stewardship Code is a worthwhile undertaking," he says. "But it doesn't overcome the fundamental structural problems which make it hard for fund managers to act as owners."

Impetus fades on project to amalgamate standards

Accounting rules

There is still hope the US will adopt international norms, says **Adam Jones**

The accounting standards used in cities as diverse as Indianapolis and Innsbruck are in the process of being made more interchangeable.

But how will corporate governance be affected by the plan to converge US Generally Accepted Accounting Principles with International Financial Reporting Standards, the norms used in the EU and an increasing number of other countries?

The first point is that the outcome of this complex endeavour is far from certain – and that this uncertainty is one of the biggest knock-on effects on corporate boards, managers and shareholders.

The current convergence push can be dated back to 2002. Then, the US Financial Accounting Standards Board, which presides over US GAAP, and the International Accounting Standards Board, the London-based overlord of IFRS, pledged to make their systems compatible.

The progress made by the two organisations led to the removal in 2007 of a long-standing requirement that obliged foreign companies with US stock market listings to reconcile financial statements prepared under IFRS to US GAAP.

The convergence project then picked up more momentum in August 2008, when the US Securities and Exchange Commission proposed a "road map" that envisaged the potential incorporation of IFRS into the US reporting system from 2014, with a decision set for 2011.

Subsequently, however, the impetus has faded.

In September 2009, the G20 nations formally demanded that the convergence project be completed by June 2011 but the IASB and FASB admitted in June 2010 that some components would slip into the second half of 2011.

There has also been divergence between the two standard-setters over the crucial issue of the extent to which financial instruments should be assessed at "fair value" – a practice that was blamed by some for exacerbating the financial crisis.

To cap it all, FASB only has an acting chairman at the moment, following the surprise announcement in August that Bob Herz was retiring from the post.

The rush to meet the G20 deadline has led to some concern about the quality of the mass of accounting standards that are being drawn up under intense time pressure.

Jérôme Haas, head of the Autorité des Normes Comptables, the French accounting standards body, worries that too many non-urgent changes are being processed at the same time as revisions that are vital to the repair of the financial system.

Jérôme Haas: 'Stability is part of the quality of standards'

"Stability is part of the quality of standards," he says, adding that changes to norms can have huge repercussions on the way companies are run, affecting finance, strategy, marketing and other functions.

Roman Weil, a professor emeritus of accounting at the University of Chicago Booth School of Business, goes so far as to say that the convergence project is in a chaotic state that will end up producing "gobbledegook" in some cases.

But in spite of the hiccups and scepticism, Sir David Tweedie, chairman of the IASB, maintains that the most likely scenario is that the US will adopt IFRS. "Frankly, I think that's what will happen," he says.

However, he recognises that there are two other scenarios.

In the first, the US says no and becomes isolated. In the second, the US says no but in doing so undermines confidence in IFRS in Asia and Latin America.

Ruth Picker, who heads the global IFRS team at Ernst & Young, says the outcome is indeed uncertain but that she is still hopeful that the US would adopt IFRS, perhaps in stages.

Some in the US are hostile to the rival standard, she adds, because they believe it is not consistently applied around the world. "That is something that the SEC is looking closely at."

Certain industries are also particularly sensitive to the rule revisions that have been chugging through the system as part of the convergence programme.

Retailers, for instance, are opposing proposed changes to lease accounting that would increase the assets and liabilities reported on many balance sheets, potentially putting some in breach of borrowing agreements.

Overall, however, Ms Picker says the companies that will be most affected by the process in the short term are US multinationals with foreign arms, since they must grapple with a series of changes to both US GAAP and IFRS.

Corporate Governance

Too few women in executive suites

Diversity

Sarah O'Connor says the crisis has set back efforts to increase female representation

In the chaotic week that followed the collapse of Iceland's banking system, the government set up three "new" nationalised banks and appointed women to lead two of them.

One official quipped that the women were there to clean up the mess left by the men.

Iceland's government was not alone in believing that the testosterone-fuelled culture of some financial institutions had contributed to the crisis. Harriet Harman, then deputy Labour party leader in the UK, captured the feeling last year when she said things would have been different had Lehman Brothers been Lehman Sisters.

Yet, rather than propel more women on to the boards of financial services companies, the crisis has actually set such efforts back, according to some people involved in recruitment decisions.

"It has been made a bit tougher," says Luke Meynell, head of the UK board practice at head hunters Russell Reynolds Associates. "The flexibility that boards have to do innovative things has probably lessened, because they are, for a while, more conservative and have been encouraged to be so by a backlash from regulators and others."

The UK's Financial Services Authority, for example, has increased its vetting of executive and non-executive directors.

While nobody thinks this has put women candidates off, head hunters say it has pushed boards to look for people with great sector-specific experience. There are more men than women who fit that bill.

"Given the requirement from the FSA for greater scrutiny of board members' experience, that's immediately setting a constraint on where you can draw board members from," says Andrew Roscoe, UK managing partner at head hunter Egon Zehnder International.

Yet the pressure from policymakers and others to increase female representation remains high. They have been making steady but slow progress.

In Australia, a push from the stock exchange is credited with helping increase women's share of board seats from 8 per cent between 2002 and 2008 to 10 per cent this year.

In the US, the Securities and Exchange Commission has prodded companies to do better – women have about 15 per cent of Fortune 500 board positions.

In Europe, where women have about 12 per cent of board seats, politicians tend to take the lead. French lawmakers are considering the nuclear option: a legal quota. And last month, Viviane Reding, vice-president of the European Commission, raised the possibility of a pan-European quota.

"I have not been an advocate of quotas for women in senior business posts in the past but given the lack of progress in this area, we might in the future have to consider taking initiatives at the European level," she says.

> 'The requirement from the FSA for greater scrutiny of experience sets constraints'

Business lobby organisations tend to be against the idea. "Regulation is unlikely to be the right answer because of the chance of unintended consequences," says Helen Alexander, president of the UK's Confederation of British Industry.

Some critics of quotas point to the experience of Norway, which in 2005 gave listed companies two years to raise the share of women on boards to 40 per cent.

While companies have complied, critics say the lack of suitable candidates has meant that a small elite (the "golden skirts" as they are known in the local press) have been spread too thinly.

Women board members in Norway hold an average of almost four positions, according to research by Egon Zehnder, double the European average for women.

But Ms Alexander, who is also a director on the boards of Centrica and Rolls-Royce, says the idea that there are not enough good or experienced women is a red herring.

"One of the points people often make is that there's no pipeline, no supply, no senior women, and I think that is not true."

Room for more women: men have 85 per cent of Fortune 500 board roles Getty

She says the problem is in the way people look. "You have to learn to recognise talent in cultures other than your own."

Mr Roscoe agrees: "There's always a tendency to recruit in your own image." He says head hunters should challenge and broaden the criteria that chairmen give them.

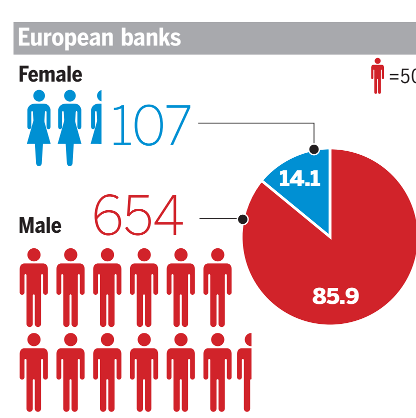
Mr Meynell has the same approach. "Forcing the search world to look harder and not default to a 63-year-old male from the same sector, is really important."

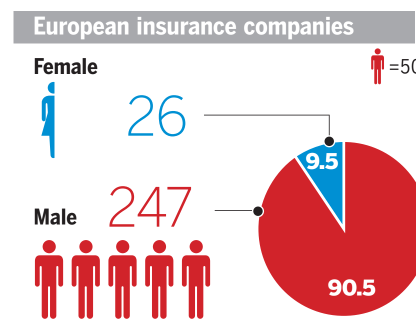
On the bright side, most chairmen and board members who have experience of having women on boards want to replicate it.

The question is whether this sentiment will spread quickly enough to satisfy policymakers such as Ms Reding, who are fed up with slow progress.

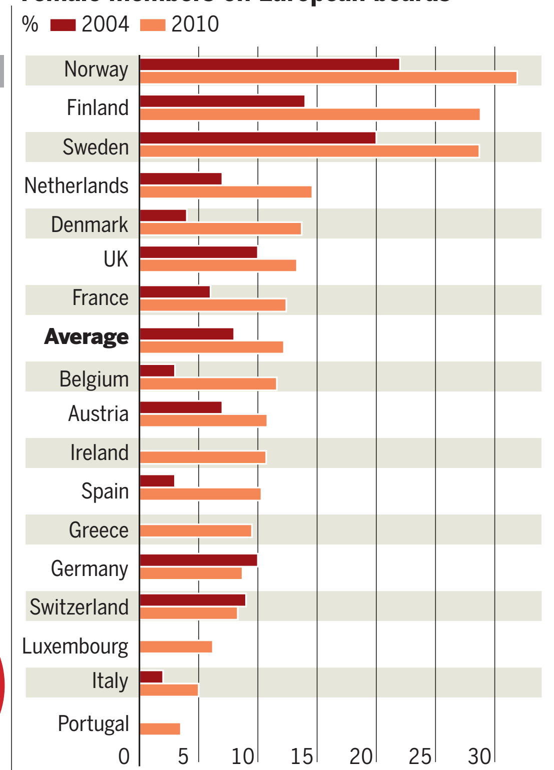
Woman power

Board positions in 2010
Actual number and %





Female members on European boards



Source: Egon Zehnder International

EU paper raises doubts over shareholder model

Europe

The UK worries about a one-size-fits-all approach to business, where the state or regulators have more power than investors. **Miles Johnson** reports

The EU worries they are not the best guardians against excess Daniel Lynch

The ability of shareholders to exercise adequate oversight over companies has been called into question by a radical green paper from the European Commission.

Surprisingly, however, it has attracted little attention outside a circle of corporate governance specialists.

This year, the Commission published a range of proposals on how shareholders, banks and other large financial institutions should reform in the light of what it argued were near catastrophic lapses in the scrutiny of reckless behaviour.

Many of the paper's points had been touched on by other post-crisis corporate governance reviews, such as the UK's Walker report, which called for an investor code of best practice.

But some proposals went far beyond the scope of other investigations – sparking debate as to whether a pan-European approach can be effective in the diverse capital markets of member states.

One of the most radical questions posed by the banking paper was about the validity of the existing model of shareholder ownership, with the Commission arguing that the financial crisis had severely dented confidence in the ability of investors to safeguard companies' futures.

"The financial crisis," the paper said, "has shown that confidence in the model of the shareholder-owner who contributes to the company's long-term viability has been severely shaken, to say the least."

This analysis, according to Vanessa Knapp, principal consultant at law firm Freshfields, could challenge many of the assumptions that underpin much of the UK governance response to the crisis – that shareholders, rather than governments or regulators, should remain the first safeguard against corporate excess.

"The EC's approach has questioned the extent to which you can rely on shareholders to control the actions of companies in a starker form than anyone else," Ms Knapp says.

"If Europe were to go down a different route that involved taking legislative measures, the UK would have to follow European law, but it is too early to say, as the Commission still needs to analyse the responses to the consultation". Responses to the paper were invited to be submitted by September.

Although green papers are for discussion and therefore preliminary in nature, its tone on banks has been interpreted as a signal of the Commission's intentions ahead of wider consultation on corporate governance due in the first quarter of 2011.

As the shareholder structure, regulatory regimes and company law of each EU member state can differ significantly, the recommendations that finally emerge after the responses have been digested by the Commission will need to balance the accommodation of disparate interests.

> 'The crisis has shown that confidence in the model of a shareholder-owner who contributes to a company's long-term viability has been shaken'

For the Association of British Insurers, a UK trade body that represents about a fifth of UK shareholders, the prospect of a so-called "one size fits all" approach to governance across the EU is worrying.

"We feel quite threatened," says Hugh Savill, acting director of investment affairs at the ABI.

"Unlike most of Europe, the UK has a dispersed shareholder base and the entire corporate governance model we have has grown up around that. If you have a system of shareholders owning large blocks of companies, as exists across much of Europe, there are different governance requirements.

"This difference leaves us in an awkward position if the Commission chooses to legislate on corporate governance."

The European Commission, however, argues it has not suggested a universal approach but has instead put forward suggestions that would vary according to the size and complexity of a bank or financial institution that would work alongside existing legal frameworks.

Further controversial topics raised by the paper included whether the number of boards that a director can sit on should be limited and whether recruitment policies for bank boards should specify that directors have both the required skill and the diversity to work effectively.

This, for Mark Wippell, a partner at law firm Allen & Overy, demonstrates that the debate over the roles of directors is still an area "riddled with contradictions".

"If non-executives are required to do more and to scrutinise a board more effectively then there is an argument to say they should be paid more," he says.

"However, at the same time, there are arguments that people are being paid too much. But non-executives are by definition risk-averse. They are not being paid like top executives, so they are not incentivised to take risks."

Ahead of next year's general governance green paper, the Commission is facing calls from politicians across Europe for new measures on governance, weighed against a body of investors anxious about blunt reforms.

To find a solution that leaves both sides happy will be a great challenge.

FT GLOBAL CONFERENCES & EVENTS

GLOBAL EMERGING RISKS:
Steering the Course, Seizing the Opportunity

Whitepaper now available online!

The **Financial Times** and **Oliver Wyman**, an international management consulting firm, have just released their second annual Global Emerging Risk Report. Based on a survey of 650 senior executives at companies around the world with more than $1 billion in revenues, the white paper examines what executives consider to be the biggest risks to their businesses and evaluates the methods used to identify and assess potential threats.

The report confirms that three years since the financial crisis started, most companies still fail to integrate emerging risk information into their decision making. Most are not focusing on potential threats that are seemingly unrelated to their businesses, while less than half use critical risk management tools. At a time of systemic uncertainty and volatility, this report makes recommendations for how risk management programs should address not only traditional risks but also new risks that threaten to change the rules of the game.

For more information on the issues discussed in this whitepaper, please contact Alex Wittenberg

Telephone: +1 646-364-8440
Email: alex.wittenberg@oliverwyman.com

To download the whitepaper, please visit:
www.oliverwyman.com/ow/risk_survey_2010.htm

FT FINANCIAL TIMES

IN ASSOCIATION WITH OLIVER WYMAN

We live in FINANCIAL TIMES®