

GLOBAL REFERENCE GUIDE

# governance & executive compensation

2011 with global advisor directory

**FINANCIER**  
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GLOBAL REFERENCE GUIDE

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**governance & executive  
compensation  
2011**

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**Global Reference Guide**  
**Governance & Executive Compensation 2011**

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## NORTH AMERICA

**Say on pay**


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by *Thomas M. Ball | Morrow & Co., LLC*

2011 MARKED A seminal year in corporate governance in the United States as most public companies were required by the SEC to submit non-binding proposals to shareholders regarding executive compensation – the Say on Pay proposal (SOP). Just past the mid-point of the 2011 proxy season, the trends are clear: (i) boards and senior management are very focused on SOP voting; (ii) support has been high, but there have been notable failures; (iii) the ISS recommendation will influence the vote, in some cases substantially; (iv) companies are fighting back when a vote or recommendation is against SOP; and (v) voting in 2011 will have an impact in 2012.

*Results to date.* The level of support on SOP has been high. As of mid-May the average vote is 89.3 percent, and the number of failed SOP votes is minimal at just over 20, with some notable failures such as Hewlett-Packard, Janus Capital, and Stanley Black & Decker.

*ISS impact.* The proxy recommendation firm Institutional Shareholder Services (ISS) has had an impact on the vote on SOP. For example, at S&P 500 companies, ISS has made an against recommendation at over 50 companies, of those that have released voting results, the average support was just 64 percent.

**Tripwires causing ISS against recommendations**

The primary reason for an ISS against recommendation is that ISS perceived a pay-for-performance disconnect; for example, negative total shareholder return (TSR) in conjunction with an increase in the CEO's compensation. Other reasons for an against recommendation included poor pay practices, either on a stand-alone basis or in combination with governance concerns, such as: (i) excise tax gross-up and modified-single-trigger provisions in new change-in-control agreements; (ii) lack of meaningful performance criteria for incentive awards; (iii) a compensation program that was largely discretionary and/or did not rely on pre-established performance metrics; (iv) lack of a claw-back policy, stock ownership guidelines, or holding period requirements; (v) vague disclosure, lack of transparency in the use of performance metrics, overly complex compensation schemes; (vi) excessive golden handshakes to incoming executives and excessive severance payments to outgoing ones; (vii) CEO pay that was substantially above the peer medians; and (viii) providing special death benefits to senior executives.

## Responses to ISS against recommendations

For most companies, an against recommendation on SOP was a call to action. Institutional outreach, additional solicitation of individual holders, and changes to compensation practices are the primary avenues to overcome an adverse recommendation.

*Fighting back.* Some companies challenged an ISS negative recommendation by taking their case directly to shareholders. For example, Allegheny Technologies filed additional proxy material taking issue with ISS's methodology, noting "ISS's methodology does not provide an accurate comparison of ATI's performance to that of its true peers". GE initially took a confrontational approach, noting in a letter to shareholders "a significant disagreement between the Company and ISS".

Harsco Corporation noted a "significant disagreement" between the Company and ISS, and filed a 14 page presentation that is an excellent example of a detailed rebuttal, reading much like a presentation that would be used in a proxy fight. Johnson & Johnson and Unisys also provided rebuttals to negative ISS recommendations on SOP, but took more of a 'just the facts' approach. Johnson & Johnson reiterated and highlighted sections of its CD&A, while Unisys noted that while ISS was against SOP, Glass Lewis recommended in favour and quoted from the Glass Lewis report.

*Changes.* Several companies made changes to their executive compensation as a result of against recommendations from ISS and/or discussions with institutional shareholders. Disney amended employment agreements with four executives to remove a provision that provided for gross-ups for excise tax payments the executives could incur upon termination following a change in control. Both Lockheed Martin and GE modified stock options granted to the CEO to include additional performance conditions.

## Impact on 2012

There will be carryover impact in 2012 from the 2011 vote. First, all issuers will be required to disclose in the CD&A section of their proxy statements whether, and if so, how, their compensation policies and decisions have taken into account the results of the last SOP vote. For companies with a low favourable vote, additional actions may be required. For some boards, anything below 90 percent may be perceived as a 'low' vote. Companies that received tepid majority support for their SOP should consider an institutional outreach to determine investor concerns. Certainly, those companies with a failed vote will need to take action to avoid consequences in the form of negative votes on directors, and further votes against SOP in 2012. This should include an outreach to institutional holders, as well as considering changes to compensation practices to demonstrate that the company has 'responded' to the against votes. Any changes made, and results of discussions with investors, should be worked into the CD&A in 2012, to show that companies are responsive to the concerns of their shareholders. ■

## NORTH AMERICA

**The five critical compensation committee issues in 2011**

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*by David Swinford | Pearl Meyer & Partners*

**Emphasising pay for performance**

INVESTORS AND OUTSIDE advisers typically look to absolute and relative Total Shareholder Return (TSR) to measure corporate performance and to value a company's business strategies. Ultimately, however, TSR is a rear-view mirror assessment of where you've been – not a guide to where you should be going. The company's business plan and related incentive pay programs should focus on the performance metrics that will drive earnings growth over the long-term. The resulting programs will provide a clear direction to what employees should be doing to build the business. Such forward-looking measures may not correlate with short-term share price growth, but if properly chosen will relate closely to shareholder gains over the long term.

**Balancing performance demands with retention needs**

Withholding pay when goals are not met requires that retention incentives be in place. As most senior executive retirement benefits have been phased out and replaced by enhanced at-risk compensation, companies are finding it more difficult to hold on to talent in challenging periods when performance levels are insufficient to earn bonus or equity payouts. In a lower-performing environment, companies may want to reconsider the risk profile of incentive plans and revise the time frame for delivering rewards. There are several possible approaches. Companies in some industries have maintained significant retirement programs; traditional defined benefit programs are very back end-loaded, providing stronger retention incentives as executives grow into key leadership positions. Other companies have stretched out the vesting of time-based restricted stock programs, in some cases to 5-10 years rather than the more typical three year period.

**Avoiding controversial pay practices that offer little or no payoff for the company**

Special severance benefits and substantial perquisites for the most highly compensated employees are increasingly difficult to justify. Components with little connection to building the future value of the firm, such as severance payouts, tax gross-ups and extraordinary relocation benefits, invariably offend stakeholders, regardless of their relatively small value impact on the overall pay package. Such features also tend to be of relatively small or unlikely benefit to executives. For

those reasons, they are rarely worth fighting for and can be trimmed or eliminated without compromising a pay program's overall competitiveness. While contractual obligations need to evolve more slowly, companies can and should eliminate all problematical arrangements for incoming executives. Other red flag areas are equity-based designs that fail to adequately address grant timing or hedging, or that pay dividends on unearned performance share/units.

### **Clearly communicating pay programs internally and externally**

A compensation plan should not be any simpler than the business it supports, but no more complex than absolutely necessary. In order to effectively motivate the performance desired, it must be clear to every participant what he or she can do specifically to influence results. We often find even senior executives puzzled by the workings of extremely complex incentive designs. Equally important to internal communications, how you describe compensation programs in public disclosures will send a strong message to the entire organisation and its shareholders about priorities, values and goals. Unions and shareholder activists in particular comb public filings for information on pay programs, particularly employment contracts, special severance benefits, or other perquisites that may demonstrate inappropriate organisational values or encourage inappropriate behaviours.

### **Recognising that how you make compensation decisions is important**

Decision-making around compensation is often highly emotional because what is at issue isn't just the value of the pay package, but what it says about the value the company puts on the individual. The CEO's recommendations deserve careful consideration, since compensation programs function as a key management tool. But the committee must remember it will ultimately be held responsible for the programs it approves. Once issues have been thoroughly discussed and all views heard, members need to stand up for their judgments about what is right or wrong, and push back when needed. This is especially true if directors conclude, as increasingly happens, that the most prevalent market practices are not right for their particular organisation. ■

## NORTH AMERICA

**Perspective on the Dodd-Frank Act**

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by *Dennis M. Hild and Gregory B. Hahn* | *Crowe Horwath LLP*

AS THE ONE year anniversary of the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act approaches, numerous questions remain about the compliance challenges the Act will cause financial service organisations in the coming years. There have been dozens of proposals issued and studies started, but many of the critical aspects of the landmark legislation remain in limbo as Congress and federal regulators work through issues.

**Major provisions**

*Elimination of OTS.* As required by the Dodd-Frank Act, the Office of Thrift Supervision (OTS) will be eliminated 90 days after the 21 July 2011 transfer date, with its supervision authority over thrift banks transferred to the Office of the Comptroller of the Currency (OCC) and oversight of savings and loan holding companies (SLHCs) transferred to the Federal Reserve Board. OTS and OCC officials have indicated they began joint examinations in larger thrifts in early 2011 and will continue to transition all thrifts to the OCC examination standards during 2011 and 2012. As this transfer of authority approaches, thrifts and SLHCs should evaluate whether their existing compliance management programs – initially designed to satisfy OTS regulations and oversight – meet the OCC and Federal Reserve regulatory examination and inspection standards. While the agencies will be working toward a smooth transition and will be applying similar methodologies, the transition for thrifts and SLHCs likely will be challenging.

*Consumer financial protection regulation.* The Act creates a new autonomous Bureau of Consumer Financial Protection (CFPB). The CFPB will establish a new set of standards and enforcement mechanisms. While the law explicitly grants the bureau authority to regulate commercial banks with assets of \$10bn or more, the CFPB also will monitor consumer compliance for smaller financial institutions. There continues to be significant debate between the House and the Senate on how the bureau's leadership should be structured. House Financial Services Committee chair Spencer Bachus introduced a bill (H.R. 1121), that would reform the CFPB leadership and establish a five-member commission to govern the agency. President Obama previously named Harvard professor Elizabeth Warren as a special adviser to oversee the creation of the CFPB, but has yet to name a director who would be subject to Senate confirmation.

*Systemic risk oversight council.* Dodd-Frank seeks to increase transparency and stability in the financial marketplace by establishing the Financial Stability Oversight Council (FSOC) to focus on identifying and monitoring systemic risks posed by financial firms and financial activities and practices. The vast majority of the systemic risk provisions in the Act require implementing regulations, and many give regulators the discretion to modify the statutory standards or issue exemptions. The FSOC has completed several studies and is expected to produce its first annual financial stability report, with public release expected later this year. The annual report is anticipated to discuss major financial and regulatory developments, potential risks to the financial system, and recommendations to mitigate potential risks. At its March 2011 meeting, the FSOC issued a proposal on how it would determine systemically important financial institutions (SIFIs). The proposal outlines designating financial market utilities for heightened supervision by the Federal Reserve as required by Dodd-Frank.

### **Other initiatives**

There also are several important outstanding proposals related to Dodd-Frank that are expected to pose significant compliance challenges for financial institutions:

*Interchange fees.* The Federal Reserve in December 2010 issued a proposed rule that would establish debit card interchange fee standards and prohibit network exclusivity arrangements and routing restrictions as required by Dodd-Frank. While explicitly directed at banks with more than \$10bn in assets, significant concerns have been raised on the potential impact on all banks. The rule is scheduled to take effect on 21 July 2011 but legislative efforts are underway to further delay the effective date.

*Risk retention.* In March 2011, the federal banking agencies issued a joint proposed rule with the SEC that would require sponsors of asset-backed securities to retain at least 5 percent of the credit risk of the securities' underlying assets and that provides key exemptions for qualified residential mortgages (QRMs).

*Underwriting standards.* In April 2011, the Federal Reserve issued a proposed rule, per Dodd-Frank requirements, that would require creditors to determine a consumer's ability to repay a mortgage before making the loan and would establish minimum mortgage underwriting standards. The proposal applies to all consumer mortgages except home equity lines of credit, time-share plans, reverse mortgages, or temporary loans. The CFPB is expected to take over responsibility for issuing final guidance since the comment period is beyond the July 21 transfer date. ■

## NORTH AMERICA

**The US adopts new whistleblower rules**

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*by Ellen J. Odoner, Christian R. Bartholomew and Alan Dinkoff \ Weil, Gotsbal & Manges LLP*

THE US SECURITIES and Exchange Commission (SEC) recently voted three-to-two to approve new rules implementing the whistleblower bounty program and anti-retaliation provisions mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The new rules will take effect on 12 August 2011. The divided vote reflects continuing concern that, although incentives for internal reporting have been added, the new rules will undermine corporate compliance programs by allowing whistleblowers to bypass internal mechanisms and go directly to the SEC.

The SEC's program will be administered by the newly created Office of the Whistleblower residing within the Division of Enforcement (DoE). An eligible individual (but not a corporation or other entity) may receive a cash award ranging from 10 percent to 30 percent of the total amount of monetary sanctions collected by the SEC in a civil judicial or administrative action. An eligible whistleblower may also receive a cash award based on monetary sanctions collected by other regulatory or law-enforcement authorities in a 'related action', including fines and penalties imposed in a federal criminal prosecution brought by the US Department of Justice. To recover, a whistleblower must 'voluntarily' provide, in accordance with specific rules, 'original information' about a violation of the federal securities laws that has occurred, is ongoing or is about to occur, and that ultimately leads to successful enforcement action in which the SEC collects in excess of \$1m. While until now the SEC could offer financial incentives only for tips about insider trading, the new whistleblower program provides bounties for information relating to any violation of the US federal securities laws, including the Foreign Corrupt Practices Act. Recent SEC settlements for FCPA, fraudulent financial reporting and other matters have involved sizeable sums that may entice aspiring whistleblowers.

The whistleblower anti-retaliation provisions – which are enforceable by the SEC as well as by aggrieved whistleblowers – are broader in scope than the recovery provisions, and offer more stringent remedies than the anti-retaliation provisions of the Sarbanes-Oxley Act of 2002. They apply even if a complaint does not result in an SEC enforcement action or the whistleblower ultimately fails to receive an award. They also apply to internal statements already protected by Sarbanes-Oxley, such as concerns raised about accounting or internal controls.



The new rules are likely to change the landscape for corporate compliance programs, which were strengthened in response to Sarbanes-Oxley and are premised on internal reporting. The rules are intended to encourage a whistleblower to report to the company first by: (i) preserving his or her ‘place in line’ for the award for 120 days; (ii) attributing to the whistleblower all information subsequently uncovered by the company and reported to the SEC; and (iii) giving ‘credit’ for internal reporting in setting the size of the award. Nevertheless, companies face considerable challenges in keeping these programs viable in the face of the new bounty system. To help do so, companies should revisit existing policies and procedures to ensure that they convey the importance directors and top management place on employees coming forward with concerns and that the steps for internal reporting are easy to follow. The prohibition against retaliation (and, for supervisors, how to identify and prevent it) should be reinforced throughout the organisation.

The new rules are also likely to change the landscape in the SEC enforcement area, including the calculation for deciding whether, and when, to self-report to the SEC. Companies need to be prepared for a range of possible enforcement scenarios such as: (i) where the whistleblower complains to the company but waits up to 120 days before going to the SEC; (ii) where the whistleblower complains to the company and the SEC simultaneously; or (iii) where the whistleblower complains only to the SEC. The DoE staff has suggested that it will continue its general practice of notifying companies when it receives complaints and giving them an opportunity to investigate and report back. However, new issues will undoubtedly arise, for instance, will the agency defer to a whistleblower’s demand not to inform the company out of fear that his or her identity will be revealed? Moreover, the staff will have wide latitude to administer the program and decide whether to follow its general approach in a particular case.

Companies must respond to the new rules in the context of an already heightened enforcement environment. Overall, the most constructive approach is to ensure that the company has in place robust internal compliance and audit procedures designed proactively to uncover potential wrongdoing and, where misconduct is found, to promptly address and remediate it aggressively before any whistleblower surfaces. Where a company receives allegations of misconduct from a whistleblower, it should ensure the whistleblower is protected from retaliation, immediately investigate and, where the claims are credible, consider whether, and when, to report to the SEC. ■

## NORTH AMERICA

**Environmental criminal prosecutions: avoid being one of the EPA's next victories**

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*by Patricia Brown Holmes | Schiff Hardin, LLP*

THE ENVIRONMENTAL PROTECTION AGENCY (EPA) has recently embarked on an ambitious initiative of prosecuting criminal violations of environmental protection laws. In fact, in 2010, the EPA prosecuted its second-highest number of new environmental crimes since 2005. They have indicated upcoming plans on prosecuting fewer, but more 'significant', cases aimed at both corporations and, most significantly, individuals. Implementing and enforcing compliance programs will be vital to preventing these sometimes innocent mistakes from becoming costly and serious criminal prosecutions.

**Recent prosecutions of corporate environmental crimes have been devastating**

Rarely does a company set out to violate the law; typically, a simple lack of understanding or an inadvertent mistake in interpreting a company's responsibilities to comply with environmental laws is what leads to being criminally prosecuted – with devastating results. During 2010, the EPA opened 346 new environmental crime prosecutions, including cases not only against corporations or businesses, but against their executives. The EPA emerged the clear 'winner' in the majority of these cases – 88 percent ended in a guilty plea or a conviction at trial. The EPA's victories resulted in roughly \$41m in fines and restitution, \$18m in court-ordered environmental remediation projects, and 72 years of aggregate jail time for the executives.

Some corporate defendants experienced especially harsh punishments for problems that may have been avoided had proper procedures been adopted and carefully followed. For example, Alabama-based McWane Cast Iron Pipe Company – one of the largest cast iron manufacturers in the US – was prosecuted when wastewater from its Birmingham facility allegedly polluted a nearby creek. McWane had properly obtained a permit to discharge wastewater into the creek, as long as the water was treated before being discharged. Unfortunately, the EPA proved that McWane failed to implement the necessary procedures or have the proper equipment to comply with its permit. McWane eventually pleaded guilty to nine felony counts of violation of the Clean Water Act and was fined \$4m and sentenced to five years probation. McWane was also required to implement the EPA required procedures, making the cost of the compliance lesson fairly steep.

Arguably an inadvertent lack of proper procedures unfortunately led to disastrous consequenc-

es for Southern Union Company, which was found guilty by a Rhode Island jury of illegally storing mercury at a site near a river. Southern Union hired an environmental services company to prepare the mercury for shipment to a processing facility for recycling, but the project inadvertently ceased and Southern Union allegedly failed to renew it. Unfortunately, the inattention to detail was costly – Southern Union was sentenced to pay a total of \$18m in penalties, including a \$6m fine and \$12m to various groups for hazardous waste remediation projects, along with two years probation.

### **Taking the initiative to protect your company and the environment**

To avoid being the EPA's next landmark case, companies must be meticulous about complying with the environmental laws applicable to their businesses. The first step is to know what state and federal environmental laws and regulations apply to your business, industry and geographic location. The task may seem daunting, but the EPA provides legal compliance information based on industry-type (EPA Industry-Specific Assistance) and by statute (Compliance Assistance by Statute). Knowledgeable corporate leadership must develop cost-effective strategies to prevent the inattention and innocent mistakes that might lead to criminal charges.

Key corporate staff must understand that some everyday corporate business activity may actually require a permit or other type of regulatory procedure. Understanding when those procedures or permits are required, how to implement the permit, and what necessary measures must be in place to enforce compliance are key to avoiding the innocent mistakes that result in costly prosecution and the harsh penalties and fines that accompany it.

Companies should also consider developing auditing protocols to identify problems within their organisation and fix those problems at their cause, before any significant environmental damage occurs. Southern Union properly engaged a company to deal with their mercury storage and recycling issues, but, according to the EPA, they got in trouble when they failed to follow through to the project's end. Formalised audit procedures ensure that companies periodically address symptoms of environmental problems, analyse the source of the problems, and follow through on eliminating the problems, so that issues don't 'fall through the cracks', creating even larger liability.

Overall, environmental compliance is very industry specific, and companies should obtain guidance from knowledgeable environmental experts who can craft programs for their specific situation. Companies must keep in mind that inattention to environmental laws and regulations puts them at risk of not just potentially harming the environment, but may result in an expensive and damaging criminal prosecution of not only the corporation but the individuals who run it. ■

## CENTRAL &amp; SOUTH AMERICA

**Recent developments in Brazilian capital markets: the case of proxy solicitation**

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*by Bruno Robert and Fabio Weinberg Crocco | Lilla, Huck, Otranto, Camargo Advogados*

INDIVIDUALLY AND FAMILY-OWNED businesses account for the vast majority of Brazilian firms, regardless of their size. Not surprisingly, concentrated ownership structures have historically been predominant among Brazilian companies. In consequence, the design of the current legal and judicial framework in Brazil was influenced by this fact. Nonetheless, a different trend has gradually started to emerge among Brazilian publicly traded corporations. In recent years, the level of dispersion in ownership structures has significantly increased, particularly among companies listed in BOVEPA's Novo Mercado, a premium segment of the Brazilian stock exchange, with higher corporate governance standards. Currently, in around 60 percent of companies listed in this segment, there is no shareholder who individually owns more than 50 percent of voting stocks.

Indisputably, the change has had a significant impact on the traditional structure of the Brazilian capital markets. The business environment is becoming more complex and different from that which the country used to deal with. This arises from the fact that, even though small in number, companies listed in BOVEPA's Novo Mercado represent an important stake at the Brazilian economy, since Novo Mercado accounts for approximately 25 percent of the total BOVESPA capitalisation.

From an economic standpoint, the trend takes place in a country where financial markets have traditionally been more vibrant than capital markets. Thus, it is not a coincidence that changes began to be more clearly perceived as foreign investments inflows were intensified, with non-national (and national) investors, especially funds, becoming more interested in investing in Brazilian capital markets. On the other hand, from the legal perspective it is interesting to note that in a nation where corporate law was designed considering historic patterns of concentrated ownership structures, with no role to be played by significant institutional investor, the ongoing trend may put the stability of capital markets on a course to collide with the current legal system.

In this complex context, in December 2009 the Brazilian Securities Exchange Commission (CVM) enacted the first norm concerning proxy solicitation in Brazil: Instruction CVM No. 481/2009. This piece of regulation is clear proof that the CVM not only acknowledges recent developments in the Brazilian capital markets, but is also concerned with designing mechanisms well suited for a new economic environment. Instruction CVM No. 481/09 binds exclusively

publicly traded corporations. It covers, therefore, the environment where the tendency towards dispersion of control and ownership is more accentuated. In particular, the rule is clear, straightforward, and, in spite of not having foreseen further detailed discipline for proxy solicitation, has regulated sensitive issues for dispersed owned corporations.

The first issue within the scope of Instruction CVM No. 481/09 is director nomination. Article 28 expressly requires the inclusion in the company's proxy solicitation materials of nominees to the board of directors indicated by minority shareholders owning at least 0.5 percent of the totality of the company's shares. The provision, which has not yet been subject to extensive public debate, may be at the centre of attention in the future, when there will most probably be greater shareholder activism.

A second interesting feature of Instruction CVM No. 481/09 concerns cost allocation structures for proxy solicitation. Following international regulations, the Brazilian rule shifts certain costs burdens by providing that companies are responsible for reimbursing expenses incurred by shareholders with proxy solicitation. More particularly, the rule incentivises the use of internet-based systems, as it shifts costs burdens exclusively to companies that do not employ online proxy solicitation mechanisms. During the last shareholders meetings season, electronic proxies were used by 12 companies, reaching around 1000 investors. Additionally, in a clear demonstration of the importance of the subject to the Brazilian markets, and following recent regulatory advances, the Brazilian Senate has passed a bill – Projeto de Lei 13 – which expressly foresees distance voting in general meetings of publicly traded companies. The enactment of the bill now depends exclusively on the President's decision. The bill will certainly reinforce the advances already made by CVM's regulation.

The experience accumulated up to now, demonstrates that in Brazil, dealing with the necessity of giving a voice to a diffuse base of shareholders is not only a new regulatory challenge, but also a shock to the country's corporate culture. Indeed, regulating Brazilian capital markets requires remembering that controllers are used to deciding exclusively by their selves; that legislation was drafted based on the premise of concentrated ownership structures; and that minority shareholders have no experience regarding activism. The trend to dispersion and enhanced shareholders activism, nevertheless, is an incontestable reality in Brazil.

Wisely, important steps have already been taken by the CVM, such is the case of the regulation concerning proxy solicitation. The consequences of the recent regulatory initiatives will be clear in the near future. Up to this moment it is possible to diagnose that the Brazilian regulator is attending to economic developments and employing significant efforts to satisfy demands arising thereof. ■

## EUROPE

**Corporate governance – the regulatory merry-go-round**

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*by Timothy Copnell | KPMG*

THE RECENT FINANCIAL crisis has all too graphically illustrated the importance of good corporate governance – and by good governance we mean the key ‘behavioural’ issues rather than simply compliance with statute, regulation and codes of best practice.

It is regrettable, therefore, that the political and regulatory response to the crisis has, in the main, been to look again at board composition and governance structures, and, at least in some cases, propose burdensome practices that appear out of tune with the value achievable. This is particularly unfortunate as the global nature of the crisis provided a unique opportunity to provide a common global, or at least European, response to the universal issues around boardroom behaviour rather than tinker with national and European governance frameworks. So, rather than a debate around the board mandate (a framework against which company and its capacity to deliver its strategic objectives can be assessed); the different types of boardroom conversation (or the modalities of board decision making); and the other ways in which boards can progress up the value ladder, we face the prospect of mandated practices relating to the composition and operation of boards.

Of the two recent consultation papers issued by the European Commission – ‘Green paper: Corporate governance in financial institutions and remuneration policies’ and ‘Green paper: The EU corporate governance framework’ – it is the latter that is least controversial. But even this paper includes proposals to limit the number of board mandates a director may hold and ensure the roles of board chairman and CEO are carried out by different people. Perhaps nothing more than perceived good governance wisdom; but surely these are matters to be covered by governance principles rather than hard and fast rules.

The proposals with respect to financial institutions are even more unsettling. First there is the suggestion that it “should be compulsory to set up a risk committee within the board of directors”; then there is the proposal that “senior management approve an evaluation report on the adequacy and functioning of the internal control system”.

The recommendation relating to risk committees is, at least, curious given that several recently failed institutions had risk committees. Risk committees do not ensure good governance – a point that did not escape the House of Commons Treasury Committee which heavily criticised the risk

committee of one of the failed UK banks for failing to act as an effective restraining force on the strategy of the executive board members. The key to good governance in this respect is how such committees go about their business: which brings us back to board behaviour.

Turning to the issue of executives being required to approve a report on the adequacy of internal control systems, it appears that the Commission is proposing something that looks very much like Sarbanes-Oxley 404 – although, in addressing all controls (operational, compliance and financial), the scope of the EC proposal goes far deeper than the US requirement which focuses only on internal controls over financial reporting. This would be a significant change to most European governance regimes, not least because such a statement is likely to lead to expensive testing and verification work and arguably a focus on compliance rather than substantive assessment and management of risk.

The latest report from the European Parliament draws even closer comparison with Sarbanes-Oxley in that it proposes “... it should be mandatory for financial institutions to draft an annual report ... on the adequacy and effectiveness of their internal control systems and for their board of directors to adopt that report [and] it should be mandatory for the annual report drawn up by a financial institution’s external auditors to contain a similar assessment”, but then goes on to assert that the ‘Sarbanes-Oxley effect’ must be avoided in the EU. The so-called Sarbanes-Oxley effect being a reference to the ineffectiveness of the legislation in protecting US institutions during the financial crisis, whilst at the same time increasing compliance costs for listed companies, reducing competitiveness, and hampering the creation of new listed companies.

The European Parliament should be congratulated for at least identifying the Sarbanes-Oxley effect and for seeking to avoid it. But the reality is that it will be extremely difficult to replicate – and, in truth, to extend – the US requirements without duplicating the burden on business. In seeking guidance, the first thing preparers (and others) will do is look at what is done elsewhere – and that is the US rules, guidance and practice that is responsible for the Sarbanes-Oxley effect in the first place.

In conclusion, whilst most observers agree that good corporate governance is all about behaviour – there seems little appetite or political will to work towards ‘behavioural’ solutions. Instead, we have regulatory proposals that seem destined to add significantly to the burden on business. Will they be effective? Only time will tell. ■

## EUROPE

**Balancing the board**

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*by Stephen Cabill and Alison Smith | Deloitte LLP*

“AN EFFECTIVE BOARD should not necessarily be a comfortable place. Challenge, as well as teamwork, is an essential feature. Diversity in board composition is an important driver of a board’s effectiveness, creating a breadth of perspective among directors, and breaking down a tendency towards ‘group think’” – Guidance on Board Effectiveness – Financial Reporting Council (FRC), March 2011).

Over the past 10 years the shape of the board in a UK plc has changed considerably. The board of a FTSE 350 company was, 10 years ago, made up of broadly equal numbers of executive and non-executive directors, typically with five executive directors and five non-executive directors, excluding the chairman. Currently there are almost twice as many non-executive directors for every executive and a typical board now has only three executive directors and six non-executive directors. Following the introduction of the UK Corporate Governance Code, board composition is likely to be on the agenda again as companies assess whether they have the right balance of skills, experience, independence and knowledge of the company and whether there is the right degree of diversity.

Research suggests that there has certainly been an increase in the number of non-UK nationals on the boards of UK companies. Ten years ago it was estimated that around 10 percent of the directors of FTSE 350 companies were non-UK nationals – this has now increased to around 20 percent. However, in around one quarter of FTSE 350 companies with an overseas presence there are no board members from outside the UK and this may be an area for companies to address. But the aspect of diversity which is causing the most debate is the number of women on FTSE 350 boards. A recent report by Lord Davies states that there is evidence to suggest that companies with a strong female representation at board and top management levels perform better than those without. At the start of the new millennium around 2 percent of executive and 6 percent of non-executive directors in FTSE 350 companies were female. This has doubled over 10 years to 4 percent of executive and 11 percent of non-executive directors but the rate of change is slow.

If the goal of better gender balance is to be achieved, one of the challenges will be to ensure more women reach senior executive positions. Executive directors in other UK listed companies remain the biggest pool from which non-executive directors are recruited, and the pool of women

in senior positions needs to be much larger. A further challenge is that there does not yet appear to be a broad acceptance of the need for change. Gender diversity is not considered an important factor by the majority of respondents in a recent survey and very few companies, or non-executive directors, believe that more female board members would improve the effectiveness of the board. However, there seems little doubt of the necessity to broaden the pool from which non-executive directors are appointed. Partly because the number of non-executive director positions continues to increase, but, more importantly perhaps, the time required to perform a non-executive role effectively continues to increase and the recent financial crisis has demonstrated that, in difficult times, non-executive directors need to be able to devote the necessary amount of time to deal with the challenges. Individuals are therefore likely to take fewer roles.

The research suggests that over the past few years there has been an increase of around 10 to 15 percent in the time requirement as specified in company policy. But from the perspective of the non-executive directors the time requirement has increased by something in the region of 30 to 50 percent. Interestingly, shareholders apparently see the role as requiring a much greater time commitment – almost double that currently reported as company policy. Other key considerations for a non-executive director when thinking about taking up a position are the risks involved, whether the role is likely to be enjoyable, and the quality of the other board members. But around two thirds of the non-executive directors responding to the survey are also concerned that fee levels have not kept up with the increased time requirement and almost half consider this to be a factor that would prevent them from taking a role. It is worth noting that many companies appear to still be taking a very cautious approach to both salary and fee increases for board members. Given the concerns of the non-executive directors this may be an area for consideration over the coming year.

As economic stability and confidence returns, it is expected that companies will be turning their attention to board effectiveness and as part of this process will be reviewing not only the composition of the board but whether the time requirement of the non-executive role and the fees paid to perform these roles remain appropriate. ■

## EUROPE

**UK corporate governance: evolution or revolution?**

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*by Mark Howard and Zoe Pepper | Charles Russell LLP*

THE WESTERN BANKING crisis led to serious questions being raised about the adequacy of UK corporate governance and much has been written about reckless boards, absentee shareholders, and excessive bonuses. After much consultation a raft of new rules and updated guidance is now in place including the revamped UK Corporate Governance Code (Governance Code), formerly known as the Combined Code on Corporate Governance (Combined Code), and a new UK Stewardship Code (Stewardship Code).

**Governance Code**

The Governance Code applies to all companies, including overseas companies, with a premium listing of equity securities on the London Stock Exchange. Crucially, the principles based approach and ‘comply or explain’ regime which underpinned the Combined Code, have been retained, instead of moving to a more prescriptive framework. The Financial Reporting Council (FRC) has recognised that the quality of corporate governance ultimately depends on behaviour not process, which was the main shortcoming in how the Combined Code was applied by some.

The major and most controversial change is a requirement for annual re-election of all directors. This change is intended to improve accountability and to give boards the incentive to understand and respond to shareholders’ concerns before the AGM, leading to ongoing engagement. Recognising that one size does not fit all, the FRC has restricted this requirement to FTSE 350 companies. Interestingly, some institutional investors have written to listed companies encouraging them to ignore the requirement whilst the Pension Investment Research Council (PIRC) has said that it is looking to all listed companies to hold full elections annually from 2012.

Other key changes introduced include new requirements for: (i) non-executive directors to have more access to operations and staff to better empower them to provide constructive challenge in the boardroom; (ii) disclosure of the company’s business model in its annual report; (iii) chairmen to agree and regularly review a personalised approach to training and development with each director; (iv) annual board reviews to be externally facilitated at least every three years – this requirement has been limited to FTSE 350 companies due to concerns about the availability of board evaluation services; and (iv) an amendment to the main principle on internal control to

make explicit the board's responsibility for defining the significant risks it is willing to take and for internal control systems to be reviewed at least annually.

In a new chairman's preface, the 'fungus of boiler-plate' disclosure is attacked as 'dead communication' and the chairmen of companies are encouraged to report personally in their annual statements on how the principles relating to the role and effectiveness of the board have been applied.

### **Stewardship Code**

If governance behaviour is to change it has to be a two-way street, with institutional investors playing their part and the Stewardship Code, aimed at institutional investors, is seen as a first step in reforming their attitudes to governance. Reported to be the first of its type anywhere in the world, the Stewardship Code formalises the rules of engagement between institutional investors and companies. The Stewardship Code, which consists of seven main principles each of which is elaborated upon in further guidance, fleshes out the engagement principles originally set out in the Combined Code (and now deleted from the Governance Code) and introduces a comply or explain approach. From 6 December 2010, the Financial Services Authority has introduced a requirement for UK-authorized asset managers to disclose whether or not they comply with the Stewardship Code and the FRC encourages all institutional investors to report on their websites how they have complied with the code. The FRC is also hoping that overseas investors who hold a significant proportion of FTSE shares will commit to the Stewardship Code.

### **Conclusions**

In responding to political calls for change, the FRC has had to balance concerns that their proposals could destabilise boards and encourage short-term thinking against the benefit of improving the board's accountability and stimulating shareholder engagement. They have also had to consider the potential costs and practical consequences of the changes. The result, thus far, has been a structural re-working of the corporate governance paperwork and a number of important changes but no radical overhaul. Principles based guidance and 'comply or explain' disclosure remain at the heart of UK corporate governance, the question now is whether this can really change behaviour. We will get an insight when most listed companies report against the Governance Code for the first time in 2012. ■

## EUROPE

**Liability risks in view of changing corporate governance standards**

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*by Dr Tibor Fedke and Matthias Kaulich | Noerr LLP*

CORPORATE GOVERNANCE HAS been a frequent and much debated issue on both the German and the European political agenda in recent years. Efforts to assemble the entirety of corporate governance rules in a comprehensive codification have peaked with the enactment of the German Corporate Governance Code (GCGC) in 2002.

From a legal point of view, the stipulations of the GCGC – except for the repetition of duties arising from compulsory law – are not legally binding. They constitute mere recommendations. However, they may have considerable effects on the factual as well as on the legal level. On the factual side, Section 161 of the German Stock Companies Act requires stock companies to compile and publish a comprehensive annual report on the level of implementation of the requirements of the GCGC within the company (comply or explain). Hence, non-compliance remains possible, but requires public explanation and may entail negative publicity.

In addition, the recommendations laid down in the GCGC have an indirect legal impact as they serve to define and specify the legal duties and obligations of managers and directors and thereby affect the overall standards of scrutiny. When acting on behalf of the company, managers and directors are obliged under German law to adhere to a number of fiduciary duties, most notably to observe at all times the diligence of a prudent business person. Failure to comply with this requirement to the detriment of the company may result in personal liability of the officers. This does not only concern the management boards of stock companies (Section 93 of the German Stock Companies Act, Article 51 of the European Company Statute), but also directors of limited liability companies (Section 43 of the German Limited Liability Companies Act). As a consequence of these liability risks, formerly abstract standards of good governance increasingly determine the practical scope of managerial actions in day-to-day business.

Originally devised exclusively to regulate large corporations and stock companies, the scope of application of the GCGC has been extended considerably in recent years and notably in the wake of the global financial crisis of 2008. Continuous revisions have substantially raised the standards of good governance, thus creating corresponding fiduciary duties for its officers, in particular with respect to listed enterprises to whom the GCGC is addressed, but also to non-listed enterprises for whom compliance with the GCGC is recommended as well. New standards of good corporate



governance are likely to affect the standards of scrutiny applicable to officers in all entities.

Parallel to national efforts, corporate governance has become a major issue on the European echelon as well. As a result of the financial crisis, the European Commission (EC) currently undertakes to draw up a European system of corporate governance standards. These efforts have recently led to the publication of a European Green Paper for the European Corporate Governance Framework in April 2011. The green paper contains a number of suggestions to further implement and raise good governance standards for European companies.

As one of the determining factors of the past financial crisis is generally seen to be a lack of effective control over corporate decision-makers, the green paper aims to strengthen the instruments of internal and external control of management boards. Featured prominently among these suggestions are recommendations to reshape the balance of powers between managing and supervisory bodies, to promote internal diversity, notably by introducing a women's quota, and to expand the scope of the comply or explain requirement.

For companies doing business in Germany, the contemplated changes may carry substantial consequences, notwithstanding that the GCGC already has taken up a significant number of suggestions that are currently being debated on the European level. As the EC seems to regard current control mechanisms as insufficient, especially with regard to high-risk transactions, it is likely that it will seek implementation of more rigorous compliance standards. This may particularly affect the scope of the Business Judgment Rule in German corporate law, which in principle is applicable to all entities. Whereas under this rule a company officer is currently immune from liability to the company for losses incurred if he or she acts in good faith and in accordance with the company's best interest, future amendments will most likely constrict the boundaries of that rule and require the implementation of a more elaborate and transparent risk management on the part of the concerned companies, hence generating a growing demand for legal counselling in that field.

In order to reduce liability risks, it thus remains essential for the companies concerned to closely monitor the ongoing debate. The upcoming Corporate Governance Conference on 29-30 June 2011 in Berlin – organised and chaired by the Government Commission of the GCGC and under participation of the Federal Minister of Justice – is likely to offer additional insight into the current state of discussion. ■

## MIDDLE EAST &amp; AFRICA

**Executive remuneration practices and corporate governance across the Gulf**


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by Tom O'Byrne, Lucye Rafferty and Raffaella Stutz | Mercer Consulting Middle East Limited

THIS IS THE season in the Arabian Gulf for a wind the locals call *shamal*. Every winter and summer it sweeps in from the west across the Gulf States and out to the Indian Ocean, and the fine sand left behind is its distinctive calling card. In the corporate arena too, a more subtle, less visible *shamal* is making its presence felt across Gulf businesses, in the area of corporate governance standards and executive remuneration practices. More and more local boards and shareholders are taking an active interest in ensuring executive rewards are aligned with the gains – and losses – companies and their shareholders are experiencing. And so the gap between businesses in the Gulf and those in North America, Europe and elsewhere is closing fast.

*Putting pay at risk for performance.* The proportion of performance-based pay relative to guaranteed components is still relatively low in the GCC compared to other markets. A 2010 executive remuneration pay mix study clearly shows the disparity. The total fixed component – base pay and allowances – in mature markets, standing at 20 percent in North America and 30 percent in Europe, is outweighed by substantial short-term and long-term variable components (STI and LTI) – ranging from around 80 percent in North America to 70 percent in Europe, at the most senior executive levels.

In contrast to that, top GCC executives' average fixed component stands at 61 percent, with performance linked STIs being a minor component and LTIs even less prevalent. Across the GCC, STIs still tend to be discretionary payments allocated around corporate performance. The trend to bonuses being linked to individual or unit performance is on the rise via the use of business scorecards, but even today clear formulaic linkages between performance and pay below the top one or two tiers remain rare.

With LTIs in the GCC, even the phrase 'long-term-incentive' is something of a misnomer. More often they mean three-year, cash-based vehicles designed to retain top talent. As would be expected, the market sees vehicles shaped by the organisation's ownership structure or business model. Most common are ESOPs, phantom options, share/phantom share plans, or stock price appreciation models, but among family businesses those that dilute ownership control remain rare and cash plans dominate.

*An emerging governance framework.* The traditional western model is undergoing its own form of local

stress-testing as part of its importation and customisation to the Middle East market. Relative to most of the more mature G20 economies, ownership of wealth is still concentrated in relatively few hands. This has an impact on how CEOs and boards see their role.

The external pressure for reform continues to build. Last year for example, the Saudi Arabian Monetary Authority set tight timelines for banks to introduce new disclosure requirements around governance and executive compensation. Bahrain's Ministry of Industry and Commerce introduced similar requirements for the country's banks. Some commentators see the post-credit crunch effort around transparency as a differentiator among the highly-competitive GCC markets – the greater the transparency, the more likely the chances to attract key talent, business and investments away from your neighbours.

*Disclosure standards – early days.* One only needs to look at the annual reports for GCC-listed companies to get a sense of the challenges ahead when it comes to communication and education about disclosure standards. As one example, a Mercer study of 144 public companies reveals there are no fewer than 36 variations of labels used to refer to compensation paid to top management. Yet the signs of change are there – as 104 of these same reports actually detailed in some format the compensation paid to their top executives.

Disclosure is taking shape and form, but the forward momentum continues to be more as a reaction to events and policy shifts than as any company-driven initiative. Some companies report that audit conditions or bank credit requirements are serving as external drivers for setting or updating disclosure policies. And efforts to take a more proactive stand are often dampened by boards and owners who are more likely to wait for another large company to make the first move.

*Caution is key.* As the *shamal* leaves its subtle footprint across the region, so too, the shifts around corporate governance and executive compensation are leaving marks. Company filings and annual reports are setting new benchmarks for transparency in the region's stock markets; so too are institutions like Hawkamah and the private-sector Arabian Gulf Pearl Initiative emerging with clear change agendas and aggressive timelines. Middle East firms are increasingly resorting to survey data because of the benchmarks that boards demand and prefer when setting and aligning executive remuneration. There continue to be sporadic reports that top talent is staying away because the region's governance and pay-for-performance standards are nascent. But here, a note of caution is key. The *shamal* can shift the top layer. The broader desert landscape – sculpted over the ages – is something far more permanent and resistant to wholesale movement. Measuring change, therefore, will take far longer than we might first imagine. ■

## MIDDLE EAST &amp; AFRICA

**Fraud risk governance in South Africa**


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*by Peter Goss | PricewaterhouseCoopers South Africa*

ONE OF THE gaping holes in business leadership's interpretation of good corporate governance is having the right structures in place and then blindly driving forward towards the core purpose of business. This risk-taking stems from what are often rather limited assessments of a company's business risks. These assessments normally culminate in the compilation of a list of risks with supporting controls that are either too high-level, impractical to implement, or conflict with the directors' or management's good governance intentions.

For example, a risk could be identified where collusion between company directors and trading partners exposes the company to fraud. The default mitigating control for this is often internal controls such as proper supervision and oversight of material transactions.

One will seldom find more probing strategies to mitigate such a risk than: (i) the ongoing probity of the affairs (both business and personal) of directors and managers throughout their tenure of service with the company, with the obvious prevention of these processes infringing on their fundamental human rights; (ii) by independent pro-active, and in-depth, pre and post-award evaluation of high-value contracts or business decisions for actual or potential conflicts of interest by company directors and managers and trading partners; (iii) by encouraging firm action against trading partners for unethical conduct and ensuring that the repercussions of behaving without integrity when dealing with the company, and on behalf of the company, will lead to your isolation from any future relationship with the company; and (iv) by setting clearly measurable integrity criteria for the behaviour of directors and managers. In other words, taking detailed stock of how they truly live the rhetorical 'tone at the top', and taking prompt, firm and decisive action for unethical conduct, however trivial it may seem.

Why bring to the fore the above strategies in the language of good corporate governance? The answer is simple. In business, when you mention 'governance failure' we all immediately think of shocking cases, such as: (i) Bernard Madoff's embezzlement scheme which involved the skimming of millions of US Dollars from investors; (ii) various examples during the financial crisis of banks collapsing, and multinationals being rescued by governments, stemming from poor business decisions; (iii) the disappearance of some R2bn in investors' money experienced in the Fidentia saga, linked to the highly publicised personal spending spree of its jailed CEO; and (iii) never-ending

public sector dilemmas such as alleged corruption in the ubiquitous South African Arms Deal valued at being worth up to R30bn.

In light of the above, there is absolutely no need to state the case for good corporate governance. What we must bring to the fore though is the more profound, and little mentioned, concept of fraud risk governance. Most companies will tell you that they have some level of internal control in place to address fraud risk, but few to none have considered a probing fraud risk governance strategy to compliment their good corporate governance ideals.

Using the King Code on Corporate Governance III as a guideline, companies and other entities must ask the following questions to test and then develop a comprehensive fraud risk governance framework: do we measure the impact, or lack thereof, of our standards of integrity and ethical business conduct? Is fraud risk considered adequately with the governance of risk and are all board members aware of the company's position on actual or potential conflicts of interest and the acceptance and offering of business courtesies? Does the audit committee have access to the appropriate blend of skills to discharge its responsibilities in relation to fraud reports, other whistle blower reports, related investigations, fraud risk management and fraud risk controls, as opposed simply to basic internal controls? Do we understand how fraud risk identification, assessment and response is managed in our organisation and how often have we considered the same fraud risk-related issue in various management and governance meetings with no firm corrective action being taken? Do we apply appropriate fraud detection and analysis software to identify and respond to our fraud risk exposures? And what are the key anti-fraud statutory and regulatory obligations to which our organisation needs to comply?

In our business universe, which is burdened with the risk of fraud, now, more than ever before, we need to give urgent attention to fraud risk governance as part of an organisation's good corporate governance framework. This will help us to plug the gaping hole that we are exposed to because of our need to progress enterprise and entrepreneurship focused on good sustainable returns. ■

ADVISOR DIRECTORY

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Firm biography: PwC provides industry-focused assurance, tax, and advisory services to build public trust and enhance value for its clients and their stakeholders. More than 163,000 people in 151 countries across our network share their thinking, experience and solutions to develop fresh perspectives and practical advice.

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- Area of specialisation:** General Practice
- Firm biography:** Schiff Hardin LLP was founded in 1864. Since then we have expanded with offices in Chicago and Lake Forest, Illinois; New York, New York; Washington, D.C.; Atlanta, Georgia; San Francisco, California; and Boston, Massachusetts. As a general practice firm with local, regional, national, and international clients, Schiff Hardin has significant experience in most areas of the law.
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Areas of specialisation: Business Finance & Restructuring; Corporate; Litigation; Tax

Firm biography: Weil, Gotshal & Manges LLP is an international law firm of over 1200 lawyers in 20 offices worldwide that is premised upon a 'one-firm' approach to deliver sound judgment to our clients on their most difficult and important matters.

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