MANAGEMENT FOCUS

Corporate Governance: Pushing Ahead Without Best Practices

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In the early 1990s, international capital flowed to emerging markets in record levels. As long as returns remained spectacular, few investors paid attention to the behind-the-scenes manner in which companies went about their business. The Asian financial crisis, however, has led investors to attach new importance to corporate governance. Shareholders are realizing that because corporate managers lacked the incentive to adhere to sound management practices, poor corporate governance contributed to this crisis.

Today, the language of corporate governance—"disclosure," "transparency" and "shareholder value"—are buzzwords at the World Bank, the IMF and the OECD. These institutions regard improved corporate governance standards as critical in helping emerging markets rebuild competitiveness, restore investor confidence, and promote sustainable economic growth. The World Bank and the IMF are implementing governance reform in those still-ailing markets, and they are developing policies to stem the possibility of future financial crises in other countries.

While it may have taken a global crisis for good corporate governance to be recognized as a guiding principle for sustained economic development, a handful of leading US pension funds and investment managers were already using the standards to guide their overseas investment policies. Most countries have company laws or stock exchange provisions similar to those in the US that stipulate that companies must obtain shareholder approval for their proposed business.

As a consequence of these legal requirements, company management distributes to shareholders proxy voting cards and proxy statements that detail their proposals prior to an annual or special shareholder meeting. Proposed items can range from the routine—approving financial statements, for example—to complex transactions including mergers and acquisitions.

In the late 1980s, due to the absence of formal codes of corporate governance best practice in most emerging markets, US pension funds and investment managers began to actively exercise their proxy voting franchise for foreign companies. The US managers' motivation was straightforward. Their institutions recognized that proxy voting was the most effective way to induce companies to pursue sound management practices and promote better corporate performance. They have found that the failure to vote on financial issues can lead to lower portfolio returns.

Exercising their vote not only makes good economic sense to US institutional investors, it is also their fiduciary responsibility. In 1994, the US Department of Labor formally extended the legal stipulations of proxy voting requirements for public pension funds to proxies for non-US corporations.

US institutional investor efforts to vote global proxies are often an exercise in frustration. This is particularly the case with shares primarily traded in non-US markets, but it also includes American Depository Receipts (ADRs). An ADR is a type of security that represents a share of a non-US company that is traded on a US stock exchange. Although proxy voting has become significantly easier in recent years due to increased interest by institutions, obtaining materials pertaining to resolutions and executing votes is often difficult even under the best of circumstances. This is particularly true of companies in emerging markets.

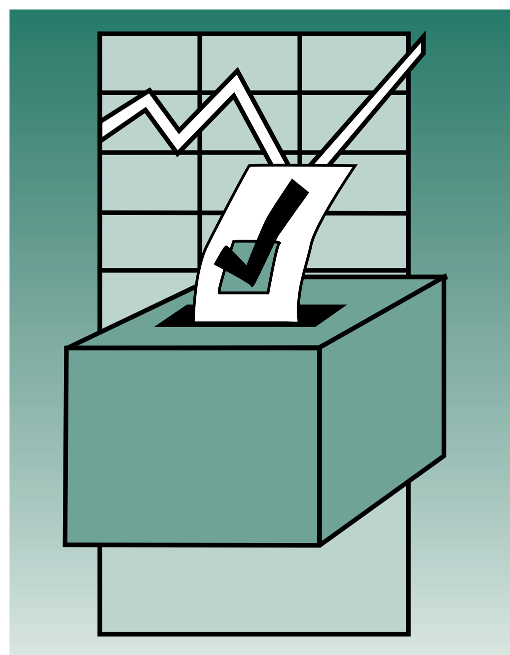
Global proxy voting

With regard to institutions' interest in voting globally, today's situation is dramatically different from only five years ago. Institutions with voting authority—for instance, pension plan sponsors, investment managers, trustees, and custodians—are developing proxy policies that reflect both overall investment goals and local market practices. Many institutions have already implemented a proxy review and research system, in which they determine how to vote in routine situations. They analyze non-routine issues for their financial impact and send them to a senior analyst or policy committee for approval. In an effort to impel managers to rigorously monitor corporate governance guidelines, some institutions offer voting guidelines and ask for global voting reports.

Much of this increased global activity has to do with the success of their domestic corporate governance programs. For instance, the California Public Employees' Retirement System (CalPERS) claims that its governance activities increased the value of its domestic portfolio by roughly $150 million. CalPERS advocates board independence, pay-for performance structures, and the removal of anti-takeover devices.

Global custody banks play an important role in facilitating US institutions' global voting programs. In each market, a global custodian bank usually has a relationship with a sub-custodian bank which holds the record for their clients' shares. These sub-custodian banks are entitled to receive proxy materials from foreign issuers. Therefore, US pension funds and investment managers have relied on their global custodians to gather proxy material from their sub-custodians and deliver it to them in time to vote.

US global custodians have responded to these requests from investment managers, although current SEC shareholder communication rules do not cover global proxies. A number of leading US banks now offer their larger clients translated meeting notices. They do not deliver a physical proxy card to the US client for a global security. Instead, they deliver a meeting notice which may include the time, date, location, and agenda of the meeting, as well as any additional information available from the issuer.



Upon review, the bank's client will return its voting instruction to the global custodian, which will then relay the voting instruction to its sub-custodian, which is responsible for executing the vote. Depending on the country, execution may mean returning a proxy card, physically attending the meeting, or hiring a third party to act as a proxy for the bank.

The efforts of institutional investors to effect change in emerging market companies by exercising their shareholder votes have recently received significant aid. International organizations are encouraging corporate governance reform, while financial sector leaders in several emerging markets—particularly in nations hardest hit by the Asian cri-

sis—have demonstrated increased commitment to these principles. Clearly, a climate of change can be detected, and several countries have witnessed improved disclosure requirements and stronger minority shareholder rights.

Shareholder activism

Korea. Buoyed by these developments, shareholder activism in emerging markets appears to be on the rise and generating results that seemed unthinkable just a short time ago. For example, in a victory for fledgling shareholder activism in South Korea, SK Telecom, the country's largest provider of mobile phone services, bowed to shareholder demands to implement safeguards against mismanagement. South Korea's Fair Trade Commission (FTC) had alleged that the SK Group, the parent company of SK Telecom, was using the company to provide subsidies to other struggling group affiliates. This is a widespread practice among the large South Korean *chaebol*.

Faced with a proxy contest from institutional investors that included TEI Fund plc, The Korea Fund, Inc., Oppenheimer Global Fund, and Oppenheimer Variable Accounts Funds—which together hold 10% of the company's share capital—SK Telecom agreed to a number of concessions. Most notable among these was granting shareholders the right to appoint two outside directors to the company's board.

In the past, few dared to take on the management teams of the country's all-powerful conglomerates. While minority shareholders still have a long way to go to reform Korean companies, their efforts are already contributing to the development of better standards. For example, Korea's stock exchange recently mandated that outsiders account for at least one quarter of listed companies' boards of directors.

Brazil. The Franklin Templeton Group (FTG), one of the world's largest asset management companies, has joined forces with Brazil's second-largest equity investor, Banco Bradesco, to establish a mutual fund that will strengthen relations between target Brazilian companies and their minority owners. The mutual fund will establish minority ownership positions in undervalued companies as a way to promote changes within these companies, such as increased disclosure and new merger and acquisition opportunities.

This undertaking is ambitious, especially considering that the views of minority owners have traditionally been neglected in Brazil. Typically, minority shareholders have had no recourse against corporate actions that would be considered egregious in the United States. These include the lack of disclosure of financial and shareholder meeting agenda information, equity issues with high dilution, and questionable dealings among related parties. If the Franklin Templeton-Bradesco mutual fund is successful, improved corporate governance could boost the overall Brazilian market by enhancing firm value and generating more liquidity for companies listed on Brazilian stock exchanges.

Future trends

While corporate governance practices in emerging markets still have a long way to go before they reach the standards that shareholders in many Western countries have come to expect, the path for reform has been clearly mapped out. Much of the burden of the

remaining work, particularly in the area of proxy voting, will ultimately fall on regulatory bodies and financial and corporate leaders in emerging market countries. Despite significant improvement, proxy voting in many markets remains hindered by archaic voting practices such as share blocking, unreasonable voting deadlines, the need for power of attorney signatures, high fees, disclo-

sure of little or no information concerning how votes are carried out, voting by a show of hands as opposed to ballot and three to four levels of intermediaries between shareholders and the company.

Institutional investors must also bear some of the workload. Institutional investors must take a leadership role in encouraging parties involved in cross-border voting— companies, market regulators, as well as global and sub-custodians—to adopt simplified voting procedures. This means involving the International Corporate Governance Network, the OECD, the World Bank, and other groups that seek to unite all parties in one forum to discuss ways to simplify the process.

One possible solution is to use the Internet to vote proxies. By reducing distance and time constraints, the Internet can provide an easy solution to a complicated problem. Developed markets such as the US and UK are moving in the direction of providing shareholders with the option of casting votes via the Internet. Assuming these markets produce a successful system, it could be a useful model for developing markets.

International investors also need to become more active and more committed to reform their holdings rather than to quickly trade them. Because proxy voting is an important means to protect assets, institutional investors need to inform the companies in which they invest of their desire to exercise votes. The approaches taken by Franklin Templeton Group and Banco Bradesco represent a step in the right direction. With the growth of retirement money in Western economies flowing into stock markets, particularly North American and European markets, international activism should intensify.

Private capital can assist the formation or recovery of emerging market economies and will have a positive effect on corporate governance standards. Emerging markets and individual companies need to restore the confidence of the international capital community by addressing corporate governance issues. One important factor in raising the standards is the need for institutional investors to express to companies the need for better disclosure, more accurate financial information and a simplified proxy voting procedure.

ISS Global Proxy Voting Guidelines

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Serving more than 400 institutional investors and nearly 100 corporations, ISS is one of the financial industry's leading provider of proxy voting and corporate governance services. Each year, ISS recommends votes on ballot issues for more than 12,000 shareholder meetings around the world.

When examining global proxy voting guidelines, ISS's philosophy is rooted in two fundamental two premises: informed proxy voting can enhance long-term shareholder returns in all markets; and basic corporate governance principles should be applied across national boundaries. Such guidelines must be applied flexibly, as long as the basic principles of governance are not compromised. The purpose of corporate governance, and hence of proxy voting, is to enhance long-term shareholder returns.

Director elections

ISS considers director elections to be one of shareholders' most important voting decisions, particularly because shareholders are given the opportunity to review their companies' operations only once a year at the company's annual general meeting. Therefore, ISS rigorously analyzed detailed information, if available, on boards or nominees. Because directors function as the ongoing representatives of shareholders, they are a crucial avenue to influence management.

Levels of disclosure regarding directors vary widely across countries. In some—the United Kingdom, Canada and Australia, for example—companies publish detailed information that aids shareholders in determining the level of director independence, such as director biographies, share ownership and related information. In many other countries, the only information available about directors is their names. Other countries disclose no information at all.

While ISS supports the annual election of directors, boards in many countries are divided into two or more classes elected on a staggered basis. In certain countries, executive directors may be appointed for terms of up to five years, and a company's articles may give executive directors protected board seats under which they are not subject to shareholder election. ISS opposes protected board seats and all other types of preferential treatment for executive directors.

When reviewing a company's director election proposal, ISS examines board composition, company performance and any negative views or information about the company or individual directors. ISS determines the number of executive, independent and affiliated directors on the board, the existence and composition of board committees, and the independence of the chairman. In cases where board composition is of concern, the company's general health and its recent financial performance may play a part in the evaluation of directors. ISS also considers individual director information, such as share ownership of director nominees.

When shareholders nominate a board member, ISS places the persuasive burden on the nominee or the proposing shareholder. They must prove that their nominee is better suited to serve on the board than to management's nominee. Serious consideration of shareholder nominees will be given only if there are clear and compelling reasons for the nominee to join the board. These nominees must also demonstrate a clear ability to contribute positively to board deliberations. Some nominees may have hidden or narrow agendas and may unnecessarily contribute to divisiveness among directors.

Companies routinely issue shares in order to raise funds for general financing purposes. Company law in virtually every nation requires firms to seek shareholder approval when issuing additional shares. Approving such requests gives companies sufficient flexibility to carry out ordinary business activities without having to bear the expense of calling shareholder meetings for every issuance.

A company can issue shares with or without preemptive rights. Preemptive rights permit existing shareholders to share proportionately in new issuances of stock. These rights guarantee existing shareholders the first opportunity to purchase shares of new stock issues in the class they own equal to the percentage of the class they already own. Corporate law in many countries recognizes preemptive rights and requires shareholder approval for the disapplication of such rights.

ISS believes that the ability to increase outstanding share capital through a rights issue (with preemptive rights) provides the company with sufficient financing to meet most contingencies. Shareholders need to approve rights issues for general capital needs that exceed 100% of outstanding capital. Granting this authority for

more than 100% can lead to excessive cash calls on shareholders, thereby requiring them to provide funds to maintain their relative positions in the company or to accept substantial dilution.

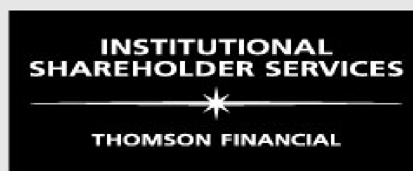
On occasion, companies may need to raise funds for routine business contingencies without the expense of carrying out a rights issue. Such contingencies include servicing option plans, small acquisitions or paying for services. When companies make issuance requests without preemptive rights, shareholders suffer dilution of the total number of shares held. Therefore, authorizations should be limited to a fixed number of shares or a percentage of capital at the time of issuance. ISS routinely approves issuance requests without preemptive rights for up to 20% of a company's outstanding capital.

Compensation plans

Although disclosure on employee or manager compensation in most countries is not as extensive as in the US, compensation plans are becoming more common on meeting agendas of foreign companies. The structures of these plans are of vital interest to shareholders. ISS reviews three main types of compensation plans: stock option plans, incentive plans and share purchase plans. ISS supports plans that motivate employees and managers to focus on long-term shareholder value and returns, encourage employee stock ownership and align more employee interests with those of shareholders.

ISS employs a complex methodology for evaluating compensation proposals in the US, but this is only possible because of the extensive disclosure provided in US proxy circulars. Compensation is not a topical issue in most non-US markets, and therefore the degree of information available to evaluate such proposals is usually limited to basic details. For this reason, ISS uses a simpler methodology for evaluating most non-US compensation proposals, but also with the goal of maximizing shareholder value.

Beyond the problems presented by limited disclosure, local conditions and traditions in particular countries also hinder the creation of a comprehensive compensation evaluation procedure. Standard market practice in one country may be illegal in another. For example, until recently employees of German firms were not allowed to own stock options in the company that employed them. Holding all global companies to the strict standards of the US could result in recommendations against almost every compensation plan in many countries. Conversely, making too many allowances for local practices may encourage poor governance standards over the long term.



Mergers and acquisitions

When evaluating the merits of a proposed acquisition, merger or takeover offer, ISS focuses on the financial and corporate governance impact on shareholder value, both in the immediate and long term. The primary concern is to determine whether or not the proposal will benefit shareholders' existing and future earnings stream and to ensure that the impact on voting rights is not disproportionate to that benefit.

In the case of an acquisition that requires large share issuances, ISS examines the level of voting or earnings dilution and the logic of the proposed purchase. The method of financing is also important, as various methods can result in different valuations than originally perceived. ISS also checks for an independent valuation of the terms, particularly if the target of the acquisition is not a publicly traded entity or asset and precise market valuations of it are not readily available.

This examination process is important when determining whether or not a specific premium is justified. Acquiring or taking controlling ownership in a company typically requires paying more per share relative to the listed stock price. These premiums, called control premiums, vary widely depending on the industry, the time period and country. For publicly traded entities or assets, ISS looks at the price of the acquisition relative to the average market price prior to any announcement, as well as the historical price trends for 60 days before the deal has been publicly announced. For entities or assets that are not publicly traded, an independent financial evaluation becomes even more important.

In the case of mergers, ISS examines whether or not the merger makes commercial or strategic sense for the company. ISS also considers the method of merger and the ultimate impact on shareholders of the proposed financial and corporate governance structure. While historical relative valuations based on market prices are useful in the financial evaluation process, the often complicated financial details of such proposals make an independent fairness opinion extremely important. The proposed board structure, share capital structure and relative share ownership of the new company are important factors in this evaluation process.