Research Review

Corporate Governance in Emerging Markets: An Investor's Roadmap

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F&C Investments

Provided by: Governance and Sustainable Investment team

Expect excellence

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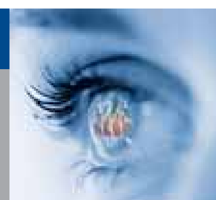


Emerging markets[1] play an increasingly important role in the global economy, and can offer an attractive opportunity for investors, given their high economic growth, improving physical and legal infrastructures and relatively low financial correlation with developed markets in normal market conditions. At the same time, investors face risks in emerging markets both at a country and individual company level. At the country level, these risks tend to reflect weaknesses in the rule of law and the pervasiveness of corruption, while for individual companies they often relate to the dominance of controlling shareholders and gaps in corporate governance and management quality.

This report underscores F&C's long-standing focus on building awareness of governance and enhancing governance standards in emerging markets through informed voting and active engagement. F&C believes that active ownership enhances long-term sustainable value, and that voting and engagement play an important role in driving down risks and raising valuations. This engagement activity is undertaken on behalf of all of F&C clients through F&C's *reo*® (responsible engagement overlay) service[2].

How is this report different from other emerging markets analysis?

In this report we offer an integrated analysis of emerging markets, incorporating the perspectives of investors active in emerging markets in both equities and fixed income. The report presents an assessment of the key opportunities and risks that relate to corporate governance from the perspective of an investor that is seeking both to make informed investment choices and to drive up valuations over the long term.

This report also develops a framework for investors to act upon the analytical findings it presents about governance risks, through a combination of active voting and direct engagement with issuers and regulators. In particular, we present a guidance framework on engagement that reflects F&C's view of what investors should look for in emerging market companies. We believe that adherence to these good practice principles will help companies achieve a better valuation, and hence a lower cost of capital, by enabling them to build a better foundation in a number of important areas; these include ownership, shareholder rights, transparency and disclosure, audit and risk management, and board effectiveness.

Who should read this report?

Although of potential interest to a broad audience, this report is aimed primarily at two groups: emerging markets companies and their investors.

- For companies. We provide an investor perspective on governance-related risks and opportunities in the emerging markets. Of particular note is that it reflects the perspective of an investor with a typically small stake in a company's capital structure, as either a minority shareholder or creditor. It therefore aims to provide company executive management and board directors with a clearer understanding of investor concerns about governance. The sections on voting and engagement illustrate what many investors, including F&C, are doing to enhance the effectiveness of their dialogue with issuers. For those companies wishing to signal improving governance standards proactively, the guidance for engagement can serve as a useful reference point to shape reforms.

- For investors. This report should also prove useful to investors, particularly those wishing to achieve better valuations by encouraging companies to move towards improved governance. It makes the case for greater engagement between issuers and their investors, and backs this up with guidance on how to translate principles into practical steps forward. As institutional asset managers and owners increasingly work together to promote better practices, this report should serve as a useful foundation.

  In this report we focus primarily on traditional themes of corporate governance; however we also acknowledge the growing attention on broader questions of business ethics and social and environmental performance. This broader ESG (environment, social, governance) agenda is more fully addressed in a companion report that F&C will release in early 2009, and will likewise outline both the state of play in Brazil, China, India and Russia, along with F&C's recommendations for good ESG practice and shareholder engagement. However, the detailed guidance framework in this report references environmental and social themes as an important dimension of F&C's engagement to promote good corporate governance and long-term sustainability.

[1] F&C's definition of emerging markets generally follows the World Bank classification of those countries that rank as low- to medium-income on a per capita basis globally. In practical terms, our focus is on those developing economies where companies present themselves to international investors through their own domestic exchanges or through listing in international exchanges.

[2] F&C uses its influence as an asset manager to encourage better management of environmental, social and governance risks by companies. As well as applying this approach to the assets it manages in-house, F&C has also been appointed by a number of pension funds and financial institutions whose funds it does not manage to engage and vote on their behalf. In total assets covered by the reo® approach totals some £63 billion, as of 30 September 2008.

I. Executive Summary

- Corporate governance has generally improved in most emerging markets following the Asian and Russian financial crises of the late 1990s. Nevertheless, it remains a key risk factor for investors. This is the case at macro (i.e. country) level, where rule of law, regulatory quality and corruption are key drivers. Governance risks are also relevant at the micro (i.e. company-specific) level, where controlling shareholders – state, families or other financial/industrial groups – play a decisive role and can be a source of real strength or weakness. This is relevant to both equity and fixed-income investors. Moreover, the interplay between macro and micro factors – in particular weak rule of law and shareholder rights – can drive up the risk that controlling shareholders will extract value at the expense of minority shareholders and creditors. It is important to understand an individual company's governance in the context of its national environment. Where a supporting governance infrastructure is not in place at the country level there is greater potential for abuse at the individual company level.

- Notwithstanding the constraints they often face, minority equity investors can and should play a role in shaping governance practices in emerging markets by asserting more actively their shareholder rights. This should involve both informed voting and ongoing engagement with companies and regulators. Creditors can likewise assert their interests more actively, particularly in those cases where a company's ESG performance can influence its long term stability and overall credit quality.

- The case studies of the "BRICK"countries (Brazil, Russia, India, China and Korea[3]) provide profiles of five key emerging markets in terms of their corporate governance. While these countries share many common themes, including the influence of dominant shareholders, they also differ in certain important respects – for example with regard to rule of law. It is of note that while the sovereign credit ratings of the BRICK countries are consolidating in the investment grade category, their respective corporate governance characteristics are very mixed, with Russia and China in particular lagging behind Brazil, India and Korea. Indeed, credit ratings that focus on the financial strength of individual countries are not necessarily accurate indicators of the governance environment for individual companies.

- The "G" (governance) of ESG has tended to receive greater attention from companies than the "E & S" (social and environmental performance).[4] This reflects greater regulatory guidance and greater market pressure in the corporate governance area, as well as clear examples of corporate governance abuses that have disadvantaged investors. Moreover, environmental and social factors tend to play themselves out over a longer time period and may appear less urgent to companies, regulators and many investors. As emerging markets firms become more integrated into the global economy, there will be increasing pressure on them to address the broader ESG agenda more systematically. In particular, there is greater scope to boost disclosure on how environmental and social issues factor into strategic planning, operational management, risk management and remuneration incentives. Although variations are evident between regions and companies, with many Brazilian companies in particular setting themselves apart, overall there is much to be done in this domain.

II. Overview: The attractions and risks of emerging markets

Emerging economies represent roughly 87% of the world's population, 81% of the world's landmass, 68% of foreign exchange reserves – yet only 22% of global market capitalisation. While emerging markets have grown in significance in global capital markets, this has been from a relatively small base, and there remains considerable scope for them to continue to gain economic importance. In terms of large companies, roughly one quarter of the global companies in the FT 500 index originate from emerging markets – with China being particularly well represented, with 7 of the top 50, and 23 of the top 500 companies. And the universe of emerging market companies available for investors continues to grow; for example, these markets accounted for around 70% of the value of global initial public offerings in the second quarter of 2008.[5] Similarly, emerging market companies – particularly in Russia and India – account for the greatest number of Global Depository Receipt (GDR) programmes in the UK, and in terms of monetary volume, Russia accounts for almost 80% of the GDR market.[6]

From an investment perspective, emerging markets offer fundamental attractions:

- Economic growth. In recent years, emerging markets have accounted for around 33% of global GDP growth, and in 2007 their GDP growth averaged 7.8%, as compared with 2.7% in more developed economies. The full impact on growth of emerging economies given the 2008 financial crisis remains to be seen, but the longer-term growth potential of emerging markets relative to developed markets remains robust.

- Diversification. The notion that emerging markets are completely "de-coupled" from developed economies is a myth; the global economy is interconnected and interdependent. But it is the case that emerging market economies are less correlated to more developed markets and offer additional diversification from a portfolio management perspective. As a practical example, the impact of the credit crunch was initially felt less in emerging economies than in North America or Western Europe. In part, this reflected growing domestic demand in emerging markets, less exposure to complex financial instruments (such as securitised mortgage lending) and lesser dependence on developed markets as trading partners. However, the sharp share price declines and capital outflows experienced in emerging economies in the autumn of 2008 demonstrate how contagion can destabilise emerging markets despite relatively stronger growth and improving fundamentals.

- Improving macroeconomic environment. Particularly for those emerging economies that produce energy or other raw materials, the commodities boom has had a notable effect on public finances in recent years. Direct investment and trade flows have been strong, with the result that foreign exchange reserves in emerging markets countries have grown from $80 billion in 2001 to over $500 billion in mid 2008. Private capital flows to emerging markets rose from $232 billion in 2006 to $604 billion in 2007[7]. Similarly, foreign debt as a percentage of GDP has dropped in emerging markets from 34% to

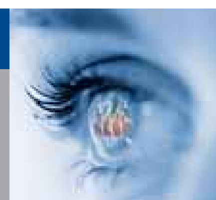
[3] Throughout this report our reference to Korea is to South Korea.

[4] F&C will be publishing a companion paper in 2009 focusing specifically on environmental and social performance of emerging market companies.

[5] "Emerging markets take lead in IPOs", David Oakley and Rachel Morarjee, Financial Times, 16 July 2008.

[6] The Bank of New York Mellon, March 2008.

[7] Ibid.



23% by mid 2008.[8] Some emerging countries have built large pools of international reserves, and sovereign wealth funds from emerging markets are cropping up as a new source of global investment capital. Reflecting these trends, the credit profile of many emerging markets has improved. Russia, which defaulted on its own domestic debt in 1998, is now established as an investment-grade sovereign credit, whereas Brazil and India have recently reached investment-grade status after years with speculative-grade sovereign credit ratings.

- Improving institutional governance and market infrastructure. While there remains considerable scope for improvement, standards of law and regulation generally have advanced in recent years in most emerging markets. Company law has undergone revision, and codes of corporate governance practice have been introduced in many jurisdictions – in part supported by technical development assistance from multilateral development banks. Transparency and disclosure have also improved and IFRS accounting standards increasingly are adopted. In some emerging markets, Brazil for example, institutional investors are also providing a supportive market discipline through more active share ownership. At the individual company level, governance standards span a wide range. But at the top end, many companies have improved their standards – most notably those that have raised capital in international financial markets and conformed to listing requirements that are in many cases more demanding than in domestic emerging markets. The net effect of this broad structural improvement for investors is that there is scope for reduction of the "discount" relating to poor governance and management quality. Framed more positively, this amounts to a potential premium for those emerging markets issuers that raise their governance standards.

These positive trends add up to potentially attractive returns for investors in emerging markets. For example, over the 5-year period from June 30 2003 through June 30 2008, the MSCI Emerging Markets Index averaged 26.72% p.a., whereas the MSCI World index returns (local currency denominated) averaged 9.99% p.a. And during the difficult economic period from June 2007 through June 2008 where the World index was off 15% year to year, the BRICK countries, while also impacted relative to prior years, still managed to generate average equity returns of 9.2%.[9] However, in the third quarter of 2008, emerging markets dropped in value significantly: the MSCI Emerging Markets Index dropped over this period by 27.61%, as compared with a loss of 15.67% by the MSCI World Index. This comparatively large drop in the emerging markets reflects overarching global economic challenges, but also specific emerging market concerns relating to weaker commodity prices, growing inflation, and geopolitical issues.[10]

Current market conditions demonstrate that the attractions of emerging markets–while real – do come with incumbent risks. These include economic volatility, political risks, corruption, poor governance standards, low transparency, and weak legal enforcement-- risks that still exist in many emerging (and in some developed) countries.

Against this background, investors need to keep the following factors in mind:

- **Macro**. While the long-term growth potential of the emerging markets remains significant, the path of growth is unlikely to be smooth. Moreover, emerging markets comprise a heterogeneous group of countries; some will show bumpy long-term improvement, and some will languish. While emerging markets were initially buffered from the more dramatic impacts of the credit crunch in Western markets, there has been a subsequent economic impact in terms of demand for exports and capital flight. At the same time, high oil and food prices have contributed to mounting inflation in emerging markets – in aggregate 6.5% for emerging markets in 2008, but notably higher in Russia and China. These rising inflation levels, particularly when joined together with a recessionary environment in key export markets, create near-term economic uncertainties – notwithstanding the promising aggregate longer term growth outlook.

- **Micro**. Particularly in jurisdictions where rule of law is weak and corruption is rife, investors must be alert to corporate governance and the protection of their shareholder rights. When the broader macroeconomic environment is stable or positive, many corporate governance risk factors may not come to the surface. However, in more challenging environments, governance quality is likely to be among the key "soft-tissue" factors that differentiate the leaders from the laggards – an indicator that also helps to inform investor views on management quality more generally.

III. What can investors do?

While some investors may explicitly or implicitly assign some form of governance-related discount or premium in valuing emerging markets companies, a further option for active investors is to work with the companies to improve their governance – with the longer-term endgame of realising value by reducing, or possibly eliminating, the governance discount in individual companies. Investors have two fundamental approaches to influence company governance: voting and engagement.

Voting

In practical terms, voting by institutional investors will tend to have a minimal near-term effect on the outcome of AGM or EGM resolutions – primarily due to prevailing ownership structures and the fact that the outcome of most votes will be determined by the way in which the controlling shareholder votes. However, notwithstanding the actual vote outcome, voting does deliver a message to management about specific investor concerns. Particularly for those companies wishing to cultivate international investors for longer-term capital raising purposes, expressions of minority investor confidence – or concerns – through the voting process provide important feedback and can be an influential agent for change.

[8] Credit Suisse, Emerging Market Quarterly, Q2 2008

[9] Data provided by JP Morgan.

[10] "Reversal of fortune for emerging markets", David Oakley, Financial Times, 11 September 2008

Corporate Governance in Emerging Markets:

Table 1 presents a table of F&C's votes in the BRICK countries for the period between July 2007 and June 2008. It quantifies the number of resolutions voted on by category, and how often F&C either voted against or abstained on management resolutions. During this period, F&C voted on 2,565 specific resolutions on companies in the individual BRICK countries. Of these resolutions, F&C did not support management in 598 cases – 23.3% of all resolutions. Compared with F&C's voting record in developed markets, this represents a greater lack of support for management in emerging markets, which, in turn, reflects the greater level of governance concerns in these markets.

F&C votes against management or abstentions in BRICK countries

	Allocation of Profits/Financial Statement	Auditor	Board	Change in Capital Stock	Change in Governance Structure	Compensation	Financial Transactions	Indemnification of Directors & Officers	Issuance of Stock non US	Miscellaneous Proposals	Amend to Charter	Strategic Transaction/Restructuring	Total 2007/2008
Brazil													
Votes Against	1	0	33	2	0	6	0	0	0	0	4	2	48
Total Votes	53	2	63	16	1	20	6	5	1	17	44	42	270
%	1.9	0	52.4	12.5	0	30	0	0	0	0	9.1	4.8	17.8
China													
Votes Against	0	1	6	0	0	1	33	4	11	9	2	4	71
Total Votes	52	21	113	7	3	35	90	22	75	83	64	40	668
%	0	4.8	5.3	0	0	2.9	36.7	0	14.7	10.8	3.1	10	10.6
India													
Votes Against	7	5	42	3	-	5	0	-	0	1	3	1	67
Total Votes	43	24	123	6	-	15	4	-	5	8	5	6	239
%	16.3	20.8	34.2	50	-	33.3	0	-	0	13	60	16.7	28.0
Korea													
Votes Against	0	-	33	-	-	2	-	0	-	0	5	0	40
Total Votes	66	-	118	-	-	76	-	1	-	1	39	3	304
%	0	-	34.7	-	0	2.6	-	0	-	0	15.4	0	13.2
Russia													
Votes Against	10	4	307	-	-	14	-	5	0	5	2	25	372
Total Votes	74	27	726	-	-	196	-	9	1	20	3	28	1084
%	13.5	14.8	42.3	-	-	7.1	-	55.6	0	25	66.7	89.3	34.3
Total													
Votes Against	18	10	421	5	0	28	33	9	11	15	16	32	598
Total Votes	288	74	1143	92	4	342	100	37	82	129	155	119	2565
%	6.3	13.5	36.8	5.4	0	8.2	33	24.3	13.4	11.6	10.3	26.9	23.3

Source: F&C Investments July 2007 - June 2008

F&C's voting in BRICK countries focused primarily on the effectiveness of the board – this area represented 45% of all resolutions, including the appointment of directors on an individual or slate basis, and the election of statutory auditors. F&C voted against or abstained on 421 – 38.6% – of board-related resolutions during this 2007/2008 period. In many cases, these votes reflected lack of independent directors or poor disclosure regarding director candidates. In the cases of Brazil and Russia, F&C did not support director candidates in 52.4% and 42.3% of the resolutions, respectively.[11]

For resolutions relating to financial transactions, F&C opposed or abstained on 33% of management resolutions. In most cases, this reflected resolutions of Chinese companies to authorise significant levels of new equity issuance without pre-emption rights. Also, F&C did not support 26.9% of votes on strategic transactions and restructuring. To a large extent, this stemmed from Russian firms, where F&C voted against 89.3% of restructuring resolutions, in most cases reflecting a lack of information on which to base a responsible voting decision.

In aggregate, these voting results demonstrate a much lower level of management support by F&C, as compared with developed markets. This reflects the heightened levels of governance risks in emerging markets, and also forms the foundation for company engagement in these markets.

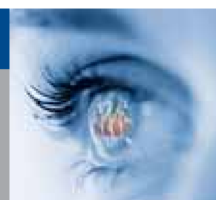
Engagement

In addition to voting, engagement represents an opportunity for investors to express concerns about company governance directly to management. Engagement can take many forms-- including face-to-face meetings, letters, email and other forms of communication and outreach. It can be done unilaterally by individual investors or in collective action among a group of investors. Compared with voting, engagement allows investors to focus on specific issues for in-depth dialogue with company management, and the nature of feedback is not limited by ballot items.

Many of the companies engaged by F&C in 2007 were in emerging markets – reflecting in part the composition of F&C's own investment portfolio and the portfolios of investment clients that F&C represents as part of its reo® service. On top of this F&C equity fund managers meet with over 500 emerging market companies per year. Specific examples of F&C in 2008 individual company engagement in emerging markets included asking companies:

- To remove the chairman of a company convicted on embezzlement charges;
- To address weaknesses in controls associated with related-party transactions;
- To bolster board independence;
- To implement business ethics systems that empower employees to resist unethical conduct;

[11] It should be noted that Director voting statistics in China are different than the other BRICK companies. This reflects the fact that the nature of Chinese ballots varies considerably, particularly in terms of the number of directors standing for election. Some ballots have 20 directors standing while others have only 1 or 2. This skews the statistics by overweighting certain meetings, such as Petrochina, for example, where F&C voted for all 20 directors and supervisors standing. On a meeting basis, rather than a resolution basis, F&C voted For all directors at 56% of meetings where there was a director resolution; we abstained at 19% of meetings; and we voted against at 25% of meetings. From this perspective F&C's director voting in China shows greater consistency with other BRICK countries.



- To explain (particularly for companies with a track record for price fixing) how the board is monitoring compliance with ethics and legal standards;
- To release more information about management resolutions to facilitate informed voting;
- To make information on director candidates available in advance of the shareholders' meeting;
- To put directors up for election individually, rather than by slate;
- To publish a stand alone corporate responsibility report;
- To remove the CEO from the audit committee;
- To factor environmental and social risks more actively in their strategy, risk management and business planning;
- To sign up to global initiatives such as the Carbon Disclosure Project, UN Global Compact or the Extractive Industries Transparency Initiative.

Examples of F&C's emerging market engagement successes

- **China**. As the world's largest mobile telephone operator, with ambitions to expand in Europe and the Middle East, **China Mobile** must compete with well-established telecom operators globally. Its success will be influenced by how effectively it manages relationships with customers, local regulators and communities. Following F&C's engagement, **China Mobile** announced a three-year sustainability strategy and new sustainability committee, and published a new sustainability report. Its environmental management system will address public health risks associated with electronic waste and electromagnetic fields, and is expected to improve energy efficiency by 40% by 2010.
- **Korea**. Following intense pressure from foreign and domestic institutional investors, including F&C, **Samsung Electronics** announced in April 2008 that its longstanding chairman HK Lee would step down from the board. This follows from his conviction on fiduciary breach of trust charges linked to an alleged slush fund that was used to bribe public officials. While we believe that a changing of the guard is an appropriate first step, we will continue to press the company to review its business ethics management systems, and to install a fully independent audit committee to review the company's internal controls on an ongoing basis.
- **Russia**. A positive example is that of the gas producer **Novatek** expanding its board to accommodate new independent directors following from engagement by F&C. We also encouraged **Lukoil** to sign the Extractive Industry Transparency Initiative (EITI) – which it has done in Kazakhstan, but not in other jurisdictions. In the area of environmental and social performance F&C has been engaging the mining company **Norilsk Nickel** and the steel company Severstal to encourage these companies to recognise the risks around human rights and labour standards and to develop environmental management systems. The result is that both companies have been selected as joint-venture partners in eastern Siberia – **Norilsk** is partner with Rio Tinto, and **Severstal** is partner with Anglo American and BHP-Billiton. When questioned, the Western miners have said that one of the reasons they selected these companies as partners was because of their positive track record in addressing key environmental and social risks.
- **Brazil**. F&C is currently working to ensure that minority shareholder rights are protected at controlled companies in Brazil, either through calling for tighter regulatory intervention or through advocating changes in the companies' own governance cultures. In addition to asking our holdings in Brazil to extend 100% tag-along rights[12] to all share classes, we encouraged the Comissão de Valores Mobiliários (CVM) to review a 2008 merger agreement between the pulp and paper companies **VCP** and **Aracruz**. Our letter to the regulator addressed the broader shareholder rights issues involved, as well as the country discount facing Brazil as a result of haphazard regulatory intervention. The specific outcome of the **VCP-Aracruz** deal is pending (currently suspended given market conditions), but the perspective of F&C and other investors influenced the CVM's most recent legal guidance regarding fiduciary responsibility in negotiating fair exchange ratios for minority investors in takeover situations.

IV. Guidance framework for improving governance in emerging markets

F&C has developed a guidance framework for companies listed in emerging markets. This aims to provide practical advice on how to address specific areas where improved disclosure and/or changes in practice could enhance investor confidence and drive up valuations over time.

Many of the risks to shareholder value that F&C has identified ultimately relate to concentrated ownership, which is the predominant form of ownership in most emerging market companies. However, in this regard, F&C is of the view that the presence of controlling shareholders can serve a positive or negative function; their influence should therefore be assessed on a case-by-case basis. In many cases, controlling shareholders can be a positive influence by providing strong oversight over executive management and by fostering a corporate culture focusing on long-term value creation. However, very often, there is scope for abusive behaviour by controlling shareholders, which can be exacerbated in jurisdictions where transparency is poor and where weak rule of law may fail to give minority investors proper judicial recourse.

What follows is an outline of key risk factors in emerging markets and the main indicators or "red flags" that can serve as warning signs of their potential existence. From this, we develop a list of recommended remedies relating to disclosure and practical measures that companies can adopt to mitigate these risks. Minority investors should exercise caution when confronted with any of the risk factors outlined below, and should encourage companies both to clarify where they stand and, wherever possible, adopt these measures in order to minimise any risk to the value of equity and credit investments.

[12] Tag-along rights allow minority shareholders to participate in share transactions at the same terms and conditions as majority or controlling shareholders.

While these individual recommendations may not be relevant for every company, this guidance can serve as a useful reference to frame investor-company dialogue.

Ownership structure

Key risks:

- Controlling shareholders that pursue private benefits of control at the expense of minority shareholders and/or creditors.
- Mild or extreme forms of expropriation through asset transfers and self-dealing.
- Related-party transactions involving transfers of wealth on uneconomic terms that deprive minority shareholders of value.

Indicators/Red flags:

- Opaque ownership structures.
- Mismatch between economic stake and voting rights: i.e. different share classes that grant the controlling shareholder voting influence in excess of its ownership stake.
- Weak regulatory environment for shareholder protections.
- Corrupt or ineffective judiciary.

Recommended good practice measures:

- **Disclosures on ownership**. Clarity about the ownership structure, (particularly beneficial ownership), relationships with third-party affiliates and the relationship between economic stake and voting control.
- **Ensure voting rights match economic ownership**. This can include eliminating voting rights differentials between different share classes or merging share classes following an independent valuation exercise to ensure that the rights of each class of owners are protected. Where this is not done, companies should at a minimum guaranty tag-along rights to owners of preferred or other non-voting shares.
- **Related party transactions**. Investors should insist that related-party transactions be scrutinised and approved by independent board members, who should, in turn, ensure that they are conducted on the basis of independently vetted arms-length valuations – and that large related-party transactions be put to a vote of non-conflicted shareholders. Controlling shareholders and other affiliated parties should recuse themselves from any role in overseeing such transactions, and refrain from participating in any vote.
- **A Relationship Agreement**. This is an arrangement where the controlling shareholder undertakes through a contractual agreement to promote the interests of the firm as a whole, and therefore to respect in full the rights of its minority shareholders and creditors. The terms of this form of agreement can relate to the appointment of board directors, the approval of capital transactions, areas of potential conflict where controlling shareholder-appointed directors cannot vote, and other forms of related-party transactions involving the controlling shareholder.

Relationships to Government or other third parties

Key risks:

- Cronyism/corruption.
- Government interference that may promote "national" or "public" interests over shareholder concerns.

Indicators/Red flags:

- Low rankings on credible and independent country risk indicators relating to rule of law, regulatory quality and corruption[13].
- High incidence of country-specific or industry-specific corruption.
- Government ownership stakes.
- Presence of government appointees on company boards.
- No evidence of effective ethics systems governing the company's relationships with both commercial and public sector entities.

Recommended good practice measures:

- **Business ethics management.** Companies should take appropriate measures internally to address ethics and corruption-related issues. This should include the development of policies, procedures and systems that link into business strategy and executive remuneration[14].
- **Disclosures on business ethics management.** Companies should also assert publicly their own policies and report on their adherence to such policies. This includes disclosures relating to a company's lobbying positions or other material government interactions[15].

Shareholder rights

Key risks:

- Unwanted dilution of minority shareholders' ownership stakes.
- Capital and strategic transactions that are inequitable to minority shareholders.
- Inability of shareholders to replace entrenched executive managers or directors that are ineffective or show disregard for minority shareholder interests.

Indicators/Red flags:

- Weak or limited shareholder rights that provide limited recourse against inequitable transactions.
- High barriers to takeover that deprive minority shareholders of their rightful premium.

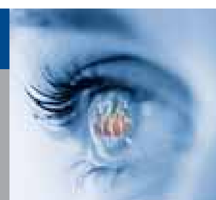
Recommended good practice measures:

- **Pre-emption rights.** Pre-emption rights provide existing shareholders with a right of first refusal to participate in the issuance of new shares by a company, thereby allowing them to maintain their relative economic stake without being diluted. This is particularly important, if not automatically required by law, since shareholders are dependent on companies voluntarily restricting their own freedom of

[13] These include the World Bank Governance Indicators and the Transparency International Corruption Perception Index which are discussed later in this report in greater detail.

[14] See F&C's response to the Woolf Commission report outlining suggested improvements relating to BAE Systems ethical policies and practices: http://www.fundnets.net/fn_filelibrary//File/Woolf%20Committee%20submission%20FINAL.pdf Also see the Transparency International Business Principles for Countering Bribery: http://www.transparency.org/content/download/561/3429/file/BPCBfinal.pdf. The International Corporate Governance Network (ICGN) will also be releasing a guidance note for investors in early 2009 on anti-corruption: http://www.icgn.org/index.php

[15] See F&C Political Lobbying and Donations Policy: http://www.fundnets.net/fn_filelibrary//file/Political%20Lobbying%20and%20Donations%20Policy.pdf



action in order to reassure them that they will not face dilution. Voting against dilutive capital transactions is a common theme in F&C's proxy voting in many emerging markets, and F&C will typically vote against dilutive new issuance of shares that are greater than 10% of issued share capital in one year. Pre-emption rights are also an important theme for engagement at the macro, or regulatory, level.

- **Tag-along/mandatory offer provisions.** Tag-along rights are aimed primarily at ensuring equitable treatment of minority shareholders in takeover situations. When a major capital transaction occurs that affects the company's controlling shareholder, tag-along rights allow minority shareholders to participate in the transaction on the same financial terms. F&C has challenged regulators in both developed and emerging markets on this theme[16], and encourages companies to offer equitable rights to all shareholders.

Transparency and Disclosure

Key risks:

- Incomplete understanding of company finances, operations and governance that limits the ability of minority shareholders to take informed investment decisions.
- Minority investors who are at an informational disadvantage as compared with controlling shareholders.
- Foreign investors who are at an informational disadvantage as compared with domestic shareholders.

Indicators/Red flags:

- Information asymmetry between minority shareholders and controlling shareholder.
- Use of non-internationally recognised accounting standards.
- Disclosure to foreign shareholders (English language) less complete than domestic market disclosures.
- Minimal reporting on operational performance, corporate governance and sustainability.
- Delayed disclosure of key corporate actions and shareholder meeting information.

Recommended good practice measures:

- A policy of **continuous and fair disclosure**. The announcement of company actions should be made to all shareholders on a timely basis, and should not provide controlling shareholders with an unfair advance notice of material company events.
- Use of IFRS or other **internationally-recognised financial accounting standards**. Financial accounts that are in line with international accounting standards and audited by a reputable accounting firm are an important step for companies wishing to appeal to international investors.
- **Language and access to disclosure**. Key disclosures for internationally-listed companies should be in English and accessible over the internet.
- **Robust operational disclosure**, including disclosure of Environmental, Social and Governance (ESG) performance. It is important for investors to understand a company's key performance indicators (KPIs) through better operational disclosure. Reporting standards tend to be weak in this area, with some notable exceptions, and reports are often minimal or incomplete. Companies should present sustainability reports and provide disclosure regarding material environmental and social risks.
- Statement of the company's **compliance with the governance standards of its domestic corporate governance** regime – or a statement of adherence to another internationally-recognised set of governance standards, where the former lacks international recognition. Explanation of any deviations from global good practice standards and indication of plans to remedy such gaps, where applicable.
- **Timing of proxy disclosure** and information regarding director candidates should be sufficiently in advance of shareholder meetings to allow foreign investors the time to make informed voting decisions. This should normally be at least 20 working days, and is particularly important with regard to strategic and financial transactions.

Board Independence and Effectiveness

Key risks:

- Weak or ineffective boards that do not hold executive management to account or provide constructive challenge to controlling shareholders; this, in turn, can lead to poor strategic decisions, or to controlling shareholders pursuing an agenda that benefits neither the company as a whole nor minority shareholders.
- Poor board understanding of director fiduciary responsibilities, leading to non-independent directors serving the interests of controlling shareholders.
- Board practices that do not facilitate informed decision-making or constructive challenges to executive management.
- Entrenchment of weak executive management. This is a particular risk factor in family companies, where attracting and retaining high-calibre professional staff can prove difficult if top jobs are reserved for family members.
- Incentive systems that do not align the interests of executive management with those of long-term shareholders.

Indicators/Red flags:

- Lack of board independence and relevant expertise, or lack of information concerning board members qualifications and skills.
- No evidence of effective succession planning.
- Lack of disclosure on board practices, poor shareholder access to board members, or disclosure that suggests poor attendance or a lack of rigour in board deliberations.

[16] Refer to the engagement case study in the report relating to the Brazilian companies VCP and Aracruz.

- Poor disclosure on executive remuneration, or remuneration policies that focus on short-term performance.

Recommended good practice measures:

- Even where there are controlling or majority shareholders, there should be enough quality **independent directors to staff key committees**, particularly the audit committee. While controlling shareholders normally can expect strong board representation by appointing their own directors, it is important to ensure that independent directors nevertheless have an effective voice. At a minimum, this implies **at least two or three independent directors – constituting at least one-third of the board**.

- **Board training regarding fiduciary responsibility** so that all directors – particularly those appointed by controlling shareholders – understand their obligation to act in the interest of the firm as a whole, including its minority shareholders.

- **Succession planning**. The company should have clear and transparent succession planning processes to guide the selection of new executive managers. These processes should be documented publicly, and possibly incorporated into a Relationship Agreement. Here, true board independence in the process of director nominations and management evaluation is essential. The board should establish explicit policies to prioritise professional management standards and insulate executive appointments from political interference or inappropriate influence from controlling shareholders.

- **Remuneration**. The company should develop a remuneration strategy – approved by independent directors – that aligns executive management with minority shareholders through a focus on long-term value creation. This can take the form of long-term share-based incentive structures that are guided by rigorous financial and operational performance targets. The company should also disclose individual remuneration packages for the chief executive and other key executive managers.

- **Best practices to enhance board effectiveness** and independent oversight. This could encompass a range of practices to facilitate more timely and relevant information flows to the board, and to encourage open and candid discussion at board level in order to reinforce the role of the independent directors. These can include:

  - direct and regular access to executive management and heads of key operating divisions;

  - identifying a specific independent director contact for investor outreach;

  - access to timely information flows, including financial statements and risk management reports;

  - private meetings of independent directors without the presence of executive management and controlling shareholders.

Audit, Control and Risk Management

Key risks:

- Executive directors and board directors lack the necessary information or control systems to manage key operational and financial risks, resulting in poor managerial decisions and ineffective board oversight.

- Company is vulnerable to self-dealing or other conflicted transactions that favour controlling shareholders, executive management or related parties.

- Company officials engaging in corrupt transactions (including the paying of bribes or kickbacks to procurement officers) that could lead to prosecutions or the risk of being the victim of embezzlement.

Indicators/Red flags:

- Weak internal financial controls.

- Limited or no formal risk management systems.

- Lack of independent oversight over audit and risk management process.

Recommended good practice measures:

- A **fully independent board audit committee**, whose members have relevant financial experience and where at least one member has experience with the preparation of financial statements. There should also be independent board oversight over the risk management process.

- **Internal controls and risk management systems**. Companies should develop and strengthen internal controls, and should be particularly alert to risks that are common to emerging market firms. These deal with transfer pricing, related-party transactions and corruption/ethics violations. In particular, there is greater scope for companies to integrate ESG factors more systematically into risk management and internal control systems.

- **Disclosure of the risk management process**. There should be clarity on how the board and executive management define and oversee risk management, including financial, operational and reputational risks. Relevant structures, policies and processes should feature in company public disclosures, and companies should report on material weaknesses in these areas.

Conclusion

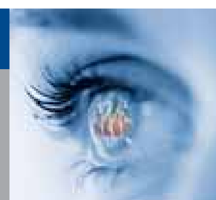
These guidance points must be framed within the overarching context of companies needing to make more **systematic outreach to minority investors**. This also would require that institutional investors in emerging market companies take greater responsibility for building a sustained dialogue with the boards and executive management of the companies they invest in. This requires the patience by investors to take a long-term view and to work with companies to help them improve their governance standards – and ultimately their valuations over time. In so doing the process of engagement will add value both to companies and to investors.

[17] See www.standardandpoors.com

[18] Kaufmann, Daniel, Kraay, Aart and Mastruzzi, Massimo, "Governance Matters VII: Aggregate and Individual Governance Indicators, 1996-2007" (June 24, 2008). World Bank Policy Research Working Paper No. 4654 Available at SSRN: http://ssrn.com/abstract=1148386

[19] Ibid.

[20] See www.transparency.org/policy_research/surveys_indices/cpi



V. A review of country governance risk

To illustrate how country environments differ along key governance factors, we gather several indicators of governance quality for a group of countries comprising major developed economies and some of the more prominent emerging markets. These indicators are as follows:

- Sovereign credit rating. This is a proxy for financial governance at the sovereign government level, with a focus on the health of the country's public finances. More specifically it is an indicator relating to the ability of sovereign governments to satisfy their debt obligations on a timely basis. For this exercise we use sovereign credit ratings by Standard & Poor's dated as of 20 November 2008.[17]
- Rule of Law. A World Bank indicator that measures perceptions including respect of social rules, law enforcement and property rights.[18]
- Regulatory Quality. A World Bank indicator which measures perceptions of the ability of the country's government to formulate and implement sound policies and regulations that permit and promote private sector development.[19]
- Corruption. Transparency International's Corruption Perception Index of 2008 - a poll of polls, drawing on corruption-related data from experts and business. Countries are ranked in terms of the degree to which corruption is perceived to exist among public officials and politicians.[20]

In **Table 2**, we assemble these indicators for a group of 25 countries, including several prominent developed market countries and some of the leading emerging market countries – both to show how emerging markets differ both between themselves and between more developed markets.[21] We have also aggregated the non-financial indicators (e.g., excluding sovereign credit ratings) in a simple index to provide an aggregate indicator of governance country risk along the dimensions of rule of law, regulatory quality, corruption and corporate accountability. Each of these variables is weighted equally in this index. This country governance index is presented in **Table 2** below, juxtaposed with the country's sovereign rating for comparative purposes.

This analysis suggests there are clear differences between the macro governance environments in developed markets and emerging markets –

Governance Indicators in Key Developed and Emerging Markets

Ranking	Rank by Overall Score	WB Rule of Law	Rank by Rule of Law	WB Regulatory Quality	Rank by Regulatory Quality	TI Corruption Perceptions Index	Rank by Corruption Perceptions Index	Sovereign Credit Rating	Rank by S&P Credit Rating
96.2	Sweden	97.6	Sweden	98.1	United Kingdom	93	Sweden	AAA	Australia
93.1	United Kingdom	96.2	Canada	96.1	Australia	87	Canada	AAA	Canada
92.3	Canada	94.8	Australia	95.1	Sweden	87	Australia	AAA	France
89.2	Australia	94.3	Germany	94.2	Canada	79	Germany	AAA	Germany
87.5	Germany	92.9	United Kingdom	92.7	Germany	77	United Kingdom	AAA	Spain
85.4	United States	91.9	United States	91.3	Chile	73	Japan	AAA	Sweden
84.6	France	90	Japan	90.8	United States	73	United States	AAA	United Kingdom
81.5	Japan	89.5	France	85.9	France	69	Chile	AAA	United States
80.8	Spain	88.1	Chile	85.4	Spain	69	France	AA	Japan
77.8	Chile	84.8	Spain	83.5	Japan	65	Spain	AA-	Taiwan
70.5	Taiwan	74.8	Korea, South	79.6	Taiwan	57	Taiwan	A+	Chile
67.0	Korea, South	70.5	Taiwan	78.6	Korea, South	52	Korea, South	A+	China
63.5	Italy	65.2	Malaysia	74.3	Italy	51	Malaysia	A+	Italy
60.9	Malaysia	61.4	Italy	72.3	Poland	49	South Africa	A	Korea, South
58.0	South Africa	59	Poland	67	Malaysia	48	Italy	A-	Malaysia
56.2	Poland	57.1	South Africa	65.5	South Africa	46	Poland	A-	Poland
55.3	Turkey	56.2	India	63.6	Mexico	46	Turkey	BBB+	Mexico
49.7	India	53.3	Turkey	59.7	Turkey	36	Mexico	BBB+	South Africa
44.2	Mexico	43.3	Brazil	53.4	Brazil	36	China	BBB	Russia
40.8	Brazil	42.4	China	46.1	India	34	India	BBB-	Brazil
39.9	China	39	Argentina	45.6	China	35	Brazil	BBB-	India
35.7	Indonesia	34.3	Mexico	43.7	Indonesia	29	Argentina	BBB-	Kazakhstan
29.4	Argentina	27.1	Indonesia	35	Russia	26	Indonesia	BB-	Indonesia
26.8	Russia	23.8	Kazakhstan	34.5	Kazakhstan	22	Kazakhstan	BB-	Turkey
19.8	Kazakhstan	16.7	Russia	21.8	Argentina	21	Russia	B-	Argentina

Notes

Rank by Overall Score incorporates the rule of law, regulatory quality and corruption indicators
Standard & Poor's Foreign Currency Sovereign Credit Ratings, as of 16 December 2008
World Bank Rule of Law Indicator, as of 24 June 2008
World Bank Regulatory Quality Indicator, as of 24 June 2008
Transparency International Corruption Perceptions Index, 2008

[21] While each of the indicators has its own basis of calculation, we have normalised the outcomes of these indicators along a 1 to 100 basis to allow for comparability.

[22] It is of note that Sweden has achieved the highest index score among this group of 25 countries. In a corporate governance context Sweden remains a country of some controversy given the common use of voting caps and different classes of voting stock. But this dimension of shareholder rights is not captured by the indicators in this index.

consistent across this range of indicators. It is noteworthy to see that while the individual indicators all have slightly different rankings and relativities, the results show these individual variables to be broadly correlated.[22]

Among emerging markets, it is interesting to note that some countries, including Chile and Taiwan, rank relatively highly and compare favourably to a developed market such as Italy. Of the emerging markets sampled here it is also of note that two of the former Soviet Union countries – Russia and Kazakhstan – rank at the bottom. China, another country with a strong state ownership tradition, also comes out towards the bottom of the emerging market countries sampled.

There is a clear correlation between this index of country governance risk and sovereign credit ratings. But the correlation is not one to one. Of the 15 emerging market countries in this index, 12 have investment grade foreign currency ratings. Over the past few years increasing numbers of emerging market countries have emerged from speculative grade status to receive investment grade ratings, including Russia, Brazil and India. As a result, the sovereign credit ratings of these emerging market countries are somewhat more compressed as compared with the other country governance indicators, and it is not necessarily the case that a country credit rating – often used as a proxy for general country risk – provides an accurate assessment of the governance environment of the individual country.

Among the BRICK countries that are reviewed in detail in this report, Korea's governance environment ranks the highest in terms of these macro indicators; India and Brazil are grouped closely together in the middle; whereas China and Russia rank among the weakest. However, indices of this nature must be taken with a grain of salt. Measuring qualitative risks such as rule of law and corruption come with considerable methodological challenges and these indicators provide at best a general perspective on the underlying governance environment.[23] As such, the precise index scores in this table are less important than the overall message that the key contributors to a healthy corporate governance environment can differ significantly on a country-by-country basis.

Moreover, in cases where the country's financial solvency (sovereign credit rating as proxy) is relatively strong, there are no assurances that the governance environment at the individual company level is also high. This is particularly true in the cases of Russia and China. Both have credit ratings that are comfortably established in the investment grade category, but have governance profiles that are more comparable with countries of lower credit ratings.

The broad message from this country analysis is that notwithstanding general improvements in corporate governance over the past 10 years in most emerging markets, the macro risks remain real, and investors in emerging market companies need to consider governance more systematically as a risk factor, as compared with investments in more developed markets.

VI. Individual Country Examples

We choose to highlight five key emerging markets in this report: the "BRICK" countries of Brazil, China, India, Korea and Russia. Each of these economies is growing in prominence to global investors, as well as to domestic investors in their home markets. While generally more advanced than "frontier" emerging economies such as Nigeria, Vietnam and Kazakhstan, the BRICK countries also carry notable corporate governance risks for investors. Each of these countries has its own history and own identity, but many of the underlying challenges relating to transparency, shareholder rights, board effectiveness and independence represent common threads between these countries.

Brazil

Indicator	Value
Population (millions)	204
Nominal GDP (billions of US$)	2,205
Real GDP growth ('08 % change)	3.7
Nominal GDP/Capita (US$)	10,808
Market Cap (millions of US$) 21 Nov '08	536,850

1. Market Overview

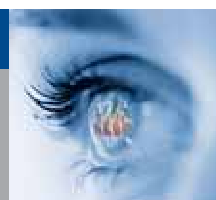
Even more so than its peers in the region, Brazil is cited as a country of extremes. With a string of contested elections since the end of military dictatorship in 1988, Brazil is the largest of Latin America's constitutional democracies. Political freedoms are relatively well-established, and Brazil's healthy news media and free press promote dissenting viewpoints, especially where business is concerned. However, while healthy political rights and a cultural emphasis on "fofoca" (or talk) feed public discourse, much of this talk still happens in secrecy, and important decisions at the intersection of business and government are not transparent and are often subject to inappropriate influence. Brazil ranked a lacklustre 72 out of 180 countries surveyed in Transparency International's 2007 Corruption Perceptions Index, and there is evidence that the problem is growing both on the national and state levels of Brazil's decentralized federal system.

Economic contrasts also mark the Brazilian landscape. Private sector growth and the emergence of genuinely international companies like **Companhia Vale do Rio Doce** and **Embraer** have helped make Brazil the world's tenth largest economy; however urban squalor and lagging rural development are pervasive. Official growth also does not wholly capture the large informal economy which constitutes the primary market of employment, goods, and services for millions of low-income Brazilians. Poverty and enterprise live side-by-side in Brazil's informal sector, as demonstrated in the growing success of the country's microcredit industry.

As in many emerging markets, Brazilian firms face a tension between their government's promising economic liberalisation and the under-provision of key public goods. For example, F&C has learned that Brazilian companies often face challenges managing the social and environmental risks of their businesses when government lacks the resources to enforce regulation on forestry or labour standards.

While a full comply-or-explain model of compliance has yet to develop in Brazil, a battery of voluntary listing standards and corporate governance codes have emerged to fill the gaps, giving market leaders a chance to

[23] For example, from F&C's own practical experience Korea is not viewed as having a stronger corporate governance environment than Brazil or India—notwithstanding Korea's relatively higher ranking on these indicators. To some extent this reflects the limitations of these indicators to reflect the influence of relatively more advanced investor activism—such as we see in Brazil, for example.



boost their international reputations in the capital markets. The Brazilian Institute of Corporate Governance (IBGC) has been instrumental in articulating preferred governance standards through promoting four versions of its Code of Best Practice. The Novo Mercado was established by BOVESPA in 2001 as a rigorous listing standard for Brazilian companies with high levels of corporate governance, mirroring those in the IGBC code. These include rules on transparency, free-float and balance of rights among controlling and minority shareholders, including the rights of minority shareholders to "tag along" (e.g. participate on equal terms) with all shareholders in key transactions.

Much has been made in recent years of the Novo Mercado's role in driving investment through promoting good corporate governance standards. While outperforming the rest of the market, the Novo Mercado also jumpstarted the entire notion of equity investment in Brazil, hosting the vast majority of 111 Brazilian IPOs since 2004 – following years of sparse offerings and the dominance of debt investment. However, a 2008 slow-down in the number of companies signing on to the Novo Mercado demonstrates the challenges of sustaining participation in a completely voluntary model.

Relative to many other emerging markets, Brazil is noted for a long experience with domestic minority shareholders and international investors. This is a positive differentiator and contributes to a greater openness and willingness by Brazilian firms to answer investor queries and show sensitivity to minority shareholder interests and concerns. Outsider and foreign capital were constant factors for Brazilian firms throughout twentieth century, with tax incentives often flowing to companies that listed publicly. However, even as access to the capital markets increased throughout the 1990s, the vast majority of Brazilian corporations remained controlled, and over eight out of ten public companies have a single shareholder in control of over 50% of the voting capital. With some notable exceptions, like retailer **Lojas Renner** which maintains 100% free-float, large public holdings remain rare.

2. Specific Company Themes

For Brazilian companies, controlling shareholders often fall into one of three categories: 1) a consortium or agreement of separate holders, often including the asset managers of Brazil's influential banks or prominent pension funds; 2) an individual or family with a controlling stake, usually as a holdover from before listing; or 3) state or federal government control (or membership in the controlling group) of a company, often as a result of partial privatisation.

Controlling shareholders may intervene in management and corporate governance in different ways. For example, family and government shareholders may be more likely to stack management with affiliated executives, and utility companies controlled by states may vary in their treatment of minority holders depending on the government's short-term finances and development agenda. In some cases, however, management may advocate policy changes not sanctioned by the controlling group.

However different, these situations can raise concerns from an investor perspective. While investors have traditionally trusted controlling shareholders to act in companies' best interests, controlling shareholders may have a different agenda than minority shareholders. In the worst case scenario, controlled companies can still exploit gaps in regulation and legal interpretations to behave like privately-held firms, and there is the danger of insufficient regard to the interests of other minority shareholders.

Shareholder Rights

- **Multiple share classes** – The existence of multiple share classes with varying rights remains a problem in Brazil, and seriously limits the rights for minority shareholders. Even as free float has increased modestly, control remains the norm as companies offer more non-voting or preferred shares. Brazil's Corporation Law was revised in 2001 to limit new listings to 50% non-voting shares, but already-listed market leaders were grandfathered under the law and maintain legions of non-voting shareholders.

- **Minority rights and tag-along** – Minority holders of both voting and non-voting shares routinely miss the financial upside available to the controlling interests that structure and approve transactions. Tag-along rights built into securities regulations require an offer to minority common stock holders of 80% of the price paid to the controlling shareholder, but 80% still represents a discount to minority holders, and the law is silent on similar rights for non-voting shareholders.

Transparency and disclosure

Transparency of accounts, ownership and board practice is generally good in Brazil, especially with respect to peer markets in Latin America. A growing portion of companies use IFRS for financial reporting, and a spate of cross-listings in the United States stock exchanges spurred efforts by larger companies to fully adopt US GAAP standards. Although the nature and influence of controlling shareholders is often questioned in Brazil, transparency of ownership is not a major concern. The presence of large shareholders and the ownership structure at listed companies is generally known, through regulations that require public disclosure of ownership stakes over 5% in any share class. Therefore, related-party transactions involving major shareholders are relatively easy to track.

Board structure and composition

Board structure generally reflects the nature of ownership and concentration of control at Brazilian companies. It is generally the case that controlling shareholders, often wielding voting capital, will elect sympathetic directors to the board. Rather than require a given standard of independence, however, regulation emphasises a balance-of-power approach to board composition, which often results in boards where a majority of directors is affiliated with the company's major investors. This raises questions about the fiduciary role of such directors. While major shareholders are dutifully disclosed, director connections involving family ties or employment are often difficult to draw. The problem is exacerbated for outside investors when inadequate biographical and professional information regarding director candidates is limited in advance of annual meetings. A lack of independent directors on key board committees and the persistent election of directors by slate raise continued questions about the ability of some Brazilian boards to oversee management effectively and remain accountable to shareholders

3. F&C Voting and Engagement Themes

The Comissão de Valores Mobiliários (CVM, Brazil's securities regulator) has supported the development of best practice governance standards in Brazil. This demonstrates an institutional commitment to competitiveness through good governance – its president described the Novo Mercado as a "national asset" in 2007. The regulator itself has also grown more active on behalf of investors in recent deals that threatened the interests of minority and non-voting shareholders.[24] However, given the Novo Mercado's voluntary framework, most Brazilian firms have not embraced these best practices, and regulators have been reluctant to progress from occasional interventions to more permanent legal changes to promote higher corporate governance standards.

It is not surprising then that much progress has been spearheaded by investors themselves. Sustained interest in the Novo Mercado indicates an implicit premium applied by investors to good corporate governance and their willingness to indirectly encourage greater transparency, shareholder rights and good board practice. In addition, however, domestic institutional investors increasingly have exerted direct influence on companies, arguing forcefully for fair outcomes in particular bid situations and for long-term regulatory improvements. Although they do not carry the force of law, actions and engagement undertaken by concerned investors on the ground are exacting management changes that we do not see in peer countries in the region with less active investor communities.

F&C has lent its voice to such calls by integrating governance issues in the investment process and by encouraging companies to adopt international governance standards in shareholder rights, board structure and disclosure. Entrenched interests and majority shareholders may still be in a legal position to reject shareholder input, but the growing confluence of activism from foreign institutions, domestic investors, regulators and development experts represents an increasing force.

- **Protection for minority and non-voting shareholders** – New company listings on the Novo Mercado have slightly decreased the overall issuance of shares with diminished rights. When such a move is proposed, F&C stands in firm opposition, voting against 12.5% of proposed capital structure changes in 2008. However, F&C realises that the persistence of controlled capital structures and voting advantages is a fact of life in Brazil, and we are simultaneously encouraging companies to consider to the interests of their preferred shareholders even when they are not ready to merge equity classes.

  In particularly abusive merger situations we have engaged directly with regulators. An investor call led by F&C in August 2007 influenced a recent CVM guidance document on mergers and acquisitions as a small step for enhanced regulatory clarity. However, this remains a frontier of engagement where a lack of voluntary response from companies has suggested the need for tighter regulatory standards.

Board composition and disclosure – In several areas F&C is generally satisfied with board operations and the clarity of by-laws for Brazilian companies, especially as more list on the Novo Mercado or cross-list their shares in US and European markets. We also recognise that progress toward increased board independence is often impeded by the dominance of controlling shareholders, who maintain representatives on the board to look after their interests. However, F&C's satisfaction is far from complete, and company performance in several areas has prevented F&C from supporting management's director slates at approximately half of Brazilian meetings in 2008. This is partly due to the fact that we ask companies to have board structures where at least one-third of directors are wholly independent of management or controlling shareholders. Moreover, through our voting on director candidates in Brazil we call for fully-independent board committees. To ensure informed voting from foreign investors and allow investors to understand the board's independence determinations, we ask Brazilian companies to submit the names and biographical details of directors standing for election at least 20 days prior to the annual meeting. This does not always happen.

Sustainability management – Brazil's abundant biodiversity and concern for its international reputation has led to a sensitivity to social and environmental risks that compares favourably with other emerging markets. As in many Latin American countries, most Brazilian firms still focus their corporate responsibility strategies disproportionately on philanthropic activities. However, active regulation on discrimination and environmental issues has led many companies to develop sustainability policies and report against key performance indicators. For example, many utilities publish environmental impact assessments on their corporate websites and most disclose diversity statistics, employee figures and environmental investments in a 1-2 page "social balance sheet." Large banks like **Banco Itaú**, **Unibanco** and **Bradesco** conduct environmental credit risk and analysis, and provide reporting at a high international standard.[25]

With some success, F&C has encouraged all Brazilian firms to follow the lead of the largest market players by developing sustainability policies focused on managing those risks that are most material for their businesses and to report against clearly disclosed targets in annual corporate responsibility reports.

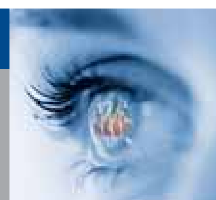
Brazilian Case Studies

Positive. A prominent domestic retailer, **Lojas Renner**, has been one of the major governance success stories of the Novo Mercado. The company is the first Brazilian company to list with only voting shares after its 2005 spin-off from US parent JC Penney. The company also has a remarkably open capital structure for a Brazilian firm, with no controlling shareholder and a 100% free float. As a result, many of the shareholder rights risks are absent at **Lojas Renner**. However, management still welcomes shareholder vigilance, encouraging shareholders to participate and vote in AGMs. The company also has a robust board of directors where five of six directors are independent of management. The company's products and expanding online offerings cater to an expanding middle class in Brazil, which is likely to support the enhancement of social and supply chain management systems that still lag international best practice.

Problematic. Regional bank **Banco Nossa Caixa** illustrates the negative role that a dominant shareholder can play in governance

[24] Most notably in the controversial de-listing of steel company **Arcelor do Brasil** and the tender offer for the paper concern **Ripasa**.

[25] **Banco Itaú** and **Unibanco** announced their merger plans in November 2008.



practices even within the Novo Mercado. Although the company has only issued voting capital, over 70% of that stock is controlled by the state of Saõ Paulo. As a result, the bank often acts as an extension of the state government, discounting the interests of Nossa Caixa's other shareholders. Under the influence of its controlling shareholder, Nossa Caixa is widely believed to have overbid for a contract to retain the accounts of Sao Paulo state employees. The company's profitability has suffered as a result, and the episode illustrates the lack of protection for minority holders (both in merger situations and everyday operation) when their interests are not in alignment with those of controlling shareholders.

Conclusion

Improving regulation, investor attention, and voluntary compliance schemes have driven a marked improvement in Brazilian corporate governance in the past decade. Combined with smart management and access to unique natural resources, these improvements have afforded Brazilian companies a favourable position in the capital markets relative to other emerging economies and have contributed to the country's recent development surge. However, ongoing ownership challenges and still-developing shareholder protections make this a pivotal moment for determining whether the pace of progress can be sustained in Brazil.

China

Population (millions)	1416
Nominal GDP (billions of US$)	6,976
Real GDP growth ('08 % change)	9.5
Nominal GDP/Capita (US$)	4,926
Market Cap (millions of US$) 21 Nov '08	1,879,557

1. Market Overview

China has attracted unprecedented public attention in recent years, given its size and rapid growth, and its increasing importance to the global economy. The Chinese government faces major challenges including inflation, rapid urbanisation, a growing divide between the urban middle class and the rural poor, corruption, and the challenge of how to relax media restrictions, while guaranteeing political stability under the tight grip of the Communist Party.

China's political system heavily influences corporate governance practices. While the governance practices of China's state-owned enterprises have improved in the ten years since their partial privatisation, the boards of many state and family-owned companies still lack adequate independent oversight and transparency, which has prompted numerous accounting scandals. Boards face challenges in creating a governance culture and engaging in meaningful dialogue with shareholders on issues such as board composition and shareholder rights. Moreover, the government has kept large stakes in many companies, and maintains control over the appointment of senior executives. Although in recent years the government has relaxed media restrictions and there have been showcase prosecutions of corrupt officials, companies face few checks and balances compared to those in regions that have a more effective legal framework, open media and non-governmental organisations. In addition, there is no national association of investors in China yet to help press for better governance practices.

Law and regulation: the basics are nearly in place

China does have a basic regulatory framework for corporate governance, which is a starting point for improving corporate governance practices going forward. As can be seen in Table 2 in this report, the World Bank's governance indicators for rule of law and regulatory quality position China behind Korea, India, and Brazil, but ahead of Russia in this domain.

International accounting standards (IFRS) were introduced in 2007, and this marks an important step forward. But this is just the beginning. Investor confidence in company accounts will depend on IFRS being properly enforced, and the lack of trained accountants and auditors is a major challenge in implementation in China.

Shareholder rights are improving in China, but at a slow pace compared to the country's breakneck economic growth. In 2002, the China Securities Regulatory Commission (CSRC) established a mandatory Code of Corporate Governance for Listed Companies. This allows listed companies to adopt proxy voting and cumulative voting methods to protect minority shareholder rights. It states that related-party transactions must be fair, transparent and approved by independent directors, and the Code encourages shareholder activism and institutional investment. As of 2004, companies must provide for holders of tradable shares to approve major business decisions, such as rights issues, and must also provide voting platforms for shareholder meetings.

In practice, minority shareholders continue to have little recourse when things go wrong. While investors can undertake "representative actions" against companies (i.e. group lawsuits), this only applies after the regulator has found definitive evidence of wrongdoing. A new Companies Act is under discussion that may allow for class-action lawsuits, which could help increase accountability to shareholders.

Independence of board directors remains a key concern The CSRC Guidelines on Independent Directors require each listed company have at least one-third of the board made up of independent directors, but independent non-executive directors are relatively new in the Chinese context. The Chinese Code on Corporate Governance permits companies to adopt a three-committee structure, comprising nomination, audit and remuneration committees, but this has not been widely adopted yet.

Market manipulation and disclosure to shareholders remain a challenge for the Chinese authorities. In 2007, the Shanghai Stock Exchange released Guidelines for the Administration of Information Disclosure Mechanism of Listed Companies, which outlined disclosure rules for board secretaries, and directors and shareholders with greater than 5% holdings in individual firms. Confusingly, the guidelines called on companies to disclose as much information as possible to shareholders, and then also implied that inappropriate release of confidential information would be punished.

Currently, companies are not required to report annual results within two months and voting by poll is not mandatory – although the by-laws of some companies require it. If the stock exchanges on mainland China are to achieve reputations similar to those achieved in Hong Kong and Singapore, regulators will need to take more action to reduce the risk of fraud. This will require better enforcement of rules for disclosure of share

transactions by directors, as well as deterrents against insider trading and market manipulation. Hong Kong, in particular, has an important influence – as it itself is part of the Peoples Republic of China-- and its exchange serves as a key listing venue for many Mainland Chinese companies accessing an international investor base. Hong Kong's listing and disclosure standards reflect its status as an international market environment, and on the whole these standards provide a positive discipline/example for the Shanghai Exchange.

2. Specific Company Themes

F&C's has encouraged Chinese companies to go beyond basic listing requirements and to create a strong governance culture by adopting international governance standards in board independence, transparency and business ethics. Our outstanding concerns are:

- Protection of minority shareholder rights. Listing rules in China provide weak protection of pre-emption rights, which runs the risk of diluting unfairly the ownership position of existing shareholders.

- State entities often own two-thirds of a company's shares, which are non-tradable and may not have same interests as minority shareholders – who mainly own tradable shares. Consequently, state entities may wield improper influence over listed companies. Connected transactions between listed and parent companies/controlling shareholders are common, and misappropriation of corporate funds by controlling shareholders can be a problem. The Chinese Government's influence through the Party committee systems means that management is in theory accountable for their actions to minority shareholders. But in practice the Government will continue to exert strong influence over key strategic and policy decisions in state-owned enterprises.

- Family-run businesses are also common among publicly listed companies. If the company founder remains the chairman, as is often the case in China, and the founding family interests are not aligned with those of all shareholders, there is the risk that corporate decision-marking works to the detriment of minority shareholders.

- Independence and constructive challenge on the board: Independent directors are mandatory and, increasingly, companies are appointing such directors. However, controlling shareholders often nominate them as non-executive directors, which may impact their independence. Too few independent non-executive directors in China have corporate management experience, spend enough time on company affairs or have enough access to corporate information. This inhibits the ability of independent directors to play a meaningful role in the governance of companies in China.

- Remuneration: In recent years, leading Chinese companies have begun to submit director remuneration packages to a shareholder vote, which F&C welcomes. However, overall, disclosure of remuneration in a meaningful way is poor, with remuneration levels low compared to those in Europe and the USA, other than in sectors such as technology and media. The Chinese Government is encouraging companies to implement a share-based management incentive programme to align majority and minority shareholder interests. In addition, leading Chinese companies are moving to introduce broad-based employee share schemes or profit-sharing plans, in an effort to retain employees amidst increased competition for skilled labour. Currently, executives of listed companies are typically paid fixed salaries with limited links to performance, and long-term incentive schemes are a rarity.

- Managing sustainability: Few companies have a strategy for managing environmental, social and governance issues, or publish a stand-alone corporate social responsibility report. F&C has provided detailed recommendations on sustainability strategy, management and reporting in face-to-face meetings with China's largest companies, including **China Mobile**, **ICBC**, **China Shenhua**, **CNOOC**, **PetroChina** and **China Life**. We also made specific recommendations to a number of Chinese companies to publish a stand-alone corporate responsibility report. These include **Ping An Insurance Group**, **China Construction Bank**, **China Merchants Bank**, and **Nine Dragon Paper Holdings**

Voting patterns

- F&C votes actively at Annual General Meetings (AGMs) of Chinese companies and the most common reasons for voting against or abstaining on management resolutions centre on shareholder rights, board structure and independence, and remuneration.

- Lack of sufficient information on management proposals means that F&C often cannot reach informed decisions or approve resolutions. More positively, since 2005, there have been improvements in English-language material on company and regulatory websites, and large Chinese companies are releasing AGM agendas with greater lead times.

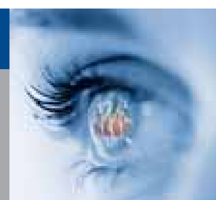
- It is common practice in China for companies to propose equity issues of up to 20% without pre-emption rights, which F&C believes is excessive. F&C generally votes against requests for capital over 10% with no pre-emptive rights, and this has resulted in a large number of F&C's votes against management in China.

- Given the complex networks of cross-holdings in China, many companies are involved in material related-party transactions, which may represent a significant risk for minority shareholders. This risk is mitigated in companies with fully independent audit committees and F&C has voted against companies that provide inadequate information on related-party transactions, or without the approval of independent audit committees.

Chinese Case studies

Positive: Li Ning, the sporting apparel firm, scored highly on a recent corporate governance assessment by the brokerage CLSA[26] on the basis of a positive alignment of management with minority shareholders following the company's listing. The high CLSA ranking also reflects an employee share scheme, whereby **Li Ning** buys back shares and distributes them to employees as incentive plans, rather than issuing new

[26] CG Watch 2007, Corporate Governance in Asia. CLSA Asia-Pacific Markets in collaboration with the Asian Corporate Governance Association, 17 September 2007, www.clsa.com.



dilutive new shares. **Weiqiao Textile Company Limited** has a large proportion of family members on the board, but its audit committee is independent. [27]Similarly, at **Shanghai Forte Land**, the controlling shareholder is Chairman of the company, but the audit committee is independent.

Problematic: The media firm, **Focus Media**, was threatened with delisting by NASDAQ following failure to file its 2006 annual report on time, with concerns raised about the company receiving payments from an advertising agency related to the Chairman. The Chairman of **Beijing Capital Land** came under investigation by the Chinese authorities following dubious dealings with Beijing's Vice Mayor; this resulted in the stock being suspended. Moreover, the Chairman and directors of **Shanghai Electric** have been investigated for corruption charges.[28]

3. Summary

Governance challenges persist in China. As in other Asian markets, a small number of large listed companies stand out as having a public commitment to improving their governance practices. Many listed companies are more interested in chasing short-term growth than in building high-quality governance for sustainable, long-term business performance. A governance culture still needs to be developed, as exists more strongly in Hong Kong, Singapore and India. Our engagement findings are that Chinese companies are better at the form than the substance of corporate governance. This suggests that investors may fail to spot problems early on, and that fraud investigations and scandals will continue to surface.

In next few years, more state owned enterprises are likely to be reformed and will need to access public capital markets, which may help to drive further governance improvements.

Meanwhile, serious governance risks remain, including:

- Weaknesses in internal controls and absence of business ethics systems to prevent abuses such as corruption;
- Protection of minority shareholder rights and low levels of transparency;
- Board independence, both in number and in quality of independent directors;
- Poor sustainability strategies for companies operating in high impact sectors, such as manufacturing, where companies may be impacted by water pollution and scarcity.

India

Population (millions)	1220
Nominal GDP (billions of US$)	2,015
Real GDP growth ('08 % change)	8
Nominal GDP/Capita (US$)	1,652
Market Cap (millions of US$) 21 Nov '08	530,931

1. Market Overview

Indian companies have won a reputation for high return on equity in Asia from 2004-2007, and the Bombay and National Stock Exchanges have surged from foreign investment. In 2007, investment flows totalled $18 billion, with $8 billion going into IPOs in the last 2 years, with a healthy level of domestic merger and acquisition activity. The country's economic growth has been 8.6% from 2003-2007,[29] and India seen greater manufacturing, higher disposable incomes and more personal consumption. Investors also have the concern that Indian politics may slow down economic reform. In the long-term though, India is poised for growth. Demographics are particularly favourable. 50% of India's population is below the age of 25, constituting a large potential consumer base as cities expand, while India's integration into the global economy is another clear growth driver. F&C expects continued growth in several sectors, including mobile telecommunications, capital goods (infrastructure), consumer staples, refining and petrochemicals.

However, infrastructure investments, combined with better governance practices, are essential to unlocking value in corporate India. This is a question of governance at the macro level. F&C encourages action by both the Indian government and by companies to attract greater private investment in ports, roads, airports, power and railways.

- Infrastructure: To support economic growth, India needs to improve infrastructure drastically; infrastructure spending currently amounts to just 4% of GDP, compared to China's 9%[30], with India currently having a 10% power deficit and limited investing in new roads. This results in severe congestion, accidents and pollution, and demonstrates the importance of public governance and its ultimate impact on the private sector.
- Role of private companies: Companies will need to rise to social expectations and tackle sustainability challenges impacting India, including pollution, climate change, water scarcity, local community relations and inclusion of the rural poor. This is not just a social need, but also a requirement for companies wishing to grow and compete on an international basis.

Although a corporate governance framework and good accounting standards are in place in India, regulators and companies need to work to build India's international reputation for a strong governance culture. F&C currently considers India behind Hong Kong and Singapore for corporate governance practices, but ahead of other Asian markets including China, Malaysia and Thailand.[31]

[27] Ibid

[28] Ibid

[29] Compound annual growth rate, quoted in CLSA, India's trillion-dollar deal: Infrastructure Spending Unleashed, April 2008

[30] CLSA, India's trillion-dollar deal: Infrastructure Spending Unleashed, April 2008

[31] Based on F&C's engagement with companies and voting at company meetings.

The foundations for good governance are laid – the rest must now be built

Foreign investors in most cases find themselves as minority shareholders in Indian companies. Concentrated ownership is typical among India's large companies – with the most common corporate models being state, family or foreign ownership.

Among emerging markets, India has a long history of equity markets, which stretch back to 1875, when the Bombay Stock Exchange opened. Following the 1956 Companies Act and a period of the "license raj" with limited private sector growth, a programme of economic liberalisation began in 1991. The Securities and Exchange Board of India (SEBI) was launched in 1992, marking a new clear regulatory framework for corporate governance:

- In 2002, SEBI established a committee to produce a corporate governance code for India, chaired by Indian businessman Kumar Bangalam Birla. This resulted in SEBI approving a new clause, Clause 49, in the listing rules, with a plan for phased implementation of mandatory requirements for governance.
- In 2003, the Narayana Murthy and Chandra committees produced recommendations to tighten corporate governance rules, resulting in the requirement that listed companies must comply with Clause 49 of the Companies Act in 2005.
- In 2007, SEBI made India the first market in the world to grade IPOs on corporate governance, to help investors understand a company's practices. In the same year, The Institute of Chartered Accountants of India's Council also agreed to adopt international accounting standards, IFRS, by 2011.
- In addition, voluntary guidelines were published to reform governance in the public sector, with the "Guidelines on Corporate Governance for Central Public Sector Enterprises." These guidelines cover board composition, audit, disclosure, accounting standards and risk management

Recent developments: listing rules and enforcement

Although Clause 49 has brought welcome new requirements to promote effective board composition and greater independence on the board, there is concern that the standards set are not sufficiently high and that SEBI takes too little action against companies that fail to comply. Between 1999-2004, SEBI took action in 481 cases, compared to 2,789 by the SEC over the same period[32], with a recent World Bank report suggesting that SEBI needs to more actively tackle enforcement prior to listing, insider trading and breaches of the Companies Act[33]. In addition, although India has an "Investor Grievances Forum", shareholder activism is in early stages, with no national shareholder association in place to encourage a culture of accountability and shareholder dialogue with companies.

Clause 49 – a work in Progress

India's establishment of Clause 49 is an important step forward towards raising corporate governance standards. Nevertheless, F&C has concerns about the extent to which Clause 49's requirements go far enough to support corporate India's reputation on the global stage. F&C recommends that companies not only adhere nominally to Clause 49, but do so in a way that imbeds a true culture of value creation for all shareholders.

2. Specific Company Themes

Ownership and board composition is a challenging area in India, particularly among family-run companies, which make up 17 out of 30 of the SENSEX index, as non-executive directors are often not well-represented and not truly independent. The roles of the audit and remuneration committees are not always clear, and often these committees are not fully independent. India's entrepreneurs have played instrumental roles in building numerous successful companies, including the **Tata Group** and the **Aditya Birla Group**. F&C's view is that family structures are not necessarily a problem; family ownership can be a source of strength or weakness, depending on the individual company. Nor are family structures as complex in India as they are in markets such as Korea. Importantly, in India the vast majority of a controlling family's net wealth is often in the publicly listed company. However, problems may arise where the family interests are not aligned with that of shareholders, and where boards face a conflicts of interest with insufficient and poor quality independent directors.

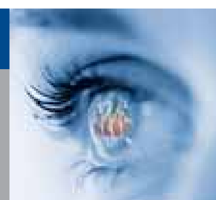
Succession-planning is a related concern, particularly at companies where the founder-owner may be the chairman and chief executive, has a high public profile, a dominant personality and no clear heirs or succession plans. This concern is highlighted in the cases of Ratan Tata (current Chairman and founder of **Tata Group**) and Dhirubhai Ambani (the late founder of the **Reliance Group**). Over the past five years, there have no changes at the Chairman and Chief Executive level among several major Indian companies. These include the **Tata Group**, the **Mahindra Group**, **Satyam Computer Services Limited**, **Cipla** and **Vedanta Resources plc** (UK listed, but with subsidiaries in India). This is striking compared to developed markets, where change of management is more frequent and often influenced by the stage of a company's development and strategy.

Long-term incentives for executives are underdeveloped, with relatively few companies having incentive plans or metrics in place to reward executives for long-term value creation. Typically, Indian companies simply offer directors a base salary that is modest by international standards, and a bonus in the form of an annual commission on profit, subject to a limit of 1% of the company's net profit. India's low levels of remuneration compared to international standards may present challenges, particularly as companies grow through cross-border acquisitions and become multinationals. Such companies may inadvertently restrict the talent pool that they can recruit from, particularly if remuneration levels are so low that they fail to attract top executives and senior managers from outside the company. In addition, low levels of compensation increase the potential risks of inappropriate benefits and poor business ethics.

[32] Suchismita Bose, Securities Market Regulations – Lessons from US and Indian Experience, June 2005

[33] World Bank and IMF, Report on the Observance of Standards and Codes, Corporate Governance Country Assessment, April 2004

[34] Source: http://info.worldbank.org/governance/wgi/sc_chart.asp



Disclosure to shareholders remains a major concern. Large companies have been involved in major acquisitions, but have not always shared sufficient information with investors to enable them to assess the impact of acquisitions. On qualitative issues, companies provide limited information to investors on director training, board evaluation and processes for non-executive directors to discuss issues independently. Although companies are required to disclose material related-party transactions, little information is reported on the audit committee oversight process, and shareholders are not always given the opportunity to approve these beforehand. In addition, little information is provided on how companies are managing sustainability issues.

Internal controls represent another area for improvement. Unlike the US Sarbanes-Oxley Act, India does not require accounts to be certified by the CFO and CEO. Anti-corruption remains a concern; for example, India has a low ranking in Transparency International's Bribe Payers Index, worse than that of China and Russia. In the World Bank's Worldwide Governance Indicators on control of corruption, India scores in the 25th-50th percentile, which is slightly ahead of China, significantly ahead of Russia (which falls in the 10th-25th percentile), but worse than Korea and Brazil (which fall in the 50th-75th percentile)[34]. Few Indian companies report on how codes of ethics are implemented, such as on board oversight, employee hotline systems and breaches of the code.

F&C's most common reasons for voting against management or abstaining on shareholder resolutions at Indian companies are:

- Board composition and directors: Key concerns are lack of sufficient independence on the board, non-independent directors on the audit committee and directors attending less than 75% of board meetings.
- Disclosure: Lack of information, particularly on the audit committee and fees, as well as on remuneration.
- Shareholder rights: Requests for significant issuance of new shares without pre-emptive rights, and options issued at less than market price or granted at a discount.

Indian Case studies

Positive. **Infosys** is an excellent domestic example of a strong governance culture. The company's founders, N. R. Narayana Murthy and Nandan Nilekani, remain on the board, but they do not sit on any committees. **Infosys** has established a three-committee structure, with the audit, remuneration and audit committees being independent. The company has strong processes for board evaluation, with non-executive directors required to present regularly to the board and explain their individual contribution. The company's external transparency is high by international standards and the company has a strong investor relations capability. Furthermore, **Infosys** is tackling India's main sustainability challenges that are relevant for its sector; its ambitious aim is to become "carbon and water neutral," and the company invests significantly in primary, secondary and tertiary education in India.

Hindustan Unilever Limited (formerly known as Hindustan Lever Limited) stands out as a leader in setting good practice with regard to board committee structures and sustainability management. **Hindustan Unilever Limited** is 51% owned by the UK-listed company Unilever. Its Chairman comes from the majority shareholder and therefore is not independent. However company's audit and remuneration audit committees are independent. It is also among a handful of Indian companies with a clear strategy for corporate social responsibility, and runs a programme called "Shakti" to empower rural women by providing income-generating opportunities, health and hygiene education.

Problematic. After years of enjoying good relations with management, shareholders in **Ranbaxy Laboratories** were recently dealt a blow – highlighting the perils of ineffective non-executives and how these can result in weak protection of shareholder rights. In July 2008, Japanese company Daiichi Sankyo Company Limited (Daiichi) offered to acquire a majority of Ranbaxy's capital in a US$5 billion deal. Daiichi paid a 30.5% premium to market price for the entire position of the controlling family and the associated concert party. However, for the remaining 40% of shareholder capital not owned by the family and concert party, Daiichi offered this premium for only a small percentage of shares. Although the deal will result in a combined group with global reach and significant R&D investments, it unfairly benefits executives and the controlling shareholder at the expense of smaller shareholders. The board has not disclosed the process by which it reached this decision, leaving F&C to conclude that non-executives waived through unfavourable terms for minority shareholders. In a separate matter, relating more to the company's corporate responsibility performance, a ban on US sales recently was imposed by the US Food and Drug Administration on more than 30 Ranbaxy medicines because of failures to meet acceptable manufacturing standards.

3. Summary

India has a good basic framework for governance, relatively strong accounting standards based on UK practice, a free press that encourages accountability, and a significant proportion of foreign investors - all of which help to promote development of a governance culture. But this culture still needs to develop further. Importantly, Indian entrepreneurs are keen to grow from domestic players into multinational companies, making the time ripe for companies to adopt high governance standards.

Meanwhile, key governance-related risks companies need to address are:

- Protection of minority shareholder rights and interests, particularly where family or government interests may run counter to those of all shareholders;
- Board composition and the extent to which this promotes sufficient challenge in board dialogue;
- Succession-planning and long-term incentives to retain senior management;
- Sustainability management to tackle India's social and environmental challenges.

Corporate Governance in Emerging Markets:

Korea

Population (millions)	49
Nominal GDP (billions of US$)	1,391
Real GDP growth ('08 % change)	4.4
Nominal GDP/Capita (US$)	28,361
Market Cap (millions of US$) 21 Nov '08	342,756

1. Market Overview

Corporate governance in Korea is undergoing a slow but significant transformation. Historically, the country has been dominated by a small group of powerful conglomerates, known as chaebols, that were marked by circulatory or interlocking ownership structures, interlocking boards, and opacity. These chaebols served as the pillars of the Korean economy during its re-industrialisation phase following the Korean War and were subject to heavy intervention by the military-led government, in its efforts to re-build a robust economic foundation and drive growth. In 1987, with the restoration of democracy, the government began slowly to release its grip on Korean business, although it maintained large ownership positions in the country's leading conglomerates and a dominant presence on many company boards.

The Asian financial crisis of 1997, however, had a profound impact on Korea with the Seoul Stock Exchange falling by over 18% in November 1997, coupled with troubling short term refinancing risks. Following the crisis, Korean regulators and companies took the opportunity to re-evaluate standard corporate governance practices and set a target to move Korean governance towards international good practice. The key structural change that emerged involved restructuring some of Korea's largest chaebols into parent holding companies, with separately listed and distinct subsidiaries. To enhance transparency and greater accountability to investors, major regulatory and fiscal reforms were introduced to incentivise the move to a holding company structure. These include reducing restrictions on debt ratios and revising corporate tax laws. From 2004 to 2007, the number of holding companies in Korea increased by over 80% and now stands at 40.

Despite economic and political developments over the last decade, the Korean economy continues to be dominated by a half-dozen large holding companies that control key sectors such as steel, telecommunications, electronics, and autos. While the move to the holding company structure has allowed outside investors to understand better who is pulling the strings, Korean companies tend to be controlled by either a single individual, such as the chairman, or by affiliated companies within the holding company structure.

Relative to other emerging markets Korea's macro governance indicators compare relatively well along the parameters of rule of law and regulatory quality. However these indicators may be misleading; the spate of corruption scandals at the senior executive level of leading Korean industrial groups shows that business ethics remain a concern, notwithstanding the country's holding company reforms. The recent Presidential pardon of a group of senior Korean executives convicted on corruption charges sends a disappointing message to investors about the government's resolve to enforce anti-corruption measures in Korea.

Nonetheless, investment in Korea has continued its resurgence since the Asian Financial Crisis, with Korean equity investment funds growing over 150% from 2006-2007, driven by strong and consistent returns. Korea is now home to some of the world's leading companies in global industries such as steel, shipbuilding, electronics, and autos. As a result, some recent developments have brought governance practices closer to the global benchmark and improved minority shareholders' rights vis-à-vis the dominant shareholder. For instance, the Korean Code of Best Practice for Corporate Governance recommends that companies have sufficient independent directors to maintain "practical independence" and that audit committees be at least two-thirds independent. The Korean Stock Exchange also introduced a requirement that all Korean companies have a designated investor relations representative who is able to communicate in English.

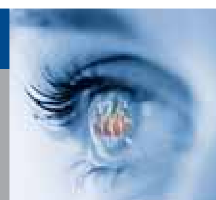
2. Specific Company Themes

The last 18 months have seen a number of show-stopping examples of corporate governance – or the lack thereof – at work in Korea. This has been particularly the case in the chaebols, with concentrated and complex ownership structures. All in all, board oversight, independence and integrity remain the key governance weaknesses in this market.

Our experience voting at company meetings in Korea indicates that many Korean companies retain boards with between one-third and one-half of directors being fully independent, and with audit committees that are majority – but not fully – independent. Despite this appearance of reasonable independence, when challenged, few Korean boards have yet to demonstrate an independence of spirit that has as its first priority protecting shareholder value. For instance, in 2007 and 2008, the boards of **Doosan**, **Hyundai** and **Samsung** all re-nominated as Chairman, men who had been convicted of serious breaches of fiduciary duty, ranging from accounting fraud to embezzlement. In these instances, we voted against all directors since the board is responsible for nominating executives who will protect shareholder value, not pilfer it.

Following engagement dialogues with a targeted group of Korean companies, and voting activities at many more, it also emerged that audit committees in Korea view their remit narrowly as enforcing accounting standards, rather than the broader remit of protecting a company's financial assets and ensuring preservation of shareholder value from a risk management perspective. No company we met with has had its audit committee systematically review the group's systems of internal controls, as would be required of, for example, US listed companies bound by the Sarbanes-Oxley Act disclosure requirements. Failure to evaluate internal controls led to large fines against Korean companies in the last three years, resulting from insider trading, price-fixing and collusion.

When pressed further, few Korean companies we met with had a group-wide employee code of ethics and supporting business ethics management system that would serve to set the tone for ethical business standards across the company, monitor for breaches, and allow employees to report concerns. According to a recent survey conducted by the Korean Corporate Governance Service, approximately 1 in 4 Korean companies had established an employee code of conduct.



Unsurprisingly, related-party transactions also dominate the governance agenda in Korea, with related companies trading goods, often at off-market prices, in order to prop-up underperforming sibling companies. With significant cash on the books, these transactions can take place at the expense of other expenditures, such as capital expenditure, dividends, or share repurchases that are more aligned with longer term shareholders' interests.

Finally, we asked Korean companies how their boards were identifying and managing environmental and social risks and opportunities that could impact shareholder value. Given record fuel prices, a US recession, inflationary pressures in emerging markets, and global climate change negotiations, environmental and social pressures are likely to have significant impacts on companies in all sectors. We found that, by and large, Korean companies were actively managing and reducing their direct environmental impacts such as emissions of hazardous pollutants.

However, broader sustainability issues such as labour standards and human rights at overseas facilities, and environmental and social impacts in the supply and logistics chain are not main areas of focus. Several leading companies including **Posco**, **Hyundai Steel**, and **Hyundai Heavy Industry** publish annual environmental or sustainability reports, which serve as clear indicators that management has a reasonable understanding of the impact of sustainability on performance. However, few companies overall had developed a sustainability strategy, with objectives and targets, for tackling key issues such as energy efficiency, climate change, human rights, and bribery and corruption.

Korean case studies

Positive. The steel giant **Posco** demonstrates a deep-rooted commitment to good governance – that in part may reflect its diverse ownership base, one that is not influenced by the interests of controlling shareholders. It has a majority independent board, as well as fully independent audit, remuneration and nominating committees. In addition, the company has voluntarily established an Insider Trading Committee of the board, as well as an internal Voluntary Advisory Committee for monitoring compliance with competition rules. An employee code of conduct and compliance monitoring programme have been established and empower employees to refuse to participate in some of the corrupt practices common in the Korean market. The **Posco** board also reflects a diversity of skills and experience, including the presence of foreign directors, that have allowed the company to avoid many of the pitfalls of its peers, and have enabled the company to win the distinction of being named Best Company for Corporate Governance from the Korean Corporate Governance Service in 2007.

Problematic. In contrast, **Hyundai Motors** provides one example of a Korean company that meets the letter, but not the spirit of good governance practice. The Hyundai Motor board consists of a majority of independent non-executive directors, and a fully independent audit committee. Nonetheless, a progressive board structure did not stop the board from re-appointing MK Chung as executive chairman, despite his conviction on criminal charges of fiduciary breach of trust linked to embezzlement. The audit committee also appears to come up short in its responsibility for reviewing internal controls and monitoring the financial health of the business. In 2007, the company was fined $56 million by the Korean Fair Trade Commission for engaging in related-party transactions for steel and auto parts from affiliated companies at inflated prices. F&C voted against all members of the **Hyundai Motors** board standing for election and has formally asked the company to 1) remove MK Chung from the board, and 2) undertake a review of internal controls and report on the outcome of the review in the 2009 annual report.

3. Summary

All in all, Korea has earned the right to be called an Asian Tiger, with strong and consistent returns and generally robust manufacturing operations. In the last several years, it has also taken some steps to strengthen its corporate governance practices as well, although recent events call into question the sincerity of this commitment. The rise in the number of independent directors on company boards, and improvements in transparency brought by the holding company structure are both steps in the right direction. However, the recent decision by South Korean President Lee Myung-bak to pardon 74 leading businessmen convicted of criminal malfeasance brings a new shadow over the market.

To this end, key governance risks will continue to result in a "Korea discount" for those companies that hold to this mould. Key indicators of governance risk we will monitor are:

- Board independence, both in number and in spirit of independent directors;
- Weaknesses in internal controls;
- Related-party transactions that disadvantage minority shareholders;
- Absence of business ethics systems to prevent abuses such as corruption;
- Poor sustainability strategies for companies operating in high impact sectors.

However, with some clear beacons of international good practice, we believe there is still opportunity for generating returns while respecting global governance standards in the Korean market.

Russia

Population (millions)	138
Nominal GDP (billions of US$)	3,463
Real GDP growth ('08 % change)	6.3
Nominal GDP/Capita (US$)	25,091
Market Cap (millions of US$) 21 Nov '08	260,174

1. Market Overview

The corporate governance environment in Russia is showing signs of improvement, but still reflects the legacy of the country's turmoil in the 1990s: the fall of the Soviet Union, the dubious-- if not lawless-- rise of financial/industrial groups controlled by "oligarchs" and the subsequent economic collapse in 1998. Since that time progress has occurred, but it has been uneven, and from a very low base.

It is of note that in our informal governance index of 25 developed and emerging economies Russia comes in next to last in aggregate – below the other BRICK countries – and ranks last in the area of rule of law for this sample group. Russia also ranks poorly on other key parameters, such as regulatory quality and corruption. On the other hand, Russia's sovereign credit rating has improved significantly since 1998 – when it was in default of both domestic and international bond obligations. With a BBB+ investment grade credit rating – often seen as a proxy for responsible public sector governance – Russia now ranks ahead of many other emerging economies.

Though Russsia has been heavily impacted in the current financial crisis, the country's public finances, external financial position and liquidity have strengthened notably in recent years, and this provided a relatively stable macroeconomic foundation for the development of commercial enterprise within Russia. Russia has been the direct beneficiary of high oil prices, and its current credit rating reflects as much or more the windfall from oil revenues as it does prudent public sector governance. Moreover, Russia's investment grade credit rating is not a proxy for corporate governance quality at the individual company level. Indeed, there is greater scope for rating agencies to incorporate governance issues more systematically into Russia's overall sovereign credit risk assessment.

The influence of the Russian state on the corporate sector remains an important factor affecting investors, both directly and indirectly. This is particularly relevant in strategic sectors, most notably energy and mining. The state still has controlling stakes in 30% of Russia's top 80 companies[35], and this influence is exerted through state representatives on company boards – creating potential conflicts between investor and public policy interests. Tax law is often used as a means for the Russian state to exert its influence in specific cases, often in an arbitrary way. This was the case with **Yukos**, the former oil company that was forced into asset sales over tax claims and faced subsequent bankruptcy. Moreover, the recent challenges faced by BP in managing its Russian venture **BP/TNK** has suggested implicit state support for the Russian venture partners through visa restrictions and other bureaucratic complications for BP executive management.

The Russian Corporate Governance Code, published in 2002 by the Federal Securities Commission, has established a good voluntary framework for governance in Russia, addressing relevant aspects of shareholder meetings, disclosure board structure, independence, board committees and internal control. The country's Joint Stock Law also has evolved in a positive way, offering shareholders many nominal rights, including annual director elections and low thresholds for nominating new directors. The Russian stock exchanges, Russian Trading System (RTS) and Moscow Interbank Currency Exchange (MMVB), have established special listing platforms for companies that conform to provisions of the Russian governance; however take-up to date has been limited.

Notwithstanding these positive top down initiatives to raise governance standards in Russia, serious gaps exist in practice, reflecting poor – or inconsistent – law enforcement, corruption and low transparency. At the core of this is the potential for misalignment of interests between controlling and minority shareholders. Of Russia's top 80 companies, 71% had a controlling stakeholder.[36] Complex and layered ownership structures and limited disclosure can obscure related-party transactions that transfer value from minority shareholders to controlling shareholders and create great challenges in legal or regulatory enforcement.

The establishment of a governance code and enhancing the legal framework in Russia does not automatically result in the transformation of corporate cultures to support good governance and minority shareholder interests. It is in the area of corporate culture where the greatest emphasis is required – and where there is a role for shareholders to fully exercise their rights and provide individual company oversight and engagement to complement these legal and regulatory standards.

At the same time not all Russian companies should be tarred with the same brush, as there is differentiation among Russian companies regarding governance standards. Some of the more progressive Russian firms in this regard, **Wimm Bill Dann** for example, have adopted more investor friendly governance structures, and in many cases governance standards have been influenced positively by raising capital in international markets outside Russia.

2. Specific Company Themes

At the individual company level in Russia there is scope for improvement in governance along a range of issues. These issues form a foundation for dialogue between investors and companies.

Transparency and disclosure. One of the major problems in Russian governance remains the asymmetry of information between majority and minority shareholders. This puts minority investors at a disadvantage, both with regard to understanding the commercial and financial performance of the company and with regard to assessing whether or not the controlling shareholder is exerting its influence to the detriment of minority shareholders. Specific issues include:

- In the area of financial accounting, there is need for greater use of IFRS or other recognised international accounting standards. Russian accounting tends to have a focus on accounting for the purpose of determining corporate tax liability, rather than reflecting the true economic performance of the company. At present relatively few

[35] "How does corporate governance in Russia stack up against the other BRICs?" Standard & Poor's RatingsDirect, 10 June 2008.

[36] Ibid.

Russian firms adopt international accounting standards; most of the firms that do so are either banks or those that issue capital in international markets. A healthy development would be the more active use of international accounting standards even for Russian firms that do not have foreign listings.

- Lack of transparency of ownership and control structures. When beneficial ownership is unclear, it can be difficult, if not impossible, for minority investors to understand the extent of the controlling shareholder's economic and voting stake in the firm, and even in some cases who the controlling shareholder is. This remains a concern in Russia. Among other things, this can create great challenges to investors in defining and controlling for related-party transactions involving the controlling shareholder.
- Disclosure of board and governance practices remains generally weak in Russia, and investors often have insufficient information to make informed decisions about director candidates and other financial or strategic transactions ahead of general or extraordinary meetings. This can be a particular complication given cumulative voting arrangements where there are more candidates up for election than there are board seats. Executive compensation disclosure is also very basic in Russia and individual compensation packages are typically not disclosed.
- Operational disclosure in Russia tends to lag standards in more developed markets. In particular relatively few Russian firms produce corporate sustainability reports, focusing on the nature of the company's environmental, social and governance (ESG) performance and how the company and its board oversee ESG issues in the context of overall enterprise management.

Board structure, effectiveness and independence. The voluntary Russian corporate governance code calls for a board with a minimum of three or ¼ independent directors. While this is a positive first step towards more robust board independence, it remains the case that independent directors in Russia are often too weak or too conflicted to ensure strong internal controls and mediate between related parties. Controlling shareholders still control Russian boards, and the fiduciary duty of all directors to look after the interests of both controlling and minority shareholders can be blurred. At a basic level, investors in Russian firms should call for greater board independence in the areas where independence is critical. This includes fully independent audit committees and independent reviews of related-party transaction or other potential conflicts of interest. Beyond this most fundamental foundation there is also further scope for greater board effectiveness in terms of committee structures, committee structures, strategy assessment, risk management and self-assessment.

Shareholder rights and relations. Shareholders in Russian firms arguably have more nominal rights than investors in US firms, including annual director elections, pre-emption rights, and the ability to nominate directors for election. However gaps do exist, including non-payment of dividends and non-independent registrars and an accountable regulator. More generally, the development of a stronger shareholder culture in Russia calls for companies to focus on bolstering their investor relations function to ensure that all shareholders, particularly minority shareholders, are appropriately informed, and to ensure that company senior management is available to meet with investors and address investor queries.

Anticorruption and ethics. The pervasive influence of the Russian state and the legacy of "bandit capitalism" in the 1990s create an environment in Russia that is vulnerable to bribery and corruption at the corporate level. This is reflected in Russia's low scoring in Transparency International's corruption perception index. This suggests the need for Russian boards to pay particular attention to ensuring that policies, systems and controls relating to anticorruption and ethics are implemented throughout the company and are monitored regularly by the board. This can include the introduction of employee hotlines or other mechanisms to control for corruption.

Remuneration. Executive compensation is less of a concern in Russia than it is other more developed economies. Indeed, controlling shareholders are often well-positioned to control senior management compensation to prevent abuses of excessive executive pay. However, remuneration packages in Russia are often focused on near term performance, and there remains scope for development of more robust long-term pay packages that provide strong incentives for management to create value for shareholders. This should be an ongoing focus of investor dialogue in Russia, and investors also should call for greater disclosure of individual pay packages for the CEO and other key executives.

Social and environmental performance. Awareness of corporate responsibility is building in Russia, but remains at a nascent level. The legacy of the Soviet Union resulted in a culture in which corporate entities provided a range of support to its workforce – sometimes including housing and schooling for its employees. However the social orientation of business is less explicitly developed in the current Russian climate. Company reporting on corporate responsibility in Russia often focuses on aspects of philanthropy rather than on how social and environmental factors influence company performance and value creation.

F&C voting and engagement themes. F&C's voting record on Russian general and extraordinary shareholder meeting resolutions reflects many of our concerns about Russian corporate governance. For the period from 1 July 2007- 30 June 2008, F&C voted on 1084 management resolutions for Russian companies, and either voted against management or abstained on 372 – or 34% – of these resolutions. The vast majority of these resolutions related to the election of director candidates. F&C only supported 58% of management's director proposals – a very low level. In many cases this resulted from insufficient information about director candidates being available to allow for an informed vote. Similarly, F&C also voted against or abstained on 89% of management resolutions from 2007-2008 relating to strategic transactions and restructuring. As with director elections, the predominant reason for lack of support of these transactions related to limited or no information available to evaluate the management resolutions. These weak disclosure practices form a key component of our engagement outreach to Russian firms.

Russian Case studies

Positive: Russia's second largest gas producer **Novatek** has demonstrated that good governance is possible even for companies with a significant shareholder. The company is 20% owned by state gas company **Gazprom**, and has had two independent directors out of a board of eight members, as well as all key committees in place. Although a small number of independent directors is relatively common for Russian companies, **Novatek** recognised that this does not meet international good practice and, in 2008, called a special shareholders' meeting to seek approval for expanding the board by two seats to enable the company to recruit additional independent directors. In so doing the company sets positive practice standards, particularly in light of the significant presence of **Gazprom** in its shareholder register.

Problematic: Amidst the steady and gradual steps forward in Russia, setbacks continue to occur, such as **Sibir Energy's** recent financial bail-out of one of its controlling shareholders. It purchased a $340 million property portfolio, not related to its core energy business, from a 23% shareholder. The purpose of this transaction was to support this shareholder who was experiencing financial difficulties separately from his holdings in **Sibir Energy**. While **Sibir Energy** is Russia-based it is also trades on London's Alternative Investment Market (AIM). However, London-based minority investors are not in a position to overturn this dubious transaction since other Russian controlling shareholders (including the City of Moscow) are supportive of this bail-out and control the outcome of the shareholder vote.

3. Summary

Corporate governance in Russia remains problematic, but has certainly improved since the country's economic crisis in the 1990s. While there have been positive developments in terms of improving written law and developing a code of best governance practice for Russian firms, concerns still remain about the effectiveness of law enforcement, the environment of corruption and poor corporate disclosure. There is also considerable scope for improvement of board structures and practices, particularly with regard to enhancing board independence and the protection of minority shareholder rights. Investors have a role to play in this debate to exercise their shareholder rights diligently, both to ensure company managements are responding to minority investor concerns, and to provide a market solution to support improved governance standards in Russia in a way that complements the legal and regulatory framework.

[37] Standard & Poor's, RatingsDirect, 8 July 2008.

Appendix

Companies mentioned in this report

Brazil
Arcelor do Brasil
Banco Itaú
Banco Nossa Caixa
Bradesco
Companhia Vale do Rio Doce
Embraer
Lojas Renner
Ripasa
Unibanco

China
China Construction Bank
China Life
China Reserves Enterprise
China Mobile
China Shenhua
CNOOC
ICBC
Li Neng
Nine Dragon Paper Holdings
PetroChina
Ping An Insurance Group
Shanghai Electric
Shanghai Forte Land
Weiquiao Textile Company

India
Aditya Birla
Cipla
Hindustan Unilever
Infosys
Mahindra Group
Ranbaxy Laboratories
Reliance Communications
Reliance Group
Satyam Computer Services
Tata Group
Vedanta Resources

Korea
Doosan
Hyundai Heavy Industry
Hyundai Motors
Hyundai Steel
Samsung Electronics
Samsung Group
Posco

Russia
BP TNK
Gazprom
Lukoil
Norilsk Nickel
Novatek
Sibir
Wimm Bill Dann
Yukos

Emerging Markets Disclosure: In February 2008, F&C became a signatory to a new Investor Statement on Sustainability Reporting in Emerging Markets. In this statement, global institutional investors representing over $400 billion in assets under management encourage companies in emerging markets to provide better information on their management of environmental, social, and corporate governance (ESG) issues. In particular the signatories of this statement encourage all companies to enhance transparency by working towards:

- Providing regularly updated ESG disclosure in financial reports or in specialized sustainability reports, focusing on the most material business risks and opportunities.
- Setting clear goals and disclosing progress towards
- Utilizing the Global Reporting Initiative (GRI) framework in preparing their reports. At a minimum, we recommend that companies list exactly which GRI indicators are addressed in their reports as part of a "GRI Index."
- Continually improving reporting based on feedback from key stakeholder groups, including both financial stakeholders and non-financial stakeholders, such as employees, customers, and relevant community and civil society groups.

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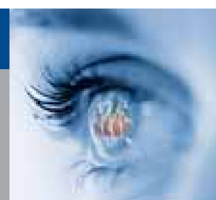

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