EMERGING MARKET GOVERNANCE ANALYSIS

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Abstract

It has generally been acknowledged that there is no single model of corporate governance that will be viable and effective in all countries around the world. However, while approaches taken in various countries may differ, there are certain basic standards or principles that can and should be applied regardless of specific legal, political and economic circumstances and report describes the approach taken by Standard & Poor to analyze corporate governance practices in countries and companies using measures of ownership structure and influence; financial stakeholder rights and relations; financial transparency and information disclosure; and board structure and process.

It has generally been acknowledged that there is no single model of corporate governance that will be viable and effective in all countries around the world. However, while approaches taken in various countries may differ, there are certain basic standards or principles that can and should be applied regardless of specific legal, political and economic circumstances and these have been broadly identified by the Business Sector Advisory Group on Corporate Governance to the OECD as fairness, transparency, accountability and responsibility. Standard & Poor ("S&P") used these principles as a guide in developing its methodology for analyzing corporate governance practices in countries and companies and generating a corporate governance score ("CGS") that "reflects Standard and Poor's assessment of a company's corporate governance practices and policies and the extent to which these serve the interests of the company's financial stakeholders, with an emphasis on shareholders' interests".[2] S&P explained that it considered corporate governance to include "the interactions between a company's

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[2] Standard & Poor's Corporate Governance Scores: Criteria, Methodology and Definitions 5 (July 2002).

management, its board of directors, shareholders and other financial stakeholders".[3] S&P assigned a CGS on a ten-point scale ("10" being the highest and "1" the lowest) and also generated scores on four components that, taken together, contributed to the overall CGS: ownership structure and influence; financial stakeholder rights and relations; financial transparency and information disclosure; and board structure and process.[4]

§_:_ Ownership structure and influence

S&P noted that understanding the ownership structure of a company is essential to identifying how governance works for that company and is particularly important in situations where there is a known majority shareholder (or when de facto majority ownership and control exists based on collusive shareholding arrangements) who may be tempted to act in a manner that is not necessarily in the interests of all shareholders.[5] The first sub-category used by S&P with respect to ownership structure focused on transparency of ownership and looked at two criteria: (1) there should be adequate public information on the company's ownership structure, including, where relevant, information on beneficial ownership behind corporate nominee holdings; and (2) the company's actual ownership structure should be transparent, and should not be obscured by crossholdings, management controlled corporate holdings, nominee holdings, etc. According to S&P the key analytical issues for this sub-category included breaking down shareholdings, identification of substantial/majority holders (including indirect ownership and voting control), shareholdings of directors, evidence of indirect shareholdings and shareholdings of management.

The second sub-category used by S&P with respect to ownership structure focused on concentration and influence of ownership and looked at three criteria: (1) if large blockholders exist, these should not exert influence that is detrimental to the interests of other stakeholders and minority shareholders should be protected against loss of value or dilution of their interests (e.g., through capital increases, from which some shareholders are excluded, or through transfer pricing with connected companies); (2) concentration of economic interest and influence of controlling shareholders of the parent/holding company on independent board/management action should not occur through block holdings of key operating subsidiaries and through effective control of key customers and suppliers; and (3) shareholders should not be disadvantaged by management and insider

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[3] Standard & Poor's Corporate Governance Scores: Criteria, Methodology and Definitions 5 (July 2002). S&P explained that "financial stakeholders" included both shareholders of a company and the company's creditors and that this approach was based on "the premise that the quality of a company's governance process can affect its ability both to honor contractual financial obligations to creditors and to maximize the value of a company's equity and distributions for its shareholders". Id.

[4] Standard & Poor's Corporate Governance Scores: Criteria, Methodology and Definitions 7 (July 2002) (includes discussion of methodology used to collect information and develop and assign components of the CGS).

[5] Standard & Poor's Corporate Governance Scores: Criteria, Methodology and Definitions 8 (July 2002).

shareholders who are shielded from accountability. According to S&P the key analytical issues for this sub-category included affiliations amongst shareholders; commercial arrangements between the company and affiliates/third parties; corporate structure, shareholding and management of key affiliates; outside holdings of major shareholders; terms of key contracts and licenses; internal financial and operational control system; management shareholding/voting control and contracts with directors/management.

§_:_ Financial stakeholder rights and relations

According to S&P its assessment of financial stakeholder relations was concerned with how companies treated their financial stakeholders and, specifically, how their corporate governance practices and policies served the interests of those stakeholders.[6] The first sub-category used by S&P with respect to financial stakeholder rights and relations focused on voting and shareholder meeting procedures and looked at three criteria: (1) shareholders holding an appropriate percentage of voting rights should be able to call a special meeting and shareholders should have the opportunity to ask questions of the board during the meeting and to place items on the agenda beforehand; (2) a shareholders' assembly should be able to control appropriate decisions through processes that ensure participation by all shareholders; and (3) the processes and procedures used for advising shareholders of general meetings should provide for equal access of all shareholders and should ensure that shareholders are furnished with sufficient and timely information so that they are able to make informed voting decisions. According to S&P the key analytical issues for this sub-category included shareholder meeting procedures, notices of meeting, documents sent to shareholders, charter provisions on the convening of meetings, arrangements for shareholders' participation at meetings, previous meeting minutes, shareholder information on voting procedures, any deposit agreement for overseas listing, proxy arrangements, charter provisions on voting thresholds and shareholder attendance records.

The second sub-category used by S&P with respect to financial stakeholder rights and relations focused on ownership rights and financial rights (including dividends) and looked at four criteria: (1) there should be secure methods of ownership of shares and full transferability of shares; (2) a company's share structure should be clear and control rights attached to shares of the same class should be uniform and easily understood; (3) a shareholders' assembly should be able to exercise decision rights in key areas, and procedures should be in place that ensure that minority shareholders are protected against dilution or other loss of value (e.g., through related party transactions on non-commercial terms); and (4) all common shareholders should receive equal financial treatment including the receipt of an equitable share of profits (i.e., dividends or other profit distributions). According to S&P the key analytical issues for this sub-category included charter provisions, arrangements with registrar, share structure – classes and rights of common and preferred shares, charter provisions – shareholder and board authorities, shareholder agreements, dividend history and examples of share repurchases and swaps.

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[6] Standard & Poor's Corporate Governance Scores: Criteria, Methodology and Definitions 9-10 (July 2002).

The third sub-category used by S&P with respect to financial stakeholder rights and relations focused on takeover defenses and corporate control issues and looked at two criteria: (1) the company should maintain a level playing field for corporate control, and should be open to changes in management and ownership that provide increased shareholder value; and (2) takeover defenses are not necessarily considered to be negative governance features on their own; such defenses are analyzed against the current ownership structure to determine how virulent or benign they are in practice and how the board intends to use them to increase shareholder value. According to S&P the key analytical issues for this sub-category included effects of provisions in company charter or articles of association; arrangements as disclosed in regulatory filings or their equivalent, annual reports, records of resolution, notices of meetings and proxy materials; and interviews with Board secretary.

§_:_ Financial transparency and information disclosure

According to S&P its assessment of financial transparency and information disclosure was concerned with timely disclosure of adequate information concerning a company's operating and financial performance and its corporate governance practices.[7] S&P argued that a hallmark of a well-governed company is high standards of time disclosure and transparency and that such practices "enables shareholders, creditors and directors to effectively monitor the actions of management and the operating and financial performance of the company".[8] The first sub-category used by S&P with respect to financial transparency and information disclosure focused on the quality and content of public disclosure and looked at whether financial reporting and disclosure is being clearly articulated and completed to a high standard. According to S&P the key analytical issues for this sub-category included comprehensiveness of financial statements and reports (including data on key affiliates) disclosed to shareholders and investment community, quality of non-financial information and quality of corporate records available at the company's headquarters.

The second sub-category used by S&P with respect to financial transparency and information disclosure focused on the timing of and access to public disclosure and looked at three criteria: (1) as a result of high internal transparency standards and effective internal control policies, all publicly disclosable information should be promptly available and freely accessible to the investment community and shareholders; (2) the company's by-laws, statutes and/or articles should be clearly articulated and readily accessible to all shareholders; and (3) the company should maintain a website and make company reports, summary reports and/or other investor relevant information available in English and the local language, if applicable. According to S&P the key analytical issues for this sub-category included timeliness of filing financial and other statements with

[7] Standard & Poor's Corporate Governance Scores: Criteria, Methodology and Definitions 10-11 (July 2002).
[8] Standard & Poor's Corporate Governance Scores: Criteria, Methodology and Definitions 10 (July 2002).

regulatory bodies, procedures for disclosure of market sensitive information, briefing materials for investment community presentations, availability of records to all shareholders at the company's headquarters, reports to shareholders and quality of website and online reporting.

The third sub-category used by S&P with respect to financial transparency and information disclosure focused on the independence and effectiveness of the audit process and looked at two criteria: (1) auditors should be independent of the board and management in all material respects and should also be reputable; and (2) there should be procedures in place to maintain the independence of the outside auditors. According to S&P the key analytical issues for this sub-category included audit contract, finance and control systems, audit committee process, charter provisions prescribing relationships with auditor and audit reports.

§_:_ Board structure and process

According to S&P its assessment of board structure and process was concerned with the role of the corporate board and its ability to provide independent oversight of management performance and hold management accountable to shareholders and other relevant stakeholders.[9] S&P noted: "Separation of authority at the board level is important. Boards with high accountability often include a strong base of independent outside directors that look after the interests of all shareholders—both majority and minority holders. Conversely, companies with a strong, self-interested majority shareholder—or dominated by a few such shareholders—may have boards with limited accountability to all shareholders. This may be case when the company's management is heavily represented on the corporate board."[10] Other factors relevant to assessing board structures and processes include the procedures for determining executive remuneration and benefits and the processes for nomination and election of representatives of minority shareholders and outside directors.

The first sub-category used by S&P with respect to board structure and process focused on board structure and composition and looked at whether the board was structured in such a way as to ensure that the interests of all the shareholders could be represented fairly and objectively. According to S&P the key analytical issues for this sub-category included board size and composition, board leadership and committees and representation of constituencies. The second sub-category used by S&P with respect to board structure and process focused on the role and effectiveness of the board and looked at two criteria: (1) the board should bear overall accountability for the performance of the company; and (2) the board should be ultimately responsible for the system of internal risk control at a company. According to S&P the key analytical issues for this sub-category included definitions of board role; board-level processes for identifying, evaluating, managing and

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[9] Standard & Poor's Corporate Governance Scores: Criteria, Methodology and Definitions 11-12 (July 2002).

[10] Standard & Poor's Corporate Governance Scores: Criteria, Methodology and Definitions 11 (July 2002).

mitigating risks faced by the company; board and committee meeting's agenda and papers; and management compensation process

The third sub-category used by S&P with respect to board structure and process focused on the role and independence of "non-employed" directors and looked at two criteria: (1) an appropriate proportion of the "non-employed" directors should be truly independent and act as such and independent or outside directors should ensure that the long-term interests of all shareholders are represented by including that the interests of other stakeholders are duly taken into account; and (2) directors should be elected under a transparent system in which they are not able to participate. According to S&P the key analytical issues for this sub-category included relationships between outside board members and senior management, history of involvement of outside directors with company, terms of outside director engagement, control committee independence and activity, articulation of the specific role of outside directors and the procedures for nomination and election of directors.

The fourth sub-category used by S&P with respect to board structure and process focused on board and executive compensation, evaluation and succession policies and looked at three criteria: (1) directors and executives should be fairly remunerated and motivated to ensure the long-term success of the company; (2) appropriate incentives should be in place connecting executive pay to the performance of the company; and (3) there should be clearly articulated performance evaluation and succession policies/plans for employed directors of the company. According to S&P the key analytical issues for this sub-category included level and form of compensation, the extent to which pay is connected to financial or other performance measures, performance evaluation criteria, independence and integrity of compensation setting process and succession planning.