



GovernanceMetrics International®

In Focus

A Look at Recent Governance Developments from GMI

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SPOTLIGHT: Shareholders Starting to Take Notice of Problems at Samsung

Samsung Electronics Co., Ltd. (KSE: 005930), a South Korean company that has alternately been lauded as an emerging tech giant and criticized for failing to shed many of the vestiges of poor governance that are typical of the country's chaebol system, is back in the news. On March 23, Lee Kun-Hee, a recently convicted felon who received a Presidential pardon, returned to the "Chairmanship" of Samsung Electronics, side-stepping the guidelines of the company's own bylaws. GMI regards Mr. Lee's return to the chairmanship as a serious board accountability issue for a company that has an Overall Global Rating of 4.0, and a Global Board Accountability rating of 2.5, as of May 15, 2010.

In April 2008, Mr. Lee had to resign as chairman of the board at Samsung Electronics amid a damaging investigation into the entire Samsung Group for tax evasion and bribery. Later that year, he was convicted of tax evasion for covering up his ownership of shares of Samsung Life Insurance, the mutual insurer of the Samsung Group. In the aftermath of the court case, Mr. Lee further consolidated his control of the Samsung Group, reinforcing his complex web of cross shareholding that ensures his control over the company. In the end, Mr. Lee paid US\$2B in fines, saw his prison terms waived, and eventually received a special Presidential pardon.

What is worrying for investors is the fact that Mr. Lee took over as chairman of the company, a position that bears little resemblance to the chairman of the board position at U.S. or European companies. In South Korea, company "Chairman" is a special senior leadership position that was once common, but has been eliminated as companies have adopted more modern management

structures. Samsung's bylaws define a role for a U.S. style board chairman, but do not mention the possibility of the appointment of a company "Chairman". Mr. Lee, in his new position, does not serve on Samsung Electronics Co., Ltd. board and is not a named executive officer. Outside observers worry that Mr. Lee has in effect established himself as a chairman-for-life who is no longer subject to a shareholder vote or legal liability.

Samsung Electronics' corporate website showcases the company's latest digital cameras, phones, and sleek new laptop computers. It appears to be the epitome of the modern business. Further, in the world of technology, creative destruction renders new products obsolete at an ever increasing rate. However, the corporate governance framework of the company is anything but modern.

After two decades, several scandals, fines, and a great deal of bad publicity, it is unfortunate that we have not seen Samsung's corporate governance modernize it into a post Lee Kun-Hee company.

EU: Green Paper on Governance in Financial Institutions

In the wake of the 2009 financial crisis, the European Commission launched an effort to examine corporate governance rules and practice within financial institutions and make recommendations, or even propose regulatory measures, that could improve member countries corporate governance practices. The Commission's [Green Paper](#) on corporate governance is a 20 page document, published in June 2010, which discusses key governance areas such as board accountability, risk management, and remuneration.

The report states that in the build-up to the financial crisis, it "is clear that boards of directors... rarely comprehended either the nature or scale of the risks they were facing." The report stresses an overall absence of effective risk management and blasts companies for engaging in excessive risk-taking.

The Green Paper is just the latest example of how seriously corporate governance is being taken in the aftermath of the Lehman Brothers debacle. The report accuses corporate boards, in general, of falling asleep at the helm, and failing to effectively steer their companies through the turbulent times of late 2008. The report specifically highlights the failure of directors at public companies to conduct performance reviews both of individual directors and of the board as whole. GMI research indicates that while 77% of financial companies in Industrialized Europe covered perform periodic board evaluations, less than 50% review individual director performance.

The European Commission believes that directors at many financial companies simply failed to understand the severity and complexity of the risks facing their company's operations. The report states that it is "necessary for boards of directors to ensure the right balance between independence and skills is struck." As of May 15, 2010, although 67% of the financial companies in Industrialized Europe GMI covers have Audit Committees with at least one non-executive member with recent financial expertise, fewer than 25% of these companies have Audit Committees where a majority of the non-executive members have both relevant industry experience and general financial expertise.

The report concludes that the "financial crisis clearly shows that financial institutions' boards of directors did not fulfill their key role as a principal decision-making body. Consequently, boards of directors were unable to exercise effective control over senior management and to challenge the measures and strategic guidelines that were submitted to them for approval." The Commission believes that non-executive directors of financial companies "devoted neither sufficient resources nor time to the fulfillment of their duties." As a result, the Commission

believes that limiting the number of boards on which a director may sit should be considered by financial companies to enable directors to devote sufficient time to performance of their duties (for example, no more than three boards at once). In addition, the Commission asks whether combining the functions of chairman of the board of directors and chief executive officer should be prohibited in financial institutions. Although 79% of the financial companies in Industrialized Europe covered by GMI have a non-executive chairman, only 4% disclose a policy limiting the number of directorships that a non-executive director may hold on the boards of other publicly traded companies.

The report states that remuneration policies in the financial sector, based on short-term profits without taking into account the corresponding risks, contributed to the financial crisis. The European Commission believes that executive remuneration needs to effectively encourage the generation of long-term shareholder value. Although 70% of the financial companies in Industrialized Europe GMI covers claim to take steps to link executive remuneration to company performance, only 25% actually disclose a specific performance target for upcoming fiscal years. Only 20% of the financial companies in Industrialized Europe GMI covers disclose that they use total shareholder return (TSR) as a performance target for executive pay. Clearly there is still some room for improvement in this area.

The Green Paper also includes many recommendations to enhance management of risk, including enhancing the role of auditors and risk officers. This is particularly important for financial institutions and the suggested options include mandating a dedicated risk committee at the board level.

The European Commission has limited the Green paper to financial institutions. However, the Commission will also soon be examining corporate governance within all listed companies, which will be another important contribution to the debate on reform.

Taiwan: Corporate Governance Practices Attracting Attention

In May 2010, the [Asian Corporate Governance Association \(ACGA\)](#), a non-profit association that focuses on corporate governance policy, held a [webinar](#) on to showcase its research on Taiwan.

In a report in 2007, the ACGA highlighted complicated voting procedures and weak shareholder rights as key areas of governance concern in Taiwan. The ACGA believed that in 2007 it was particularly difficult for foreign investors to engage in activist campaigns. In 2010, the ACGA believes that the absence of “detailed disclosure of voting results” is still a critical governance weakness in Taiwan. GMI research shows that as of May 15, 2010, only four of the 75 Taiwanese companies covered disclose vote results for the last shareholder meeting within 14 calendar days of the meeting.

Although the ACGA highlights certain weaknesses in the country’s governance framework, the group also notes that as of 2010 several improvements have been made to Taiwan’s governance policies. For instance, it is now easier for investors to judge the qualifications of independent directors, since Taiwan now requires companies to publish detailed biographies for all independent board members.

The ACGA notes that board independence is a “work in progress” in Taiwan, and advises that companies should adopt annual board elections, since the current norm of three year terms isolates ineffective directors from accountability to shareholders. GMI research shows that only three of the 75 Taiwanese companies covered have a majority independent board, and none of these companies holds annual board elections.

The ACGA will continue to engage in active discussions of governance practices in Taiwan. The group is holding a special meeting in Taipei on November 3, 2010, and is expected to publish a white paper on governance practices in Taiwan.

U.S. Financial Reform: The Future of Proxy Voting

Legislation on financial reform, which passed today in the U.S. Senate, will play a big role in the future of shareholder empowerment. In recent years, groups like the Council of Institutional Investors and the International Corporate Governance Network, with the support of many organizations, including GMI, have strongly argued that U.S. listed companies need to follow the example set by their peers in the U.K., Australia, Hong Kong, New Zealand, and other overseas markets, and offer proxy access to shareholders. In those markets it is seen as rather curious that this is not a standard right for shareholders.

Currently in the US, investors wishing to nominate their own directors to the board of publicly listed companies must undertake the expense of issuing their own proxy statements to all of the company's shareholders. The expense of engaging this type of proxy battle is a significant deterrent to many investors and is usually only practically available to activist investors who pursue a concentrated proxy battle to achieve their objectives. As a result of current arrangements incumbent directors can be insulated from the views of their shareholders, particularly long term holders, and it can also tend to stifle dissident views.

The final version of the U.S. financial reform bill affirms the Securities and Exchange Commission's right to implement so-called proxy access rules that would require public companies to allow shareholders to nominate their own director candidates on company proxies. Late in the process, there was a push for provisions to be included in the bill that would require investors to meet a high threshold of ownership over lengthy holding periods in order to be able to nominate candidates for election. A 5% ownership threshold, which was put forward, would effectively have upheld the status quo for long term institutional investors who would still be unable to get nominees for election included on company issued proxy statements. After all, even the very largest pension funds in America usually own well below 1% of the outstanding stock of any company in the Russell 3000. In the end, a rearguard action on behalf of long term investors prevailed in the bill reconciliation process, but not before considerable concern that this reform would be ineffective or possibly counter-productive in its final legislative form.

With the passage of the bill, proxy access seems to be very close with the SEC poised to put the rules in place to allow this reform to be put into effect. However, it is still not clear when the rules will come up for a final vote at the SEC. No doubt, there will be plenty of anxiety until that occurs. In the meantime, the SEC has just announced a broad review of the overall proxy voting process. This wide ranging examination under a concept release issued by the SEC on July 14, 2010 will look into the adequacy of the proxy process, including looking at the "empty voting" issue, the role of proxy advice, direct solicitation processes (including shares held in street name), so-called "over-voting" and "under-voting", vote confirmation, shareholder communications and participation and other issues. It will be timely to address a number of these issues of long standing for both companies and their advisers and the investment community. With proxy access will come plenty of responsibility and many of the issues in the concept release are in that category.

Although many investors in the U.S. have long called for proxy access, there remain some concerns about the potential risks of this reform. Companies and shareholders alike are concerned about the possible nomination of "special interest" directors, but when it comes to

proxy access, nomination is not the same as election. In markets such as those mentioned above that already allow proxy access the privilege is rarely exercised. Furthermore, in the limited number of cases where outside candidates are nominated by minority shareholders, these nominees rarely garner more than a few percentage points of the vote unless the company has very serious problems. Successful candidates are highly credible directors put on boards by shareholders seeking serious improvements in corporate performance. In most cases, however, the norm is still for incumbent directors to be re-elected with votes above 95%. It is very difficult for a “single issue” candidate to garner enough votes to be elected.

Given the overseas experience, there is limited downside and a considerable upside to implementing proxy access in the U.S. and giving minority shareholders with new ideas the opportunity to make their voices heard.

New Study Focuses on Defining Pension Fund Fiduciary Duty

In recent years, many commentators have voiced their opinions on the best way for pension funds and other institutional investors to interpret their fiduciary duties. A new project launched by the Network for Sustainable Financial Markets aims to add clarity to this debate. According to the ICPM Research Project Summary, the result of the study will be “clearer delineation of trustee responsibility and great support for taking a more balanced and longer-term approach to measuring success on the ground.”

The study will include a two year examination of the fundamentals of trust law and its relationship to modern portfolio theory as well as roundtable discussions with market participants. The project will involve interviewing key actors at institutional investors about how their thinking has or is developing beyond what it was prior to the financial crisis. The Council of Institutional Investors and the International Corporate Governance Network are expected to offer input as well. The Project Summary can be found [here](#).

From Corporate Responsibility to General Responsibility: New OVFA Report

A new study called “Corporate Responsibility 2.0: From Corporate Responsibility to General Responsibility” published by Austria’s [OVFA](#) (Austrian Association for Financial Analysis and Asset Management), highlights 44 critical Corporate Social Responsibility (CSR) focus areas. The report includes discussions of critical policy areas like environmental responsibility, CEO remuneration, and energy efficiency, positing some strong and advanced views on these issues. The study is wide ranging on a number of issues in the ESG space. On the corporate governance front, the study in particular calls on supervisory boards in the dual board system, common in parts of Central Europe, to assume an expanded role beyond being seen as having a controlling function to ensure it is more closely involved in coaching and being consulted by the management board. This is particularly important in Austria where dual boards are the norm.

A copy of the report is available [here](#).

Australia and Germany Act on Gender Diversity

Despite Australia losing to Germany in their opening match of the World Cup in June, in July it was more like a Win-Win for Australia and Germany as both have put in place new measures to promote gender diversity on boards.

Changes by the Australian Securities Exchange (ASX) Corporate Governance Council’s Corporate Governance Principles and Recommendations were brought into force on July 1, 2010 for fiscal years ending after June 30, 2010 (for most Australian companies this will mean the

fiscal year ended June 30, 2011). All companies listed on the ASX are required to report on whether they follow the Principles and Recommendations (the so-called “comply or explain” process). The changes related to diversity include establishing a policy on diversity to include requirements for the board to establish measurable objectives for achieving gender diversity and for the board to assess annually both the objectives and progress in achieving them; disclosing in each annual report the measurable objectives for achieving diversity and progress towards achieving them; and disclosing in each annual report the proportion of women employees, women in senior executive positions and women on the board. All of these changes are expected to increase the focus on diversity and establish put pressure on companies to act to increase diversity in their companies. More information about the new recommendations on diversity is available [here](#).

The next day in Germany the Government Commission of the German Corporate Governance Code recommendations on gender diversity were put in place through amendment to the Corporate Governance Code. The recommendations, originally released in May, require that "Supervisory boards should set down concrete goals for the future regarding how they are made up, goals which should lead, in consideration of the respective situation specific to each company, to more diversity and, in this case in particular, to the proper consideration of women." The Commission also recommended "that boards of directors which continue to possess management functions in companies should pay heed to diversity and take into more consideration a proper number of women." These two measures are targeted at increasing the presence of women on supervisory boards and on management boards in Germany. More information about the changes made by the Commission is available [here](#).

In Focus is a periodic publication of GovernanceMetrics International (GMI). GMI's rating system incorporates hundreds of data points across six broad categories of analysis: board accountability, financial disclosure and internal controls, executive compensation, shareholder rights, ownership base, takeover provisions, plus corporate behavior and social responsibility. Companies are rated relative to others in the GMI database on a scale of 1.0 (lowest) to 10.0 (highest). Subscribers to GMI are able to view a company's overall rating, section ratings, red flags (flags are issued by GMI from time to time to highlight specific characteristics that present notable cause for concern) plus several pages of written analysis. GMI clients include leading pension funds, investment managers, banks, insurance companies, credit rating agencies, regulatory agencies, stock exchanges and professional service firms in 16 different countries throughout North America, Latin America, Europe and the Asia-Pacific region. Please see www.gmiratings.com for additional information.

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