



GovernanceMetrics International®

In Focus

A Look at Recent Governance Developments from GMI

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December 11, 2009

Issue 2009.3

SPOTLIGHT: Apollo Group: Another Regulatory Probe Amidst Ongoing Governance Concerns

Apollo Group, Inc. (NASDAQ: APOL), a company frequently cited by GMI for its weak governance policies, is back in the news again. Apollo, a for-profit education company that operates the University of Phoenix system, has a global governance rating of only 2.0.

GMI has drawn attention to the company's transparency issues as a potential concern to investors. Apollo's common shareholders have very few voting rights and the company provides very little disclosure of governance policies and practices.

GMI's analyses of the company have highlighted areas of concern in the company's governance policies, particularly since 2006, when Apollo was found to have substantial problems with backdating of stock option grants to executives, which later resulted in restatements, investigations, and negative press attention. The company has since been subject to many investigations and lawsuits on issues ranging from financial disclosure to workplace discrimination.

GMI has regularly issued red flags to the company for its entirely non-independent board, its failure to file financial statements on time, and its deficiencies in the areas of shareholder rights and market for control. Investors who have followed the company's previous governance troubles may not be surprised that further regulatory issues have emerged for the company.

On October 27, 2009, Apollo announced that the Enforcement Division of the Securities and Exchange Commission has commenced an informal inquiry into the company's revenue recognition practices. While the investigation is still informal, the company is once again finding itself with a "please explain". The revenue recognition concerns relate to how Apollo determines when a student drops out of a class, the refund that student gets, how much income Apollo can leave on its balance sheet and for how long. Apollo has stated that it stops recognizing revenue when a refund is processed for a student that has dropped a class, according to attendance records.

On top of this informal inquiry, the company's fiscal 2009 fourth quarter results contained pre-tax charges of \$95.4 million, including an accrual for an estimated litigation settlement of \$80.5 million, which is nearly 7% of total shareholders' equity for the year. Persistent litigation, along with several regulatory inquiries already alluded to, has been a problem and distraction for the company over a number of separate issues.

GMI has highlighted possible governance concerns in two other Spotlight pieces, in 2008 and earlier this year. From shareholder rights, to financial disclosure and internal controls, and corporate behavior problems, Apollo continues to have serious governance concerns and provides an example of how consistently poor corporate governance may negatively affect shareholders.

ESG Focus: UN PRI Aims to Tighten Listing Standards

Recently the United Nations sponsored a meeting at its headquarters in New York which brought together major institutional investors including the Norwegian Global Pension Fund, France's national pensions reserve fund (FRR), representatives from major stock exchanges such as NYSE Euronext, and a number of other senior executives from major investing firms.

Held under the banner of the U.N. Principles of Responsible Investing (UNPRI), the meeting focused on matters relating to environmental, social and governance (ESG) criteria for company listings, such as the introduction of a 'comply or explain' requirement for companies to put an annual sustainability report to a shareholder vote at their annual general meetings.

Although some countries already require listed companies to include a disclosure of their corporate responsibility activities and practices in their Annual Reports, there is still room for improvement in this area.

GMI data shows that only 34% of the 3,642 developed market companies covered by GMI that operate in environmentally sensitive industries have implemented environmental management systems. Furthermore, only 29% of these developed market companies in environmentally sensitive industries offer disclosure of their environmental performance and only 12% publish environmental reports that comply with U.N. Global Reporting Initiative (GRI) guidelines.

Supachai Panitchpakdi, secretary-general of the United Nations Conference on Trade and Development (UNCTAD), who was at the conference, told reporters that there are still more investor calls for enhanced ESG disclosure, after all he said, "UNCTAD research shows clearly that disclosure requirements can have a significant impact on the transparency and long-term sustainability of companies around the world."

UN efforts to raise the importance of ESG issues will likely lead to a greater level of awareness across markets, exchanges and governments.

South Africa Adopts New Corporate Governance Code

South Africa, the highest ranked emerging market country in GMI's Country Rankings, has adopted important updates to further improve its governance policies. The country's new governance code, King III, which includes a number of key reforms, has been published and will go into effect in March 2010.

The new code includes recommendations on annual "Say on Pay" votes; increased remuneration disclosure, and increased attention to risk and remuneration issues. The code includes recommendations on the formation of risk, compensation and nomination committees, as well as increased sustainability disclosure.

The recommendations are not compulsory, but should none-the-less be an impetus for governance at companies in the country. In a change of approach, King III will use an "apply or explain" approach as opposed to the previous code's "comply or explain" approach. The "apply and explain" approach requires enhanced consideration of how a principle or a recommended practice in King III could be applied.

The new code includes a recommendation that the chairman of the board at listed companies should be an independent non-executive director. Currently 60% of the 43 South African companies GMI covers have appointed an independent chairman.

The new code also recommends that the continued independence and performance of all non-executive directors who have been on a board for more than nine consecutive years should be assessed by the board.

Money Matters: Focus on Executive Compensation: Germany Adopts "Say on Pay"

With stories relating to busts, bailouts, and bonuses hitting headlines weekly, executive compensation has been the focus of increasing scrutiny. Most recently, Germany has followed the cue of the U.K., Australia, Switzerland and others, and starting in 2010 will subject executive compensation packages to shareholder approval, via "Say on Pay" proposals. Proposals to do the same for all US companies is still very much in debate.

In terms of GMI analysis, Germany has generally had some governance concerns in the remuneration area. GMI data indicates that the German companies covered by GMI have an average Global Remuneration Rating of only 5.7.

On September 16, 2009, Germany's parliament, the Bundestag, approved the Act on the Appropriateness of Management Board Remuneration. In addition to implementing important changes concerning the composition of management board remuneration, the Act also introduces 'say on pay' in Germany, i.e., a non-binding advisory vote on remuneration for listed company shareholders. The Act aims to ensure that executive pay is more strongly linked to shareholder wealth creation. For example, new rules will require executive stock option grants to be vested, at minimum, four years after the initial grant date.

These initiatives will certainly provide a change in the way German companies look at remuneration issues and involve stronger consideration of shareholder concerns. As these changes go into effect for German companies, the new approaches will be reflected in GMI data and reports.

Given the rising interest in executive compensation, GMI continues to provide considerable focus on remuneration issues as a vital governance issue. As recently announced, GMI now publishes stand-alone Pay Alignment Ranking (PAR) reports, to allow subscribers to access information on the pay policies at the US companies that GMI covers. The PAR compares changes in total direct CEO compensation expense to total shareholder returns within specific market sectors for most of the 1,775 US companies covered by GMI. Also, starting with the December 2009 release, GMI will track more detailed information on the steps companies take to link executive pay to company performance for all of the more than 4,200 companies under coverage.

Latin America: Currency Fluctuations and Derivatives: A Risk to Investors?

On October 23, 2009, Colombia's central bank announced that it would intervene in currency markets, buying dollars in an attempt to limit the rise of the peso, which has appreciated nominally against the dollar by 30% since March 2009. Colombia, like Brazil, Chile and other countries in Latin America, is experiencing an upsurge in the value of its currency, as the dollar weakens and investors look for higher returns abroad.

Like many currencies, the Colombian peso is rebounding after crashing following the collapse of Lehman Brothers and the outset of the 2008 financial crisis. Many Latin American currencies are now the strongest they have been, relative to the dollar, since August 2008. Unlike on the downswing, as local currencies bounce back, Latin American companies seem to be better prepared, and less exposed to losses from exchange rate derivatives.

Marc Hoffstetter, a PhD economist from Colombia's Universidad de los Andes recently told reporters that "what happened in 2008 was exceptional." According to Professor Hoffstetter, at the outset of the 2008 financial crisis "investors viewed the U.S. dollar as a safe haven, and large amounts of money flowed out of Latin America and other developing countries to the U.S." As investors herded into what they perceived to be safe bets on dollar-denominated assets, countries across the globe, including Colombia, Mexico, Brazil, and Chile, experienced sharp currency depreciations.

For example, the value of the Colombian peso relative to the U.S. dollar plunged by 46% between August 1, 2008, and February 20, 2009, as peso-denominated assets were cashed out for dollars. The Mexican and Chilean pesos and the Brazilian real also experienced similar declines.

As local currencies crashed, several major companies within the region, including Controladora Comercial Mexicana S.A. de C.V. (BMV: COMERCIUBC), a supermarket company, Cemex S.A.B. de C.V. (BMV: CEMEXCPO), a cement company, and Sadia S.A. (Sao Paulo Stock Exchange: SADIA4), a food producer, teetered on the brink of collapse after sustaining multi-billion dollar losses on bets that local currencies would continue to appreciate against the dollar.

However, in a recent interview, Simon Ringrose, Managing Director at Emerging Portfolio Fund Research Global (EPFR), a Cambridge, Massachusetts based consultancy, told reporters, "there has been a complete reversal this year, after the massive outflows of '08." According to EPFR data, funds focused on emerging markets such as Colombia have received inflows worth US\$50 billion so far in 2009.

As the outflow of investor funds reversed, in the past year, currencies throughout Latin America have rebounded sharply against the dollar, possibly putting companies in the region at risk to another round of currency exposure.

Although there have been no high-profile corporate bankruptcies as a result of derivative losses stemming from this year's rebound, the question many investors should ask is whether or not companies in the region are prepared to hedge risks and avoid over-exposure to this type of currency swing.

Investors may be interested to know that only 12% of the 100 Latin American companies GMI covers have a board-level committee that is responsible for addressing risk issues, compared to 33% for U.S. companies and 57% for U.K. companies. Furthermore, 18% of all Latin American companies have boards that do not include a single director considered by GMI to be a financial expert, compared to only 3% of all U.S. companies covered by GMI.

While the region has a number of prominent and well-managed companies, it is also known for weak disclosure when it comes to governance issues. While two Latin American countries, Chile and Mexico, rank in the bottom five of GMI's Country Rankings, not one country in the region sits in the top 25. The financial disarray of the past year has highlighted the importance of transparency and adequate risk management.

Given the region's historic vulnerability to currency and commodity price fluctuations, risk management is of particular importance when it comes to Latin American companies.

ACGA Works to Improve Governance at Listed Companies in Asia

The Asian Corporate Governance Association (ACGA) held its 9th Annual Conference, the "Asian Business Dialogue on Corporate Governance 2009", in Beijing over November 11-12, 2009. The conference brought together a group of more than 180 speakers and delegates from around Asia and other parts of the world for critical discussions on a range of issues relating to corporate governance in Asia. The event featured a speech on the financial crisis by Jin Liquan, Chairman of the Supervisory Board of China Investment Corporation, Beijing, as well as a special session on Risk Management for Chinese companies with plans of global expansion.

Governance standards at many companies in the region lag behind international best practices. Companies in many Asian countries feature majority non-independent boards, controlling shareholders, limitations on shareholder rights, and weak disclosure of information on executive remuneration.

GMI data shows that China, Japan, and South Korea have average global ratings of only 3.0, 3.3, and 3.8 respectively. Furthermore, companies in these markets are known for having a low level of board independence. Average board independence in China, Japan, and South Korea is 37%, 11%, and 28%, respectively. Although companies in these markets have achieved success in a number of areas, the ACGA believes that there is still room for substantial improvement, when it comes to corporate governance and GMI analysis tends to support this conclusion.

On December 1, 2009 the ACGA announced that Dutch Pension Manager PGGM, an ACGA member, published its Annual Responsible Investment Report, which is available on the ACGA website. The [report](#) includes a corporate governance section which focuses specifically on executive remuneration and the need for enhanced corporate governance guidelines.

ACGA's work plays a key role in attracting attention to governance issues and influencing governance reform at listed companies in the region.

United Kingdom: Walker Report on Bank Governance Published

On November 26, 2009 David Walker, an influential British banking and corporate governance expert, appointed in February, 2009 to investigate governance practices at the country's banks and other financial institutions, published his findings in a report. The British government called on Walker, the country's former Assistant Treasury Secretary and a former Chairman of Morgan Stanley International with executive responsibilities in Europe, the Middle East and Africa, to look into governance practices at the banks because of public concern in the wake of the 2008 financial crisis.

Walker's report, the result of nine months of research, recommends that U.K. listed banks adopt formal risk committees in addition to audit committees. GMI research shows that while 57% of the 402 U.K. listed companies covered have some board-level committee responsible for risk issues, less than 3% of companies with these committees include at least one non-executive member with significant executive-level risk management expertise.

Christopher Hogg, Chairman of the Financial Reporting Council (FRC), the United Kingdom's independent financial market regulator said in a press release that the FRC is undertaking its own review of the U.K.'s Combined Code, the country's main governance guidelines, and as part of that process proposes may adopt some of the recommendations in the Walker Report.

The FRC will issue a report on its own review of the impact and effectiveness of the Combined Code in early December, together with a draft for a revised Combined Code. After final changes are made to the Listing Rules, the updated Code could apply to all listed companies with a Premium Listing as soon as June 2010.

The report highlights important areas where Britain, a market known for its generally solid governance policies and which ranks second in GMI's Country Rankings, can further improve its governance standards.

Still, representatives of the country's unions and other critics are disappointed that the code does not go further. Julia Finch, a columnist for the Guardian, called the Walker Report a "crashing disappointment" and an "anti-climax." The report has been criticized for not demanding far-reaching enough changes when it comes to executive pay disclosure.

Speaking at the House of Lords, Lord Myners, Britain's City Minister said there is "precious little evidence" that people at the top of banks appreciate "the concern about these extraordinary levels of income." Numerous groups in Britain are seeking to draw more attention to the issue.

Myners explained that "the real responsibility...must lie with the shareholders." Myners is seeking to enlist the help of Britain's National Association of Pension Funds, the CBI, the U.K.'s leading business lobby group, and the Trade Union Congress (TUC), the country's union centre, urging them to use their influence to persuade institutional investors to take more action on executive pay issues.

Australia Implements New Remuneration Law

On November 24, 2009 Australia's new Corporations Amendment Act, which focuses on improving accountability of executive termination payments, was signed into law.

In the wake of the 2008 financial crisis, executive bonuses and in particular large "golden parachute" payments to outgoing managers have been the subject of increasing media attention. Australia's Amendment Act will require that companies seek more frequent shareholder approval

before providing an officer with a severance payment or “golden parachute.” Moving forward, all severance payments worth more than one year's base salary will be subjected to shareholder approval. The new standard is a considerable advance. Previously payments of up to seven times average annual remuneration were permissible. However, GMI research shows that that, unlike a common practice in the U.S., not one of the 116 Australian companies covered by GMI has entered into employment agreements that provide senior executives with change in control payments worth three times or more base salary.

The Act also amends the category of officers to which the termination provisions apply, expands the range of benefits which are taken into account when assessing whether shareholder approval is required, and stiffens the penalties for companies that choose not to comply. The new rules are not retroactive and will only apply to agreements made subsequent to the Act's approval.

In a press release on the Australian Treasurer's website, Chris Bowen, Australia's Minister for Financial Services said "these reforms will empower shareholders to reject excessive termination payments and promote responsible remuneration practices."

South Korea: Chaebols Seek Protection, Poison Pills

On November 9, 2009, South Korea's justice ministry said it was holding a public hearing to discuss the introduction of a “poison pill” clause into commercial laws, which would give shareholders at companies facing unsolicited takeover bids the right to quickly buy new shares at a discount, thereby discouraging outsiders from attempting takeovers. However, GMI believes that poison pills can harm shareholders rights by preventing outsiders from staging takeovers and unlocking latent value in underperforming, mismanaged companies.

“[South Korea] has made hostile mergers and acquisition attacks easy by removing a mandatory public tender and a ceiling on foreign stock investments but it has not had any means to prevent hostile M&A,” a representative from the ministry told reporters.

In Korea, the concentration of ownership in the hands of a few powerful business groups or chaebols, is of particular concern to investors. GMI data shows that while 12% of the 85 South Korean companies covered by GMI have a controlling shareholder, 48% are involved in some type of cross shareholding arrangement.

Not surprisingly, the Federation of Korean Industries, a business lobby group, has pushed the government to introduce defensive measures, warning of the threat South Korea's companies face from corporate raiders. GMI, however, would consider the adoption of poison pills as a step backwards in South Korea's efforts to enhance its corporate governance standards.

Thus far, foreign investors have successfully acquired sizable stakes in prominent South Korean firms like Samsung Electronics and Posco, but have been less successful in taking firms over. Even Carl Icahn, the US activist shareholder, was not able to win approval for a US\$10 billion offer for KT&G, the country's dominant tobacco company, in 2006.

According to government estimates, listed South Korean companies attempted to defend themselves from takeover by purchasing their own shares. In theory, the new rules could to some extent encourage better use of capital.

“Buying their own shares and cross-shareholdings are high-cost, low-efficiency means to defend themselves and end up wasting company money that should otherwise be used for productive investments,” the justice ministry said.

South Korean laws already require investors buying more than 5% of a company to state their investment purpose and identify sources of funding. Although GMI believes that cross-shareholding arrangements are a misallocation of capital, the adoption of poison pills could hardly be seen as a governance improvement. Poison pills may not require the immediate allocation of capital, but could still encourage long-term capital misallocation, by freeing managers from the discipline of potential takeover and the ultimate price of management underperformance.

SRI Focus: New Fund to Invest in Gender Diversity

The Women's Leadership Fund, a new project started by Switzerland's Naissance Capital, will focus on investing in companies with the goal of boosting the number of women in senior roles. The fund expects to invest around US\$2 billion taking activist positions in companies with few or no women in executive or board roles.

Interest is growing in gender diversity in the corporate setting. For instance, in 2007 Norway became the first country to institute a legally mandated requirement for the inclusion of female directors on the boards publicly listed companies. Some studies have suggested businesses with a higher proportion of women in senior positions perform better.

In a September, 2009 speech, U.S. SEC Commissioner Luis Aguilar highlighted the importance of diversity in the boardroom, explaining that “in an increasingly global environment, the ability to draw on a wide range of viewpoints, backgrounds, skills, and experience is critical to a company's success.”

A [recent study](#) by the California Public Employees' Retirement System's (CalPERS) found that companies with diverse boards perform better than companies with boards composed of directors with similar profiles in terms of ethnicity, gender, and skills sets.

Daniel Tudor, the Women's Leadership Fund's project manager, aims to capitalize off this idea. In a recent interview, Tudor told reporters that his fund aims to be the first to profit from the fact that there is “an edge to be gained in investing in these kind of [diverse] companies.”

Mr. Tudor cites US chemical groups E.I. DuPont de Nemours & Co. (NYSE: DD) and The Dow Chemical Company (NYSE: DOW) and Swedish retailer the H&M Company as examples of companies that have adopted strong policies regarding gender diversity in the board room. A less positive example is French retailer Carrefour S.A. (Euronext Paris: CA), where only 11% of hypermarket directors are women compared to 80% of customers.

Starting in 2009, GMI began tracking gender diversity at all of the more than 4,200 companies covered. GMI data indicates that more than four out of ten of the 3,642 developed market companies covered have boards that do not include a single female director, an indication that there is room for improvement in this area.

The Women's Leadership Fund has an opportunity to take advantage of a new area of activist Socially Responsible Investing. The fund has already gained the support of Cherie Blair, the wife

of former UK prime minister, Tony Blair and Kim Campbell, the former Canadian prime minister.

CSR Focus: Asarco, Grupo Mexico, Sterlite

Critical issues involving shareholder rights, union interests, and corporate social responsibility issues have been highlighted in the legal battle between Mexico's Grupo Mexico, India's Sterlite Industries, and a now bankrupt U.S. mining company, Asarco, in what has been called the most important bankruptcy case in U.S. history.

Grupo Mexico has been accused of transferring Asarco's key assets to other Grupo Mexico subsidiaries, effectively forcing the U.S. company into bankruptcy, and stiffing plaintiffs seeking damages in a US\$6 billion a high-profile lawsuit involving asbestos and lead poisoning and environmental issues, which pre-dates Grupo Mexico's ownership of the company.

India's Sterlite Industries, a company with a top-notch Emerging Market Corporate Behavior rating of 9.0, is battling for control of Asarco, an Arizona based mining company, against the company's former owner, Grupo Mexico, a firm with a Corporate Behavior rating of only 2.0.

While Grupo Mexico does not publish detailed information about its environmental and safety management policies and performance and has received frequent news coverage because its troubled history of serious workplace accidents, standoffs with unions, environmental lawsuits, and accusations of criminal behavior, Sterlite Industries has a stronger corporate behavior profile. Sterlite discloses a health and safety policy, has implemented a comprehensive ISO 14001 environmental management system, and discloses its environmental performance in its annual report. Furthermore, unlike Grupo Mexico, Sterlite has not been subject to criminal or regulatory investigation in the last three years.

The Asarco case is interesting, because it forces the court to either make a ruling based on a narrow set of financial criteria, or choose to adopt a broader view that takes extra-financial factors and the interests of key stakeholders into consideration. A resolution is expected by the end of December, as a Texas judge decides whether to accept a US\$2.56 billion bid for the 100 year old Asarco from Grupo Mexico, or a rival US\$2.48 billion bid from Sterlite, that is adamantly supported by creditors, Asarco's management, the miner's union, eleven state governments, and the U.S. Department of Justice.

A previous judge ruled that the key issue in the case is repayment of creditors, arguing that Grupo Mexico's plan "is more likely to pay creditors in full." Other judges have taken a broader view, and have ruled that Grupo Mexico's management of Asarco constitutes fraud and conspiracy. Another Texas judge has ordered a Grupo Mexico subsidiary to return assets worth US\$12 billion to Asarco.

Local political leaders and union representatives have chafed at Grupo Mexico's recent efforts to oppose the Sterlite takeover. AFL-CIO President John Sweeney told press sources that "when ASARCO was controlled by Grupo Mexico from 1999 to 2005, labor relations were marked by constant strife." Sweeney stated that in addition to selling key assets Grupo Mexico "unilaterally cut health care benefits for hundreds of retirees and halted disability benefits for other employees. Members of United Steelworkers, a trade union in the US, have publicly criticized Grupo Mexico and picketed Asarco's mines and other facilities around Southern Arizona. Workers at Asarco's mining operations have stated their intention to walk off the job if the company is handed back to Grupo Mexico.

This high-drama court case should be of interest to investors concerned with Environmental, Social, Governance (ESG) and Corporate Social Responsibility (CSR) issues.

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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